Bulgarian National Bank

REPORT • January – June 2012

BANQUE NATIONALE DE BULGARIE

Bulgarian National Bank

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

Under the provisions of Article 1, paragraph 2 and Article 50 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's Semi-annual Report for the period ending 30 June 2012.

Ivan Iskrov
Governor
of the Bulgarian National Bank

BNB Governing Council

Sitting from left to right: Kalin Hristov, Ivan Iskrov, Rumen Simeonov, Dimitar Kostov.
Standing from left to right: Oleg Nedyalkov, Penka Kratunova, Statty Stattev.

Governing Council

Ivan Iskrov
Governor

Dimitar Kostov
Deputy Governor
Banking Department

Rumen Simeonov
Deputy Governor
Banking Supervision Department

Kalin Hristov
Deputy Governor
Issue Department

Penka Kratunova

Statty Stattev

Oleg Nedyalkov

Organisational Structure of the BNB

- GOVERNING COUNCIL
  - General Auditor
  - GOVERNOR Ivan Iskrov
    - STRUCTURAL UNITS SUBORDINATED TO THE GOVERNOR
      - Financial Stability Directorate
      - Legal Directorate
      - International Relations Directorate
      - Human Resources Management Directorate
      - Public Relations Directorate
      - Banking Security and Protection of Classified Information Directorate
    - DEPUTY GOVERNOR Kalin Hristov
      - Issue Department
        - Treasury Directorate
        - Risk Analysis and Control Directorate
        - Issue and Cash Directorate
        - Issuing Policy and Control Directorate
      - Economic Research and Forecasting Directorate
    - DEPUTY GOVERNOR Dimitar Kostov
      - Banking Department
        - Bank Policy Directorate
        - Statistics Directorate
        - General Accounting Directorate
      - Fiscal Services Department
        - Government and Government Guaranteed Debts Depository Directorate
        - Projections and Management of State Budget Cash Flows Directorate
    - DEPUTY GOVERNOR Rumen Simeonov
      - Banking Supervision Department
        - Legal Services and Administration Directorate
        - Supervisory Policy Directorate
        - Special Supervision Directorate
        - Macro-prudential Analysis and Strategy Directorate
        - Credit Institutions Supervision Directorate
    - SECRETARY GENERAL Petko Krastev
      - Public Procurement Directorate
      - Information Systems Directorate
      - Administrative Directorate
      - Capital Investment, Maintenance and Transport Directorate

Contents

Abbreviations

BIR	Base interest rate
BIS	Bank for International Settlements, Basle, Switzerland
BISERA	System for servicing customer payments initiated for execution at a designated time
BNB	Bulgarian National Bank
BORICA	Banking Organization for Payments Initiated by Cards
BSE	Bulgarian Stock Exchange
BTC	Bulgarian Telecommunication Company
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 Affairs Council
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union
FLIRBs	Front-loaded Interest Reduction Bonds
FOB	Free on Board
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IFO	Institute of Economic Research, Germany
IMF	International Monetary Fund
MF	Ministry of Finance
MFIs	Monetary financial institutions
NLO	National labour office
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
RINGS	Real-time Interbank Gross Settlement System
SBL	State Budget Law
SDR	Special Drawing Rights
TFP	Transitional and Final Provisions
VAT	Value Added Tax
ZUNK	Bulgarian abbreviation of the Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990 (LSNC)

Summary

In the first half of 2012 the financial crisis in the euro area continued to deepen and impact economic activity throughout Europe. Euro area GDP declined 0.3 per cent in real terms compared to the first half of 2011. Economic growth in Germany and France decelerated significantly while remaining positive, whereas in Spain, Italy and Netherlands, real GDP fell on an annual basis. Over the same period real GDP of the USA increased by 4.2 per cent on an annual basis. Global economic activity began to slow down despite comparatively high growth rates in the USA, Japan, and developing countries in East Asia and the Middle East.

Growing political instability and deepening economic crisis in Greece were the main reasons for the worsening debt crisis in the euro area. In the first quarter euro area finance ministers agreed on a second bailout package worth EUR 130 billion for Greece. Its approval allowed a market-based restructuring of Greek sovereign debt held by private creditors and the release of the successive loan tranche from the first package. The deal with Greece's private creditors went through successfully in April. The political turmoil caused by Greek general elections in May and their re-run in June challenged the capability of the Greek political parties to reach agreement on the measures necessary for implementing the second financial package. Spain and Cyprus were two other euro area countries experiencing significant economic and fiscal problems. Their debt risk premia increased over the review period. In June Spain officially requested support for its banking sector from the European Stability Mechanism (ESM). In late June Cyprus also requested the ESM and the IMF for financial assistance.

Economic activity in Bulgaria started to moderate in mid-2011 and into early 2012. The contraction of external demand from the country's main trading partners in the euro area impacted goods and services exports which declined 4.4 per cent on an annual basis in real terms over the first quarter of 2012. In the second quarter exports began to recover, rising 0.6 per cent in real terms in the first half of the year on the prior year. Domestic demand, and mainly the positive performance of fixed asset capital formation and inventories, partly offset falling exports and rising imports. Over the first half of 2012 growth was 1 per cent, domestic demand contributing and net exports detracting. On an annual basis, there was a 0.4 per cent GDP balance of payments current and capital account deficit. Compared with 2011, over the first half of 2012 foreign direct investment flows increased, boosting investment goods imports. The downward trend in employment endured, though at lower rates. Nominal unit labour cost rises slowed down to 1.9 per cent and 0.7 per cent respectively in the first and second quarters of 2012.

Global prices continued to be among the drivers of consumer price inflation in Bulgaria over the first half of 2012. Over the same period the annual inflation rate was 1.9 per cent, with energy commodities and goods and services with administratively controlled prices contributing most at 0.62 and 0.71 percentage points.

In the first half of 2012 monetary aggregate growth rates slowed down gradually. The annual broad money expansion was 10.2 per cent in June 2012, with quasi-money contributing most at 8.4 per cent because of continuing high savings. Over the same period the annual growth of claims on the non-government sector accelerated to 4.3 per cent, claims on corporations rising by 7.1 per cent. By mid-year household lending fell 1.2 per cent on an annual basis, reflecting falling overdrafts and consumer loans which declined by 8.5 and 1.9 per cent respectively on an annual basis, while housing loans continued growing at 0.3 per cent. In the first half banks tightened minimum standards for short and long-term corporate lending somewhat and eased them for households. Ample banking system liquidity continued to influence interbank money trading and hence, interest rates continued to fall, especially in the long-term segment.

The consolidated fiscal programme cash balance for the first half-year was positive at BGN 62.4 million. Government revenue and grants rose 9.8 per cent on the same period of 2011. Tax revenue increased 7.4 per cent, with VAT and excise duty contributing most at 4.2 percentage points and 1.0 percentage points respectively. This was due to higher fuel prices since early 2012, nominal import growth, and improved tax collection. Consolidated fiscal programme spending between January and June 2012 (including the contribution to the EU budget) grew 3.7 per cent on an annual basis on the same period last year. Capital expenditure and social payments, which contributed most to expenditure over the first half, rose by 26.6 and 3.9 per cent, while current operating expenditure fell 3.2 per cent. The fiscal reserve reached BGN 5061.8 million, rising by BGN 63 million since early 2012. On 22 June the EU Council's Economic and Financial Affairs Council decided to close the excessive deficit procedure on Bulgaria following an EC recommendation.

Bulgarian National Bank policy takes into account the global situation and developments of the national economy. The BNB pursues its primary goal – maintaining price stability through ensuring the stability of the national currency – as set out in the Law on the Bulgarian National Bank and by applying its potential and capabilities. The Bank invests its gross international reserves as set out in this Law and to the principles and practice of prudent investment. It regulates and supervises other banks in Bulgaria to ensure banking system stability and protect depositors' interests. It assists the establishment and operation of efficient payment systems and oversees them; it regulates and supervises Bulgarian payment system operators, payment institutions, and electronic money institutions; it ensures the printing of banknotes and the minting of coins, as well as the preservation and destruction of banknotes and coins uncirculated or withdrawn from circulation; it acts as fiscal agent and depository of the State. The BNB participates actively in the European System of Central Banks (ESCB) and other EU bodies.

By the end of June 2012 the market value of gross international reserves was EUR 13,866 million: an increase of EUR 517 million on the end of 2011. Net income from international reserve management over the review period came to EUR 159.13 million or 1.28 per cent net yield.

In the first half of 2012 the government securities market debt crisis and worsened economic prospects in some euro area countries boosted demand for low-risk assets. This cut yield from most assets into which the BNB invested to exceptionally low levels close to zero, and even below zero at the short-term end of the curve. To cut risk and make meaningful use of opportunities by fine tuning of constraints and limits, the Bank strengthened the existing risk management rules. In addition, it continued reducing government debt credit risk exposure by retaining constraints on government issuers which are conditionally divided into three inherent credit risk groups. The mandatory minimum of international reserves invested into the least risky group rose from 30 per cent last year to 40 per cent. Funds invested into assets with the highest rating averaged 72 per cent over the period.

For the fourth year in a row, the worsened external and internal environment hit credit demand, affecting lending. Credit portfolio quality also worsened, the share of non-performing loans past due over 90 days reaching 16.9 per cent by the end of June against 15 per cent by the end of 2011. The indicator which reports only the uncovered portion of worsened loans — net non-performing loans (due over 90 days) to net loans ratio — remained much lower at 11.3 per cent. Despite these unfavourable trends, the banking system remained stable due to the BNB measures and banks' management decisions. The system maintained significant capital and liquidity buffers, and profits can support capital if necessary. Total capital adequacy reached 16.74 per cent by the close of June, while primary capital adequacy was 15.19 per cent. The liquid assets ratio for the first half-year exceeded 25.7 per cent on average, reaching 26.21 per cent at the end of June. Mid-year banking sector profit was BGN 323 million or 2.7 per cent (BGN 8 million) more than last year. This put ROA at 0.83 per cent and ROE at 6.49 per cent.

Organising, supporting, and developing national payment systems by implementing and overseeing efficient payment mechanisms is a duty of the Bank under the Law on the Bulgarian National Bank. Payment systems functioned smoothly, ensuring payment flow integrity. The RINGS real time interbank gross settlement system operated by the BNB processed most payments (88.28 per cent in the first half-year), cutting payment system risks. The number and value of payments through the national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2-BNB) continued rising by 32.39 and 8.93 per cent in the first half of 2012. Limiting system risk and improving Bulgarian payment system reliability and efficiency were the major goals of payment systems overseers.

The BNB ensures the printing of banknotes and the minting of coins, as well as the preservation and destruction of banknotes and coins uncirculated and withdrawn. By the end of June 2012, the nominal value of cash in circulation was BGN 8523.5 million, up BGN 735.1 million (9.44 per cent) on June 2011. Banknotes accounted for 97.84 per cent of the total value of cash in circulation. In a year the number of BGN 50 and BGN 100 banknote denominations increased by 5.5 and 3.3 million (10.35 and 14.66 per cent), BGN 20 banknotes rising by 5.3 million in number or 5.59 per cent. By 30 June 2012 more than half the banknotes in circulation by number were BGN 20s and BGN 10s (53.56 per cent). The average banknote in circulation was worth BGN 26.88, and the average coin BGN 0.13. The Bank pursues a comprehensive policy to prevent the spread of non-genuine Bulgarian coins and banknotes. At the end of June 2012 the share of retained non-genuine Bulgarian banknotes was insignificant at 0.000282 per cent of the number of banknotes in circulation, while the share of retained non-genuine coins was 0.00003 per cent of those in circulation.

Under contracts negotiated with the Ministry of Finance (MF) to market conditions and prices, the BNB collects, processes, stores, and submits to the Ministry daily and other statements of budget entities' accounts (including municipalities) with domestic banks and acts as the government's debt agent. The Bank also services government bond trade. In the January to June period 16 government securities auctions offered issues worth BGN 826.8 million nominal value. The volume of auction bids by primary dealers exceeded supply, with an average bid-to-cover ratio of 2.4. The average number of primary dealer bids *per* auction increased to 89 from 82 in the first half of 2011, showing greater investor demand. The amount of initial acquisitions and repayment on maturing issues registered in the ESROT electronic system for registering and servicing government securities trading was BGN 1188 million, up 33 per cent on the first half of 2011.

Over the half-year continuing debate within the EU led to legislative proposals on euro area financial stability and fiscal consolidation. In February 2012 the euro area Member States signed a new Treaty Establishing the European Stability Mechanism. Financial aid under this shall be provided only in exceptional cases when it is an absolute necessity for euro area stability, and shall be tied to specific conditions. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was signed in March. It aims to improve coordination of economic policies and provide better governance in the euro area. The debate on a second package of documents targeted at improving economic governance in the euro area also continued.

By participating in the committees and working groups of the ESCB, the European Commission, the EU Council, the European Systemic Risk Board, and the Council for European Affairs, the BNB contributed to formulating Bulgarian standpoints on key economic governance areas and the financial sector. The BNB supports amendments to the euro area legislative framework, since the achievement of macroeconomic stability in the euro area is of key significance for all Member States, while highlighting the need for these amendments not to undermine the functioning of the single market. In discussions on financial system and especially banking supervision proposals, the BNB has held that national supervisory authorities should have the power to set additional capital buffers and to pose other requirements to their domestic banking systems depending on specific conditions in furtherance of stability.

I. Economic Development in the First Half of 2012

1. The External Environment

Global economic growth decelerated in the first half of 2012, exhibiting large regional diversities. World GDP rose 1.2 per cent on the second half of 2011[1], developing countries in Eastern Asia and the Middle East contributing most. Economic growth in China slowed to an annual average of 7.8 per cent. The US economy recovered strongly, real GDP rising 4.2 per cent on an annual basis. The euro area economies declined 0.3 per cent. Economic growth in Germany and France slowed, while real GDP contracted in Spain, Italy, and the Netherlands. Economic growth in Japan (2.9 per cent in the first quarter) reached 3.5 per cent in the second quarter. Global output rose 1.4 per cent on average[2] on the prior half year, world trade rising 1.7 per cent.[3]

Major Macroeconomic Indicators
(Averages for the Period)

(per cent)

	Growth				Inflation				Unemployment			
	2010	2011	2012		2010	2011	2012		2010	2011	2012	
			I	II			I	II			I	II
EU-27	2.2	1.5	0.5	-0.6	2.1	3.1	2.9	2.6	9.7	9.7	10.6	10.2
Euro Area 17	1.8	1.4	0.3	-0.8	1.6	2.7	2.7	2.5	10.1	10.2	11.4	11.0
EU-7	2.2	3.2	1.9	0.8	3.2	3.9	3.9	3.6	9.6	9.4	9.5	9.5
EU-3	3.4	1.2	1.1	-0.4	3.1	4.0	3.2	2.5	7.8	7.9	8.1	8.1
United States	3.8	4.0	4.5	4.0	1.6	3.1	2.8	1.9	9.6	9.0	8.3	8.2
Japan	4.5	-0.8	2.9	3.5	-0.7	-0.3	0.3	0.1	5.1	4.6	4.5	4.6
China	10.4	9.2	8.1	7.6	3.7	6.3	3.8	2.9	4.2	4.1	4.1	4.1

Note: : The EU-7 are countries joining since 2004 less those now in the euro area. The EU-3 are the UK, Sweden, and Denmark. EU-7 and EU-3 indicators are calculated by weighing time series by country weights in group GDP for growth, in group labour force for unemployment, and the weights of the EU-27 in HICP calculated by Eurostat for inflation.

Sources: Eurostat, the Bureau of Labor Statistics, the Bureau of Economic Analysis, the Statistics Bureau of Japan, the National Bureau of Statistics of China, BNB estimates.

In the first half of 2012 euro area economic indicators posted a decline, deteriorating significantly in the second quarter. Private consumption and investment pulled growth back. Growth declined mainly because of limited end user access to finance and modest credit demand, reflecting rising uncertainty, the cyclic effect of fiscal consolidation, tighter bank regulations, and the continuing reduction of banks' risk assets. Leading PMI[4] indicators tended downward throughout the half year. By the end of the review period industrial output, services, and composite PMI indicators reached lows showing recessionary expectations.

In the first quarter euro area finance ministers agreed on a second bailout package for Greece worth EUR 130 billion. This allowed a market restructuring of Greek sovereign debt held by private creditors and released the successive loan tranche from the first package. The restructuring reduced the face value of eligible Greek sovereign bonds by 53.3 per cent, cutting debt by some EUR 107 billion. In June Spain officially requested support for its banking sector. This followed partial nationalisation of its third largest bank by assets and an upward revision of its public deficit projection for 2012. Experts valued financial assistance for Spanish banks at some EUR 62 billion. By the end of June Cyprus requested financial assistance from the ESM and the IMF after banking

1 Based on seasonally adjusted data of the World Bank as of 12 November 2012.
2 See footnote 1.
3 Based on IMF data from 12 November 2012.
4 The Purchasing Managers' Index.

problems, a large exposure to Greek government securities, and deteriorating government finances. All this aggravated euro area markets in the second quarter.

The US recovery continued, though retail sales fell in the second quarter. Continuing difficulties in the euro area and uncertainty about global growth hit business confidence in industry and services. Construction continued to suffer limited access to credit, economic uncertainty, and accumulated housing market imbalances. The personal consumption expenditure (PCE) deflator showed falling inflation, largely from slower food price growth.

Global inflation rose to 3.7 per cent[5] on an annual basis, developing economies contributing most. Main drivers were rising international energy prices. By June, euro area inflation was 2.4 per cent on an annual basis, down from 2.7 per cent in December 2011. Core inflation was 1.7 per cent on an annual basis by June, up from 1.6 per cent in December. US inflation also slowed in the first half of 2012 from 3.0 per cent in December to 1.4 per cent in June, core inflation falling from 2.2 to 2.1 per cent.

Brent crude appreciated between January and June, trading at USD 107.7/EUR 87.5 *per* barrel and peaking at USD 117.8/EUR 94.6 in May. Food prices fell on the first half of 2011, the index falling 12.7 per cent on an annual basis. Cereals and corn dropped considerably at 9 and 7.1 per cent. Slower growth depressed commodity prices, the non-energy commodities index falling 10.8 per cent. Metal prices dropped greatly at 11.5 per cent on average. Tin and nickel declined most at 25.9 and 28.1 per cent on an annual basis.

Bond yields in some euro area countries increased on international financial markets due to higher sovereign risk and concerns about debt service. In April and May German government bonds appreciated again as risk aversion grew amid a worsening euro area outlook, pre-election uncertainty in France and Greece, the April Dutch government collapse, and concerns that Spain would seek aid to recapitalise banks. Over the half year spreads widened on Spanish, Italian, and to an extent Irish bonds. Spanish spreads ended the period comparable to Irish ones.

In the first half of 2012 the ECB kept its policy interest rates unchanged. Interest on main refinancing operations remained at 1 per cent. Deposit and marginal lending facility rates were 0.25 and 1.75 per cent. The ECB continued unconventional monetary policy measures. The 9 February Governing Council meeting cleared the Austrian, French, Italian, Irish, Spanish, Portuguese, and Cypriot central banks to extend the scope of security for refinancing operations. For a time, they can accept claims as security, extending access to ECB refinancing, including the second three-year long-term refinancing[6]. On 23 March the ECB freed national central banks from having to accept as security bank bonds guaranteed by Member States receiving EU/IMF financial support, or by Member States with exceptionally low credit ratings.

The June ECB monetary policy meeting decided to continue providing unlimited refinancing liquidity until the end of the 12th maintenance period of 2012, ending 15 January 2013. On 29 February 2012 the ECB conducted its second three-year longer-term refinancing operation, allotting EUR 529.5 billion to 800 institutions. The ECB balance sheet exceeded EUR 3 trillion by the end of June 2012, up 13.4 per cent on the end of last year.

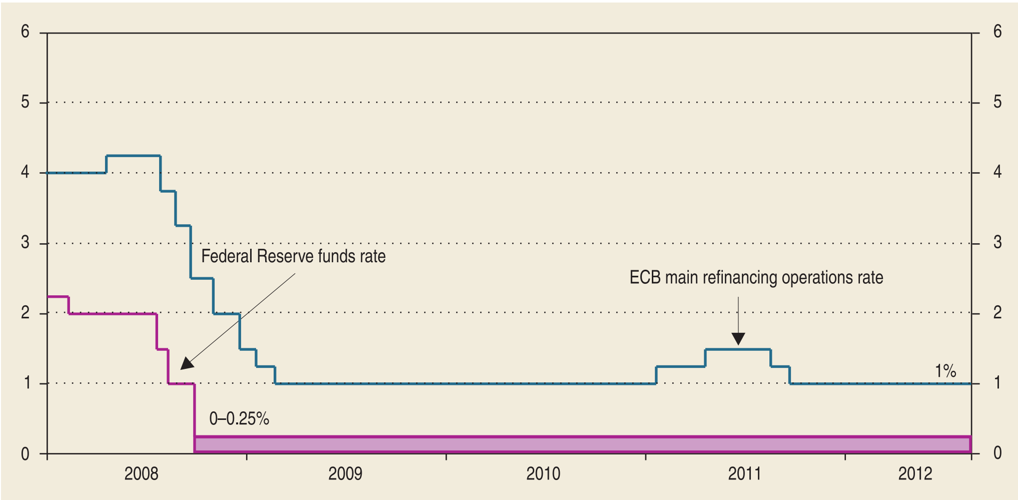
The liquidity surplus[7] of euro area banks after the second three-year operation grew to EUR 800 billion. Most released funds (EUR 772.9 billion residual value by the end of June) were in the ECB deposit facility at 0.25 per cent fixed rate. EONIA overnight interest reached 0.38 per cent by end of June from 0.63 per cent at the end of December. The drop was largely at the beginning of the year, when the ECB ran its second three-year refinancing operation, followed by very low fluctuations and stable low overnight rates.

[5] Based on IMF data from 12 November 2012.
[6] The first ECB three year operation on 21 December 2011 provided EUR 489.2 billion to 523 credit institutions.
[7] The liquidity surplus is the difference between the volumes of the refinancing operations and the two ECB covered bonds programmes and autonomous factors and required reserves.

The US Federal Open Market Committee left reference interest at nil to 0.25 per cent, intending to keep it there at least until late 2014. In June the FOMC decided to continue the Maturity Extension Program and Reinvestment Policy (Operation Twist) until the year's end instead of the end of July. This would add some USD 267 billion to the initial USD 400 billion. The monthly amount and maturity ratio of purchased long-term bonds remain unchanged. Six to 30 year bonds are bought, while the Federal Reserve System sells the same volume of up to three year bonds. The FOMC continued reinvesting earnings from Federal Reserve mortgage backed assets and government debt into mortgage backed securities. At the same time, the reinvestment aspect of Operation Twist ended.

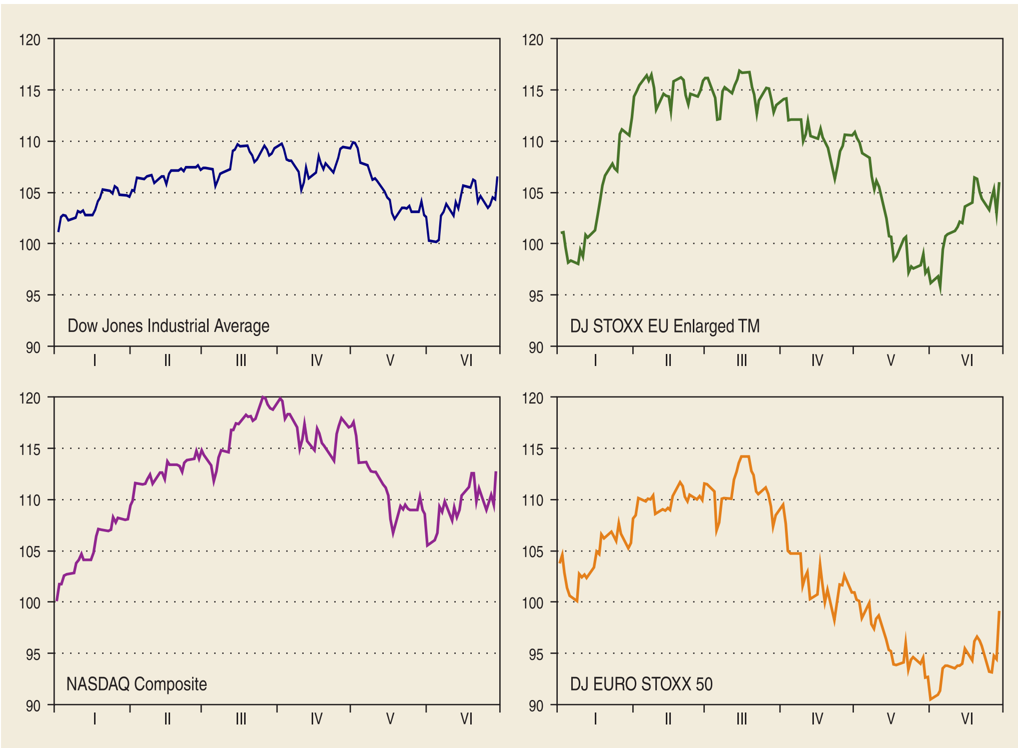
Federal Reserve System and ECB Interest Rates

(per cent)



Sources: ECB, the Federal Reserve System.

Major Stock Market Indices in the First Half of 2012



Note: (US dollars, December 2011 = 100).

Leading stock market indices reached highs in March and April. Optimism then fell, especially in Europe because of the euro area debt crisis, Greek political instability, and the deteriorating global growth outlook. The Dow Jones Industrial rose by only 3.8 per cent in June on December 2011, while the NASDAQ Composite rose 9.5 per cent. The Dow Jones EURO STOXX 50 and Dow Jones EURO STOXX EU Enlarged TM dipped 5.7 and 1.2 per cent on December 2011.

2. The Bulgarian Economy

In the first half of 2012 GDP rose 1 per cent on an annual basis. Private consumption contributed most by rising 4.3 per cent. Inventories also contributed greatly. Investment began recovering, gross fixed capital formation contributing modestly. Net goods and services exports drew growth back. Weaker demand from major euro area trading partners cut exports 4.4 per cent in real terms on an annual basis over the first quarter. In the second quarter exports began to recover, goods and services rising 0.6 per cent for the half year on the same period last year. Imports grew 5.9 per cent in real terms, outpacing exports. This was because of higher consumer and investment demand and the relatively rapid increase in inventories.

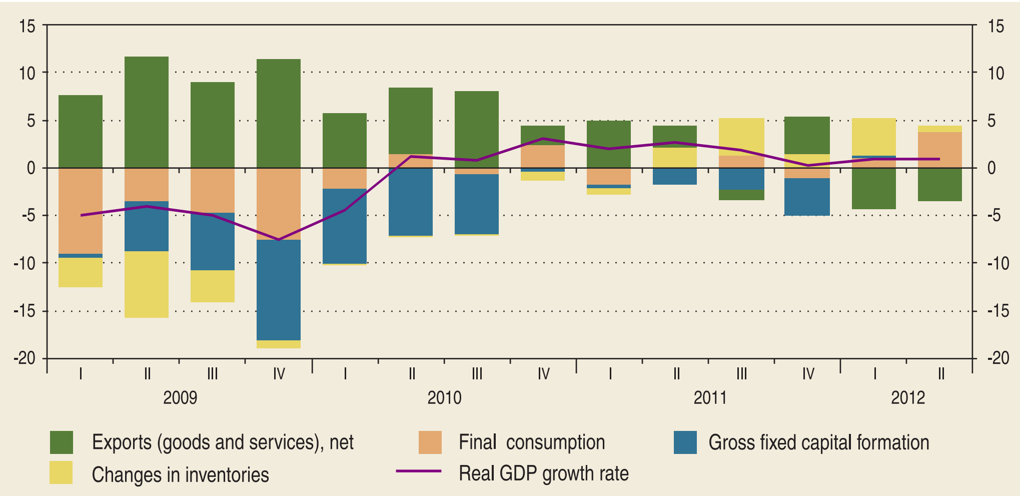
Real GDP Growth and Contribution by Component of Final Consumption
(on the corresponding period of last year, non-seasonally adjusted data)

	2011				2012	
	January–June		July–December		January–June	
	Change (per cent)	Contribution, percentage points	Change (per cent)	Contribution, percentage points	Change (per cent)	Contribution, percentage points
Produced GDP	2.4	2.4	1.1	1.1	1.0	1.0
Final consumption	-0.9	-0.8	0.2	0.2	3.2	2.5
Household consumption	-1.8	-1.2	0.5	0.3	4.3	2.7
Final consumption spending by the general government sector	6.0	0.5	0.5	0.0	-1.3	-0.1
Collective consumption	-0.7	-0.1	-2.7	-0.2	-0.4	0.0
Gross fixed capital formation	-4.9	-1.1	-13.6	-3.1	0.4	0.1
Physical changes in inventories		0.9		2.6		2.1
Exports (goods and services), net		3.5		1.4		-3.8
Exports (goods and services)	18.6	10.2	8.4	5.1	0.6	0.4
Imports (goods and services)	10.7	-6.7	6.6	-3.7	5.9	-4.3

Sources: NSI, BNB.

Real GDP Growth and Contribution by Component of Final Consumption
(on the corresponding quarter of last year, non-seasonally adjusted data)

(per cent, percentage points)

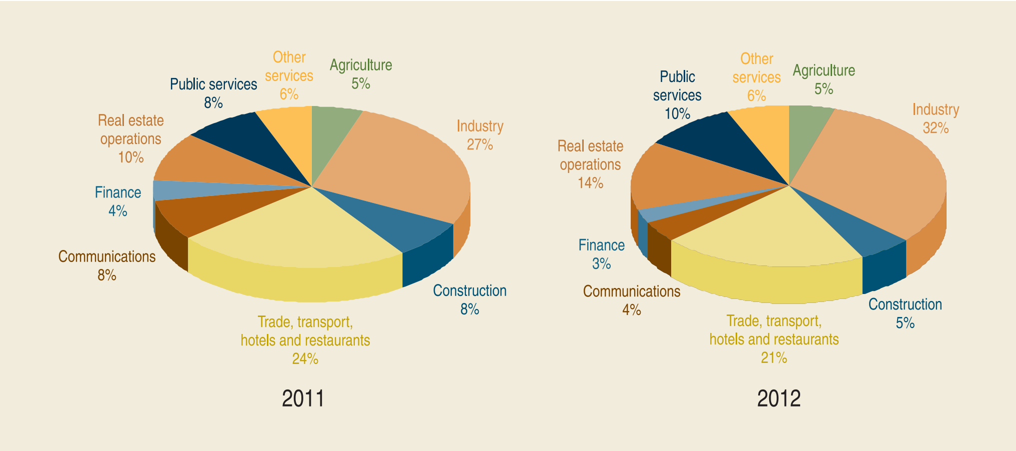


Sources: NSI, BNB.

Capital formation started recovering, that into fixed assets growing 0.4 per cent in real terms after significant falls over the past three years. Demand for investment goods contributed to higher domestic output and investment goods imports. The two main factors boosting fixed asset investment were higher foreign direct investment and increased government capital spending.

Data on fixed asset spending show the downward trend continuing in the half year. By June nominal fixed asset spending fell 3.1 per cent on an annual basis, following a 9.1 per cent rise in 2011.[8] Fixed asset spending fell in almost all sectors, with construction, trade, transport, hotels and restaurants, and information services[9] falling 27.6, 14.9, and 50.8 per cent. The 2011 fixed asset spending recovery in manufacturing and property continued into the first half-year.

Fixed Asset Spending by Sector in the First Half of 2012



Note: Preliminary data.

Sources: NSI, BNB.

Gross value added in economy fell 0.1 per cent in real terms, mostly because of information and public services. Industry suffered falling external demand, value added falling 0.3 per cent there. Agricultural value added grew 9.2 per cent, contributing 0.2 percentage points to overall value added. Construction and property operations value added grew 1.9 per cent.

Real Gross Value Added Growth and Contribution by Industry
(on the corresponding period of last year, non-seasonally adjusted data)

	2011				2012	
	January–June		July–December		January–June	
	Change (per cent)	Contribution, percentage points	Change (per cent)	Contribution, percentage points	Change (per cent)	Contribution, percentage points
Gross value added	2.9	2.9	1.0	1.0	-0.1	-0.1
Agriculture and forestry	-3.0	-0.2	-0.2	0.1	9.2	0.2
Industry*	11.5	3.6	2.3	0.6	0.3	0.1
Services	-0.8	-0.5	0.4	0.2	-0.6	-0.4

* Industry and construction.

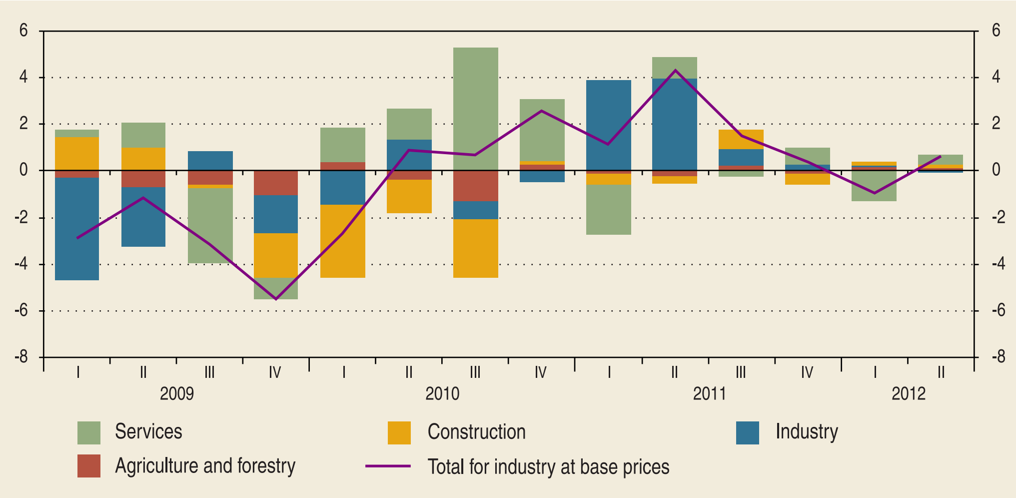
Sources: NSI, BNB.

[8] Based on the NSI preliminary data.

[9] Here the *information services* item means creation and dissemination of information and author products; communications.

Gross Value Added Change in Real Terms and Contribution by Industry
(on the corresponding quarter of last year, non-seasonally adjusted data)

(per cent, percentage points)



Sources: NSI, BNB.

Employment continued falling, though more slowly than in 2011. National data show that over the first half year job numbers fell 2.2 per cent on an annual basis against 4.7 and 3.7 per cent in the first and second halves of 2011. Agriculture, forestry, fisheries, and industrial subsectors lost most jobs, followed by services subsectors. Industrial job losses rose to 2.1 per cent, those in construction slowing to 5.6 per cent. There were differences between services sectors. Trade, transport, and hotels and restaurants jobs continued to fall, though more slowly. Information and communications and finance and insurance jobs grew 5.0 and 1.7 per cent on an annual basis.

The Labour Force Survey shows that unemployment continued rising to 12.3 per cent in the second quarter on 11.2 per cent in 2011. The Employment Agency set unemployment at 10.8 per cent in June by the number of people registered with labour offices. The Labour Force Survey set second quarter long-term unemployment at a relatively constant 55.6 per cent of all unemployed against 55.7 per cent at the end of 2011.

Pay grew slower than in the second half of 2011. After growing 9 per cent in the second half of 2011, nominal employee pay rose relatively steadily by 4.5 per cent on an annual basis in the half year. Industrial pay fell gradually on an annual basis, second quarter falls led by construction (down 14.4 per cent on an annual basis). Services pay grew moderately. Nominal pay showed continuing changes in workforce sectoral distribution, age, and qualifications since 2009. It continued to reflect real GDP *per* employee, which grew more slowly than in most of 2011. Annual labour productivity continued growing at 2.6 and 3.8 per cent in the first and second quarters against 7.5 and 4.9 per cent in 2011. Gross operating surplus fell 10.3 per cent on an annual basis in the first quarter after a 6.1 per cent fall in the prior quarter. This showed industry's export difficulties and lesser problems in trade, transport, and hotels and restaurants. The second quarter decline in this indicator moderated to 0.7 per cent, more pronounced in some services.

The wage fund grew 3.0 and 2.5 per cent in the first and second quarters on an annual basis. Pay and productivity pushed up unit labour costs by 1.9 and 0.7 per cent in these quarters.

World prices continued driving Bulgarian consumer price inflation.[10] Annual inflation was 1.9 per cent in the first half-year, as in the same quarter of 2012, falling to 1.8 per cent in the second quarter. Energy commodities and administratively controlled prices contributed most at 0.62 and 0.71 percentage points. Energy commodity inflation followed international prices. In April transport fuel prices rose at 11.9 per cent on

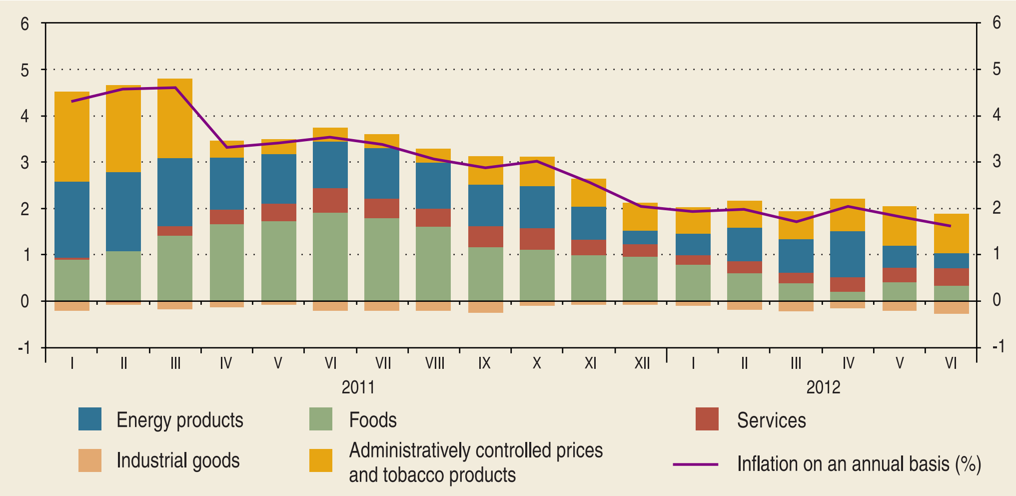
[10] Analysis based on HICP data.

an annual basis from 4.0 per cent in December, moderating to 3.6 per cent in June. World food prices remained steady, continuing the late 2011 trend and cutting annual food inflation to 1.4 per cent in June. Administratively controlled prices led inflation, with higher hospital charges and general practitioner fees (the latter directly linked to minimum pay) contributing most. Rises in district heating, public transport, water and gas contributed less.

Core inflation (excluding food, energy, tobacco, and administratively controlled prices) remained relatively low at 0.2 per cent on an annual basis against 0.3 per cent in 2011, contributing 0.1 percentage point to overall consumer inflation. This reflected the slight depreciation in non-food products (excluding fuels) and comparatively low inflation in services. As in 2011, non-food prices fell mainly because of falling durables prices. Catering and transport services boosted consumer price inflation most in the half year.

Annual Inflation and Contributions by Major Goods and Services

(percentage points; per cent)



Sources: NSI, BNB.

Accumulated HICP Inflation Since January and Contributions

	2011, January–June		2012, January–June	
Inflation (per cent)	1.1		0.7	
	Inflation by group (per cent)	Contribution, percentage points	Inflation by group (per cent)	Contribution, percentage points
Foods	2.9	0.70	0.3	0.09
Processed foods	4.2	0.66	0.1	0.02
Unprocessed foods	0.6	0.05	0.8	0.06
Services	0.2	0.05	0.6	0.14
Catering	1.9	0.09	0.8	0.04
Transport	3.7	0.13	3.1	0.14
Telecommunications	-0.9	-0.04	-0.4	-0.02
Other services	-1.1	-0.13	-0.1	-0.01
Energy products	4.0	0.29	3.9	0.34
Transport fuels	4.3	0.30	3.9	0.32
Industrial goods	-0.2	-0.05	-1.2	-0.24
Administratively controlled prices	0.8	0.13	2.2	0.36
Tobacco products	-0.2	-0.02	0.0	0.00

Note: The structure corresponds to the Eurostat classification. Tobacco and administratively controlled prices are shown separately, the latter calculated at the consumer basket elementary aggregates level.

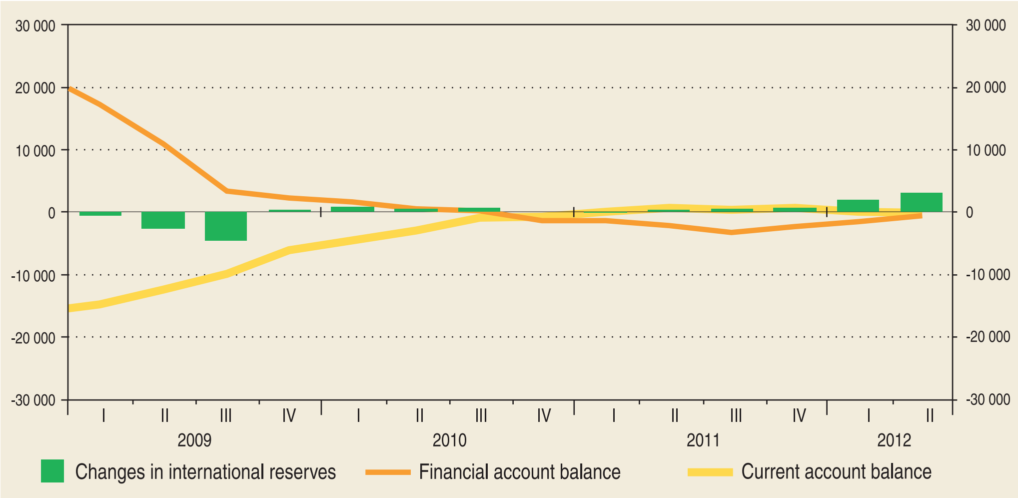
Sources: NSI, BNB.

Over the half year the total current and capital account balance was in deficit by EUR 783.3 million (0.4 per cent of GDP on an annual basis). The trade deficit rise contributed most. In the first two quarters the negative trade balance came to EUR 2188.5 million, an increase of EUR 1281.1 million on the same period last year. At the same time, the services, income, and current transfers balance improved. The surplus in services was EUR 712.3 million on EUR 642.5 million between January and June 2011, mainly due to more receipts on other services (mostly construction). In the first half of 2012 current transfers increased by EUR 180.5 million to EUR 1186 million, mostly because of greater government receipts. The income balance deficit was EUR 558.1 million against EUR 837.2 million for the same period of 2011. This was because of lower foreign direct investment incomes. The capital account balance remained unchanged on early 2011 at EUR 65 million.

The trade deficit increase in the first half year reflected higher nominal import than export growth at 13.7 *versus* 1.8 per cent. Export performance varied across commodity groups. Mineral products and fuels, animal and plant products, food, drink, and tobacco contributed most to growth at 4.1, and 1.1 percentage points. Base metals and their products detracted most at -2.6 percentage points. Rising world fuel prices and falling world metal prices affected commodity exports. Animal and plant products, food, drink, and tobacco was an exception, export growth helped by the good harvest last year. All import groups by use grew, investment goods and energy commodities leading at 6.0 and 4.5 percentage points. Relatively high investment goods imports growth related to recovering domestic investment and foreign direct investment.

Current Account, Financial Account, and International Reserve Movements
(on an annual basis)

(BGN million)



Source: BNB.

Foreign direct investment to June 2012 came to EUR 810.1 million (5.9 per cent of GDP on an annual basis), attracted funds in the form of equity contributing greatly. Investment went mainly into generating and distributing electric power, heating, gas, and water (EUR 333.2 million). Net payments were the largest in manufacturing at EUR -112.9 million.

In the first half of 2012 the balance of payments financial account balance was positive at BGN 644.2 million against a deficit of BGN 816.3 million in the same period last year. Foreign direct investment rises by EUR 536.1 million on the first six months of 2011, decreases in other sectors' currency assets and deposits by EUR 441.7 million and bank loans worth EUR 315.3 million contributed most. Banks' currency deposits abroad grew more slowly (by EUR 129 million) than in the first half of 2011, while other sectors' external obligations fell EUR 215.5 million.

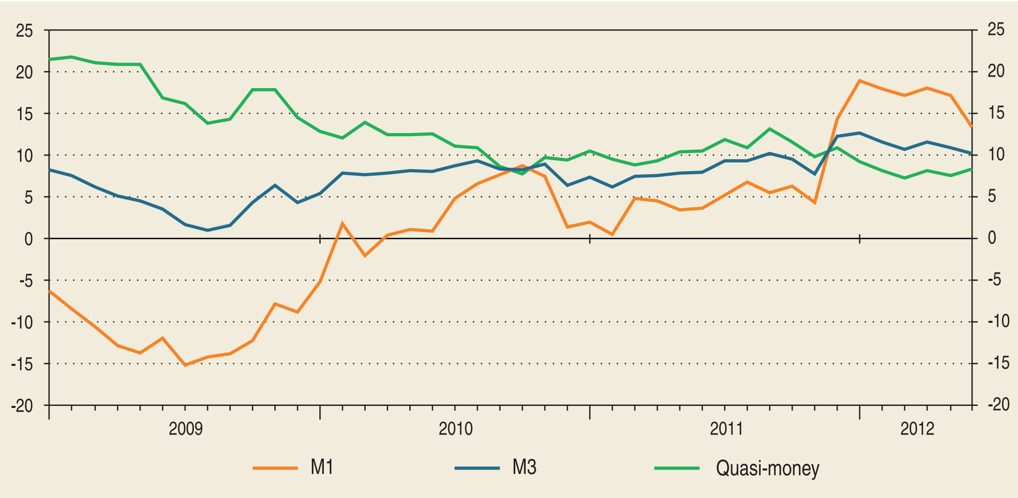
All external current, capital, and financial transactions boosted BNB international reserves by EUR 463.4 million, valuation adjustments excluded. Changes in international foreign reserves on the BNB Issue Department balance sheet, including revaluation adjustments, boosted them by EUR 517 million.

Gross external debt came to EUR 35.8 billion by June 2012 (92.9 per cent of GDP on an annual basis), up by EUR 392.8 million on December 2011. Increasing foreign direct investment debt worth EUR 363.5 million contributed most. Its share of gross external debt rose from 41.8 to 42.3 per cent over the half year. Banking sector external debt also grew to EUR 1701 million, mainly due to a EUR 171.2 million increase in banks' long-term loans. Public and publicly guaranteed debt fell by EUR 153.0 million over the half year.

Monetary aggregate growth slowed gradually. By June 2012 the annual growth rate of broad money was 10.2 per cent from 12.3 per cent in late 2011. Quasi-money (up 8.4 per cent) made a big contribution to broad money growth as households continued saving relatively much. The narrow money aggregate M1 rose 13.4 per cent on an annual basis by mid-year from 14.4 per cent at the end of last year, mainly due to overnight deposits (9.7 percentage points). The growth of currency outside banks has picked up gradually since early 2012, rising 10.1 per cent by mid-year on 5.9 per cent by the end of 2011.

Monetary Aggregates
(annual change)

(per cent)



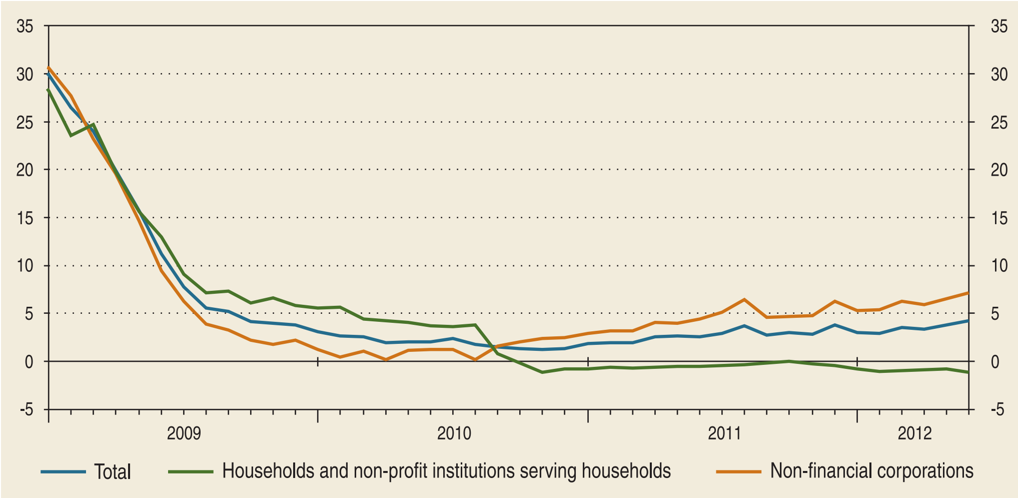
Source: BNB.

By the end of June 2012 the annual growth of claims on the non-government sector reached 4.3 per cent against 3.8 per cent at the end of 2011.[11] The volume of new corporate and household loans[12] in the first half-year reached BGN 8.2 billion (2.0 per cent up on the corresponding period of 2011).[13] Lending grew to trade and industry while declining to construction on an annual basis. By the end of June the annual growth of claims on corporations was 7.1 per cent on 6.2 per cent at the end of last year. Household lending dropped 1.2 per cent on an annual basis, reflecting lower overdrafts and consumer loans by 8.5 and 1.9 per cent on an annual basis. Housing loans continued growing at 0.3 per cent. In the first half year banks somewhat tightened short and long-term credit for corporations. The business climate in sectors with large shares of the credit portfolio, security-related risk, and the macroeconomic environment prompted this. At the same time household credit eased. The reasons were the cost and volume of attracted funds and competition between banks.

[11] BNB monetary statistics were used to analyse lending here.
[12] The term new loans refers to the new business statistical category.
[13] Data on household deposits and loans include NPISH to tally with monetary statistics.

Claims on the Non-Government Sector
(annual change)

(per cent)



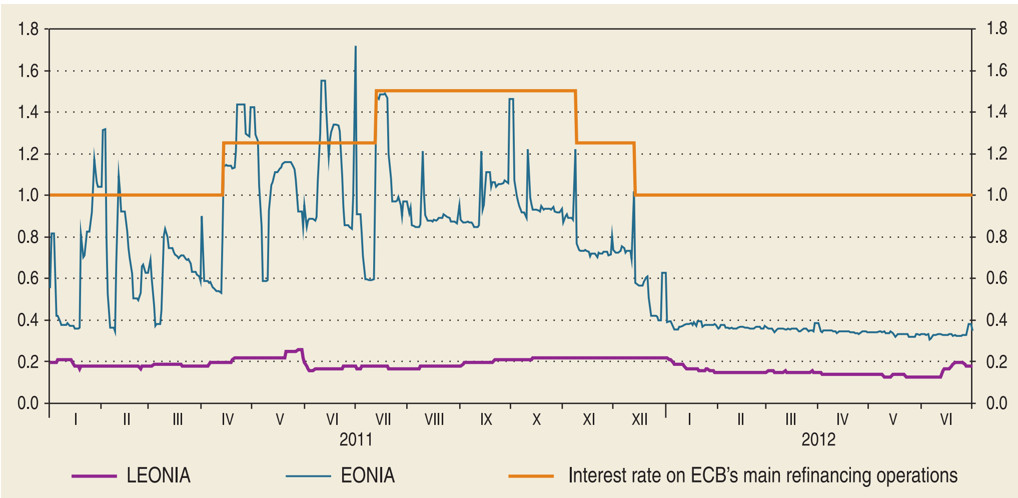
Source: BNB.

Increased claims and nominal GDP below last year's level raised the claims on the non-government sector to GDP ratio to 73.2 per cent, up 1.1 percentage points on late 2011.

Bulgarian banks continued to finance lending from resident household and corporate deposits. Household deposits, the main source, grew BGN 1.5 billion in the first half of 2012. Overall resident deposits grew BGN 1.8 billion. Non-resident deposits fell BGN 75 million. Rising residents' deposits provided high liquidity,[14] allowing banks to invest into external assets, service foreign obligations, and expand credit.

Interbank Money Market Interest Rates

(per cent)



Sources: BNB, ECB.

Banks managed lev liquidity mainly through foreign currency trade with the BNB. This took advantage of the main function of the currency board: buying and selling levs for euro at the fixed exchange rate under the Law on the Bulgarian National Bank.[15] Total foreign exchange market turnover in 2011 was EUR 302.1 billion,[16] up 62.0 per cent on the same period of 2011. Its main segments were turnover between banks, between them and the BNB, and between them and final customers. Turnover between banks

[14] The banking system liquid assets ratio was 26.21 per cent in June 2012

[15] See Chapter II.

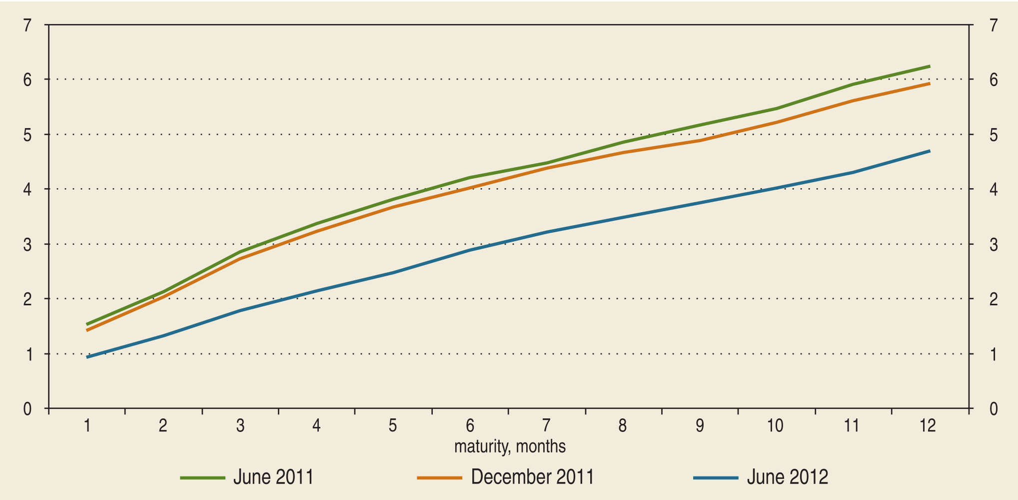
[16] This comprises transactions by banks and the BNB in foreign currency against levs with a spot value date of up to two business days and includes the double volume of trade between the BNB and banks, as well as interbank trading.

rose by EUR 218.2 million. Interbank foreign exchange trading remained unchanged at 95.4 per cent in euro, 4 per cent in US dollars, and 0.6 per cent in other currencies. Interbank transactions in euro continued rising by 4 per cent entirely at the expense of a drop in USD transactions. Final customer turnover also rose on the same period last year, the currency structure broadly unchanged at 85.4 per cent in euro, 13.1 per cent in US dollars, and 1.5 per cent in other currencies.

Ample banking liquidity continued to affect the interbank money market. This extended the downward interest trend, especially as regards the long-term. Average interbank deposit and repo interest fell from 0.24 per cent in 2011 to 0.18 per cent over the review period. The LEONIA-EONIA spread remained negative throughout, averaging 20 basis points over the half year against 67 basis points in 2011. This narrowing was due to EONIA falls prompted by the ECB providing long-term liquidity to euro area banks in early 2012.[17] The total volume of interbank money market transactions dropped to BGN 21.0 billion, down 57.5 per cent on the same period of 2011. Between January and June 2012 deposits comprised 72.1 per cent of turnover and government securities repos 27.9 per cent. Overnight transactions dominated deposits at 86.6 per cent.

Interbank Money Market Yield Curve

(per cent)



Note: Average SOFIBOR/SOFIBID Index.
Source: BNB.

Rising tax collection and effective spending limits improved the budget balance in the first half of 2012. The consolidated fiscal programme cash balance was positive at BGN 62.4 million. This resulted from a BGN 467.7 million national budget surplus and a BGN 405.3 million deficit on EU programmes. The budget balance rose BGN 712.1 million on January to June 2011. Government revenue and grants were BGN 13,224 million between January and June. The 9.8 per cent increase on the corresponding period of 2011 was mainly due to strict tax collecting and higher revenue from EU funds. Tax revenue rose 7.4 per cent on the first half of last year. VAT and excise duty contributed most at 4.2 and 1.0 percentage points. This was due to fuel price rises in early 2012, growing nominal imports, and improved tax collectability. Grant and non-tax revenue also contributed to the budget revenue rise. Non-tax revenue came mostly from May dividends on government-held equity. Consolidated fiscal programme spending to June 2012 (including the EU budget contribution) was BGN 13,162 million: a 3.7 per cent annual rise on the same period last year. Capital[18] and social spending contributed most, rising 26.6 and 3.9 per cent. The 3.2 per cent decline in current operating expenditure and limited public sector pay rises helped keep budget spending low. A second quarter budget surplus took the fiscal reserve to BGN 5061.8 million, BGN 63 million more than at the year's start.

[17] See Section I this Chapter.
[18] Capital costs include changes in government reserve assets.

After an EC recommendation, on 22 June the EU Economic and Financial Affairs Council (Ecofin) abrogated an excessive deficit procedure on Bulgaria. This followed Eurostat confirmation that 2011 data showed 2.1 per cent of GDP deficit under ESA'95 methodology and the EC spring forecast of improvements to -1.9 per cent in 2012 and -1.7 per cent in 2013.

There was continuing investor interest in treasury bills and bonds offered by the Ministry of Finance. The average annual yield of government securities placed in 2011 declined 0.42 percentage points on 2011 to 3.79 per cent. Average maturity fell by four months to 65 months compared to the same period last year. Bid-to-cover ratio rose 0.1 to 2.4. This helped government finance some budget deficit more cheaply than in 2011 by positive net issues of BGN 387.9 million on the home market. The increase in government securities in circulation and higher average issue volumes promoted the development and liquidity of the government debt secondary market.[19]

By the end of the review period EUR-denominated global bonds maturing in 2013 were quoted at 103.3 per cent (1.31 per cent yield) and USD-denominated global bonds maturing in 2015 at 111.8 per cent (3.36 per cent yield). The price of USD-denominated ZUNK[20] bonds hovered around nominal.

Bulgarian Stock Exchange Indices
(December 2011 = 100)

Sources: BNB, Bulgarian Stock Exchange.

Over the half year the Bulgarian Stock Exchange leading SOFIX and BG40 indices[21] remained low and volatile at levels close to those at the end of 2011. They reflected growing world market uncertainty amid debt problems in some EU countries. In June SOFIX declined 5.6 per cent on December 2011, while the BG40 grew 1.0 per cent. In the half year secondary market trading fell 24.1 per cent to BGN 178.5 million, while bond turnover fell 31.2 per cent to BGN 50.6 million. There were BGN 233.7 million[22] over the counter equity and BGN 5.5 million bond transactions. By the end of June the capitalisation of the Bulgarian Stock Exchange, Sofia, market was BGN 9.7 billion or 12.9 per cent of GDP against 16.5 per cent at the close of 2011. This was mainly because of late June price falls in several companies with large market capitalisations.

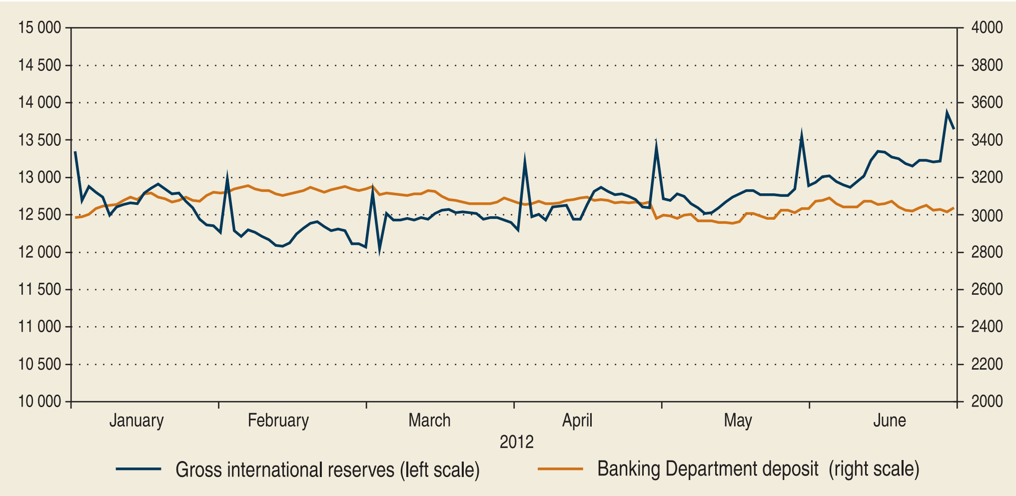
[19] For more on the government securities primary and secondary markets see Chapter VIII.
[20] The Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990.
[21] On 1 March 2012 the Bulgarian Stock Exchange restructured trading into a Main and Alternative Markets with instrument segments. The Main Market Premium Equities Segment is roughly the former Official Equities Market Segments A and B. The Standard Equities Segment is the former Unofficial Equities Market Segment A. The Alternative Market is for issues outside Main Market issuer, trading duration, turnover, and transaction numbers criteria. Its Equities Segment is roughly the former Unofficial Equities Market Segment B. The former Official and Unofficial Bond Markets are now a Main Market Bonds Segment.
[22] Major exchange traded and over the counter transactions involved, *inter alia*, Petrol AD, the ELARG Agricultural Land Opportunity Fund REIT, Sopharma AD, Chimsnab Bulgaria AD, Bulgartabac Holding AD, Sila Holding AD and the CCB Real Estate Fund REIT.

II. Gross International Reserves

Gross international reserves are managed according to the statutory provisions of the Law on the Bulgarian National Bank,[23] investment constraints, business procedures and methodologies, and the opportunities offered by international financial markets. They comprise the assets on the Issue Department's balance sheet, and their role is to provide complete coverage for monetary liabilities at the fixed exchange rate of the lev to the euro set out in the Law on the Bulgarian National Bank.[24] The excess of gross international reserves over monetary liabilities forms the Banking Department deposit item or the net value of the Issue Department's balance sheet.[25]

Gross International Reserves and Banking Department Deposit

(EUR million) (EUR million)



Note: The chart shows the daily movements of the Issue Department balance sheet figure and the Banking Department Deposit in the Issue Department balance sheet, including the two tranches of Special Drawing Rights worth SDR 611 million received by the BNB in August and September 2009 upon a general SDR allocation by the IMF.

Source: BNB.

1. The Amount and Structure of Gross International Reserves

By the end of June 2012 the market value of gross international reserves was EUR 13,866 million: an increase of EUR 517 million on the end of 2011.[26] The 3.9 per cent increase on the close of 2011 was mainly from foreign currency inflows formed primarily by receipts on BNB clients' accounts in the Issue Department balance sheet.

[23] There were no Law on the BNB amendments concerning the regulatory framework for gross international reserve management in the period under review.

[24] The Law on the BNB Article 28, paragraph 2 defines the Bank's monetary obligations as all circulating banknotes and coins issued by itself, and all BNB account balances held by others except the IMF with the Bank.
The Law on the BNB Article 28, paragraph 3 lists assets which may 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 other financial institutions or international financial organisations with one of the two highest ratings by two internationally recognised credit rating agencies; securities issued by foreign countries, central banks, other foreign financial institutions, or international financial organisations assigned one of the two highest ratings by two internationally recognised credit rating agencies with the exception of collateralised debt instruments; the balance on accounts receivable and payable on BNB forward or repo agreements with (or guaranteed by) foreign central banks, public international financial organisations or other foreign financial institutions with one of the two highest ratings from two internationally recognised credit agencies; and BNB futures and options which bind non-residents and which are payable in freely convertible foreign currency. The Law on the BNB stipulates that these assets be estimated at market value.

[25] The Law on the BNB Article 28, paragraph 1 provides that 'the aggregate amount of the monetary liabilities of the BNB shall not exceed the lev equivalent of gross international reserves,' with that equivalent based on the fixed exchange rate.

[26] Over the first half of 2012, neither the two tranches totalling SDR 611 million received by the BNB in August and September 2009 upon general SDR allocation by the IMF, nor the total income on them were included in the analysis of changes in BNB gross international reserves. For further details, see BNB Annual Report, 2009, p. 25.

External Cash Flows in Foreign Currency

(EUR million)

	January – June 2011	January – June 2012
I. Purchases and sales of euro		
at tills	-5	-5
banks	-732	-494
banks' purchases	15 968	22 114
banks' sales	-16 701	-22 609
Subtotal I	-738	-500
II. Currency flows with banks, the MF, *etc.*		
Minimum Required Reserves	-80	349
Government and other depositors (total)	185	453
Subtotal II	105	802
Total I+II	-633	302

Notes: 1. Outflows are shown with a minus sign.
2. Figures may not add up due to rounding.

Source: BNB.

Over the review period positive receipts on government accounts and other depositors worth EUR 453 million (mostly from funds received on the EC's foreign currency account with the BNB and from issuing government securities in euro on the domestic market) contributed most substantially to external flows. Net sales of reserve currency to commercial banks resulting in an outflow of EUR 494 million were also significant. The trend was similar to that in the first half of 2011 when these two flows were in the same sense. Minimum reserve funds on commercial banks' foreign exchange accounts with the BNB amounted to EUR 349 million. Over the same period in 2011 the BNB refunded a total of EUR 80 million into banks' required reserve accounts.

In the first half of 2012 the upward trend in the share of monetary gold, reaching 13.70 per cent of the market value of assets, endured. Though the volume of gold in reserves remained unchanged, the growth reflected its higher price on financial markets compared with the end of 2011.

Currency Structure of Gross International Reserves

(per cent)

Currency	Issue Department Balance Sheet	
	January – June 2012	2011
EUR	85.71	86.76
USD	0.24	0.10
XAU	13.70	12.79
XDR	0.33	0.33
CHF	0.01	0.01

Notes: 1. Average data for the period.
2. Figures may not add up due to rounding.

Source: BNB.

The structure of assets by financial instrument experienced no significant changes in the first six months of 2012: the share of investments in securities decreased to 68.94 per cent of the market value of assets at the expense of the increased share of investments in deposits and cash.

Gross International Reserves by Financial Instrument

(per cent)

Financial instruments	January – June 2012	2011
Cash in vaults*	6.43	5.95
Deposits**	24.63	22.49
Securities**	68.94	71.57

* Account balances, payments, and monetary gold.
** Including instruments in foreign currency and gold.
Notes: 1. Average data for the period.
2. Figures may not add up due to rounding.

Source: BNB.

The structure of assets by residual term to maturity underwent no significant changes compared with the prior year. The bulk of assets continued to be concentrated in the sector of up to a year (current accounts, short-term deposits in foreign currency and gold, and short-term securities), its share averaging 69.96 per cent. All sectors over three years posted a decrease at the expense of the increasing share of the one to three-year sector, which reached 26.42 per cent.

Gross International Reserves by Residual Term to Maturity

(per cent)

Maturity Sectors	January – June 2012	2011
Up to a year	69.96	70.92
One to three years	26.42	22.05
Three to five years	2.11	5.33
Five to ten years	1.36	1.49
Over ten years	0.14	0.22

Notes: 1. Average data for the period.
2. Figures may not add up due to rounding.

Source: BNB.

2. Gross International Reserve Risk and Yield

The Market Environment

In the first quarter of 2012 the market environment improved, mainly through the provision of long-term liquidity by the ECB through two three-year refinancing operations totalling EUR 1 trillion[27] as part of the unconventional measures of monetary policy. The conclusion of Greek debt restructuring brought some relief. Italian, Spanish, Irish, and Portuguese bond yield spreads narrowed and demand for newly issued securities by these countries rose. The yield in the sectors of up to three years changed most strongly. As a result, these countries', and especially Spain's and Italy's, government securities yield curves steepened. As financial markets stabilised by March 2012, the ECB ended its Securities Markets Programme.

The market improvement turned out to be unstable. By the end of the first quarter euro area market expectations started declining again. Worsened economic prospects reflecting downward revisions of EC and ECB macroeconomic projections of euro area GDP growth in 2012 challenged some countries' fiscal consolidation plans. Market participants' concerns of an intensification of the euro area debt crisis also increased due to political instability in Greece, problems in the banking sector, Spain's upward 2011 budget deficit revisions, and delayed introduction of the permanent European Stability Mechanism (ESM).

In the first half of 2012 the ECB retained its policy interest rates unchanged and continued implementing its policy of providing unlimited liquidity allotment on its refinancing operations.[28] Due to intensified euro area crisis, expectations in the second quarter were for a decrease in ECB policy interest rates, including the deposit rate, to 0 per cent.

[27] The first three-year refinancing operation was in December 2011 and the second one in February 2012.
[28] For further details, see Chapter 1.

In the USA, the US Federal Reserve kept the federal funds interest rate at 0 to 0.25 per cent. Worsened labour market conditions and slower economic growth in the second quarter of 2012 gave grounds to the US Federal Reserve to change its monetary policy in support of US growth.[29]

Government Securities Yield Curves

Between January and March 2012 yield on German government securities changed slightly reflecting financial market stabilisation after ECB provision of long-term liquidity and the restructuring of Greek government debt held by private creditors. In the second quarter the yield decrease trend returned and early June saw the lowest yields on German government securities (0.002 per cent in the two-year and 1.17 per cent in the ten-year maturity sectors). This reflected higher demand for low-risk assets due to increased concerns about a deepening of the debt crisis and worsened global economic prospects. Factors contributing to financial market uncertainty were the political turmoil in Greece, which gave rise to speculations about Greece leaving the euro area, and problems in the Spanish banking sector. By the end of June yield on two-year German benchmark government securities reached 0.12 per cent (-2 basis points on the end of 2011), while that on ten-year government securities reached 1.58 per cent (-25 basis points on the end of 2011).

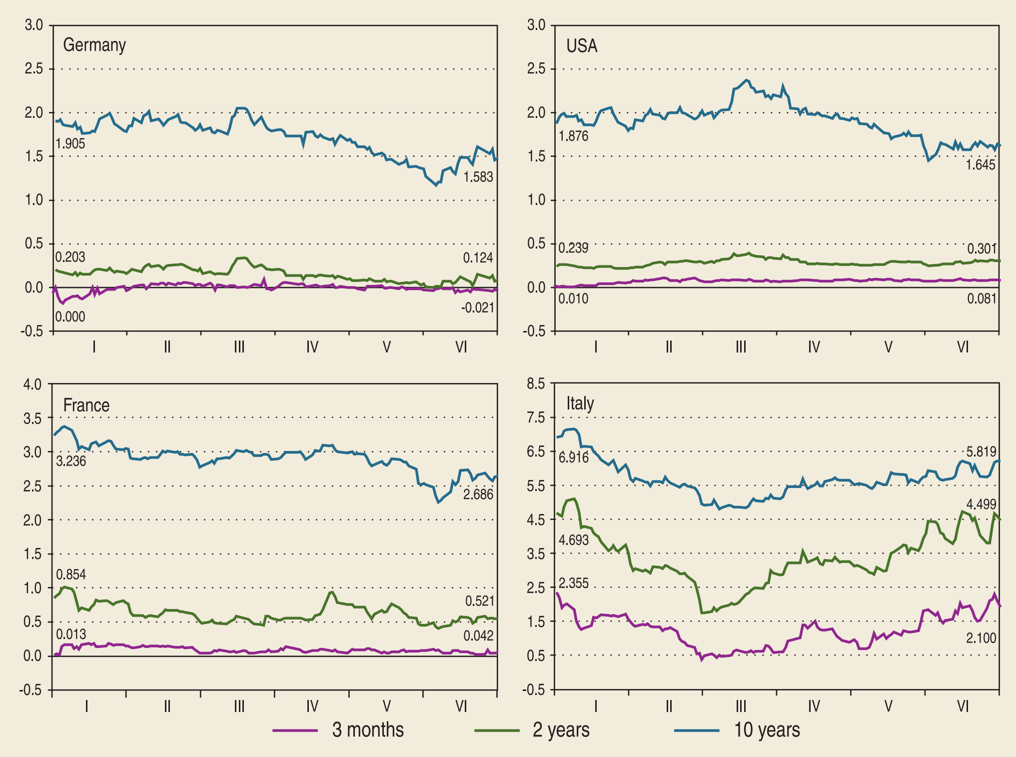
The government securities yield spreads of euro area periphery countries compared with benchmark German ones narrowed early in the year. In the second quarter there followed a new widening of yield spreads on Spanish and Italian government securities. The widened spread on Spanish government securities (99 basis points in the two-year and 149 basis points in the ten-year maturity sector) reflected internal factors, mainly higher risks to fiscal consolidation (high budget deficit expectations in 2012 and upward revisions of 2012 deficit data), worsening economic prospects, and deepening banking sector problems. The yield spread on Dutch securities also widened by 16 basis points in the two and ten-year sectors. This reflects increasing political uncertainty and pending early parliamentary elections in the autumn, as well as the changed prime-rate outlook from stable to negative. In the second quarter spreads in Italy widened but by the end of June levels remained lower than the end of the prior year (-160 basis points in the two-year and -104 basis points in the ten-year sector). Portuguese and Irish government securities' yield spreads narrowed significantly, particularly in the first quarter. Both countries enjoyed positive EU and IMF assessments on progress in implementing economic programmes. Spreads also narrowed in France, Austria, and Belgium (by 22 basis points, 24 basis points and 65 basis points in the ten-year sector). In France, the change was weaker due to uncertainty on the results of the presidential elections and credit rating downgrades.

In the first quarter, yield on US government securities steadily increased following optimistic macroeconomic data which reduced demand for government securities in favour of risk assets. Signs of a US labour market recovery, improved consumer expectations, and optimism from the ECB second three-year refinancing operation prompted a strong yield increase over the entire curve of US reference government securities in the second half of March. In the beginning of the second quarter the market environment worsened after poor economic results in the USA, Europe, and China led to a new hike in demand for low-risk US government securities. The intensification of the debt crisis in Europe added pressure on securities yields. Worsened global economic outlook and increased tension in the euro area cut yield on US government securities in early June. By 30 June the yield in the two-year maturity sector reached 0.30 per cent, that in the ten-year sector decreasing to 1.64 per cent. In the second quarter the yield in the short-term maturity sectors stabilised at low levels, further decreasing in medium-term and long-term sectors. The greater decline in the long-term maturity sectors curbed the slope and by the end of June yield spread in the sectors of two to ten years reached 134 basis points against 164 basis points at the end of 2011.

[29] For further details, see Chapter 1.

Government Securities Yield to Maturity in the First Half of 2012

(per cent)



Gold and the Exchange Rate

In the first half of 2012 the US dollar appreciated cumulatively by 2.2 per cent on the single European currency, mainly through second quarter increases. The USD/EUR exchange rate moved within the 0.74 to 0.81 range, with strong fluctuations. In the first quarter the euro cumulatively appreciated against the US dollar. In March the interest differential between European and US government securities became the major factor behind exchange rate dynamics as investors' risk appetite declined. This followed a formal US Federal Reserve statement that low interest rates on US federal funds would remain at least until the end of 2014 due to US economic conditions. In the second quarter the US dollar appreciated against the euro mainly as an investment safe heaven, with financial market uncertainty around the Greek parliamentary elections the major factor. Worsening euro area macroeconomic data and eroded investor confidence in the single currency had an additional effect.

In early 2012 the gold price went up both in US dollars and euro. It closely followed US stock market index movements and commodity price developments. The price also strongly reflected investor expectations of unconventional monetary policy measures by the US Federal Reserve in support of the US economy. In the first half of 2012 the gold price moved within the USD 1540 to 1784 *per* troy ounce range. The overall increase in the first half of 2012 was 1.99 per cent in US dollars and 4.89 per cent in euro or USD 1597.4 and EUR 1268.00 *per* troy ounce by the end of June.

The USD/EUR Exchange Rate

(EUR))

Troy Ounce Gold Price in US Dollars

(USD)

Troy Ounce Gold Price in Euro

(EUR)

Major Types of Risk

Over the review period BNB gross international reserves were invested in line with the long-term risk tolerance set by the BNB Governing Council as regards the net value[30] in the Issue Department balance sheet: -7.0 per cent ≤ VaR ≤ 0 per cent at 95 per cent confidence level.[31]

In the first six months of 2012 international reserve **interest rate risk** measured by reserves' average modified duration was 0.73. The duration was slightly lower than the 0.78 years average in 2011.

International reserve **currency risk** was constrained by the Law on the Bulgarian National Bank provision that the sum of the absolute values of open foreign currency positions[32] in currencies other than the euro, SDR, and monetary gold, should not exceed 2 per cent of the market value of monetary liabilities in these currencies. In the reporting period minimal open currency positions in currencies other than euro were maintained, with the open gold position actually posing the major currency risk to the Bank.

In the first six months of 2012 **credit risk** remained the main factor influencing European government securities markets. Demand for low-risk assets continued as investors sought security and quality amid market uncertainty caused by the debt crisis and worsened euro area economic prospects. Implicitly, the yield of most assets into which the BNB invested was exceptionally low: close to zero, and even negative at the short-term end of the curve.

Additional changes to credit risk management rules over the review period included further tightening and fine tuning of constraints and limits to curb risk to the BNB and to use available investment opportunities within the credit risk budget effectively. The Bank continued reducing credit risk in government debt investment by retaining constraints on government issuers, which are conditionally divided into three risk groups based on credit risk inherent in their government securities. The requirement that not less than 30 per cent of international reserves should be invested into Group I, with least risk, was raised to 40 per cent. The maximum term to maturity for new investment into Group II debt issuers rose from one to three years, and that for Group III issuers, from three to six years. In the first half of the year the maximum maturity of bank foreign currency exposures rose in two steps: from one week at the end of 2011 to one and three months respectively at the beginning of the first and second quarters of 2012. Funds invested into assets with the highest long-term credit rating averaged 72 per cent over the period.

Strict monitoring and control of investment restrictions and business procedures for international reserve management constrained **operational risk**.

Return and Efficiency

Net income from assets in euro is the sum of three components: i. income from investing gross international reserves into original currency; ii. currency imbalance yield,[33] and iii. expenditure on liabilities. In the first half of the year BNB income from international reserve investment came to EUR 89.60 million: 0.76 per cent yield. The currency imbalance yield was entirely due to the change in the EUR-price of monetary gold and came to EUR 69.67 million. Interest paid on Issue Department balance sheet liabilities was EUR 0.13 million. As a result of these three components, net earnings from international reserve management came to EUR 159.13 million: 1.28 per cent net rate of return in the first half of 2012.

[30] Net value means the Banking Department Deposit item in the Issue Department balance sheet.

[31] Net value risk measured by VaR=-X per cent (X>0) at 95 per cent confidence level and allowing for normal yield allocation means that 95 per cent of the time maximum net value loss would not exceed X per cent.

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

[33] Currency imbalance yield is the sum total of the effects of exchange rate movements on assets and liabilities open foreign currency positions.

Earnings and Profitability* of International Reserves in the First Half of 2012

Quarter	Net income (1)+(2)+(3)	Investment income (1)	Currency Imbalance Yield (2)	Expenditure (Interest) on Liabilities (3)
First quarter	120.19	66.35	53.95	-0.12
Second quarter	38.94	23.25	15.71	-0.02
Total income, million EUR	159.13	89.60	69.67	-0.13
Total rate of return*, per cent	1.28	0.76	0.52	0.00

* Earnings shown in the table are for the first six months of 2012. Annualised earnings would almost double the six-month profitability.

Source: BNB.

International reserves are split operationally into portfolios depending on currency and investment goal, each with a benchmark, investment goals, and investment limits set by the BNB. Major BNB portfolios and results from their management are presented in the table below.

Earnings and Risk of Portfolios in the First Half of 2012

Portfolio	Earnings		Risk[1]		Information ratio[4]
	Absolute (per cent)	Relative[2] (b.p.)	Absolute (b.p.)	Relative [3] (b.p.)	
Investment 1, EUR	0.50	-19	37	25	-3.02
Investment 2, EUR	0.96	23	36	27	3.39
External manager A, EUR	0.79	29	49	13	8.80
External manager B, EUR	0.74	24	59	23	4.04
Liquidity, EUR	1.41	9	94	62	-
Liquidity, USD	0.37	36	50	50	-

[1] Risk means the standard deviation of yield.
[2] The positive/negative relative yield of a given portfolio is the attained profit/opportunity cost against the respective benchmark yield. Relative yield is rounded to 1 basis point; within the -0,5 and 0 band it is -0, and within the 0 and 0.5 band +0.
[3] The relative risk against the benchmark indicates the deviation degree of the risk characteristics of the portfolio from those of the benchmark through active portfolio management. The risk is on an annual basis.
[4] The information coefficient indicator is the ratio between the relative yield of the portfolio to its relative risk (on an annual basis).

Source: BNB.

To diversify management styles and reduce operational risk, the bulk of euro-denominated assets continued to be distributed into two investment portfolios with identical benchmarks and investment limits, managed by different BNB teams. By 30 June 2012, external managers at international financial institutions managed about 6 per cent of international reserves, each with a benchmark, with investment goals and investment limits set by the BNB. Beside additional diversification, using them helped exchange expertise in international market investment management. Liquid portfolios assisted immediate payment needs.

III. Payment Systems

The Law on the Bulgarian National Bank tasks the Bank with payment system organisation, support, and development by assisting the implementation, operation, and oversight of efficient payment mechanisms. The Bank's major goals are to curb systemic risk and facilitate Bulgarian integration into the euro area payment infrastructure.

Lev settlement systems are:

- RINGS, a real-time gross settlement system, operated by the BNB;
- Ancillary systems settling transactions in RINGS:
  — BISERA, for settling customer transfers at a designated time, operated by BORICA–Bankservice AD;
  — BORICA, for servicing bank card payments in Bulgaria, operated by BORICA-Bankservice AD;
  — SEP, for mobile telephone payments, operated by SEP Bulgaria AD.

Euro settlement systems are:

- The TARGET2 national system component, TARGET2-BNB, run by the BNB;
- The TARGET2-BNB ancillary BISERA7-EUR for servicing customer transfers at a designated time, operated by BORICA–Bankservice AD.

Securities settlement systems (SSS) are:

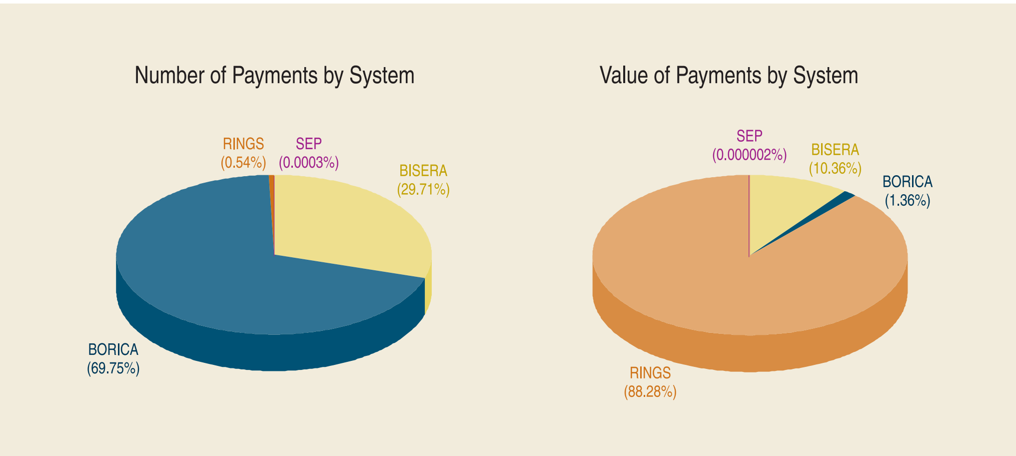
- The book-entry government securities settlement system, run by the BNB;
- The book-entry securities registration and servicing system, run by the Central Depository.

1. Payment Systems for Settlement in Levs and Securities Settlement Systems

In the first six months of 2012 RINGS processed over 88.28 per cent of payments by value in Bulgaria. (Values around 80 per cent are optimal for the operation of real-time gross settlement systems.) In addition, RINGS processed 0.54 per cent of non-cash payments.

In the first half year payments processed by BORICA rose 8.76 per cent in value and 6.52 per cent in number compared with 2011 due to the higher number and value of ATM transactions.

Payments in Bulgaria by Payment System in the First Half of 2012



Source: BNB.

The number of transactions through POS terminals fell slightly by 1.53 per cent.

In the first half of 2012 transactions processed by BISERA increased in number and value (4.25 and 10.03 per cent respectively) on the corresponding period of 2011.

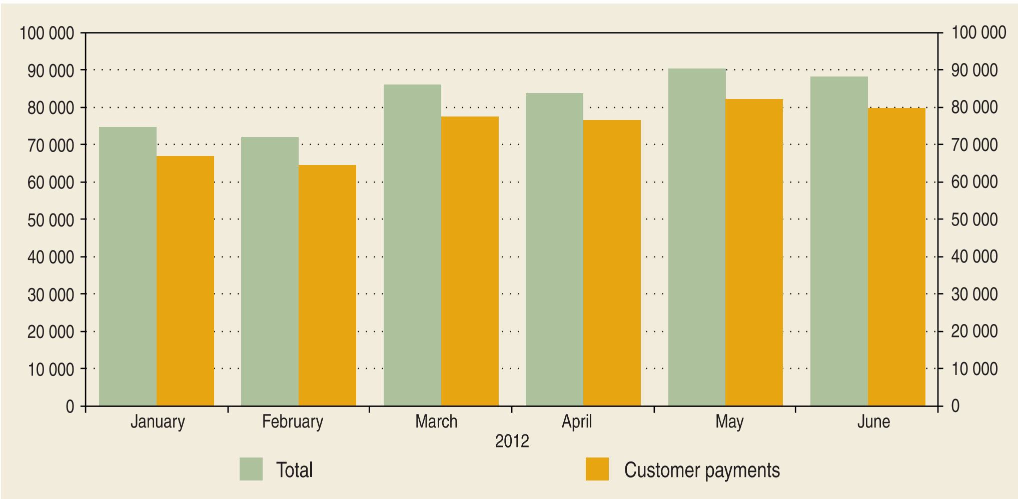
Equity market declines in the first half of 2012 on the first half of 2011 depressed the value and number of Central Depository transactions significantly by 49.20 u 24.79 per cent.

By the close of June 2012 only seven banks in Bulgaria participated in SEP. Transactions through the system declined 15.45 per cent in number and 6.69 per cent in value on the fist half of 2011.

RINGS Real-Time Gross Settlement System

Processing most payments in Bulgaria through the Real-Time Gross Settlement System (RINGS) cut payment risk: one of the major goals of a central bank. Over the review period RINGS processed 494,762 payments for BGN 411,274 million: down 2.76 per cent in number and up 30.50 per cent in volume on the first half of 2011. Customer payments numbered 447,009, or 90.35 per cent of the total, worth BGN 80,879 million or 19.67 per cent of the value of all payments. The daily average number of payments was BGN 3927 and their daily average value reached BGN 3264 million: up 28.43 per cent on the first half of 2011.

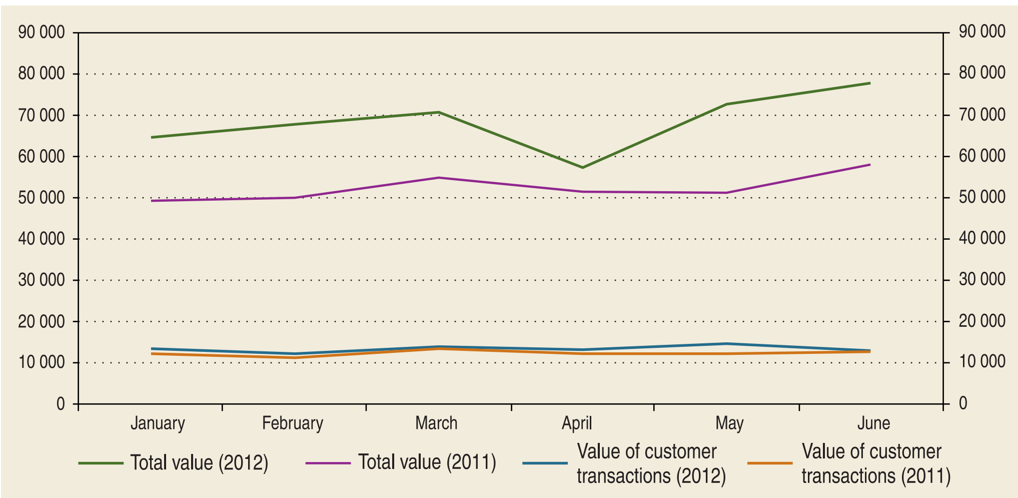
Number of Payments Processed in RINGS



Source: BNB.

Value of RINGS Transactions in the First Half of 2011 and 2012

(BGN million)



Source: BNB.

In the first six months of 2012, 71.39 per cent of payments went through by noon and 88.15 per cent by 2:30 pm. As regards system traffic, 82.97 per cent of RINGS payments went through by 2:30 pm.

By 30 June 2012, 31 banks including the BNB participated in RINGS.

In the first half of 2012 no payments were rejected by the close of a RINGS' system day due to insufficient funds on participants' accounts, indicating good liquidity management by banks. The Bank took no radical steps to provide liquidity to participants. Over the review period there was no recourse to the Reserve Collateral Pool: an interbank mechanism guaranteeing settlement of payment and securities' system orders. Between January and June 2012 RINGS offered 99.52 per cent availability.[34]

2. Payment Systems for Settlement in Euro

TARGET2 settles gross euro payments in real time using central bank money. It is a Single Shared Platform (SSP) system, with each participating and connected central bank legally responsible for the operation of its system component. The BNB runs the TARGET2-BNB system component and is responsible for the business relations of its participants and coordination with the European Central Bank and participating central banks. By 30 June 2012 the ECB and 23 EU central banks connected with TARGET2.

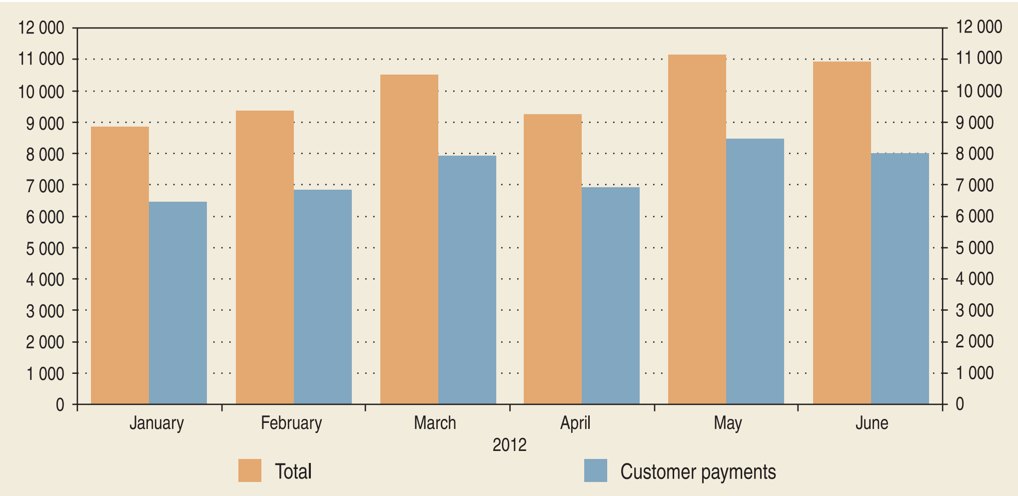
TARGET2-BNB National System Component

The TARGET2-BNB national system component includes the BNB, 17 direct participant banks, three addressable BIC holders, and the BISERA7-EUR ancillary system for settling customer transfers in euro at a designated time. BORICA–Bankservice AD operates this ancillary system, processing solely SEPA payments (*i.e.*, payments meeting Single Euro Payments Area requirements): SEPA credit transfers and SEPA direct debits.

In the first half of 2012 TARGET2-BNB processed 60,056 payments for EUR 152,992 million, including 44,665 customer payments for EUR 1917 million. Compared with the first half of 2011, the number of settled transactions rose 32.39 per cent, their value rising 8.93 per cent.

Payments by other system components to banks were 88.76 per cent of the number and 93.02 per cent of the value of all payments processed through TARGET2-BNB. There were 473 average daily payments through TARGET2-BNB, up 32.46 per cent on the first half of 2011. The average value was EUR 1204. The daily numbers peak was 815, with a daily value peak of EUR 2233 million.

Number of Payments Ordered by TARGET2-BNB Partcicipants

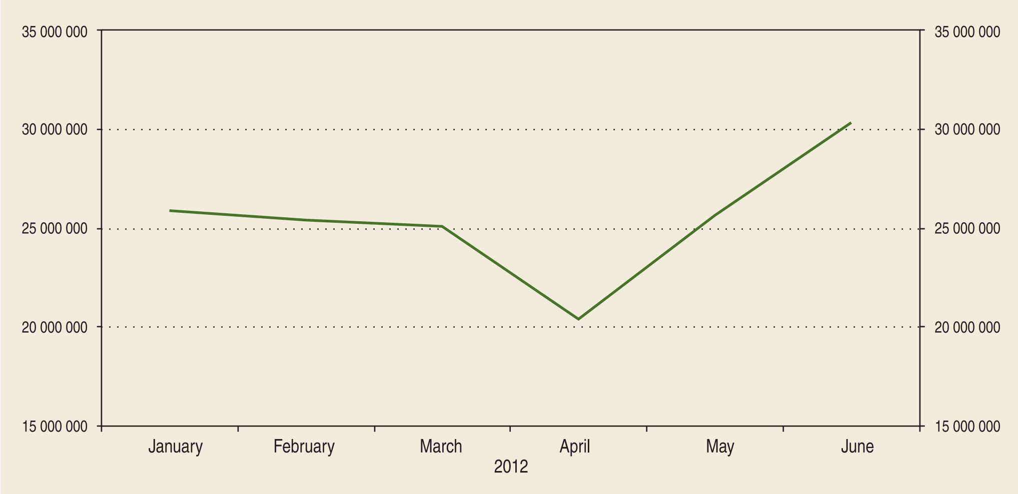


Source: BNB.

[34] The ratio of time when the system is operational to scheduled operating time.

Value of Payments Ordered by TARGET2-BNB Partcicipants

(EUR'000)



Source: BNB.

The BISERA7-EUR ancillary system includes 14 participants and processes designated time euro customer transfers. In the first half of 2012 this system processed 9471 payments worth EUR 101.543 million, up 123.80 per cent in number and 193.17 per cent in value on the corresponding period last year.

3. Payment and Settlement System Development

The Single Euro Payments Area (SEPA) was the most significant initiative to harmonise small-payment practice and standards within the EU. New pan-European instruments to transform divergent and fragmented small payments infrastructures into a single euro payments area, a key element in SEPA, boost security and efficiency through economies of scale. SEPA credit transfers and SEPA card payments were launched in early 2008, payment service end-users enjoying SEPA direct debits since November 2009. By mid-year all banks and foreign bank branches in Bulgaria could handle SEPA credit transfers. BISERA7-EUR operated by BORICA–Bankservice AD handles only SEPA payments. To ensure banks' availability in processing euro payments to and from foreign banks in other SEPA countries, BISERA7-EUR connected with SEPA Clearer operated jointly by the Deutsche Bundesbank and Equens. This allows SEPA credit transfers between banks in Bulgaria and other EU countries, mainly Germany, Greece, Italy, the Netherlands, Poland, and Switzerland.

By the end of June 2012, 63.26 per cent of Bulgarian cards, including 60.48 per cent of debit and 92.90 per cent of credit cards were to the EMV standard.[35] EMV implementation into the card payments infrastructure was almost complete by the close of June 2012, with 99.98 per cent of ATMs and 98.73 per cent of POS terminals migrated.

The first half of 2012 saw the adoption of Regulation (EU) No 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009 on end-dates for migration to SEPA direct debit and credit transfer. The Regulation sets rules and technical requirements for credit transfer and direct debit transactions in euro within the European Union and mandates payment services providers (PSPs) to adhere to the IBAN and ISO 20022 XML standards.

[35] EMV is a global standard for credit and debit cards based on microprocessor technology (smart or chip cards) developed by Europay, Mastercard, and Visa to increase card payment security and limit abuse.

4. Payment System Oversight

Limiting system risk and improving Bulgarian payment systems' reliability and efficiency were the major goals of payment systems supervisors. They monitored observance of standards and recommendations by the Bank for International Settlements, the International Organization of Securities Commissions, the European Central Bank, and the European System of Central Banks.

The BNB Governing Council Resolution No 2 of 26 January 2012 under the Law on Payment Services and Payment Systems Article 97, paragraph 1 in connection with Article 137, paragraph 1 licensed BORICA–Bankservice AD as a settlement finality payment system operator for designated time servicing of customer transfers in euro.

Finding that the conditions of the same Law's Article 10, paragraph 4 for payment institution licensing were met, the BNB Governing Council Resolution No 11 of 23 February 2012 pursuant to Article 12, paragraph 1 in connection with Article 137, paragraph 1 licensed Euromoney Transfer OOD under Article 4, item 6 as a money remittance business.

At its 5 April 2012 meeting, the BNB Governing Council approved an Ordinance extending the cover of BNB Ordinance No 22 on the Central Credit Register of Banks to payment and electronic money institutions which may extend loans related to payment services under the Law on Payment Services and Payment Systems Article 19.

The review period saw applications by the TBI Bank EAD and the Bulgarian American Credit Bank AD to broaden their payment service licenses within the Law on Payment Services and Payment Systems.

Under the same Law's Article 137, paragraph 2 in connection with Article 114, item 4 and Article 122, the Bank conducted three supervisory inspections to check whether credit institutions complied with the Law and its statutory instruments.

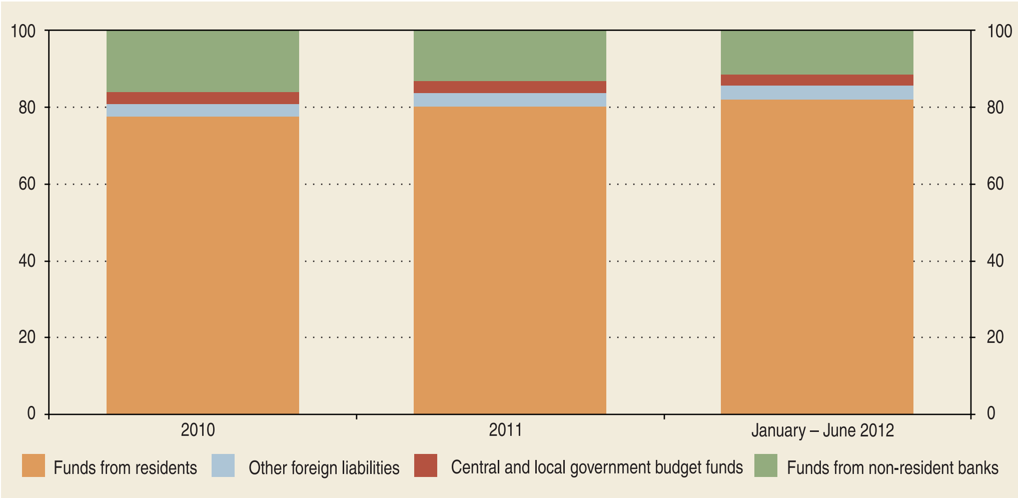
By mid-2012, 102 agents went onto the public register of licensed payment institutions and their branches and agents under Article 17 of the Law and 208 agents were deleted. Two agents went onto the public register of licensed electronic money institutions and their branches and agents under Article 17 of the same Law. Over the same period, 14 payment institutions from other EU states providing services in Bulgaria and 12 agents went onto the public register under Article 7 of BNB Ordinance No 16 of 16 July 2009. Three companies went onto the public register of electronic money institutions licensed elsewhere in the EU and issuing, distributing, and redeeming electronic money in Bulgaria directly, through branches, or agents under Article 39 of the same Ordinance.

IV. Bank Reserves with the BNB

Over the review period reserve developments reflected mainly the growth of funds attracted by residents due to the high saving rate of households and firms in Bulgaria.[36] In the first half of 2012 the average daily value of attracted bank funds for reserve calculation purposes increased 6.7 per cent on the average daily value for 2011, including 14.7 per cent and 0.7 per cent growth in lev and foreign currency liabilities respectively. Funds from residents (excluding central and local government accounts) rose by 9.1 per cent and those from non-residents fell by 4.6 per cent. Central and local budget liabilities grew 6.5 per cent.

Structure of Attracted Funds in the Banking System

(per cent)



* Average daily value for the period (for reserve calculation purposes).

Source: BNB.

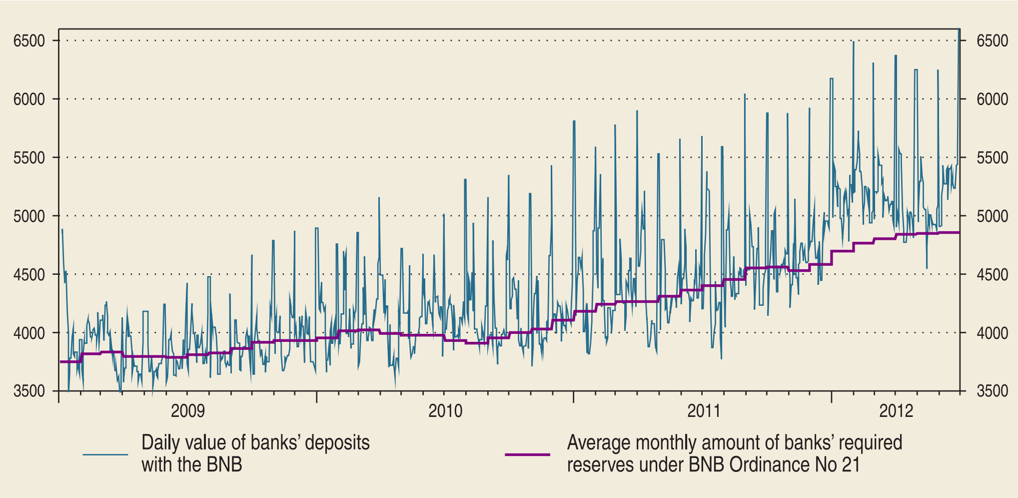
The change in the structure of attracted funds in the first half-year did not change the effective implicit rate of minimum required reserves which remained at 8.9 per cent.[37] Reserve assets covering this ratio include funds on bank accounts with the BNB (7.8 percentage points) and 50 per cent of cash balances recognised as reserves (1.1 percentage points). The currency structure of banks' reserve assets changed: reserve assets in levs fell 0.4 per cent from the average 2011 level, while those in foreign currency rose 41.4 per cent, their relative share in total reserves maintained by banks went up to 39 per cent in June.

[36] In the first half of 2012 there were no amendments to Ordinance No 21 on the Minimum Required Reserves Maintained by Banks at the Bulgarian National Bank.

[37] BNB Ordinance No 21 sets banks' minimum reserves at 10 per cent of their deposit base, except on funds attracted from abroad (5 per cent) and central and local government budget funds (nil).

Bank Reserves with the BNB

(BGN million)



Source: BNB.

Banks reported high liquidity over the first half of 2012. They preferred to maintain part of this liquidity as excess reserves on accounts with the BNB, the average daily share of excess reserves in the total amount of reserves maintained with the BNB rising to 7.7 per cent from 3.0 per cent in 2011.

V. Cash in Circulation

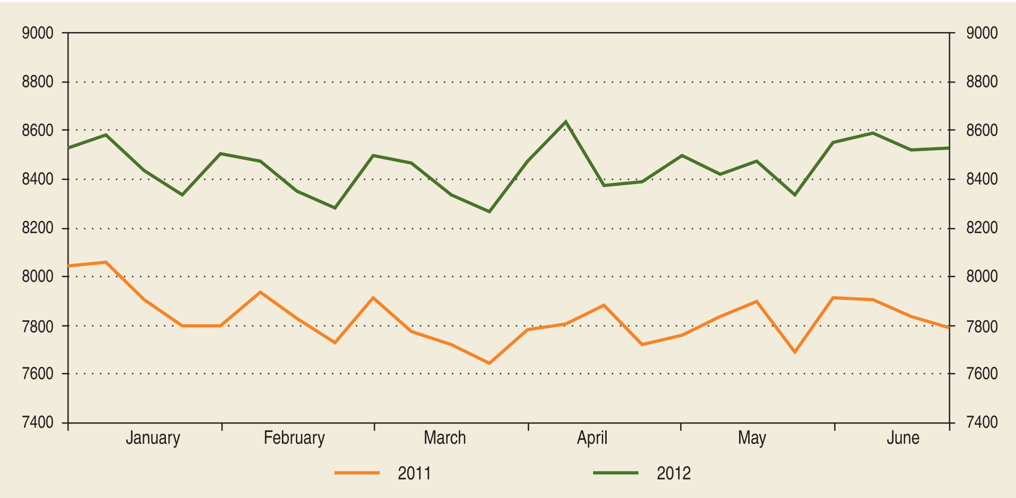
The Bulgarian National Bank has a monopoly on Bulgarian cash issue.[38] The Bank's cash is legal tender mandatorily acceptable as payment at full face value without restriction. The BNB ensures the printing of banknotes and minting of coins, as well as preservation and destruction of banknotes and coins uncirculated or withdrawn from circulation.

Banknotes and Coins in Circulation (Outside BNB Vaults)

Circulating cash[39] by 30 June 2012 was worth BGN 8523.5 million, down BGN 205.4 million or 2.35 per cent on the end of 2011 mainly due to seasonal factors and up by BGN 735.1 million or 9.44 per cent on an annual basis (compared with end-June 2011).

Banknotes and Coins in Circulation (Outside BNB Vaults)

(million BGN)



Source: BNB.

The sustainable upward trend in circulating cash continued in the first half of 2012, rising from 6.94 per cent on an annual basis in early 2012 to 9.44 per cent by end-June 2012, while the growth in the corresponding period of 2011 was within the range of 2.32 per cent and 4.03 per cent.

In late June 2012, 310.2 million banknotes were in circulation, amounting to BGN 8339.8 million, down 9.0 million in number (2.81 per cent) and BGN 209.0 million in value (2.45 per cent). Compared with June 2011, banknotes in circulation increased by 16.7 million in number (5.68 per cent) and BGN 722.4 million in value (9.48 per cent). Banknotes comprised 97.84 per cent of the total value of cash outside BNB vaults by 30 June 2012.

As regards the number of circulating banknotes, since the start of the year only the low-value BGN 2 and BGN 5 denominations grew by 1.74 per cent and 2.94 per cent respectively. The number of others posted a decline, with BGN 10 and BGN 20 banknotes falling more substantially over the same period. Their number in circulation decreased by 4.6 million (4.34 per cent) and 4.2 million (6.05 per cent) over the first half of 2012, while that of BGN 100 and BGN 50 by 0.90 per cent and 1.89 per cent respectively.

In annual terms (compared with end-June 2011), however, the number of BGN 50 and BGN 100 continued to grow faster than the remaining denominations in overall cash in circulation. The trend was crucial for the total nominal value growth of circulating cash.

[38] Law on the Bulgarian National Bank Article 2, paragraph 5.
[39] Banknotes and circulating and commemorative coins issued after 5 July 1999.

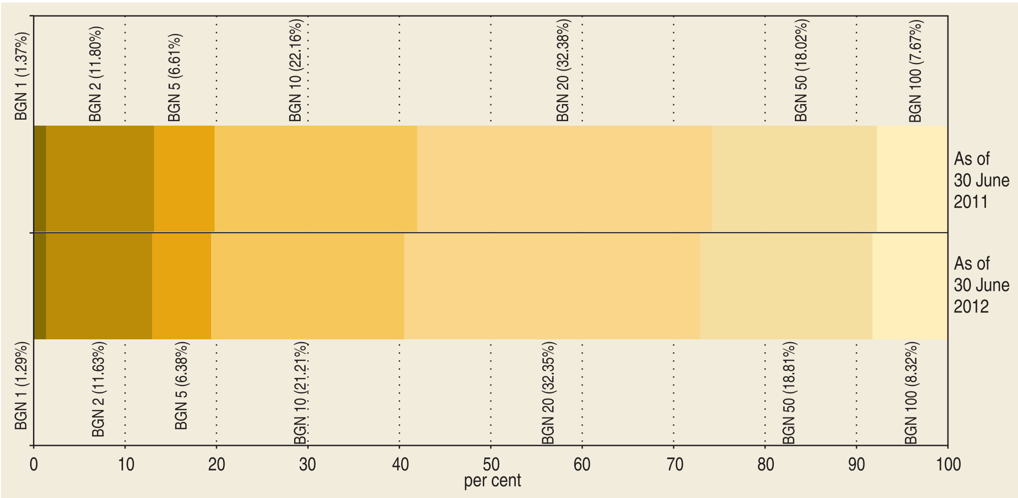
Developments in low-value banknotes of BGN 2 and BGN 5 were determined by their common use as means of payment, servicing the retail daily turnover, which was the factor behind their number variance in a very narrow range.

In a year (compared with end-June 2011) the number of circulating banknotes of BGN 50 and BGN 100 increased by 5.5 million (10.35 per cent) and 3.3 million (14.66 per cent) respectively. Over the same period the number of the other denominations in circulation also grew, with the BGN 20 banknote rising more significantly by 5.3 million in number or 5.59 per cent.

Banknotes of BGN 50 had the largest share in the value structure of denominations in circulation. By the end of June 2012, 58.4 million of these banknotes were in circulation, worth BGN 2918.0 million in nominal value (34.99 per cent of the value of all banknotes in circulation), followed by BGN 100 and BGN 20 banknotes whose shares comprised 30.95 per cent and 24.07 per cent respectively.

Denomination Composition of Circulating Banknotes

(share of total number)



Source: BNB.

By 30 June 2012 more than half of all circulating banknotes were BGN 10 and BGN 20 (53.56 per cent). By the end of the review period BGN 20 banknotes numbered 100.4 million and BGN 10 banknotes 65.8 million, or 32.35 per cent and 21.21 per cent of the total number of banknotes in circulation. They were followed by the BGN 100 and BGN 50 banknotes, whose shares came to 8.32 per cent and 18.81 per cent respectively.

The average value of banknotes in circulation as of 30 June 2012 was BGN 26.88. It increased by BGN 0.10 on late 2011 and by BGN 0.93 (3.58 per cent) on the end of June 2011, as a result of higher increase rates in the number of BGN 100 and BGN 50 banknotes in cash in circulation.

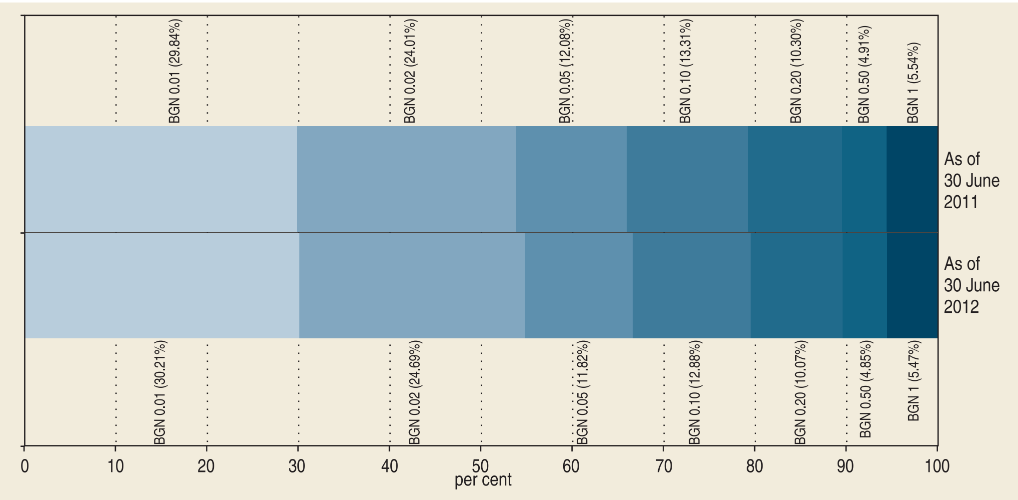
By the end of June 2012, 1413.7 million coins were in circulation, amounting to BGN 177.9 million. Since the start of 2012 coins outside BNB vaults grew by 44.0 million (3.22 per cent) in number and BGN 3.6 million (2.05 per cent) in value. Within a one-year horizon, circulating coins grew by 118.1 million (9.12 per cent), their value rising by BGN 12.5 million (7.58 per cent). By 30 June 2012 the share of circulating coins accounted for 2.09 per cent of the total value of banknotes and coins outside BNB vaults.

Changes in the structure of circulating coins followed its long-lasting downward trend in the share of high-value coins and the upward trend in that of low-value coins. Year-on-year shares of BGN 0.01 and BGN 0.02 coins in the total number of coins grew by 0.37 and 0.68 percentage points. The share of coins with the other nominal values decreased within the range of 0.06 and 0.43 percentage points compared with end-June 2011. By end-June 2012 the average coin in circulation matched its level of late 2011 at BGN 0.13.

Commemorative coins outside BNB vaults came to BGN 5.8 million, comprising 0.07 per cent of the value of cash in circulation.

Denomination Composition of Circulating Coins by Value

(share of total number)



Source: BNB.

Non-genuine Banknotes and Coins

In the first six months of 2012 the BNB National Analysis Centre retained 874 non-genuine Bulgarian banknotes having entered into circulation. The number of retained non-genuine banknotes fell by 47.44 per cent on the same period of 2011. The share of all retained non-genuine banknotes remained very low at 0.000282 per cent of total banknotes in circulation by end-June 2012.

The BGN 20 banknote had the largest share of all non-genuine banknotes reported in the first half of 2012 (51.60 per cent). By 30 June 2012 they comprised 0.000449 per cent of total circulating BGN 20 banknotes. The share of non-genuine BGN 10 banknote was 24.49 per cent, while that of BGN 50 occupied 21.28 per cent of total non-genuine banknotes registered in the first six months of the present year. Non-genuine BGN 2, BGN 5, and BGN 100 banknotes numbered 23 (2.63 per cent of all retained non-genuine banknotes). Non-genuine Bulgarian coins numbered 442: 388 of BGN 0.50 nominal value and 54 of BGN 1 nominal value. The share of retained non-genuine Bulgarian coins in the total number of circulating coins by 30 June 2012 was 0.00003 per cent.

As regards foreign banknotes and coins retained within Bulgaria, in 2012 the National Analysis Centre also retained 823 euro banknotes, 740 US dollar banknotes, and 66 assorted foreign non-genuine banknotes.

BNB Issue and Cash Activities

BNB issue and cash operations include printing banknotes and minting coins; accepting, delivering, repaying, processing, authenticity and fitness checking of banknotes and foreign currency; exchanging damaged cash; and destroying unfit Bulgarian banknotes and coins.

Between January and June 2012, 10 million new banknotes of BGN 10 nominal value and 55 million new coins, of which 30 million coins of BGN 0.02 nominal value and 25 million coins of BGN 0.01 nominal value, were supplied under contracts with producers. The total nominal value of supplied circulating cash amounted to BGN 100.9 million. In the first half year the Bank launched three commemorative coins planned in its 2012 minting programme under the Law on the BNB Article 25, paragraph 1.[40]

Banknote and coin deposits and withdrawals from the BNB totalled BGN 12,881.3 million in the first half of 2012. Banks deposited Bulgarian banknotes and circulating coins worth BGN 6543.4 million with the BNB, up BGN 890.1 million or 15.75 per cent on the same period of 2011. Banknotes and coins withdrawn from the BNB in the first six

[40] For information on new banknote, circulating, and commemorative coin issues, see the BNB website.

months of 2012 totalled BGN 6337.9 million, up BGN 1199.0 million or 23.33 per cent on the corresponding period of 2011.

Between January and June 2012 sorting machines at the BNB and Cash Services Company[41] tested 364.4 million banknotes and 86.5 million circulating coins. Compared with the same period of 2011, the number of processed banknotes increased by 14.96 per cent, while that of processed circulating coins by 22.70 per cent. BGN 10 and BGN 20 banknotes and BGN 0.10, BGN 0.20 and BGN 1 coins were most frequently processed in the nominal value structure.

Following machine processing and fitness checks, the retained unfit banknotes numbered 42.9 million, up 5.9 million or 16.07 per cent on the same period of 2011. In the first half of 2012 banknotes of BGN 2, 10 and 20 had the largest shares (21.06 per cent, 26.28 per cent and 26.65 per cent respectively) of all banknotes retained as unfit for circulation.

The retained unfit coins in fitness sorting numbered 443.3 thousand, up 5.9 million or 16.07 per cent on the same period of 2011.

Over the review period BNB reserve currency purchases came to EUR 0.15 million, including EUR 0.07 million from budget organisations and EUR 0.08 million from individuals. Over the same period BNB reserve currency sales were EUR 5.5 million, including EUR 3.6 million to budget organisations and EUR 1.9 million to individuals.

In order to achieve its objectives to ensure the integrity and security of cash circulation, in the first half of 2012 the BNB performed three full and 16 spot on-site checks at banks and service providers to ensure compliance with the regulatory framework requirements for cash handling and banknote recycling. This involved checks into how credit institutions and service providers which handle cash professionally follow the cash handling procedures, as well as functionality checks of their sorting and/or customer-operated machines.

[41] Cash Services Company is a joint-stock company for handling cash and a service supplier within the meaning of BNB Ordinance No 18, whose shareholders are the BNB and four commercial banks.

VI. Maintaining Banking System Stability

1. State of the Banking System

In the first half of 2012 credit institutions in Bulgaria continued to operate in an adverse economic environment. Limited credit demand, growing attracted funds due to households' continuing strong propensity to save, and a still-limited range of financial services on offer defined the major parameters of banking sector development.

Credit risk dominated banking's balance sheet. The corporate segment contributed most to the rise in non-performing loans in the first six months of the year. The increase in household loans overdue over 90 days reflected both the continuing trend towards a worsening of consumer and mortgage loans, and weak demand for such loans. The dynamics and sharpness of credit risk continued to exert pressure on banks' return and equity.

Banks achieved better financial results than in the first half of 2011, though some banks reported a slight decline in returns on assets and equity. Net interest margins narrowed because of a number of factors like declining interest income from classified loans, slow credit growth, and rising interest payments on attracted resources. Impairment costs also rose, though slower than in the same period of 2011.

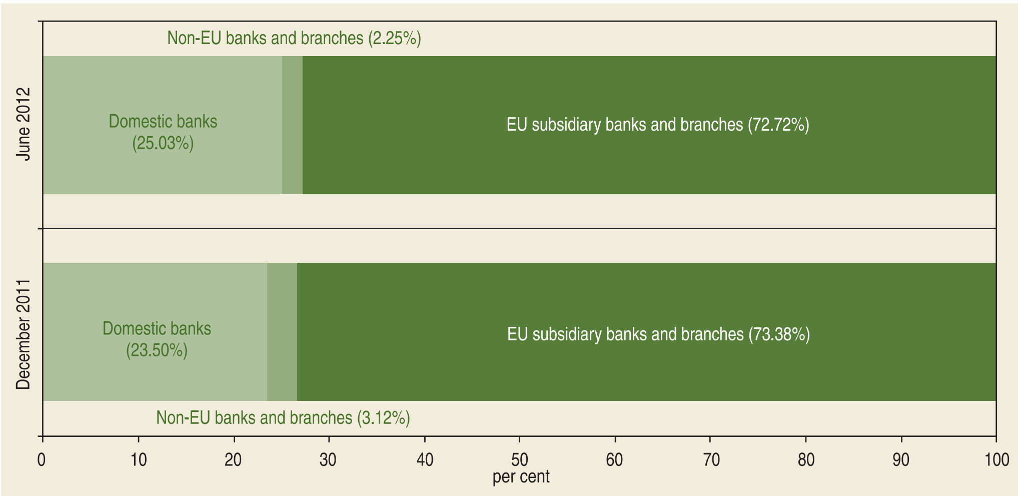
Overall, credit institutions maintained their capital buffers and capacities to grow. Weaker financial results, rising impairment costs, and specific credit risk provisions at some banks, however, limited their ability to support capital from internal sources.

Additional supervisory measures and management decisions kept banking's liquidity position adequate to balance sheet structure and liability maturity and concentrations.

Structural Changes in the Banks' Balance Sheet

By 30 June 2012 banking system assets reached BGN 79.4 billion: 3.5 per cent (BGN 2.7 billion) more than at the end of 2011. Annual growth was 5.9 per cent (BGN 4.4 billion) against 5.6 per cent (BGN 3.9 billion) between June 2010 and June 2011.

Market Shares of Domestic and Foreign Banks by Asset



Source: BNB.

The five largest banks retained the 51.7 per cent market share they had at the end of 2011. Small and medium banks' market share fell marginally to 43.2 per cent in favour of foreign bank branches which now hold 5.1 per cent of banks' assets. Banks with mainly Bulgarian equity attracted more resources, boosting their market share to 25 per cent.[42] Falling assets at banks with Greek equity cut the market share of EU subsidiary banks to 68.5 per cent by the end of June 2012. The share of banks and branches from outside the EU declined slightly to 2.3 per cent, while that of EU bank branches rose to 4.2 per cent.

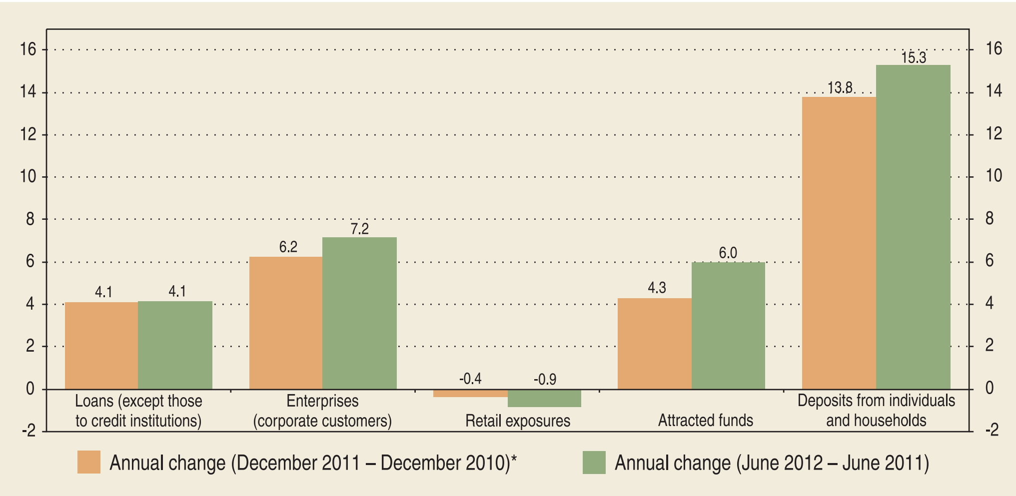
Major balance sheet aggregates changed little. Increased placements with other credit institutions and increasing loan impairment cut the share of loans (excluding those to credit institutions) in assets from 67.7 to 66.1 per cent in the six months to 30 June 2012. The BGN 610 million increase in placements with credit institutions boosted their share to 11.2 per cent. Securities grew BGN 755 million or 12.7 per cent, and cash BGN 550 million, their shares rising to 8.4 and 10.3 per cent in their balance sheet assets. Foreign debt securities grew faster but Bulgarian government securities continued dominating banks' portfolios at over two thirds of the total. Resident individual and household deposits continued to be a major source of finance retaining its early year's level at 80.8 per cent. On an annual basis, the share of attracted funds in euro fell, while those in levs and other currencies rose.

Lending

Credit demand remained low. By the end of June the gross amount of loans (excluding ones to credit institutions) was BGN 56.8 billion, their BGN 782 million or 1.4 per cent growth matching that of the first half of 2011. This was because of BGN 1031 million of growth in the corporate segment; retail exposures fell BGN 77 million. Growth in corporate credit was through small and medium banks which increased their market share to 46 per cent. They also disbursed more consumer loans and mortgages. Overall, however, housing mortgage lending fell 0.2 per cent and consumer credit 0.7 per cent. Over a year, mortgage lending stayed static, consumer credit falling 1.8 per cent. With credit demand still low, institutions invested 7.3 per cent more attracted resources into claims on other institutions. The currency composition of loans and advances showed a 61.8 per cent rise in the share of euro exposures and 33.5 and 4.7 per cent falls in lev and other currency exposures.

Dynamics of Selected Financial Indicators

(per cent)



* Audited annual data.

Source: BNB.

Attracted Funds

Attracted funds grew BGN 2428 million or double their increase in the first half of 2012. Individuals and households deposited about half the funds attracted by banks to the end of June 2012. Individual and household deposits grew BGN 1878 million (5.9 per cent), while those from institutions other than credit fell 0.4 per cent on the end of 2011. Between January and June resources from credit institutions increased BGN 603 mil-

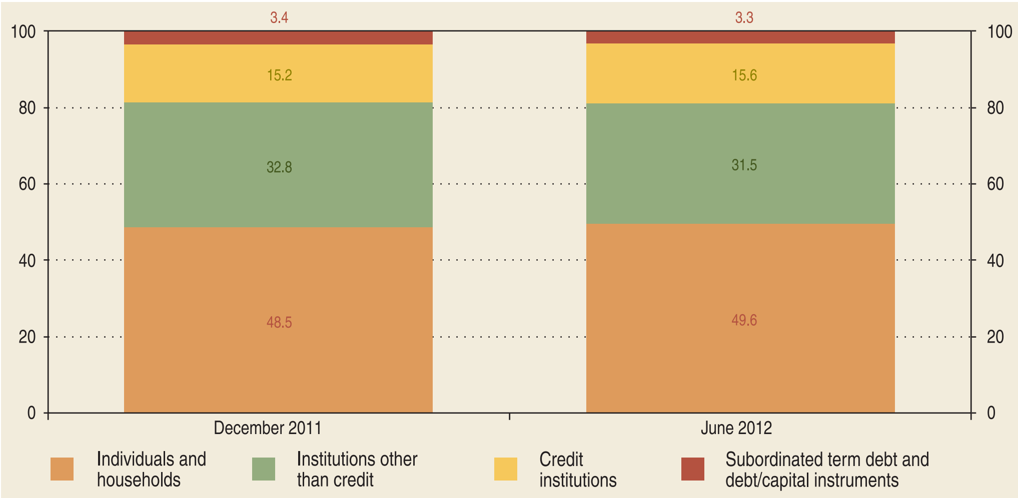
[42] The higher share of domestic banks also reflects the Bulgarian American Credit Bank AD moving to this group in early 2012 following ownership changes.

lion (6 per cent), down BGN 1577 million (12.9 per cent) on June 2011 at the expense of non-resident institutions.

The currency structure of attracted funds reflected growing household deposits: the lev component reached 45.8 per cent from 43.1 per cent at the end of June 2011. The share of the euro fell to 47 per cent, while other currencies rose to 7.2 per cent.

Structure of Attracted Funds

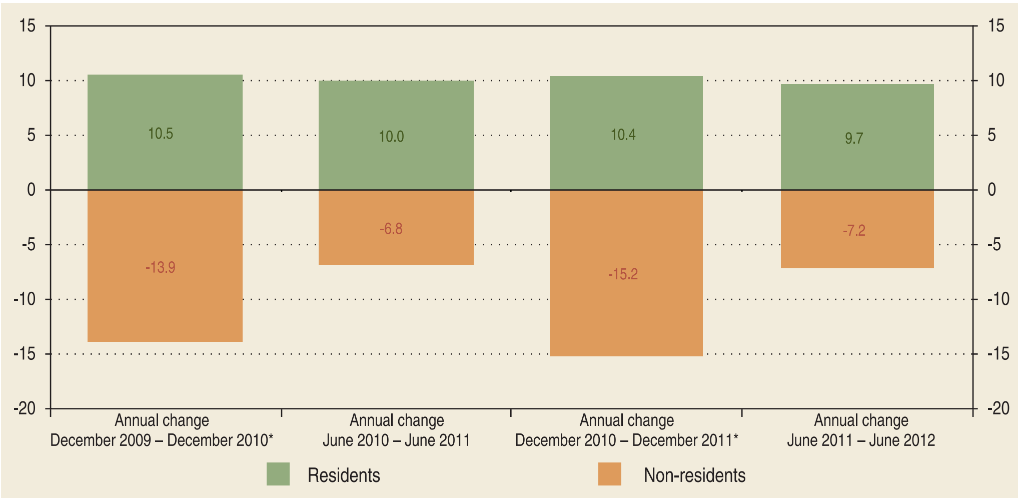
(per cent)



Source: BNB.

Dynamics of Funds Attracted from Residents and Non-Residents

(per cent)



* Audited annual data.

Source: BNB.

Balance Sheet Equity

Banking system balance sheet equity continued rising, by BGN 213 million or 2.1 per cent on the end of 2011 and BGN 540 million or 5.4 per cent on an annual basis. Issued capital picked up BGN 26 million and reserves (including retained profits) BGN 335 million. Other components changed little.

System Risk Profile

Banking system risk profile reflected Bulgaria's economic performance:

- growing credit risk sharpness prompting a continuing decrease in the share of standard loans;
- the continuing effect of factors constraining banking profitability;
- difficulties in placing credit resources in the volumes and sectoral diversity which would be sufficient to offset reduced interest income from extended loans;

- a continuing decline in investment opportunities for placing growing attracted funds into profitable, low risk instruments.

Despite this, measures by the BNB and banks maintained capital and liquid buffers, and profitability was able to support banks' capital if necessary.

Asset Quality

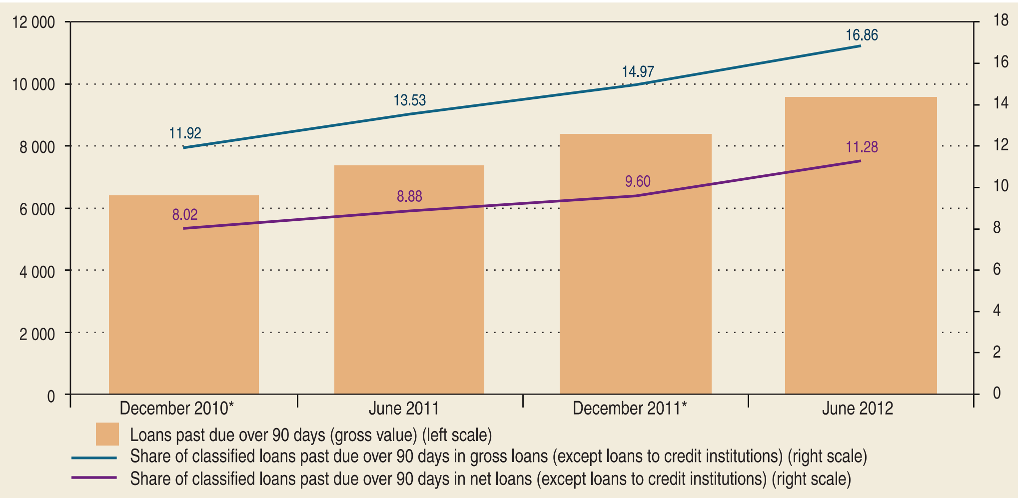
Asset risk continued rising in the first half of 2012, entirely due to individual credit institutions' credit portfolios. The annual growth rate of classified loans slowed to 13.7 per cent from 30.6 per cent in the year to June 2011. Problematic corporate loans increased, while retail exposures exhibited divergent dynamics. The classified portion of corporate loans increased 7.1 per cent. A smaller share of housing loans was classified than in the same period of 2011. The classified portion of consumer loans[43] fell for the first time, reflecting also the selling of worsened loan portfolios by some banks.

The share of loans overdue over 90 days grew at unchanged rates. By the end of June their share in the total credit portfolio reached 16.9 per cent from 15 per cent at the end of 2011. The sectoral split of overdue loans confirms a trend observed in prior periods: construction and real estate operations deteriorated worst of the ten sectors which occupy just over three quarters of the gross credit portfolio. Households continued to find it hard to service mortgage loans whose portion overdue over 90 days remained higher than that of consumer loans.

The indicator reporting only the unsecured portion of worsened loans (non-performing loans over 90 days to net loans:[44] the ratio of the gross amount of loans less impairment costs) remained considerably lower (11.3 per cent) than the gross ratio.

Classified Loans Past Due over 90 Days

(BGN million) (per cent)



* Audited annual data.

Source: BNB.

Banks preserved the quality of provisioning standards, with total provisions and impairments covering 67.4 per cent of loans overdue over 90 days.

Profitability

Low credit demand and the continuing worsening of credit portfolios constrained banking profitability. Despite the gradual fall in the cost of funding, the continuing growth of attracted funds boosted interest disbursement compared with income. Banking sector gains came to BGN 323 million, an increase by BGN 8 million (2.7 per cent) on those by 30 June 2011. Return on assets (ROA) at 0.83 per cent was similar to the 0.85 per cent of a year earlier. Return on balance sheet equity and reserves (ROE) fell slightly from 6.68 to 6.49 per cent due to the equity increase. Despite lower impairment costs

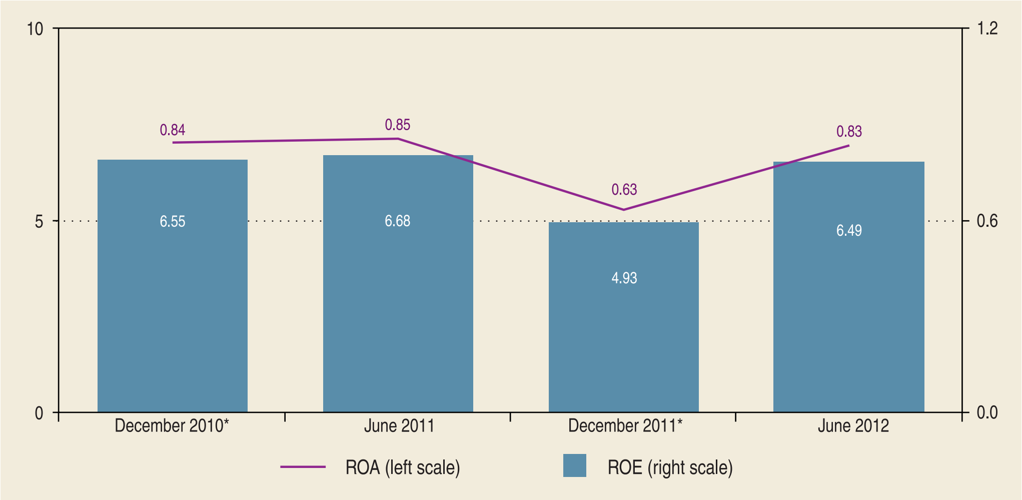
[43] Between June 2011 and June 2012 the classified portion of consumer loans went down 2.1 per cent, falling 5.7 per cent in the first half of 2012.

[44] The non-performing loans (over 90 days) to credit portfolio indicator reports the gross value of loans, including risk already reported in the income statement through impairment costs.

of BGN 542 million compared with the BGN 625 million of the same period in 2011, they continued to engage significant portions of individual credit institutions' incomes.

Return on Assets and Return on Equity

(per cent) (per cent)



* Audited annual data.

Source: BNB.

Equity

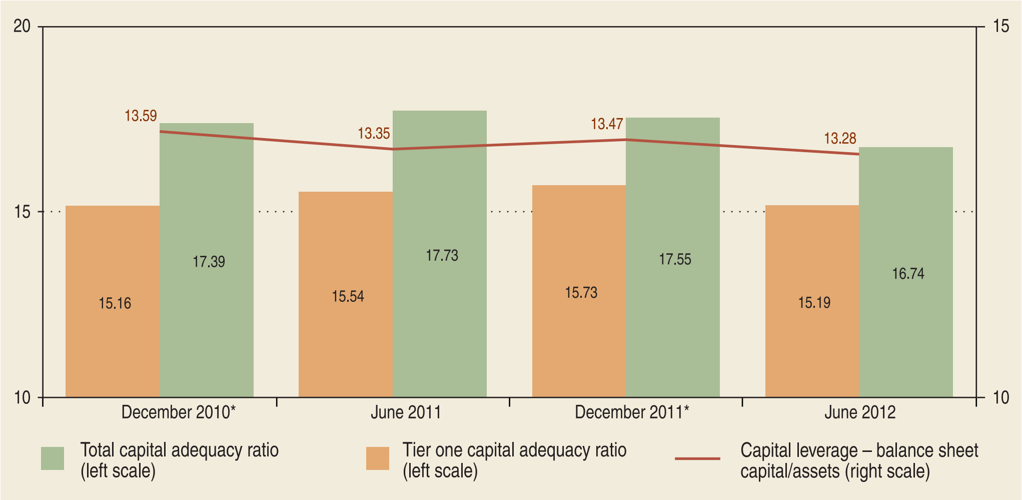
Banking system capital base and tier one capital remained significantly above regulation levels. Capital adequacy remained also a function of supervisory recommendations and management action. Though banking system capital surplus decreased to BGN 2.6 billion, it allows bank asset growth and remains a reliable buffer against adversity. Between January and June 2012 capital requirements rose 2.8 per cent mainly because of credit growth. Equity fell 1.9 per cent because of additional specific provisions and rising capital commitments. Banking's total capital adequacy reached 16.74 per cent by the close of June, with primary capital adequacy at 15.19 per cent.

Despite the slight trend change, banking system leverage (balance sheet equity/assets) remained above EU averages.

Primary capital – of the highest quality in the structure of banking's own funds (tier one capital/capital base) – continued increasing. By the end of June tier one capital comprised 90.7 per cent of the capital base, and the number of banks with 100 per cent ratios increased to twelve.

Selected Capital Indicators

(per cent)



* Audited annual data.

Source: BNB.

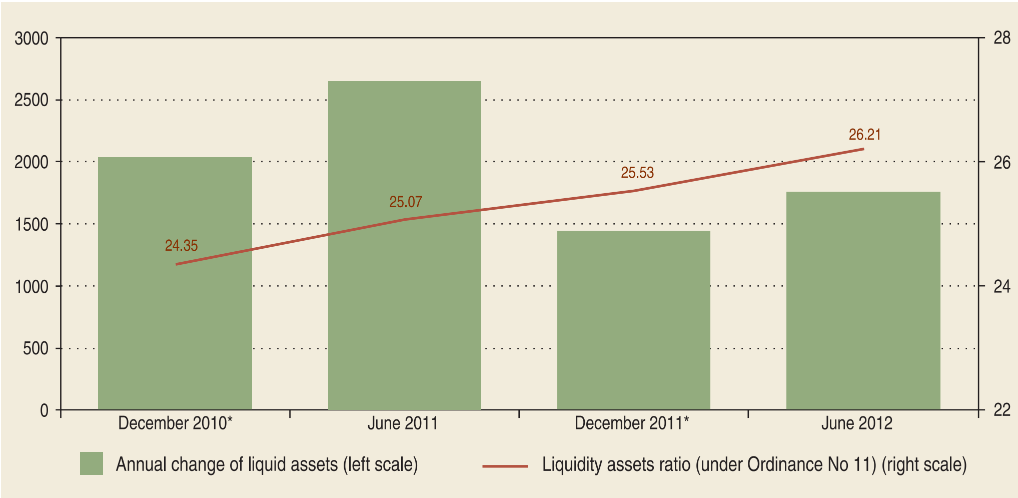
Capital requirements by risk (credit, market, and operational) did not change greatly. By the end of June credit risk accounted for 58.3 per cent, operational 7.8 per cent, and positioning, foreign currency and commodity risk 0.6 per cent of total capital requirements. In the review period 87.9 per cent of credit risk capital requirements was assessed based on the standard approach and 12.1 per cent on the Internal Ratings Based Approach.

Liquidity

Banking system and individual credit institutions' liquidity continued growing. Banks observed additional supervisory requirements for enhanced liquidity to cover attracted funds adequately with liquid assets. The liquid assets ratio for the half year exceeded 25.7 per cent, reaching 26.21 per cent at the end of June.

Selected Liquidity Indicators

(BGN million) (per cent)



* Audited annual data.

Source: BNB.

The faster six-month growth of liquid assets compared with attracted funds was mostly because cash, the most liquid component, grew BGN 550 million. Low-risk marketable debt issued by governments or central banks contributed significantly at BGN 342 million. Bulgarian government securities went up BGN 157 million and cash on current accounts with banks and interbank deposits of up to seven days, BGN 57 million. Within the structure of liquid assets, the share of cash rose to 45.5 per cent, while balances on current accounts with banks and interbank deposits up to seven days fell to 37.7 per cent.

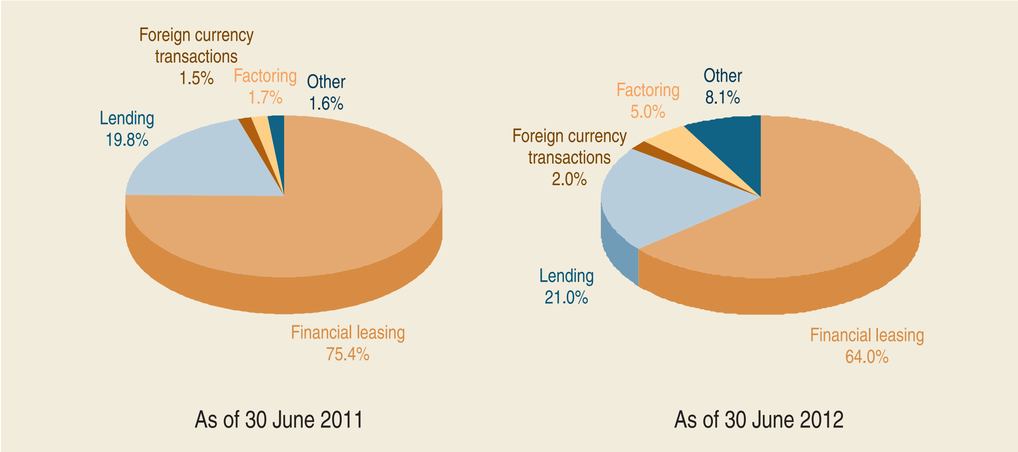
2. Financial Institutions under the Law on Credit Institutions Article 3, Paragraph 4

By 30 June 2012, 280 financial institutions had registered to operate mostly in financial leasing (73 companies) and lending own funds (101 companies).[45] Their assets totalled BGN 6.7 billion or 2.6 per cent down on the end of 2011. The balance sheet figure of the 20 largest financial institutions was BGN 4.6 billion, of which BGN 3.7 billion with lessors.[46] The expansion of lending financial institutions' operations boosted their market share to 21 per cent from 19.7 per cent at the end of 2011, at the expense of leasing companies (64 per cent from 66 per cent in December 2011).

[45] Over the review period nine institutions deregistered, bringing the number of deletions to 18.

[46] By the end of June the assets of the 20 largest institutions (mostly subsidiaries of foreign credit institutions) comprised 68 per cent of all assets, against 70.2 per cent in 2011.

Asset Shares at Financial Institution Groups under the Law on Credit Institutions Article 3, Paragraph 2

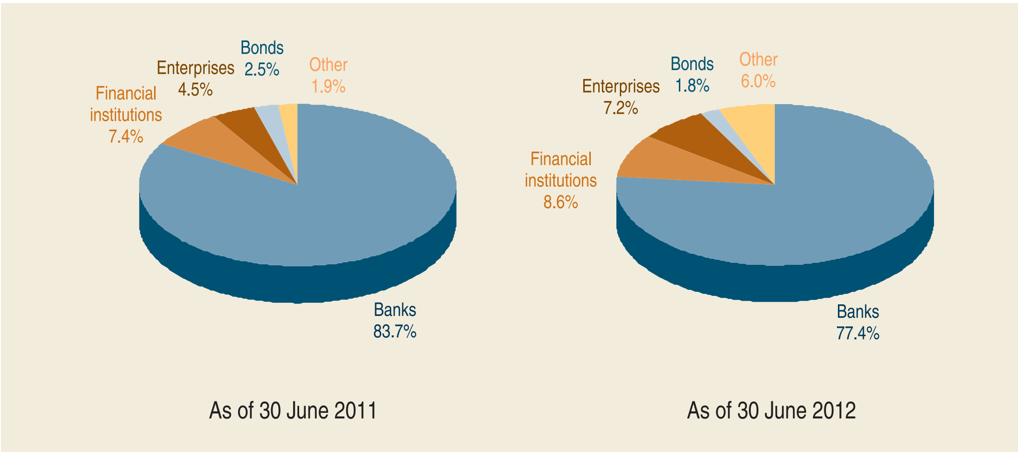


Source: BNB.

Loans and receivables (including financial leasing) again dominated the asset structure at BGN 5 billion (75 per cent), with euro-denominated receivables at 59 per cent comprising the largest share.[47]

Loan quality (including financial leasing) continued to worsen. Gross impaired loans (including financial leasing) amounted to BGN 2.6 billion (47.6 per cent) of the BGN 5.6 billion gross credit portfolio of registered companies. Over half (51.8 per cent) of classified loans (including financial leasing) were overdue over 90 days, followed by ones overdue because of deteriorated finances and other reasons (29.8 per cent). The share of impaired receivables remained largest at 70.4 per cent in financial leasing. Asset impairment costs of BGN 867 million in June 2012 were 9.4 per cent higher than the BGN 785 million in the same period of last year.

Sources of Funds Attracted by Financial Institutions under the Law on Credit Institutions Article 3, Paragraph 2



Source: BNB.

By the end of June the financial companies had attracted BGN 5.3 billion of funds, down 4.5 per cent on the end of 2011. Euro resources comprised 78 per cent of this. Banks (mostly foreign ones) remained the major source of finance, providing BGN 4 billion or 77.4 per cent of it. Obligations to other financial institutions (8.6 per cent) and international programmes (6 per cent) both rose.

[47] In June 2011 euro-denominated receivables comprised 65 per cent.

Profits were BGN 92.5 million, up 47.5 per cent on the BGN 48.5 million for the same period last year. All was from lending (67 per cent) and interest acquisitions (24 per cent). The efficiency ratio improved because net income from operations grew faster than administrative spending. By the end of the first half-year return on assets and return on equity rose 2.75 and 16 per cent on the 1.55 and 11.07 per cent a year earlier.

Financial institutions' equity rose 24 per cent to BGN 1.1 billion in a year.

3. Banking Supervision

Supervisory Policy

Between January and June 2012 supervision focused on the coming implementation of an improved regulatory framework in full concert with EU developments. This aims to strengthen banks' capital positions, improve liquidity management, and help overcome the financial crisis.

The BNB continued issuing instructions and recommendations for reliable and effective banking enforcing consistent harmonisation in particular areas. This involved publishing Guidelines on Operational Risk Management in Market Operations to relevant European Banking Authority (EBA) guidelines.

The Bank collected aggregate information from banks under its commitment to report on progress towards European Systemic Risk Board (ESRB) recommendations on lending in foreign currency and the US dollar denominated financing of EBO and ESRB credit institutions.

Credit Institutions Supervision

Supervisory reviewing and reporting of and on bank operations remained intense and efficient. Banks reported performance regularly for monthly analyses. Their individual risk profiles and financial performance emerged from such analyses and periodical onsite inspections. Reviews of regular reports based on quantitative financial ratios and indicators provided assessment information and indicated changes in performance, risk profile, and solvency. Offsite supervisory reviews and assessments prompted onsite inspections of risk management and highlighted underestimated risks and threats to solvency.

Between January and June 2012 onsite inspections focused on credit, liquidity, and operational risk management and controls, concentration risk, and credit institutions capacity to generate profit. Such inspections resulted in final assessments of individual institutions' capital adequacy and potential threats to equity integrity. They also looked at how some of the largest banks analysed capital adequacy internally. There were 14 supervisory inspections in the first half of 2012. The comprehensive supervisory review suggests that banks maintained solvency above regulatory minima, had high liquidity, and managed credit risk in line with economic conditions. The 180 formal regulatory violations resulted in 150 recommendations to institutions' management and control bodies.

Macroprudential Analyses and Strategies

Work here continued to focus on banking risk dynamics. Continuous monitoring and analysis of banking system financial parameters suggested timely diagnostics and the right tools for preventing any sharpening of systemic risks. Obtaining timely and adequate information on the degree of banking system risk was a priority. Active communication with credit institutions, particularly on risk analysis and business forecasting, improved macrostrategy precision and banking trend assessment. There were studies of expected performance and credit risk management to the end of 2012. Current financial reporting for supervisory purposes supplemented information from institutions and included major business plan parameters like assets, attracted funds, and capital. Information on individual parameters like lending and financing and on risk areas like loan quality and capital support provided more detail on expected results for 2012 and measures to tackle diverse risks in balance sheets.

Periodic stress testing helped assess banking sector sustainability and the ability of individual institutions to withstand varying acuities and scopes of shocks.

The quarterly *Banks in Bulgaria* advised the public on banking sector developments. Monthly press releases on the state of banking supplemented the wide range of financial supervisory data published by the BNB on paper and electronically.

Special Supervision

Special supervision monitors the stability and transparency of banks' shareholder structures. Continuous monitoring of shareholders' financial status helped assess their ability to support capital where necessary. There were no breaches of good banking practice on equity holder structure, transparency and clarity, and proved fund origins.

Significant attention fell on money laundering, terrorist financing, and financial fraud with the publication of additional *Guidelines on Implementing Prevention Systems Against the Risk of Money Laundering*. Banks applied generally effective policies and procedures to prevent transferring funds of unclear and/or criminal nature.

The half-year saw close cooperation with bodies fighting fraud and money laundering. There were measures, discussions, and information exchanges on cross-border financial crimes. Active partnership with competent institutions made the fight against the use of the banking system for transferring criminal funds more effective.

The National Strategy to *Counteract Money Laundering in the Republic of Bulgaria between 2011 and 2015* saw consistent implementation. A schedule and special actions addressed national risk assessment, establishing coordination and cooperation units for counteracting money laundering, and legislative changes to be made in the long run.

To promote good corporate management compliant with legal requirements, supervisors helped improve individual banks' practice through publicising examples of good and bad banking practice.

Credit and financial institutions' market behaviour was continuously monitored under Regulation (EU) No 1093/2010 of the European Parliament and of the Council. Supervision aimed to improve market discipline and service quality, boost confidence in bank products and services, improve communication between market participants, minimise risks for users amid changing conditions, and raise financial culture.

Regular registration of entities conducting financial institution operations continued, with lenders and financial leasing companies leading. Continuous target reviews of the conditions and features attached to products and services offered by financial institutions provided the public with clear, relevant, and precise information on all attendant costs.

Supervisory Administration, Licensing, and Permits

There were no new credit institution licensing procedures in the first half of 2012.

There were no significant changes in banks' shareholder structure. CSIF AD, the previous qualified shareholder in the Bulgarian American Credit Bank AD, was cleared to assume control of the bank through acquiring over half its voting shares. The TBI Bank EAD and the Bulgarian American Credit Bank AD broadened operations by providing the full range of payment services.

Capital instruments remained at the centre of banks' attention. The First Investment Bank AD issued bonds, a demand capital instrument by whose lev equivalent its tier-one capital rose. The Corporate Commercial Bank AD increased its tier two capital by attracting subordinated term debt. The Allianz Bank Bulgaria AD and the TBI Bank EAD repaid subordinated term debts early.

There were no substantial changes to institutions' management bodies. The Bank cleared changes in the management bodies of the Allianz Bank Bulgaria, the TBI Bank, and the UniCredit Bulbank.

The supervisory bodies of six EU Member State credit institutions notified the BNB of intent to provide transborder services in Bulgaria. This brings the number of such institutions to 202. No new foreign bank branches from EU Member States opened. There were two procedures to notify EU Member State supervisors of intent by banks headquartered in Bulgaria to open branches abroad: the Central Cooperative Bank AD in the United Kingdom and the TBI Bank in Romania. The Regional Investment Bank of Latvia prepared to close its Bulgarian branch.

In the first half of 2012 a domestic bank was instructed to improve its credit, operational, and market risk management and its liquidity and internal control systems. The complex political and financial situation in Greece prompted a recommendation that domestic banks, subsidiaries, and branches of institutions headquartered in Greece should keep higher than usual amounts of high liquid assets in a limited set of elements. Other recommendations aimed to restrain investment into debt instruments issued by entities with credit ratings lower than investment, and to ensure information system independence. These banks also had to report leading liquidity indicators daily. After a majority shareholder restored control over a small domestic bank, constraints imposed in 2007 on its operations were lifted.

BNB supervisory powers under the Law on the BNB aim to maintain banking system stability and protect depositor interests and do not cover protection of consumers of financial services. The BNB continued receiving complaints from banks and financial institution customers. Since most fell within the purview of the Consumer Protection Commission, the BNB passed them onto that Commission.

VII. The Central Credit Register

The Central Credit Register (CCR) provides information on customers' debt to banks, financial institutions, payment institutions, and electronic money institutions in Bulgaria. Ordinance No 22 of the BNB of 16 July 2009 governs the CCR and information flows to and from it.

Amendments to Article 56 of the Law on Credit Institutions in late 2011 triggered changes to Ordinance No 22. Alongside banks, foreign bank branches, and financial institutions (Articles 2 and 3), under Article 4 the CCR now covers payment institutions and electronic money institutions which lend in connection with payment services under Article 19 of the Law on Payment Services and Payment Systems. This improves CCR user information and facilitates credit risk analyses and assessments. CCR information will extend the basis for computing set banking and financial system indicators.

All loans by financial institutions under Article 4 of Ordinance No 22, irrespective of amount, are reported to the CCR. Loans to government and the Bulgarian National Bank are not subject to reporting, as well as agreed overdrafts under BGN 1000 classified as standard under BNB Ordinance No 9 on the Evaluation and Classification of Risk Exposures of Banks and Allocation of Specific Provisions for Credit Risk.

Over the first half of 2012, 13 new financial institutions entered the CCR information system under Ordinance No 22. The amended Ordinance includes 166 of the 193 financial institutions in the public register under Ordinance No 26 and Article 56 of the Law on Credit Institutions, plus two branches of EU Member State banks. Four financial institutions left the register under Article 9 of BNB Ordinance No 26 due to termination of operations and deletion from the Banking Supervision Department public register. The process of expanding the Central Credit Register under Article 4 continued after 30 June 2012 with inclusion of payment institutions and electronic money institutions.

By 30 June 2012 the CCR listed 4,050,776 loans (3,958,074 by 30 June 2011), with balance sheet exposure increasing to BGN 61,793 million (BGN 58,110 million by 30 June 2011). There were 2,106,357 borrowers in the Register: 1,997,289 individuals, 7471 self-employed people, 98,371 legal entities, and 3226 foreigners.

Financial institutions under Article 4 of Ordinance No 22 get CCR information including borrower and loan service history. Debt information includes status and arrears on current and extinguished loans for five years back, enabling timely analysis and preventive measures in lending.

In the first half of 2012 banks and financial institutions made 2,366,000 digital certificate searches on 1,756,000 individuals and 610,000 legal entities. This was some 262,000 more than the 2,104,000 searches in the same period of 2011. The average monthly number of searches in the first half of 2012 was 394,000.

Articles 21 and 22 of Ordinance No 22 govern information disclosure on individual and legal entity debt, including that of heirs and deceased persons. Access involves applying and settling a published fee. In the first half-year there were 3146 applications for statements: 3047 from individuals and 99 from legal entities *vis-à-vis* 2945 in the same period of 2011.

VIII. The Fiscal Agent and State Depository Function

The Bulgarian National Bank acts as the fiscal agent and official depository of the state under the Law on the BNB. Under contracts negotiated with the Ministry of Finance to market conditions and prices, the Bank submits statements of budget entities' domestic bank accounts to the Ministry and acts as government debt agent.

The Bank's duties include maintaining and developing the GSAS system for conducting government securities auctions, the ESROT electronic system for registering and servicing government securities trading, the SDTK system for government securities settlement, the Register of Special Pledges, the AS ROAD automated system for registering and servicing external debt and the IOBFR system for budget and fiscal reserve information servicing.

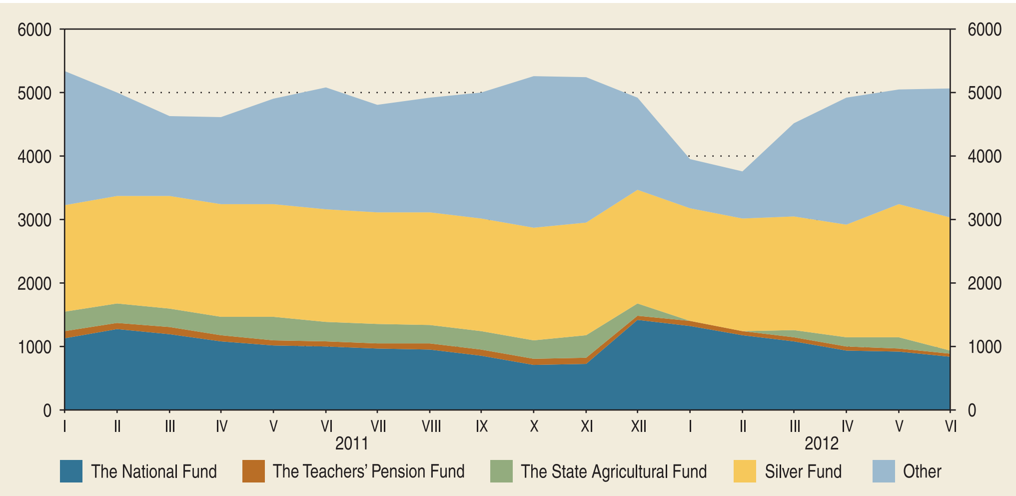
In the first half of 2012 revenue from BNB agency function fees and commissions was BGN 889,000, an increase of 12.6 per cent on the prior year. This was mainly due to higher fees and commissions from processing documents on participation in auctions, and government securities registration and settlement in the primary market and on issue maturities.

Information Service

BNB obligations related to state budget information servicing under the agreement with the MF involved collecting daily and periodical data on operations and balances on budget, extra budgetary, deposit, foreign currency, and letter-of-credit accounts of budget entities (municipalities included) in levs and foreign currency with the BNB and other banks in Bulgaria for submission to the MF *via* the IOBFR system for budget and fiscal reserve information servicing. In addition, the Bank performed daily monitoring on behalf of the MF on security pledged by banks under the State Budget Law and compared it with reported balances.

Fiscal Reserve Structure

(BGN million)



Sources: MF, BNB.

By 30 June 2012, the number of budget servicing banks (including the BNB) with access to the IOBFR was 22 (21 in the previous year). Based on summarised information, at the end of the review period the total balances on budget entities' accounts came to BGN 6394.8 million,[48] up BGN 130 million on 30 June 2011. Of them, 74 per cent was on

[48] Balances on foreign currency accounts are recalculated in levs at the BNB exchange rate for the relevant currency on 30 June 2012.

accounts with the BNB and the rest with domestic banks. Account balances decreased 4.8 per cent on the same period of the prior year, reflecting mainly a decline in MF National Fund account balances. By the end of the review period, some 60 per cent of balances on budget entities' accounts were still held by the same five banks as in the first half of 2011.

Approximately 80 per cent of budget funds was on bank accounts included in the fiscal reserve.[49] On 30 June 2012 this came to BGN 5061.8 million, of which BGN 3022.7 million on State Fund for Guaranteeing the Stability of the State Pension System (Silver Fund), the MF National Fund, the Agricultural State Fund,[50] and the Teachers' Pension Fund accounts. A year earlier, budget balances on fiscal reserve accounts amounted to BGN 5072.8 million, of which BGN 3151.2 million on the accounts of the Silver Fund, MF National Fund, the Agricultural State Fund and the Teachers' Pension Fund.

In the first half of 2012 the AS ROAD system continued to maintain up-to-date information on the Bulgarian government's foreign financial obligations, on which the BNB acted as calculating and paying agent. After MF advice, the second tranche of the credit agreement between the Bulgarian government and the European Investment Bank to the amount of EUR 82.4 million was registered over the review period. At the same time, 18 regular payments of EUR 133.1 million were effected after coordination with the MF[51], comprising EUR 26.6 million principal and EUR 106.5 million interest. All records made by 30 June 2012 show that obligations registered in AS ROAD were EUR 2517.5 million[52] *vis-à-vis* EUR 2372.6 million by 30 June 2011. Structurally, euro-denominated debt continued to occupy the largest share (64.7 per cent), followed by USD-denominated debt (34.3 per cent), and JPY-denominated debt (1.0 per cent).

Servicing Government Securities Trading

In the first half of 2012 there were 16 MF-scheduled monthly auctions[53] for government securities against payment, as in the same period of 2011. The auctions offered seven medium and long-term issues with a fixed interest rate and average residual term to maturity of five years three months and twenty days. The early 2012 two-year lev-denominated issue had most openings (four) and the shortest maturity among the issues sold over the review period.

The total nominal value of government securities offered by the MF was BGN 826.8 million, up BGN 329.5 million on the same period in the prior year.[54] Of this, over 43 per cent (BGN 361.8 million) was denominated in euro, sold in the first quarter. Overall, the volume of auction bids by primary dealers exceeded supply, with the average bid-to-cover ratio comprising 2.4, a decrease on the first half of the prior year (2.84). At one auction, the ratio was below unity (0.95). The average primary dealer bids *per* auction increased to 89 from 82 in the first half of 2011, reflecting mainly greater demand by more investors. The total nominal value of bids by non-bank institutions (BGN 763.1 million, including the lev equivalent of EUR 179.7 million) more than doubled on the first quarter of 2011 (BGN 362.9 million). Pension funds were among most active investors with a share of 17.7 per cent of bids over the review period, followed by the National Insurance Institute (5.1 per cent), the Deposit Insurance Fund (4.9 per cent), and insurance companies (4.8 per cent). The volume of bank bids also rose, though their share in total bids fell from 74.3 per cent in the same period of 2011 to 62.1 per cent.

Though demand exceeded supply, the MF decision to approve the auction results led to sales of only 88.8 per cent or BGN 733.8 million (including the lev equivalent of EUR 134.5 million) of all government securities offered. More than half were acquired by non-bank institutions.

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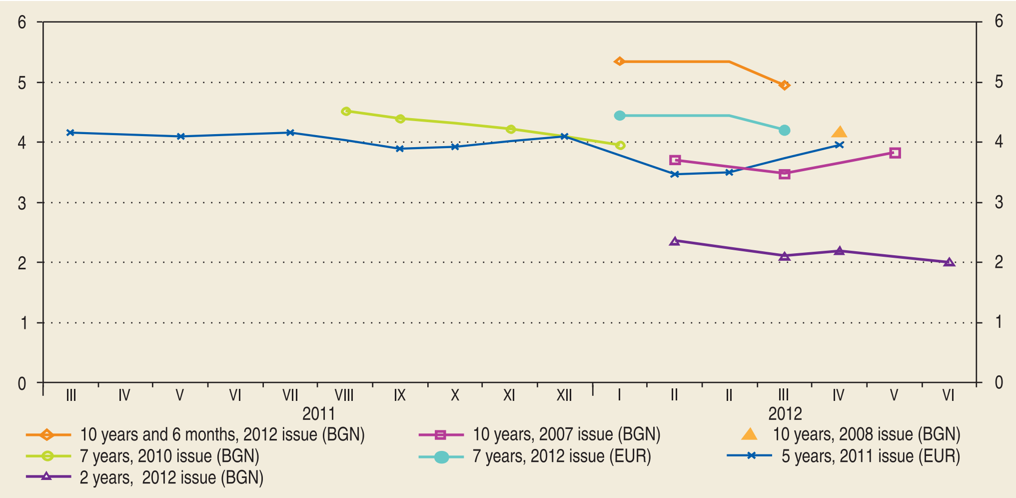
[49] The scope of bank accounts whose balances by 30 June 2012 are included in the fiscal reserve is defined by the MF with reference to Council of Ministers' Decree No 367 of 2011 on implementing the 2012 State Budget of Bulgaria.
[50] On 30 June 2012 the total balance on the Agricultural State Fund's accounts was BGN 58.5 million against BGN 301.1 million on 30 June 2011.
[51] The payments total was recalculated in euro at the BNB rate for 30 June 2012.
[52] The debt total was recalculated in euro at the BNB rate for 30 June 2012.
[53] In the first half of 2012 the issuer introduced a series of changes to the issuing calendars, with two new auctions included over the first quarter and two euro-denominated bond auctions cancelled over the second quarter.
[54] The *Government Securities Market* quarterly provides detailed information on government bond primary and secondary market developments.

The average annual yields of two-year, five-year, seven-year, ten-year and 10.5-year issues attained at the auctions were 2.17, 3.48, 4.21, 3.77 and 5.14 per cent respectively.

Average Annual Yield Attained at the Auctions for Sale of Domestic Government Securities

(per cent)



Note: Since all bids at the five-year EUR bond auction on 5 December 2011 and 9 April 2012 were rejected by the Ministry of Finance, relevant data on the chart cover the average annual yield of submitted bids.

Source: BNB.

Actual budget revenue from bond sales in the review period was BGN 732.6 million. Budget funds were spent on government securities repayments to the amount of BGN 344.8 million. On 30 June 2012 positive net government bond financing came to BGN 387.9 million.

Total initial acquisitions of government securities and repayment on maturing issues registered in ESROT came to BGN 1188.0 million,[55] up 33 per cent on the first half of 2011. The increase was mainly due to the greater volume of newly issued government securities. Up-to-date system information on circulating government securities shows that 454 regular payments of BGN 454.2 million were effected after coordination with the MF, comprising BGN 352.9 million principal and BGN 101.3 million interest. By 30 June 2012, 26 issues were in circulation with the following maturity structure: six medium-term (one to five years) and 20 long-term (over five years) issues. The total nominal value of these government securities was BGN 4856.1 million,[56] including BGN-denominated issues redeemable in levs at BGN 3142 million (64.7 per cent), EUR-denominated issues redeemable in euro at BGN 1494.5 million (30.8 per cent), and EUR- and USD-denominated issues redeemable in levs at BGN 219.6 million (4.5 per cent).

In the first half of 2012 the total nominal volume of ESROT-registered secondary market transactions in government securities was BGN 21,590.6 million against BGN 43,153.8 million in the corresponding period of 2011. Repos had the largest share (60.2 per cent), followed by blocking and unblocking transactions (27.4 per cent), operations with or between ESROT participants' customers (8.4 per cent), and outright purchases and sales (4.0 per cent).

Despite the decrease in sold volumes, demand for liquid government bonds assured the traditionally high share of repo agreements in the secondary market. Repos with a flow of funds on current accounts had the largest share (82.2 per cent) of the total volume, those concluded for a day being most attractive (62.2 per cent). The average-weighted annual yield by maturity was: 0.15 per cent in transactions concluded for a day, 0.17 per cent for two to three days, 0.23 per cent for four to seven days, 0.37 per

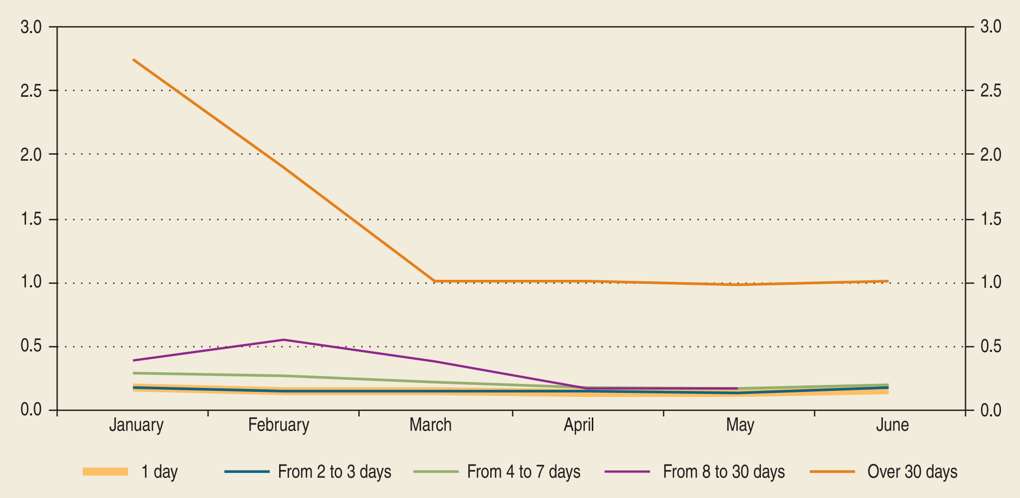
[55] The lev equivalent of payments on foreign currency denominated government securities issues was calculated at the BNB rate on the date of payment.

[56] The debt total was recalculated in levs at the BNB rate for 30 June 2012.

cent for eight to 30 days, and 1.26 per cent for over 30 days. There were greater yield fluctuations in the first months of the year, mainly for longer-term repos.

Average-weighted Annual Yield of Repo Agreements in Domestic Government Securities over the First Half of 2012

(per cent)



Source: BNB.

Operations with or between ESROT participants' customers were most active in February and outright purchases and sales in April. Government securities across the whole yield curve were traded, with offer and bid spreads widening on the first half of 2011. Given the institutional investor preference to invest free funds into longer-term government debt instruments, the most liquid issues were those denominated in levs and euro with a residual term of five years or over. The average annual yield of the long-term reference issue (ten years and six months) retained its downward trend: 5.30 per cent in January and 5.07 per cent in June.

Reflecting active trading, the liquidity ratio[57] in the secondary government bond market was 3.23.

The issuer cancelled government securities of USD 399,000 under ZUNK over the review period and approved them for repayment of obligations to the government under this Law.

Government securities in insurance corporations and pension fund portfolios rose greatly (by BGN 352.3 million) on the end of June 2011, most (88 per cent) comprising government debt instruments with a maturity of over five years. Government securities in bank portfolios increased essentially (BGN 346.0 million). Changes occurred in the structure of government securities by holder: 54 per cent with banks, 25 per cent with insurance corporations and pension funds, 20 per cent with non-bank financial institutions, corporations and individuals, and 1 per cent with foreign investors (compared to 57, 21, 21, and 1 per cent in the same period last year).

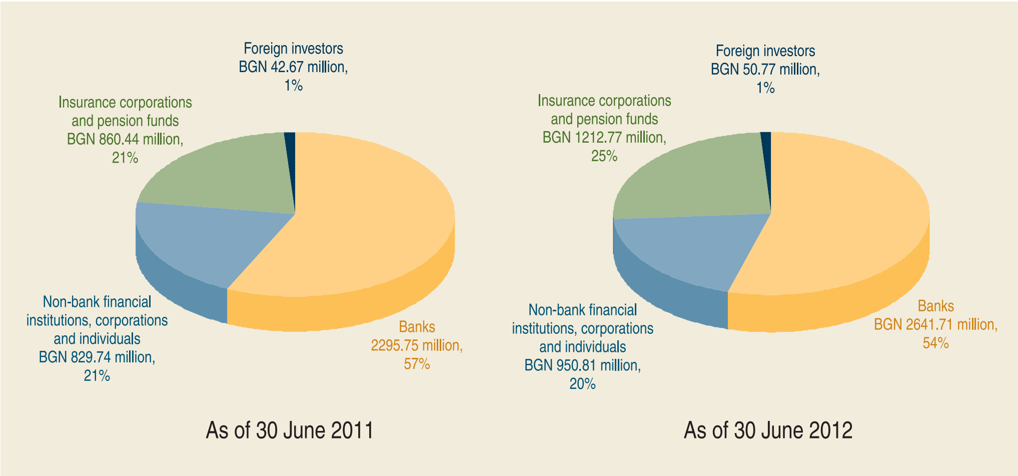
Most blocking and unblocking operations in domestic government securities related to securing funds in budget entities' bank accounts under § 24 of the Transitional and Final Provisions of the Republic of Bulgaria 2012 State Budget Law.[58] These operations helped banks regulate security in real time. Lack of dramatic daily fluctuations in the amount of budget balances with banks which could entail the relevant blocking and unblocking operations led to a significant decline in their volume (by 39 per cent) on the first half of 2011. Thus, average daily nominals of domestic government securities

[57] The ratio between the volume of secondary market government securities transactions concluded in a specified period and the volume of circulating government securities by the close of the period.

[58] According to § 24, paragraphs 2 and 5, servicing banks secure in favour of the MF funds in all budget entities' lev and foreign currency bank accounts, deposits, and letters of credit by blocking Bulgarian domestic and external debt government securities. Government securities are blocked with the BNB and this has the legal effect of a special pledge on them in favour of the MF. Only government securities free of encumbrances or security are blocked.

blocked in ESROT increased to BGN 1048.9 million, EUR 178.5 million and USD 29.1 million by 30 June 2012 (BGN 939.4 million, EUR 132.7 million and USD 30.3 million in the same period a year earlier). To secure budget accounts, servicing banks also blocked government securities issued in international markets (external debt government securities) by transferring them to dedicated BNB accounts. In the review period average daily nominals of these securities were BGN 43.4 million, EUR 76.4 million and USD 171.3 million: an increase in the shares of euro- and dollar-denominated blocked government securities on the same period last year.

Holders of Government Securities Issued on the Domestic Market



Source: BNB.

As of 30 June 2012 government securities blocked in ESROT under the Law on Registered Pledges amounted to BGN 73.3 million, down 10.6 per cent on end-June 2011 (BGN 82.0 million).[59]

Over the reporting period ESROT offered 99.5 per cent availability,[60] with outages handled under contingency rules for interaction between systems operated by the BNB. System participants numbered 30: 25 government securities subdepository banks, three investment intermediaries, the Reserve Collateral Pool, and the MF.

System Development

In line with the MF proposal to settle euro-denominated government securities on banks' accounts in TARGET2 using the DVP (delivery *versus* payment) principle, and the BNB Governing Council decision to develop and launch a project for the BNB government securities depository to participate in TARGET2-BNB as an ancillary system, ESROT, GSSS and other relevant systems received technical and functional updates. There was also internal integration testing, including testing with the ECB. Statutory instruments on the government securities market and relevant BNB fiscal agent functions received an overall review. To complete the project by the end of 2012, consultations with the issuer started on amendment drafting, and on a new agent agreement between the MF and the BNB under Article 43, paragraphs 1 and 2, item 3 of the Law on the BNB.

[59] The lev equivalent of blocked/unblocked foreign currency denominated government securities is calculated at the BNB rate on the date of transaction.
[60] The ratio of the time when the system is fully operational to the scheduled operating time.

IX. Participation in ESCB and EU Institutions

Debate continued on proposed legislation to improve the functioning of the EU with the focus on the euro area. There was agreement to expand the European Stability Mechanism. In February 2012 euro area Member States signed the Treaty Establishing the European Stability Mechanism.[61] Financial aid would be provided only in exceptional cases when absolutely necessary for euro area stability and under strict conditions. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was signed in March. It improves euro area economic policy coordination. The BNB participated in ESCB, European Commission, EU Council, the European Systemic Risk Board, and the Council for European Affairs committees and working groups, contributing to the formulation of Bulgarian standpoints on key economic governance areas and the financial sector.

European System of Central Banks

As member of the ECB General Council, the BNB Governor sits on its meetings with EU central bank governors and the ECB President and Vice President. BNB representatives sit on 12 ESCB committees and 32 working groups, the Human Resources Conference (HRC), and two ESCB networks on supervisory macroeconomic research and competition.

Through ESCB bodies, committees and working group,[62] the Bank helps elaborate ECB legal instruments on monetary and banking infrastructure, payment and settlement systems, statistical reporting, and sundry central banking issues.

The BNB was active in ESCB written consultations to elaborate ECB opinions on national and EU legislative proposals affecting central banks. The BNB stated opinions on the EC's proposed Directive on Credit Institution Licensing and Trading, Prudential Supervision of Credit Institutions and Investment Firms, and a proposed Regulation on Prudential Requirements for Credit Institutions and Investment Intermediaries. In written consultations on the 2012 ECB Convergence Report, the BNB stated opinions on the methodology for calculating convergence criteria and interpreting sustainability.

EU Member States consult the ECB in writing on relevant legislation. The Ministry of Justice consulted the ECB on amendments to the Law on the State Fund for Guaranteeing the Stability of the State Pension System.

The Bank continued translating and producing ECB periodicals under the agreed ESCB communication policy, including the ECB Annual Report 2011, the Convergence Report 2012, and Monthly Bulletin chapter summaries.

On 31 May and 1 June the Bank hosted a session by the Executive Board of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).

European Systemic Risk Board, European Banking Authority, Colleges of Supervisors

The BNB was also active in European Systemic Risk Board business.[63] ESRB General Board debate focused on systemic risks faced by the EU financial system and measures to tackle them, and on developing sound macro-prudential policy and instruments at the EU and national levels. The ESRB monitored EC proposals for a capital requirements directive and regulation, and the effect of Solvency II legislation in insurance on macro-prudential policy scope and objectives. The Board presented categorical views on the credit institution capital requirements directive and regulation. They largely tally

[61] The original Treaty signed in July 2011 was amended to improve ESM flexibility and effectiveness.
[62] The Accounting and Monetary Income Committee (AMICO), the Financial Stability Committee (FSC), the Banknotes Committee (BANCO), the Eurosystem/ESCB Communications Committee (ECCO), the Information Technology Committee (ITC), the Internal Auditors' Committee (IAC), the International Relations Committee (IRC), the Legal Committee (LEGCO), the Market Operations Committee (MOC), the Monetary Policy Committee (MPC), the Payment and Settlement Systems Committee (PSSC), the Statistics Committee (STC), and the Human Resources Conference of Eurosystem Banks/ESCB (HRC).
[63] The Bank is represented on the ESRB General Board, the Advisory Technical Committee and three working groups.

with the BNB's position that the ability of national authorities to supervise in line with national specifics is key to maintaining financial stability.

The ESRB asked Member States and national supervisors for interim reports on its 2011 recommendations by the end of June. The recommendation on lending in foreign currency was to Member States and national supervisors. Working with the MF and the FSC, the BNB reiterated its consistent position that lending in euro does not threaten financial stability due to the euro-based currency board. BNB macroprudential policy has so far curbed risks related to lending in currencies other than the euro. The recommendation on US dollar-denominated funding of credit institutions was to national supervisors. In its report, the Bank stated that the insignificant share of US dollar funding did not threaten the Bulgarian financial system.

BNB experts joined public consultations on the new capital requirements framework (Basel III) and worked in committees and working groups of the European Banking Authority and European bodies drafting and implementing new international capital standards for banks.

BNB supervisors continued working on cross border bank groups in Bulgaria. They exchanged supervisory information in line with memoranda of understanding and cooperation. Working with colleges, BNB experts helped elaborate bank group level common risk assessments.

European Council, Ecofin Council and Economic and Financial Committee

Addressing financial market tensions and ensuring financial stability remained top priority for European bodies in the first half of 2012. The 25 participating Member States signed the Treaty on Stability, Coordination and Governance in the European Monetary Union on 2 March 2012 at the European Council.[64] Alongside Bulgaria, signatories outside the euro area were Denmark, Hungary, Latvia, Lithuania, Poland, Romania, and Sweden.[65] The Treaty strengthens EMU through a fiscal compact for budgetary discipline, better economic policy coordination, and improved euro area governance. Welcoming the Treaty in principle, the BNB has consistently backed the Bulgarian government opinion that Member State freedom to pursue independent tax policy is of prime importance alongside economic and fiscal coordination. As agreed in negotiations, Bulgaria will apply only set provisions specified at ratification. The whole Treaty will become binding at Bulgarian accession to the euro area, end of derogation under Article 5 of the Act concerning the accession of the Republic of Bulgaria and Romania and the adjustments to the Treaties on which the European Union is founded.

Publication of the EC Annual Growth Review in November 2011 marked the beginning of the second European Semester. As scheduled, on 12 April Bulgaria presented its updated 2012 National Reform Programme and the 2012 to 2015 Convergence Programme. The Bank helped draft and coordinate the Programmes which outline priorities under the 2012 Annual Growth Report.

Talks continued on the second enhanced economic governance package. This comprises two EC regulation proposals for euro area Member States. One aims to improve coordination and monitoring of draft budgets. The other focuses on closer monitoring of euro area members experiencing or facing serious financial issues, receiving or likely to receive financial assistance. Bulgaria supported the regulations in principle to ensure macroeconomic stability in the euro area and prevent crises. The BNB shared government concerns on negative financial market reactions to EC requests for changes to national budget plans, the possible suspension of EU funds upon excessive macroeconomic imbalance procedures, and increased EC powers to act independently.

In late March Denmark hosted an informal meeting of EU finance ministers and central bank governors where the BNB was represented. This tackled economic prospects and risks to EU financial stability, and the proposed financial transactions tax (FTT) and recovery and resolution framework for financial institutions. The Bulgarian government

[64] Given no consensus on amending EU Treaties to enable new measures under the Treaty on Stability, Coordination and Governance in the European Monetary Union, euro area governments adopted the Treaty as a binding international agreement.

[65] On 27 January 2012 the 41st National Assembly voted to accede to the Treaty on Stability, Coordination and Governance in the European Monetary Union.

and the BNB consistently opposed FTT without global consensus. Discussions in diverse Council fora show that a number of others oppose harmonisation of financial sector taxation at EU level. Members in favour sought clearance to introduce it by December 2012 through the TFEU enhanced cooperation mechanism.[66]

At its 15 May meeting, Ecofin adopted a general approach on two proposals to amend credit institution and investment firm supervision (CRD 4 package[67]). This opened the way to talks with the European Parliament on adopting the package at its first reading. In negotiations, Bulgaria insisted on national supervisory authorities being able to set additional capital buffers for systemic risk, and on preferential treatment for Bulgarian banks on capital requirements for foreign currency positions in euro given the currency board. Bulgaria's major objections related to the proposed maximum harmonisation of capital requirements, the concept of a liquidity subgroup, and the EC proposal that unrated institutions be ranked by the ratings of bonds issued by their governments. The Bulgarian position attracted support and set Bulgarian arguments found their way into the general approach.

BNB representatives sat on Economic and Financial Committee meetings where discussion focused on economic governance and measures to restore financial sector confidence. In the context of the European semester, the Committee deliberated national fiscal and macroeconomic policy surveillance and the European position on the growth framework, international monetary system reform, and financial regulation discussed by the G20, IMF, and FSB. On measures to reinforce banks, the BNB consistently argued that Bulgarian banks' high capital and liquidity levels and accumulated capital buffers guaranteed system stability.

The half year saw intensive discussions on EC proposals for residential property loans and deposit guarantee scheme directives. On the former, the Bank supported broadening the directive's scope since it not only protects consumers but also adds new financial stability requirements. The right to withdraw from agreements was questioned and a clearer definition of the early repayment option was proposed, with no national discretion which might lead to divergent regimes. On the latter proposal, the BNB supported the government's preference for keeping the current 20 business day settlement period and for settling in national currency or euro. The Bank and government opposed deposit guarantee fund target levels at which contributions would end as they considered it important for financial stability to promote funds' increase.

In May the BNB held a seminar to advise the banking community of the new EU financial sector measures at an early stage. This helped national coordination, transposition, and implementation of new EU laws.

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[66] The enhanced cooperation mechanism meets the requirements of Treaty on European Union Article 20 and Treaty on the Functioning of the European Union Articles 326 to 334. The procedure calls for no fewer than nine members to show interest in enhanced cooperation, specifying its scope and aims.

[67] CRD IV proposes a Directive and Regulation on Prudential Requirements for Credit Institutions and Investment Firms to replace Directives 2006/48/EC and 2006/49/EC.

X. International Relations

The Law on the BNB encourages the Bank to participate in international initiatives to further monetary and credit policy cooperation. Where the state participates in international financial institutions, the BNB is its official fiscal agent and depository.

The Bulgarian National Bank holds equity in the Bank for International Settlements (BIS). The BNB Governor sat on the bimonthly meetings of BIS central bank governors: a major forum for cooperation between member central banks and for debate on world economic developments and the prospects for the global economy and international financial markets. The Governor represented the Bank at the Annual General Shareholder Meeting in late June 2012, where the BIS Governors allocated net profit, the BNB receiving a dividend of EUR 2.9 million.

The BNB Governor is a member of the IMF Board of Governors and a representative of the state. In February the BNB took part in the preparation of the 63rd IMF Annual Report on Exchange Agreements and Restrictions to reflect changes in Bulgarian currency legislation made in 2011.

In June 2012 BNB representatives sat on the International Monetary Fund and the World Bank's Netherlands Constituency meeting in Bucharest. Discussions focused on fiscal consolidation, structural reforms, the quality of central banks' balance sheets, financial stability, and conditions for economic growth in Europe. The group also tackled the establishment of a new constituency group headed by the Netherlands and Belgium on a rotating principle. The new group will expand to include Luxembourg. Bulgaria will retain its membership and representatives.

In January the BNB paid its annual contribution of USD 8500 to the International Accounting Standards Committee Foundation.

The Bank continued fruitful relations with other central banks and financial institutions. In March the BNB hosted a visit by Mrs Shirai, Member of the Policy Board of the Bank of Japan. Its purpose was to exchange views on the economic situation and central bank policies in Bulgaria and Japan. The visit featured a seminar on Opportunities and Challenges facing Japan and the Bank of Japan.

In April the BNB hosted nine representatives of the Chinese Development Bank. Discussions between the delegation and BNB Deputy Governors focused on the development of the banking sector and central bank policies, promoting further cooperation between the BNB and the Chinese Development Bank, and Chinese investment into Bulgaria.

The three-year technical cooperation programme for the Central Bank of Egypt in banking supervision managed by the ECB and other central banks ended successfully in March 2012. In cooperation with the central banks of Italy and Greece, the BNB was the partner responsible for three strategic areas: a standardised approach to credit risk, own funds, and reporting. The programme aimed at introducing the Basel II capital framework requirements into the Egyptian banking system. Under this project, BNB experts developed a new regulatory capital framework compliant with Basel II which also takes into account some Basel III related changes.

Work continued on the Strengthening the Institutional Capacity of the Central Bank of Serbia project where the BNB is responsible for statistics and EU pre-accession assistance components. The Bank shared its experience and advised the central bank of Serbia on implementing a direct reporting system for the balance of payments statistical purposes and on aligning external debt statistics with the IMF External Debt Statistics Guide.

XI. Statistics

The BNB gathers, compiles, and disseminates statistics under the Law on the Bulgarian National Bank Article 42 and as an ESCB member under the Statute of the ESCB and the ECB Article 5. Under the additional requirements of the 2009 amendments to Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the ECB, the Bank now also provides statistics to the European Systemic Risk Board.

Monetary and interest rate statistics are implementing the methodological guidelines to Regulation (EC) No 25/2009 of the ECB of 19 December 2008 on the balance sheet of the monetary financial institutions sector (Recast) (ECB/2008/32) and Regulation (EC) No 290/2009 of 31 March 2009 amending Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans *vis-à-vis* households and non-financial corporations (ECB/2009/7). These broaden the scope of information from financial institutions and give more detail on counterparties and their financial operations, enabling more comprehensive economic analyses.

Preparations to implement new methodological guidelines progressed in line with work on the new European System of Accounts (ESA 2010) expected in 2014 and new statistical information user requirements for monetary policy, financial stability, supervision, and risk management purposes. This monetary and financial statistics project should shed more light on economic sectors and financial instruments.

Given the importance of insurance and re-insurance to financial stability and systemic risk, the ECB intends to introduce within the ESCB a harmonised statistical reporting framework for such companies. The Bank is preparing to examine the proposed guidelines on the framework's scope and their applicability at the national level.

In 2012 balance of payments and international investment position statistics used information collected directly from residents through regular quarterly surveys of receipts and payments between residents and non-residents for services, remuneration, insurance, and sundry receipts and payments in the balance of payments current account.[68]

Work continued on a subsystem to input statistical reporting forms to the BNB Integrated Automated Statistical Information System (the ISIS) electronically.

Work on introducing the sixth edition of the Balance of Payments Manual (IMF, 2008) by 2014 advanced. Preparations are complex due to the need to harmonise the new methodology with the European System of Accounts (ESA '2010) and the fourth edition of the OECD Benchmark Definition of Foreign Direct Investment (2008). The sixth edition of the Balance of Payments Manual significantly changes definitions and presentation of balance sheet and international investment position items.

Over the first half of 2012 drafting started on amendments to Ordinance No 27 of the BNB on the Balance of Payments Statistics and the International Investment Position. These stem from late 2011 changes in Currency Law provisions on balance of payments statistics and the international investment position and the sixth edition of the Balance of Payments Manual.

Work continued on data quality management for the ESCB Centralised Securities Database project and compiling a Bulgarian securities database. Over the review period BNB as part of the ESCB also took part in the Securities Holdings Statistics project, of significance to other statistics and financial stability analyses.

In the first half of 2012 the BNB continued compiling data on General Government sector quarterly financial accounts under Regulation (EC) No 501/2004 of the European Parliament and of the Council of 10 March 2004 and reporting data on government fi-

[68] For details on methodological changes for service export and import data and other current account operations, see BNB Annual Report 2010, p 60 and BNB Report January — June 2011, p 63.

nances to ECB requirements. Flows statistics are now gathered alongside regular data compiling and transmission of quarterly financial accounts statistics for all economic sectors (stock data) under Guideline ECB/2002/7 (recast) on the statistical reporting requirements of the ECB in the field of quarterly financial accounts.

With NSI assistance, the Bank continued sending macroeconomic indicator information to the ECB and the Bank for International Settlements. There were regular updates and metadata certification under the Special Data Dissemination Standard to IMF methodology and dissemination schedule using statistical information from the NSI and the Ministry of Finance.

The BNB publishes monthly and quarterly statistical publications presenting data and comprehensive clarifications on balance of payments monetary and interest rate statistics, gross external debt, and the international investment position.

XII. Research

Economic research, analyses of the Bulgarian economy, and macroeconomic forecasts support the Bank's management in making decisions and formulating economic policy. In the first half of 2012 research focused on financial sector modelling, studying the macroeconomic effect of fiscal policy, and developing macroeconomic models for forecasting.

Specialised research under the 2011 and 2012 BNB Research Plan supported the Bank's operations by analysing individual economic processes and issues and improving forecasting and modelling. The period saw research on the competitiveness of Bulgarian exports on international markets, the development of a dynamic stochastic general equilibrium model for the financial sector and macro-financial models binding financial stability to the state of the economy, credit process modelling, fiscal multipliers research, and modelling of the relationship between monetary aggregates and inflation. Testing and honing the basic model for BNB macroeconometric forecasting continued. Research results featured in technical reports and seminars held by the Bank for experts from relevant bodies, academia, and non-governmental organisations.

Through its Discussion Papers research series, in 2012 the BNB continued to encourage the research potential of Bulgarian economic science and practice in macroeconomics and finance. In the first half year the Discussion Papers Editorial Board reviewed one submission and made recommendations to its author.

The BNB quarterly *Economic Review* presents information and analyses of balance of payments dynamics, monetary aggregates, and the bearing of the latter on the real economy and price stability. External environment developments were also analysed since they directly affect the Bulgarian economy. The *Economic Review* presents short-term quantitative assessments of developments in major macroeconomic indicators, namely inflation, economic growth, exports, imports, the balance of trade, and the balance of payments current account. It contains information on the results of BNB analyses of individual macroeconomic issues.

XIII. Information Infrastructure

BNB information system development encompasses conducting ECB/ESCB projects, developing and updating the Bank's communication and information infrastructure by replacing main communication equipment, providing comprehensive technical maintenance to BNB employees and the banking and financial community, ensuring the smooth functioning of RINGS servicing lev payments in Bulgaria and of the TARGET2-BNB national system component, and keeping BNB financial information systems up to date.

Information Security and Network Management

In the first half of 2012 the BNB took part in the local implementation of ECB/ESCB projects. The new versions of the ESROT and GSSS systems were prepared to be backed up. A project to update SAN infrastructure involved replacing old SAN commutators, full SAN backup, replacing old optical connections and doubling the communication speed to 8 Gbps. The internal BNB voice communication infrastructure also was upgraded.

BNB Databases and Application Systems

Over the first half year databases and application systems broadened their scope and expanded functionality in preparation for emerging business and project documentation requirements. The project to make the BNBGSSS an ancillary to TARGET2 involved developing new functionalities to improve ESROT, RINGS, SWIFT Alliance, TARGET2 and SOFI. Integration tests began on 18 June 2012. In addition, the second stage of the ESROT project ended with system software and the new application version installed in a new hardware-configured test environment. The TREMA configuration changed and new ESROT messages were tested along with integration aspects. The Fiscal Reserve module of the IOBFR system became ready to receive data from reporting units. The BNB Single Data Depository/Banking Supervision Reports information system was upgraded along with the two applications of the CCR information system (data generation application and online statement application). Upgrades began to the BNB cash reporting, control and management system. There were also changes to the automated information system for collecting and processing reporting forms for bank card issuers and system operators/payment system participants. At the request of banks, the IOBFR Security module also changed.

Data Processing

The main task in the first half of 2012 remained maintaining information systems' integrity and stability and preventing downtime caused by system outage or technical issues. In tandem with end users, work continued on expanding OBIS Core Banking Information System functionality, with particular emphasis on system and individual element security. The paperwork and schedule for the project on BNB hardware and software migration to the SAP system are ready. The review period also saw the launch of a module to reconcile nostro accounts and securities in the SAP environment. The SOFI, TurboSwift and SAP systems adopted business procedures aligned with BNBGSSS participation as an ancillary to the TARGET2-BNB national system component. The project to migrate BNB technical infrastructure to SWIFTNet Release 7.0 ended successfully.

Technical Maintenance of the Payment Systems

The technical maintenance of payment systems focused mainly on ensuring the smooth function of RINGS for servicing lev payments in Bulgaria, of the Bulgarian component of TARGET2 — TARGET2-BNB for payments in euro, and of related Swift Alliance services and products. Along with daily system administration and monitoring, in the first half year new statements for RINGS and TARGET2-BNB were developed. TARGET2-BNB migrated to new SWIFT Alliance Gateway servers and now generates TARGET2 individual access certificates for TARGET2-BNB National Service Bureau users. The SWIFT Alliance Gateway application was re-licensed and adapted to allow simultaneous multiple user access.

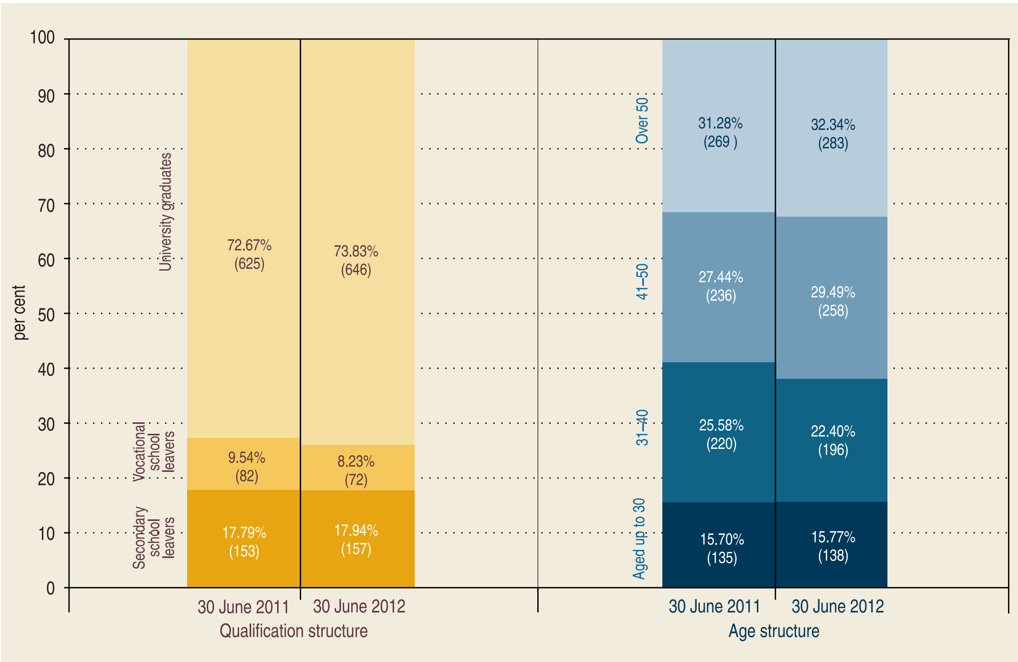
XIV. Human Resource Management

Over the first half year BNB human resource management focused on the key priorities of boosting efficiency through training and professional development, maintaining a solid administrative and analytical capacity meeting the Bank's high standards, improving staff recruitment to optimise the age and professional qualification structures, continuing the performance-related pay policy, maintaining a sociable environment, and ensuring health and safety at work.

Recruitment sought highly qualified employees to meet modern requirements and job descriptions. In June 2012 there were 875 employees against 860 a year earlier. Between January and June 2012, 30 new employees started work at the BNB (19 in the corresponding period of 2011) and 14 left. Legislative changes meant that nobody retired. In the same period of the prior year 21 employees left, of whom nine retired. Low staff turnover reflected a number of internal factors such as established organisational culture, motivating working environment, effective teamwork, opportunities for training and professional advancement, and the sociable environment. Labour market changes also influenced staff intentions.

Staff Structure

(per cent, number)



Source: BNB.

There were no major changes to staff age structure by the end of June 2012, other than the share of employees over the age of 41 rising insignificantly on the same period of the prior year. As regards the education and qualification structure, the number of new employees with university degrees kept rising in line with Bank preferences for better educated staff and the growing need for analytical specialists.

The practice of offering diverse modes of labour mobility at the BNB continued, broadening employees' experience and increasing the exchange of experience across different business areas within the Bank and with the ECB and ESCB central banks. In the first half year eight employees changed jobs within the Bank: double that number in the corresponding period of 2011. Four BNB employees took on short-term ECB secondments

Pay continued to reflect performance and each employee's contribution to the attainment of Bank targets.

Under the annual schedule, employees enjoy plenty of opportunities to take part in training and qualification improvement programmes at both national organisations and foreign banks and international financial institutions: distant learning programmes, vocational training, and seminars in Bulgaria and abroad, foreign language, and information technology courses.

Induction training familiarised new employees with the Bank's corporate culture, current priorities, internal rules, and administrative procedures. Over the review period one induction session involved 14 new employees.

Twenty six employees boosted their educational attainments at different universities without discontinuing work. Strong interest continued in various distant training programmes: 20 employees took part in eight such programmes. The number of employees interested in distant and certification programmes in areas such as reserve management and internal audit is rising. The first member of staff embarked on a certification programme for internal auditors in risk management assurance.

Employees from various structural units attended specialised courses on, *inter alia*, changes in labour and social security legislation, health and safety at work, and public tendering procedures.

The BNB continued working with European counterparties and international financial institutions offering specialised central banking courses in areas of importance to modern central banking. In the first half year, more than 100 BNB employees took part in courses, seminars and conferences abroad. BNB employees continued to participate in seminars, training courses, and workshops related to ESCB committees and working groups and other EU structures.

More than 40 employees attended foreign language courses. These aimed to provide language proficiency levels consistent with job descriptions for all employees. English courses were most widely attended, as required for better work performance.

Information technology training focused on providing and updating specialised software and systems skills. Training addressed the acquisition of key competences and optimising external service costs.

Legal requirements and internal rules called for training in operating, servicing, and maintaining equipment requiring competence certificates.

Current trends, European regulations, and national legislation place health and safety at work firmly within the ambit of human resource managers. To safeguard staff health and safety, the review period saw continuous attention to identifying, managing, and eliminating workplace hazards, including managing occupational risk, drafting safety instructions for new machines, equipment, and dangerous substances, products, and personal protection equipment. The working conditions committee and working groups held several meetings. There were measures to prevent and limit professional risks and workplace hazards under an approved programme. Work environment monitoring and management aimed to keep conditions in line with modern requirements and standards.

Within the scope of its national responsibilities, the BNB provides career opportunities to young people and encourages students to opt for research and academic knowledge. The Bank was at the March student training and career forum and the April professional training and development forum hosted by the Sofia University of the National and World Economy where it promoted internship, scholarship, and guest-researcher programmes, candidate requirements, and staff recruitment procedures. The Bank participated in Varna Free University's Chernorizets Hrabar initiative to acquaint students with national institutions and business organisations, and in the Svishtov D A Tsenov Academy of Economics survey on satisfaction with the quality of education and the professional fitness of its alumni at the BNB.

XV. Facilities Management

The BNB trades from wholly owned premises. This provides the degree of independence, security, and protection required of a central bank. Property management spending was in line with the BNB budget for the year. It went on new construction, refurbishment and modernisation, deliveries and equipment, current repairs, maintaining technical facilities (transformers, power supply, distribution boards, diesel generators, AVR controllers, mechanical rooms, pressure boilers, lifts, HVAC installations, and heaters), vehicles, supplying long and short-term assets and cash processing consumables, and optimising power, heating, and water use.

There were no acquisitions or sales of BNB properties in the first half of 2012.

XVI. Internal Audit

Audits followed the BNB Internal Audit annual programme approved by the Governing Council for January to June 2012. There was also one ESCB Internal Auditor Committee programme audit.

A banknote and coin audit assessed the organisation and control of accepting, transferring, and storing cash at BNB structures and reviewed control system performance, risks, and efficiency.

An audit on monetary policy and market operations addressed how minimum required reserves maintained by banks with the BNB were calculated and monitored. It assessed effective achievement of aims and tasks and the reliability and integrity of related significant information.

In the payment and securities settlement area, an audit addressed the Real-time Interbank Gross Settlement system (RINGS). Its main purpose was to establish reasonable assurance of corporate governance adequacy and efficiency, risk management, and control over RINGS administration and operations.

Two audits followed-up implementation of recommendations from prior BNB Internal Audit and ESCB Internal Auditor Committee audits by addressing the adequacy, effectiveness, and timeliness of measures by relevant unit managers.

The table below shows audit commitments on major and auxiliary Bank functions:

BNB Function	Audits under the BNB Internal Audit and the ESCB Internal Auditors Committee Programmes
Banknotes and Coins	Organising and controlling the acceptance, transfer, and storage of cash at BNB structures
Implementation of Monetary Policy and Market Operations	Calculating and monitoring minimum required reserves maintained by banks with the BNB
Payment and Securities Settlement Systems	RINGS
BNB Internal Audit	Implementation of recommendations by the Bank's Chief Auditor and Internal Audit unit arising from earlier audits
BNB Internal Audit	Implementation of recommendations by the Bank's Chief Auditor and Internal Audit unit arising from earlier ESCB Internal Auditors Committee audits

Source: BNB.

In the first half of 2012 the BNB Chief Auditor organised and coordinated internal audits with the external auditor, KPMG Bulgaria. The inspecting team from the Republic of Bulgaria Audit Office received expert assistance in examining the annual excess of Bank revenue over expenditure owed to the 2011 government budget, and in reporting and managing BNB budget expenditure.

Internal auditors continued to issue opinions on draft internal statutory instruments on major BNB and subsidiary functions.

BNB operational risk management followed a schedule approved by the Operational Risk Management Committee for 2012. The Committee defined three horizontally ranked risk categories: information systems, human resources and facilities, and physical security. They will be assessed by structural units in calculating overall risk facing the Bank. The aim is to manage these risks at the institutional, rather than structural unit level.

A process automation software for BNB operational risk management began going live in May. Current progress involves introducing the first of three project modules.

XVII. BNB Budget Implementation

The BNB Governing Council adopted the BNB Budget for 2012 by Resolution No 103 of 29 November 2011.

The report on the Bank's budget comprises two sections pursuant to the BNB Governing Council's Internal Rules on Drafting, Implementing, and Reporting the BNB Budget: BNB Operating Expenditure and Investment Programme.

1. Operating Expenditure

In the first six months of 2012, the BNB spent BGN 35,290,000, or 42.0 per cent of its budgeted figure for the year.

Currency circulation expenditure was BGN 3,028,000 or 23.4 per cent of the approved budget for 2012 and 8.6 per cent of operating expenditure. The production of new banknotes cost BGN 1,024,000 and of new coins BGN 1,797,000, of which BGN 1,613,000 went on circulating coins. The BNB Governing Council's commemorative coin programme cost BGN 184,000.

Spending on machines for servicing circulating cash came to BGN 73,000. Expenses on consumables for banknote and coin processing were BGN 52,000.

Renting premises at the State Mint and at the Cash Services Company cost BGN 81,000.

Materials, services, and depreciation spending totalled BGN 18,445,000, or 43.4 per cent of annual budget under these items and 52.3 per cent of all Bank's operating expenditure for the first half year.

Materials cost BGN 444,000 and their relative share in all operating expenditure was 1.3 per cent over the review period. Fuel and spares for the transport flee (BGN 192,000) and office consumables (BGN 145,000) occupied the largest share in this group.

Expenditure on external services was BGN 8,422,000, or 23.9 per cent of half-year operating expenditure. Software maintenance spending came to 2,012,000, occupying a significant share in this group. The Bank spent BGN 1,135,000 on its security contract with the Ministry of the Interior Security Police Administration and the National Fire Safety and Public Protection Service. Property and refuse collection levies were BGN 863,000. Expenses on major building maintenance totalled BGN 833,000. Software maintenance subscriptions amounted to BGN 813,000. The cost on Bloomberg, Reuters, internet and other system provision was BGN 601,000 and expenses on TARGET2 compulsory modules BGN 549,000. Electric bills were BGN 323,000, heating and water spending, BGN 160,000. Property insurance premia came to BGN 148,000.

Consultancy services (BGN 64,000) went on analysing wireless communications between BNB buildings, preparing their technical passports, and legal issues.

In the first six months depreciation expenditure amounted to BGN 9,579,000 and their relative share in operating expenditure was 27.1 per cent.

Payroll, social, and healthcare spending totalled BGN 10,639,000, or 49.9 of the approved annual budget and 30.2 per cent of the Bank's operating expenditure in the first half of 2012. In accordance with IAS 19, Income of Hired Persons and further to licensed valuation, the Bank reported BGN 1,256,000 of current retirement obligations and unused paid leave, including social security contributions, under this item.

Social expenditure was BGN 1,567,000, or 69.5 per cent of budgeted funds for the year. The share of this expenditure in Bank operating expenditure was 4.4 per cent.

Miscellaneous administrative expenditure was BGN 545,000 or 25.8 per cent of annual budget and 1.5 per cent of total operating expenses in the first half of 2012. Inland travel, worth BGN 36,000, involved mainly cash logistics in regional cash centres and checks there.

Foreign travel spending totalled BGN 116,000.

The annual BNB Staff Education and Professional Training Programme cost BGN 344,000 in the first half of 2012. BNB employees took part in various distance learning programmes organised by foreign banks and international financial institutions, language and professional training courses, and seminars in Bulgaria and abroad.

Bank representative and protocol expenses came to BGN 49,000, or 0.1 per cent of operating expenditure.

The Bank spent BGN 1,066,000, or 35.9 per cent of annual projections, on BNB participation in the ESCB. The share of this expenditure in Bank's operating expenditure was 3 per cent.

The cost of BNB representatives' participation in ESCB committees and working groups and other EU bodies was BGN 400,000. The annual fee for European Banking Authority membership was BGN 647,000. Over the half year the Bank hosted a meeting of the ECB Committee on Monetary, Financial, and Balance of Payments Statistics.

2. The Investment Programme

The BNB spent BGN 3,129,000 on its Investment Programme in the first half of 2012, or 22.4 per cent of the approved annual budget. Programme implementation involved public tendering and ensuing negotiations. Their completion is expected in the second half of 2012, with disbursements under them following that.

Under the construction, refurbishment and modernisation item, BGN 7000 was spent on an architectural project for the restoration of the Plovdiv BNB Cash Centre façade.

In the period under review BGN 97,000 or 4.4 per cent of approved annual funds went on machines and equipment, vehicles, and other equipment. This included BGN 82,000-worth of equipment for the Bank's headquarters and staff recreation homes, and BGN 15,000-worth of equipment for servicing currency in circulation.

In the first half of 2012 funds invested into information systems totalled BGN 3,025,000, or 27.6 per cent of projected annual funds and 96.7 per cent of total investment for the review period. Investment funds went mostly on keeping the Bank's technological infrastructure modern.

The Bank spent BGN 579,000 to expand the functionality of existing information systems, and BGN 360,000 on software licences.

Hardware costs of BGN 2,086,000 went on equipping a backup information system centre at the Bank.

BNB Budget Implementation as of 30 June 2012

Indicator	Report 30 June 2012 (BGN'000)	Budget 2012 (BGN'000)	Budget Implementation (per cent)
Section I. Operating expenditure	35 290	84 117	42.0
Currency circulation expenditure	3 028	12 954	23.4
Materials, services, and depreciation expenditure	18 445	42 511	43.4
Staff expenditure	10 639	21 315	49.9
Social activity expenditure	1 567	2 254	69.5
Other administrative expenditure	545	2 115	25.8
BNB expenditure on ESCB membership	1 066	2 968	35.9
Section II. The investment programme	3 129	13 999	22.4
Expenditure on construction, refurbishment, and modernisation	7	596	1.2
Expenditure on machines, vehicles, and other equipment	97	2 229	4.4
Expenditure on computerisation	3 025	10 978	27.6
Investment related to ESCB membership	0	196	0.0

Source: BNB.

XVIII. Bulgarian National Bank Consolidated Financial Statements as of 30 June 2012

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

The Law on the Bulgarian National Bank requires the Governing Council to prepare financial statements to present the Bank's financial position and performance for the period.

The financial statements of the BNB approved by the Governing Council are prepared in accordance with the International Financial Reporting Standards adopted by the European Commission.

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 overall responsibility for taking such steps so as 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 Statement of Comprehensive Income for the Period Ended 30 June 2012 (unaudited)

(BGN'000)

	Note	30 June 2012	30 June 2011
Interest income	7	211,023	211,948
Interest expense	7	(1,202)	(13,729)
Net interest income		**209,821**	**198,219**
Fee and commission income		4,464	4,482
Fee and commission expense		(1,773)	(1,660)
Net fee and commission income		**2,691**	**2,822**
Net profit from financial assets and liabilities at fair value through profit or loss	8	45,987	(184,137)
Other operating income	9	29,417	29,539
Total income from banking operations		**287,916**	**46,442**
Administrative expenses	10	(52,947)	(50,851)
Profit for the period		**234,969**	**(4,408)**
Other comprehensive income			
Other comprehensive income		(75)	(197)
Other comprehensive income, total		**(75)**	**(197)**
Total comprehensive income for the period		**234,894**	**(4,605)**
Profit attributable to:			
Equity holder of the Bank		234,896	(4,440)
Non-controlling interest		73	32
Profit for the period		**234,969**	**(4,408)**
Total comprehensive income attributable to:			
Equity holder of the Bank		234,821	(4,637)
Non-controlling interest		73	32
Total comprehensive income for the period		**234,894**	**(4,605)**

The accompanying notes on pages 81 to 104 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Financial Position as of 30 June 2012 (unaudited)

(BGN'000)

	Note	30 June 2012	31 December 2011
ASSETS			
Cash and deposits in foreign currencies	11	6,294,241	6,722,318
Gold, instruments in gold and other precious metals	12	3,176,025	3,096,194
Financial assets at fair value through profit or loss	13	17,612,258	16,252,939
Financial assets available for sale	14	1,565,280	1,541,720
Tangible assets	15	223,009	225,219
Intangible assets	16	6,128	7,687
Other assets	17	69,015	63,398
Total assets		**28,945,956**	**27,909,475**
LIABILITIES			
Banknotes and coins in circulation	18	8,523,374	8,728,750
Due to banks and other financial institutions	19	6,741,245	6,179,598
Liabilities to government institutions and other liabilities	20	5,830,934	5,234,032
Borrowings against Bulgaria's participation in international financial institutions	21	2,869,272	2,824,412
Other liabilities	22	148,709	164,627
Total liabilities		**24,113,534**	**23,131,419**
EQUITY			
Capital	23	20,000	20,000
Reserves	23	4,808,258	4,753,965
Non-controlling interest	24	4,164	4,091
Total equity		**4,832,422**	**4,778,056**
Total liabilities and equity		**28,945,956**	**27,909,475**

The accompanying notes on pages 81 to 104 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Cash Flows
for the Period Ended 30 June 2012 (unaudited)

(BGN'000)

	Note	30 June 2012	30 June 2011
Operating activities			
Net profit		234,969	(4,408)
Adjustments:			
Dividend income		(8,621)	(7,961)
Depreciation	15, 16	12,865	12,769
(Profit)/loss on disposal of tangible assets		232	(10)
(Profit)/loss on financial assets and liabilities arising from market movements		(125,752)	47,952
(Profit) of associates		-	-
Other adjustments		(56)	(31)
Net cash flow from operating activities before changes in operating assets and liabilities		**113,637**	**48,311**
Change in operating assets			
(Increase) in gold, instruments in gold and other precious metals		(1,082)	(83)
(Increase)/decrease in financial assets at fair value through profit or loss		(1,291,016)	1,449,999
(Increase) in other assets		(5,820)	(9,590)
Change in operating liabilities			
(Decrease) in currency in circulation		(205,376)	(514,159)
Increase/(decrease) in due to banks and other financial institutions		561,647	(130,480)
Increase/(decrease) in due to government institutions and other liabilities		596,902	(313,095)
Increase in borrowings from IMF of total allocation of SDR		-	-
(Decrease) in other liabilities		(15,918)	(19,453)
Net cash flow used in/(from) operating activities		**(247,026)**	**511,450**
Investing activities			
Purchase of tangible and intangible assets		(9,347)	(3,302)
Dividends received		8,621	7,961
Other investments		-	-
Net cash flow used in/(from) investing activities		**(726)**	**4,659**
Financing activities			
Payments to the Government		(180,528)	(200,914)
Net cash outflow from financing activities		**(180,528)**	**(200,914)**
Net (decrease)/increase in cash and cash equivalents		**(428,280)**	**315,195**
Cash and cash equivalents at beginning of period		**6,764,467**	**5,718,030**
Cash and cash equivalents at end of period	11, 17	**6,336,187**	**6,033,225**

The accompanying notes on pages 81 to 104 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Changes in Equity for the Period Ended 30 June 2012 (unaudited)

(BGN'000)

Source of changes in equity	Capital	Revaluation of non-monetary assets	Special and other reserves	Total capital and reserves	Non-controlling interest	Total equity
Balance as of 1 January 2011	**20,000**	**140,044**	**4,186,696**	**4,346,740**	**3,854**	**4,350,594**
Profit for the period			(4,440)	(4,440)	32	**(4,408)**
Other comprehensive income:						
- other income		(197)		(197)		**(197)**
Other comprehensive income, total		(197)		(197)		**(197)**
Total comprehensive income for the period		(197)	(4,440)	(4,637)	32	**(4,605)**
Other movements		-	-	-	-	**-**
Contributions by and distributions to owners:						
- contribution to the budget of the Republic of Bulgaria			(200,914)	(200,914)		**(200,914)**
Transactions with owners, total			(200,914)	(200,914)		**(200,914)**
Balance as of 30 June 2011	**20,000**	**139,847**	**3,981,342**	**4,141,189**	**3,886**	**4,145,075**
Balance as of 1 January 2012	**20,000**	**138,773**	**4,615,192**	**4,773,965**	**4,091**	**4,778,056**
Profit for the period			234,896	234,896	73	**234,969**
Other comprehensive income:						
- other income		(42)	(33)	(75)		**(75)**
Other comprehensive income, total		(42)	(33)	(75)		**(75)**
Total comprehensive income for the period		(42)	234,863	234,821	73	**234,894**
Other movements		747	(747)	-	-	**-**
Contributions by and distributions to owners:						
- contribution to the budget of the Republic of Bulgaria			(180,528)	(180,528)		**(180,528)**
Transactions with owners, total			(180,528)	(180,528)		**(180,528)**
Balance as of 30 June 2012	**20,000**	**139,478**	**4,668,780**	**4,828,258**	**4,164**	**4,832,422**

The accompanying notes on pages 81 to 104 form an integral part of the Consolidated 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 Bulgarian state and is the central bank of the Republic of Bulgaria. The operation of the Bank is governed by the Law on the Bulgarian National Bank (LBNB), which has been effective since 10 June 1997.

Under this Law, the principal activities of the Bank may be summarised as:

- Maintaining price stability through ensuring national currency stability;
- Exclusive right to issue banknotes and coins;
- Regulation and supervision of other banks' activities in the country with a view to banking system stability maintenance;
- Establishment and operation of efficient payment systems and their oversight;
- The Bank shall 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 provide credit to 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 lev equivalent of the gross international foreign currency reserves;
- Under terms agreed with the Minister of Finance, the Bank acts as agent for public debts or for debts guaranteed by the State;
- The Bank acts as a central depository of government securities.

The Governing Council of the BNB approved the Consolidated Financial Statements, set out on pages 75 to 104, on 22 November 2012.

2. Applicable Standards

These Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Commission.

3. Basis of Preparation

The Financial Statements are presented in Bulgarian levs rounded to the nearest thousand (BGN'000) They are prepared on a historical cost basis, except for derivative financial instruments, financial assets and liabilities at fair value through profit or loss, available-for-sale assets and properties presented at fair value.

When preparing the financial statements in conformity with IFRSs, the Bank makes judgement, estimates and assumption that affect the reported amounts of assets and liabilities for the following financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under certain 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 polices 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 share in the net assets of the Bank's subsidiaries, which corresponds to the minority shareholders' proportionate share, is disclosed separately from Capital and Reserves under the Non-controlling Interest item.

Associated companies

Associates are those entities in which the Bank has significant influence, but which are neither subsidiary enterprise nor joint venture. Investments in associates are included in the Bank's Consolidated Financial Statements on an equity accounted basis as an amount corresponding to the Bank's share in the associates' own funds as of the end of the reporting period. The Bank's share of associates' net results subsequent to acquisition is disclosed in the *profit or loss* as investment income/expenses and is added to/ subtracted from the carrying value of the investment.

5. Principal Accounting Policy Elements

(a) Income recognition

Interest income and expenses are recognised in the 'profit or loss' on an effective interest rate basis. The effective interest rate is the rate which precisely discounts the expected future cash payments and income over the term of the financial asset or liability to the book value of the asset or liability. The effective interest rate is determined on the initial recognition of the financial asset or liability and does not change thereafter.

The calculation of the effective interest rate includes all commissions received or paid and any discounts or premiums which are integral parts of the effective interest rate. Transaction costs are intrinsic costs directly attributable to the acquisition, issue or derecognition of a financial asset or liability.

Interest income and expense in the 'profit or loss' include:

- interest on financial assets and liabilities at amortised cost calculated by the effective interest rate method;
- interest on investment securities available for sale calculated by the effective interest rate method.

Dividends are recognised in the profit or loss when the Bank establishes the right to their receipt. Exchange rate gains or losses from available-for-sale investments are recognised in the profit or loss.

Net profit/loss from financial assets and liabilities at fair value through profit or loss includes net gains from operations in securities, net gains from operations in foreign currency, net revaluation gains on securities, net gains from gold revaluation, net gains from revaluation of futures, and net gains from revaluation of assets and liabilities denominated in foreign currencies.

(b) Financial instruments

1) 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 or loss are those that the Bank holds primarily 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 for trading (negative fair value), as well as options written, if any, are reported as trading liabilities.

Loans and receivables are instruments 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 financial asset intended for this purpose at its initial recognition

2) Recognition

The Bank recognises trading financial assets and investments, the Bank's loans and receivables, and financial liabilities at amortised cost on the settlement date. All other financial assets and financial liabilities are initially recognised on the trade date when the Bank becomes a party to the contracted provisions of the instrument. From that moment on, any gains and losses arising from changes in their fair value are recognised by the Bank.

Financial instruments are initially recognised at fair value, and for those financial instruments which are not recognised at fair value through profit or loss the amount recognised includes directly attributable acquisition costs.

3) Amortised cost measurement

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured upon the initial recognition, minus principal repayments, plus or minus cumulative amortisation, using an effective interest rate for the difference between the initially recognised amount and the amount at maturity minus any reduction for impairment.

4) Fair value measurement and disclosure principles

Fair value is the amount at which an asset can be exchanged or a liability can be settled, between informed consenting parties on the measurement date.

Whenever possible, the Bank measures the fair value of an instrument using quoted prices in an active market of this instrument. A market is considered active if quoted prices are regularly published and easily accessible and there are actual regular and direct market transactions on an arm's length basis.

If the market for a financial instrument is not active, the Bank establishes the fair value using valuation techniques. They include using recent arm's length transactions between knowledgeable, willing parties (if available), comparison with the current fair values of other instruments, that are substantially the same, discounted cash flow analyses and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Bank, incorporates all factors that market participants would consider in setting a price, and is consistent with accepted economic methodologies for pricing financial instruments.

Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Bank calibrates valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument or based on other available observable market data.

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price, i.e., the fair value of the consideration given or received, unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When the transaction price provides the best evidence of fair value at initial recognition, the financial instrument is initially measured at the transaction price and any difference between this price and the value initially obtained from a valuation model is subsequently recognised in profit or loss on an appropriate basis over the life of the instrument but not later than when the valuation is supported wholly by observable market data or the transaction is closed out.

Assets and long positions are measured at a bid price; liabilities and short positions are measured at an asking price. Where the Bank has positions with offsetting risks, mid-market prices are used to measure them and a bid or asking price adjustment is applied only to the net open position as appropriate. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Bank entity and the counterparty where appropriate. Fair value estimates obtained from models are adjusted for any other factors, such as liquidity risk or model uncertainties, to the extent that the Bank believes a third-party market participant would take them into account in pricing a transaction.

5) Derecognition

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire, or when it transfers the rights to the receipt of the contractual cash flows from the financial asset in the transaction in which all material risks and profits from the holding of the financial asset are transferred. Any holding in transferred financial assets, which has been originated or kept by the Bank, is recognised as a separate asset or liability.

The Bank derecognises a financial liability when its contractual obligations have been fulfilled or cancelled, or have extinguished.

The Bank conducts transactions for transferring assets recognised in the statement of financial position, but it retains all or almost all material risks and rewards from the transferred assets or a portion of them. If some or all material risks and profits have been retained, then the transferred assets are not derecognised from the statement of financial position. A transfer of assets which retain some or all material risks and profits is, for instance, a securities lending agreement or a repurchase transaction.

In transactions where the Bank does not keep, nor does it transfer, all material risks and profits from the holding of a financial asset, it derecognises the asset if it does not keep control of that asset. The rights and obligations kept in the transfer are recognised separately as assets and as liabilities respectively. In transactions where control of the asset is retained, the Bank continues recognising the asset up to its participation, depending on the extent to which the Bank is exposed to changes in the value of the transferred asset.

In certain transactions, the Bank retains the obligation to service the transferred financial asset for a fee. The transferred asset is derecognised if it meets the derecognition criteria. An asset or liability is recognised for the servicing contract, depending on whether the servicing fee is more than adequate (asset) or is less than adequate (liability) for performing the servicing.

6) Offsetting

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Bank has a legal right to offset the recognised amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under IFRSs, or for gains and losses arising from a group of similar transactions such as in the Bank's trading operations.

7) Impairment of assets

Financial assets which are not carried at fair value through profit or loss are reviewed at each reporting date to determine whether there is evidence of impairment. A financial asset is impaired if there is objective evidence of impairment as a result of a loss event that occurred after the initial recognition of the asset and that the loss event had an impact on the estimated future cash flows of the asset and a reliable estimate of the loss can be made.

Objective evidence of impairment loss from financial assets, including equity instruments, is a default or a borrower's inability to repay his obligations, restructuring of loans under unfavourable financial conditions for the Bank, indications that a borrower or the issuer of a financial instrument would go out of business, the disappearance of an active security market, or other public information. Furthermore, in case of a continuous or significant fall in the market value of an investment in equity instruments, there is objective evidence of impairment of these equity instruments.

The Bank judges the need of impairment of loans or investments to maturity on an individual or group basis. All individually significant loans and investments to maturity are evaluated for specific impairment. All individually significant loans and investments held to maturity on which no specific impairment losses have been charged are evaluated on a portfolio basis. Loans and advances and held-to-maturity investment securities that are not individually significant are collectively assessed for impairment by grouping together loans and advances and held-to-maturity investment securities with similar risk characteristics. In assessing collective impairment, the Bank uses statistical modelling of historical trends of the probability of default, timing of recoveries and the amount of loss incurred, adjusted for management's judgement as to whether current economic and credit conditions are such that the actual losses are likely to be greater or less than suggested by historical modelling. Default rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

Impairment losses from assets entered at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of the approximately estimated future cash flows discounted by the initial effective interest rate of the asset. Losses are recognised in profits and losses and go to an allowance account against loans and receivables. Interest on the impaired asset is still recognised through depreciation of the discount. When a subsequent event reduces the impairment loss, the reduction in the impairment loss is reversed in profit and loss.

Impairment losses on available-for-sale investment securities are recognised by transferring the cumulative loss that has been recognised in other comprehensive income to profit or loss as a reclassification adjustment. The cumulative loss that is reclassified from other comprehensive income to profit or loss is the difference between the acquisition cost, net of any principal repayment and amortisation, and the current fair value, less any impairment loss previously recognised in profit or loss.

If in a subsequent period the fair value of an impaired debt security available for sale increases and the increase can be objectively linked to an event that occurred after the impairment loss had been recognised in profit and loss, then the impairment loss is reversed and the reversed amount is recognised in profit and loss. However, any subsequent recovery in the fair value of an impaired equity instrument available for sale is directly recognised in other comprehensive income.

8) Financial assets/liabilities held for trading

Financial assets at fair value through profit or loss include instruments for trading which the Bank holds primarily for the purpose to sell or repurchase in the short term or holds them as part of a portfolio which is managed as a whole with the purpose of short-term profit.

Initially, the financial assets and liabilities for trading are recognised at fair value in the statement of financial position and the transaction costs go directly to profit and loss. All changes in the fair value are recognised as net income from trading operations in the profit or loss.

9) Investments

(1) Held-to-maturity investments

Held-to-maturity financial assets are non-derivative assets with fixed or determinable payments and fixed maturity that the Bank has the intent and ability to hold to maturity, are not designated at fair value through the profit or loss, and are not available for sale financial assets.

Held to maturity investments are carried at amortised cost on the basis of an effective interest rate method. In case of sale or reclassification of more than an insignificant part of the assets held to maturity which are not falling due in the immediate future, there should be a reclassification of the entire portfolio of investments held to maturity in the group of available for sale investments. As a result of this reclassification, the Bank may not classify investments as investments held to maturity in the current year, and in the following two years.

(2) Financial assets available for sale

Available-for-sale investments are non-derivative assets that cannot be classified in any other category of financial assets. Equity investments not quoted in the market and whose fair value cannot be reliably measured are carried at cost. All other available for sale assets are carried at fair value.

Differences in the fair value are recognised directly in other comprehensive income until the investment is sold or fully impaired, when the cumulative income and expense recognised in other comprehensive income are in the profit or loss.

(c) Gold and other precious metals

The BNB as a central bank maintains particular volumes of gold as part of Bulgaria's international reserves. In compliance with the requirements of the Law on the BNB, the Bank may take any necessary action in connection with the acquisition, possession and sale of gross international reserves, including monetary gold. Consequently, monetary gold as part of international reserves may be immediately used by the BNB without further constraints which determines it as a monetary asset. Pursuant to the requirements of the *General provisions for defining the valuation basis in the financial statements* to the IFRS, the Bank defines the recognition and valuation of the monetary gold as a financial asset reported at fair value through profit or loss as the most reliable and appropriate base for a subsequent valuation of this financial asset.

Gold and other precious metals are measured at market value based on the official London Bullion Market closing price at the reporting 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 measured at fair value.

Details of investments held by the Bank are set out in note 14.

(e) Property, plant, equipment and intangible assets

The Bank pursues a policy of recognising land and buildings at revalued amount as per the alternative approach allowed in IAS 16 *Property, Plant and Equipment*. The other groups of property, plant, equipment and intangible assets are measured in the statement of the financial position at their acquisition cost, less accumulated depreciation, and impairment losses.

Land and buildings are recognised at fair value which is regularly assessed by professional qualified valuers. The revaluation of property is done asset by asset, and any accrued depreciation at the revaluation date is derecognised on the gross balance sheet amount on the assets side, and the net value is recalculated against the revaluation of the asset. When the value of assets increases as a result of revaluation, the increase is reflected directly in the other comprehensive income. When the value of assets decreases as a result of revaluation, the decrease is recognised by decreasing the revaluation reserve in equity, and in case of a shortage, the difference is recognised as an expense in the profit or loss.

1) Subsequent expenditure

The separately accounted for expenditure incurred to replace a component of an item of property, plant and equipment are capitalised. All other subsequent expenditures are capitalised only future economic benefits embodied in the item of property, plant and equipment will flow to the Bank. All other expenditures are recognised in the 'profit or loss' as an expense as incurred.

2) Depreciation

Depreciation is provided on a straight-line basis at prescribed rates designed to write down the cost of revalued amount of property, plant, equipment and intangible assets over their estimated useful lives. Land is not depreciated. The annual depreciation rates used are as follows:

(%)

Buildings	2 – 4
Plant & equipment	3 – 15
Computers	30 – 33.3
Fixtures and fittings	15 – 20
Motor vehicles	8 – 25
Intangible fixed assets	20 – 25

Expenditures incurred for the acquisition of property, plant, equipment and intangible assets are not depreciated until they are brought into use.

3) Calculation of recoverable amount of assets

The recoverable amount of the Bank's property, plant and equipment is the greater of the net selling price or 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.

4) 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 recognising impairment loss.

(f) Foreign exchange

Income and expenditure arising in foreign currencies are translated to BGN at the official rates of exchange on the transaction date. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated at the official exchange rate of the Bank on that day. Foreign exchange gains and losses resulting from the revaluation of monetary assets and liabilities are recognised in the profit or loss. Foreign currency denominated non-monetary assets and liabilities are valued at the exchange rate at the date of the transaction or at latest determination date of fair value.

Outstanding forward contracts in foreign exchange are marked to market. The gains and losses on revaluation of outstanding forward contracts are recognised in the profit or loss.

The exchange rates of the major foreign currencies as of 30 June 2012 and 31 December 2011 are as follows:

Currency	30 June 2012	31 December 2011
US dollars	1 : BGN 1.55348	1 : BGN 1.51158
Euro	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rrights	1 : BGN 2.35748	1 : BGN 2.32068
Gold	1 troy ounce: BGN 2,440.90	1 troy ounce: BGN 2,380.35

(g) Taxation

The Bank is not subject to income tax on income from its core activities. Tax on the profit from subsidiaries for the period comprises current tax and deferred tax. 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 at the reporting date. Deferred tax is derived using the balance sheet liability method on all temporary differences between the amounts used for taxation purposes and the carrying amounts of assets and liabilities.

The deferred tax is calculated on the grounds of the tax rates which are expected to be used for the period of asset realisation or liability settlement. The effect on the deferred tax from changes in the tax rates is recorded in the statement of comprehensive income up to the amount already charged or reported directly as other comprehensive income.

A deferred tax asset is recognised up to the amount to which it is probable to acquire future taxable profits against which the unused tax losses or tax credit could be utilised. The deferred tax assets are decreased in the degree in which it is not probable to realise relevant tax benefits.

(h) Profit distribution policy of the Bank

The Bank's policy of distribution of profit from banking operations is defined in the Law on the BNB. Internal rules for preparation of financial statements and accounting policies were adopted upon a decision of the Governing Council effective from 1 January 2007, which are in compliance with Article 36, paragraphs 1 and 2 of the Law on the BNB. According to these rules, the Bank allocates to special reserves unrealised net gains and losses arising from revaluation of assets and liabilities denominated in foreign currency or gold. According to the requirements of Article 8, paragraph 2 of the Law on the BNB, the Bank sets aside 25 per cent of the excess of its annual revenue over its annual expenditure into a Reserve Fund. According to Article 8, paragraph 3 of the Law on the BNB, after the allocation to the Reserve Fund, the Bank may allocate reserves to cover market risk losses and other reserves upon a decision of the Governing Council. Subsequent to the allocation of reserves as required by the Law on the BNB, the Bank stipulates the remainder to be paid into the State Budget. The distribution of excess of income over expenditure is set out in note 23.

(i) 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.

(j) Employee benefits

The Bank has the obligation to pay certain amounts to each employee who retires in accordance with the requirements of Article 222, § 3 of the Labour Code in Bulgaria. According to these Labour Code requirements, on termination of the employment contract of an employee who has become entitled to retirement, the employer is obliged to pay him/her compensation amounting to twice his/her gross monthly salary. If, at the date of retirement, the employee has been employed by the Bank for ten or more years, the amount of the compensation is six gross monthly salaries. The Management of the Bank estimates the approximate amount of the potential expenditures for every employee based on a calculation performed by an actuary using the projected unit credit method. The estimated amount of the obligation and the main assumptions, on the base of which the estimation of the obligation has been made, is disclosed to the financial statements in note 10.

Termination benefits

Termination benefits are recognised as an expense when the Bank is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognised as an expense if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably. If benefits are payable more than 12 months after the reporting period, then they are discounted to their present value.

Short-term employee benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Bank has a present constructive obligation to pay this amount as a result of past services provided by the employee, and the obligation can be estimated reliably. The Bank recognises as a liability the undiscounted amount of the estimated costs related to annual leave expected to be paid in exchange for the employee's service for the period completed.

(k) New standards and interpretations which have not been adopted so far

Certain new standards, amendments to standards and interpretations which will become effective for financial periods beginning after 1 January 2012, have not been early adopted when preparing these Consolidated Financial Statements. Management does not expect that these future changes will have an impact on the Bank's Consolidated Financial Statements.

Standards, interpretations and amendments to standards, issued by the IAS Board and the IFRS Interpretations Committee which so far the European Commission has not endorsed for adoption

Management believes that it is appropriate to disclose that the following new or revised standards, new interpretations and amendments to current standards, which, as of the reporting date, have already been issued by the International Accounting Standards Board (IASB), are not yet endorsed for adoption by the European Commission, and therefore are not taken into account in preparing these Financial Statements. The actual effective dates for them will depend on the endorsement decision by the EC:

- IFRS 9 Financial Instruments (issued in November 2009) and Amendments to IFRS 9 (issued in October 2010) will become effective on 1 January 2015 and may change the classification and measurement of financial instruments.
- IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IFRS 12 Disclosure of Interests in Other Entities and IFRS 13 Fair Value Measurement (issued in May 2011) effective from 1 January 2013. The IASB also issued IAS 27 Separate Financial Statements (2011) superseding IAS 27 Consolidated and Separate Financial Statements (2008) and IAS 28 Investments in Associates and Joint Ventures (2011) superseding IAS 28 Investments in Associates (2008) which will become effective as of 1 January 2013.
- Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards – Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters (issued in December 2010), in effect as of 1 July 2012.
- Amendments to IAS 12 Deferred Tax: Recovery of Underlying Assets (issued in December 2010), in effect as of 1 January 2012.
- In December 2011, the IASB issued amendments to IFRS 7 Disclosures – Offsetting Financial Assets and Financial Liabilities with effective date 1 January 2013.
- In December 2011, the IASB issued amendments to IAS 32 Financial Instruments – Disclosure and Presentation – Offsetting Financial Assets and Financial Liabilities with effective date 1 January 2014.
- Amendments to IFRS 1 – First-time Adoption of International Financial Reporting Standards – Government Loans (issued on 13 March 2012) with effective date 1 January 2013.
- Improvements to IFRS (2009 – 2011), (issued on 17 May 2012), with effective date 1 January 2013.
- Amendments to IFRS 10, IFRS 11 and IFRS 12, Transition Guidance (issued on 28 June 2012), with effective date 1 January 2013.
- Interpretation IFRIC 20 Stripping Costs in the Production Phase of a Surface Mine coming into effect on 1 January 2013.

6. Financial Risk Management Policy Disclosure

(a) Introduction and overview

The Bank is exposed to the following types of risk in relation to the operations with financial instruments:

- credit risk;
- liquidity risk;
- market risk;
- operational risk.

This note provides information on the Bank's goals, exposures to each of the above types of risk and the policies and processes for risk measurement and management.

General provisions of risk management

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

The major portion of BNB's international reserves is invested in relatively low credit risk assets such as discount and coupon securities issued by governments, government agencies or supranational financial institutions, and 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 risks to the international reserves are managed by an independent risk management unit. It is directly responsible for the strategic asset allocation and the determination of the international reserves benchmark, and prepares and submits for approval the investment management limits. On a quarterly basis, an overall review is made of the changes in the market conditions, the amount and structure of international reserves, and if required, the investment limits and model portfolios (benchmarks) are updated. The monitoring of underlying limits, rules, and procedures is undertaken on a daily basis. Reports are regularly prepared both for the needs of international reserves operating management, and for providing updated information to the Bank's management.

All approved financial instruments and asset classes in which the BNB can invest are set out in internal documents. The documents define the main portfolios and the respective model portfolios (benchmarks), as well as limits for credit, interest rate, currency and operational risk, and list the approved debt instrument issuers which the BNB can invest in and the foreign financial institutions acting as BNB counterparties.

The international reserves management is governed by rules of behaviour and procedures regulating the performance of the functions and tasks of the main structural units involved in the process.

(b) Credit risk

The BNB is exposed 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 purchases and sales of foreign currency with banks. In general, this credit risk is associated with the probability of insolvency of a BNB's counterparty or the insolvency of an issuer, in whose debt instruments the Bank has invested its own funds. The credit risk in managing BNB's gross international reserves is assessed in line with the requirements in Article 28, paragraph 3 of the Law on the BNB. According to these requirements, the BNB may invest in debt instruments issued by foreign governments, central banks, other foreign financial institutions or international financial organisations whose debts are rated with one of the top two grades by two internationally recognised credit rating agencies and are payable in freely convertible currency in line with internally developed methodology as per the requirements of Article 28 of the LBNB.

According to these requirements, the approved types of financial instruments for investment of funds in managing the international reserves are as follows:

- Investment programmes with central banks;
- Automatic borrowings/lending of securities with the main depository;
- Deposits in foreign currency (time deposits and funds on current accounts) with counterparties or central banks;

- Deposits in gold (time deposits and funds on current accounts) with counterparties, central banks or supranational financial institutions;
- Commercial securities (of up to 1 year term to maturity), issued by governments or government guaranteed institutions, supranational financial institutions, specialised financial agencies, banks, and other financial institutions – issuers of European covered bonds;
- Bonds issued by governments or government guaranteed institutions, supranational financial institutions, specialised financial agencies, banks and other institutions – issuers of covered bonds. All bonds must be with a one-off payment of their face value on the maturity date and without any embedded option;
- Purchases and sales of foreign currency with a value date of up to 2 business days.

Two basic types of limits are set which are calculated based on the market value of foreign currency reserves – 1) maximum or minimum limit on the weight of each asset class and 2) individual maximum acceptable exposure of the BNB to an issuer/counterparty (concentration limit).

(c) Liquidity risk

Liquidity risk arises in the funding of the Bank's core activities and in the management of positions. It is primarily manifested in two aspects: the first aspect is the risk for the Bank of being unable to meet its obligations when due, and the second aspect comprises the risk of its being unable to sell an asset on international markets at a fair value within an appropriate time frame in compliance with the respective market conventions.

The BNB seeks to keep up a balance between the maturity of attracted funds and that of assets through investments in financial instruments with a range of maturities. The instruments for attracting funds, which are provided to customers on the liability side, are primarily deposit/investment accounts and settlement accounts. Minimum liquidity by type of currency is provided on a daily basis, thus ensuring all BNB foreign currency payments. To better manage the risk arising from liquidation of positions in financial instruments, the latter are grouped by liquidity rank subject to the level of difficulty (i.e. discount from the fair value), at which they could be sold on the market in critical times. Limits are set for the different types of financial instruments based on the liquidity ranks.

As part of its overall liquidity risk management strategy, the Bank has defined requirements for the management of a portfolio of liquid assets denominated in euro and for maintaining assets denominated in other currencies for the purposes of meeting its cash inflows and outflows.

The Bank's financial assets and liabilities, analysed by residual term to maturity from the date of the statement of financial position to the date of any subsequent agreement or agreed maturity, are as follows:

(BGN'000)

As of 30 June 2012	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	Over 5 years	Undefined maturity	Total
Financial assets							
Cash and deposits in foreign currencies	6,294,241	-	-	-	-	-	6,294,241
Gold, instruments in gold, and other precious metals	568,514	1,311,415	-	-	-	1,296,096	3,176,025
Financial assets at fair value through profit or loss	1,760,761	2,005,924	5,061,900	8,440,795	342,878	-	17,612,258
Financial assets available for sale	80,393	-	-	-	-	1,484,887	1,565,280
Other assets	10,826	10,500	20,494	126	-	-	41,946
Total financial assets	**8,714,735**	**3,327,839**	**5,082,394**	**8,440,921**	**342,878**	**2,780,983**	**28,689,751**
Financial liabilities							
Banknotes and coins in circulation						8,523,374	8,523,374
Due to banks and other financial institutions	6,741,245	-	-	-	-	-	6,741,245
Liabilities to government institutions and other borrowings	5,592,304	13,692	224,938	-	-	-	5,830,934
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	2,869,272	2,869,272
Total financial liabilities	**12,333,549**	**13,692**	**224,938**	**-**	**-**	**11,392,646**	**23,964,825**
Asset-liability maturity mismatch	**(3,618,814)**	**3,314,147**	**4,857,456**	**8,440,921**	**342,878**	**(8,611,663)**	**4,724,926**

(BGN'000)

As of 31 December 2011	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	Over 5 years	Undefined maturity	Total
Financial assets							
Cash and deposits in foreign currencies	6,526,069	-	196,249	-	-	-	6,722,318
Gold, instruments in gold, and other precious metals	1,365,445	466,816	-	-	-	1,263,933	3,096,194
Financial assets at fair value through profit or loss	1,353,216	1,844,674	7,926,658	4,787,545	340,846	-	16,252,939
Financial assets available for sale	79,138	-	-	-	-	1,462,582	1,541,720
Other assets	12,534	6,706	22,909	-	-	-	42,149
Total financial assets	**9,336,402**	**2,318,196**	**8,145,816**	**4,787,545**	**340,846**	**2,726,515**	**27,655,320**
Financial liabilities							
Banknotes and coins in circulation	-	-	-	-	-	8,728,750	8,728,750
Due to banks and other financial institutions	6,179,598	-	-	-	-	-	6,179,598
Liabilities to government institutions and other borrowings	3,241,167	1,992,865	-	-	-	-	5,234,032
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	2,824,412	2,824,412
Total financial liabilities	**9,420,765**	**1,992,865**	**-**	**-**	**-**	**11,553,162**	**22,966,792**
Asset-liability maturity mismatch	**(84,363)**	**325,331**	**8,145,816**	**4,787,545**	**340,846**	**(8,826,647)**	**4,688,528**

The outstanding contractual maturities of the Bank's financial liabilities are as follows:

(BGN'000)

	Book value	Gross nominal outgoing cash flow	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	Over 5 years
As of 30 June 2012							
Banknotes and coins in circulation	8,523,374	8,523,374	-	-	-	-	8,523,374
Due to banks and other financial institutions	6,741,245	6,741,245	6,741,245	-	-	-	-
Liabilities to government institutions and other borrowings	5,830,934	5,831,189	5,592,304	13,695	225,190	-	-
Borrowings against Bulgaria's participation in international financial institutions	2,869,272	2,869,272	-	-	-	-	2,869,272
	23,964,825	**23,965,080**	**12,333,549**	**13,695**	**225,190**	**-**	**11,392,646**
As of 31 December 2011							
Banknotes and coins in circulation	8,728,750	8,728,750	-	-	-	-	8,728,750
Due to banks and other financial institutions	6,179,598	6,179,598	6,179,598	-	-	-	-
Liabilities to government institutions and other borrowings	5,234,032	5,234,261	3,241,167	1,993,094	-	-	-
Borrowings against Bulgaria's participation in international financial institutions	2,824,412	2,824,412	-	-	-	-	2,824,412
	22,966,792	**22,967,021**	**9,420,765**	**1,993,094**	**-**	**-**	**11,553,162**

(d) Market risk

Market risk

All financial instruments are subject to market risk, i.e. the risk of impairment as a result of changes in the market conditions. The instruments are evaluated on a daily basis at fair market value which best reflects current market conditions for the respective type of financial instrument. The Bank manages its portfolios in response to changing market conditions and to changes in the liability structure of Issue Department balance sheet. Exposure to market risk is managed in accordance with the relevant limits set forth in the *Investment Limits and Benchmarks for the Management of the Gross International Reserves*.

The table below presents one important measure of market risk, i.e. Value at Risk (VaR). VaR is an indicator of the maximum loss over a certain period of time (holding period) and with a certain probability (called confidence level or confidence interval). The VaR used in this report is based on a 95 per cent confidence level and a one-day holding period.

For the calculation of the total risk, the currency risk and the interest rate risk, the empiric distributions, derived from time series of 30 daily observations of total income, currency income and interest income of assets, respectively have been used. The correlation between the currency and interest rate risk is also presented. For each of the parameters, the value as of the last date for the period, the average value for the whole period, as well as the minimum and maximum values have been calculated.

(BGN'000)

	As of 30 June 2012	Average	Maximum	Minimum
Currency risk	(45,514)	(32,595)	(54,420)	(23,909)
Interest rate risk	(6,571)	(3,837)	(6,017)	(1,920)
Correlation (per cent)	0.13	0.18	0.57	(0.11)
Overall risk	**(48,000)**	**(33,465)**	**(51,273)**	**(23,440)**
	As of 31 December 2011	Average	Maximum	Minimum
Currency risk	(47,488)	(48,590)	(117,776)	(19,207)
Interest rate risk	(1,867)	(7,117)	(12,912)	(1,680)
Correlation (per cent)	(0.07)	0.17	0.70	(0.45)
Overall risk	**(49,352)**	**(48,625)**	**(116,265)**	**(18,352)**

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations, which impacts the prices of interest-earning assets (including investments) and interest-bearing liabilities. The Bank uses modified duration as a key measurement for interest rate risk. Modified duration measures the effect of the change in the market value of an asset (liability) in percentage points in response to 1 basis point (1/100th of 1 per cent) change in the interest rate levels. In addition, portfolios' technical parameters such as protuberance (convexity), duration in a fixed point of the yield curve, etc. are monitored on a daily basis. 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 deviation of the modified duration of the portfolio from that of the respective benchmark.

Assets and liabilities with floating interest rates involve the risk of changes in the base which serves to determine the interest rates.

(BGN'000)

	Total	Floating rate instruments	Fixed rate instruments		
			Up to 1 month	From 1 month to 3 months	Over 3 months
As of 30 June 2012					
Interest-earning assets					
Cash and deposits in foreign currencies	6,221,763	2,309,600	3,912,163	-	-
Gold, instruments in gold and other precious metals	1,879,876	-	568,513	1,311,363	-
Financial assets at fair value through profit or loss	17,515,847	1,349,353	1,474,589	1,993,542	12,698,363
Financial assets available for sale	80,393	-	80,393	-	-
Other interest-earning assets	41,946	4,741	6,085	10,500	20,620
Total	**25,739,825**	**3,663,694**	**6,041,743**	**3,315,405**	**12,718,983**
Interest-bearing liabilities					
Due to banks and other financial institutions	6,179,598	-	6,179,598	-	-
Liabilities to government institutions and other borrowings	3,100,329	-	2,861,718	13,691	224,920
Borrowings against Bulgaria's participation in international financial institutions	1,440,127	1,440,127	-	-	-
Total	**10,720,054**	**1,440,127**	**9,041,316**	**13,691**	**224,920**
Interest-bearing assets/liability gap	**15,019,771**	**2,223,567**	**(2,999,573)**	**3,301,714**	**12,494,063**
As of 31 December 2011					
Interest-earning assets					
Cash and deposits in foreign currencies	6,635,495	2,242,276	4,197,636	-	195,583
Gold, instruments in gold and other precious metals	1,498,736	-	1,031,942	466,794	-
Financial assets at fair value through profit or loss	16,165,186	1,342,240	1,338,616	1,833,778	11,650,552
Financial assets available for sale	79,138	-	79,138	-	-
Other interest-earning assets	42,149	3,788	8,746	6,706	22,909
Total	**24,420,704**	**3,588,304**	**6,656,078**	**2,307,278**	**11,869,044**
Interest-bearing liabilities					
Due to banks and other financial institutions	6,179,598	-	6,179,598	-	-
Liabilities to government institutions and other borrowings	3,465,346	-	1,474,249	1,991,097	-
Borrowings against Bulgaria's participation in international financial institutions	1,417,647	1,417,647	-	-	-
Total	**11,062,591**	**1,417,647**	**7,653,847**	**1,991,097**	**-**
Interest-bearing assets/liability gap	**13,358,113**	**2,170,657**	**(997,769)**	**316,181**	**11,869,044**

For managing interest rate risk and the band of interest rate changes, the sensitivity of financial assets and liabilities to various standard and non-standard interest rate movement scenarios is monitored.

The standard scenarios include the following changes in yield curves: 1) 100 basis points instant and parallel increase; 2) 100 basis points instant and parallel decrease; 3) 50 basis points parallel increase in the yield curves for a period of 12 months, and 4) 50 basis points parallel decrease in the yield curves also for a period of 12 months. The second two scenarios assume that the change in yields takes place at the beginning of the period and over the one-year period the yield curve remains unchanged.

The analysis of the sensitivity of the Bank's assets (to first approximation) to changes in interest rates, assuming a constant spread of assets and liabilities and expectations for parallel movements of the yield curves of the relevant assets, is as follows:

(BGN'000)

	100 b.p. parallel increase	100 b.p. parallel decrease	50 b.p. parallel increase in 1 year	50 b.p. parallel decrease in 1 year
As of 30 June 2012	(205,783)	205,783	101,973	93,445
As of 31 December 2011	(138,134)	138,134	177,533	113,485

Currency risk

For the Bank a currency risk exists where there is a mismatch between the currency structure of assets and that of liabilities. The Bank is exposed to currency risk when conducting transactions in financial instruments denominated in foreign currencies other than the euro.

With the introduction of the currency board arrangement in Bulgaria and the pegging of the Bulgarian currency to the euro, the Bank's financial statements, prepared in Bulgarian levs, are affected by movements in the exchange rate of the lev against the currencies other than the euro.

To minimize currency risk, there is a limit to the mismatches between the currency structure of assets and that of liabilities. According to Article 31, paragraph 3 of the Law on the BNB, the total market value of assets in a foreign currency other than the euro, SDR and monetary gold, may not deviate by more than +/-2 per cent from the market value of the liabilities denominated in these currencies.

(BGN'000)

	30 June 2012	31 December 2011
Assets		
Bulgarian lev, euro and currencies of euro area countries*	22,757,686	21,906,659
US dollar	80,042	19,195
Japanese yen	153	220
Pound sterling	158	212
SDR	2,973,010	2,927,098
Gold	3,132,216	3,053,483
Other	2,691	2,608
	28,945,956	27,909,475
Liabilities, Capital and Reserves		
Bulgarian lev, euro and currencies of euro area countries	25,992,708	25,062,368
US dollar	80,574	19,154
Japanese yen	-	-
Pound sterling	-	-
SDR	2,870,022	2,825,351
Other	2,652	2,602
	28,945,956	27,909,475
Net position		
Bulgarian lev, euro and currencies of euro area countries	(3,235,022)	(3,155,709)
US dollar	(532)	41
Japanese yen	153	220
Pound sterling	158	212
SDR	102,988	101,747
Gold	3,132,216	3,053,483
Other	39	6

* Currencies of Member States prior their accession to the euro area, which are bought by the central banks.

(e) Using accounting judgements and assumptions

The Governing Council discusses the development, choice, and disclosure of essential accounting policies and measurements, as well as their implementation.

These disclosures supplement the notes to the financial risk management.

The Bank is operating in a complicated global economic and financial environment which also affects the Bulgarian market and could have negative implications for the Bank's performance and risk. Management has already taken measures, and its major priorities in the next few years will still be to keep the Bank's stable liquidity position and the continuous improvement in its evaluation methods, international reserves quality control and management.

Major sources of uncertainty for evaluation

1) Determination of fair values

The determination of fair values of financial assets and liabilities for which there is no observable market price requires the use of valuation techniques described in the accounting policy. For financial instruments that trade infrequently and whose price is not transparent, the fair value is less objective and requires an expert's judgement depending on liquidity, concentration, market factors uncertainty, pricing assumptions, and other risks affecting the particular instrument.

2) Measurement of financial instruments

The Bank measures the fair value of financial instruments using the following hierarchy of methods:

- Level 1: Quoted market price or a price for closing positions for which there is a reliable market;
- Level 2: Valuation techniques based on observable market information about the yield curve. This category of methods is used to evaluate debt securities for which there is no reliable market.
- Level 3: Valuation techniques, where inputs on financial assets and liabilities are not based on observable market data.

The fair values of financial assets and liabilities traded in international financial markets for which there is accessible market information are based on market quotes or prices formed at the closing of a market. The use of actual market prices and information reduces the need for managerial judgement and assumptions, and the uncertainty surrounding the determination of fair values. The availability of actual market prices and information varies depending on products and markets and changes because of specific events and the general conditions of financial markets. The Bank determines the fair values of all other financial instruments for which there are no current market quotes by using a valuation technique based on a net present value. The net present value is computed by means of market yield curves and credit spreads, where necessary, for the relevant instrument. The purpose of the valuation techniques is to determine a fair value which reflects the price of the financial instrument on the reporting date.

The Bank has established a control environment for measuring fair values. The fair values of financial instruments are set by an independent risk analysis and control unit. Specific controls include: checking the actual price information; regular reviews of current valuation models and, if necessary, development, approval and introduction of new valuation models; follow-up verification by means of analysis and comparison of data from various information sources, etc.

The table below analyses financial instruments reported at fair value using valuation models. The data does not include equity instruments reported at acquisition cost (Note 14).

(BGN'000)

	Level 1: Market quotes in active markets	**Level 2:** Evaluation techniques using market data	Total
30 June 2012			
Cash and deposits in foreign currency	6,294,241	-	6,294,241
Gold, instruments in gold and other precious metals	3,176,025	-	3,176,025
Financial assets at fair value through profit or loss	17,027,149	585,109	17,612,258
Total	**26,497,415**	**585,109**	**27,082,524**
31 December 2011			
Cash and deposits in foreign currency	6,722,318	-	6,722,318
Gold, instruments in gold and other precious metals	3,096,194	-	3,096,194
Financial assets at fair value through profit or loss	15,830,248	422,691	16,252,939
Total	**25,648,760**	**422,691**	**26,071,451**

7. Interest Income and Expense

(BGN'000)

	30 June 2012	30 June 2011
Interest income		
– on securities	202,840	197,058
– on deposits	8,182	14,888
– on other	1	2
	211,023	211,948
Interest cost		
– on deposits	1,202	14,265
– on other	-	2
	1,202	14,267

Interest paid on government deposits denominated in foreign currency as of 30 June 2012 is BGN 13 thousand. Interest paid on foreign currency deposits of other organisations as of 30 June 2012 is BGN 230 thousand.

8. Net Profit/Losses from Financial Assets and Liabilities at Fair Value through Profit or Loss

(BGN'000)

	30 June 2012	30 June 2011
Net (losses) from operations in securities	(96,719)	(74,093)
Net gains from operations in foreign currency	194	236
Net revaluation gains/(losses) on futures	553	(1,517)
Net revaluation gains/(losses) on securities	61,968	(46,362)
Net revaluation gains/(losses) on foreign currency assets and liabilities	1,242	(3,313)
Net revaluation gains/(losses) on gold	78,749	(59,088)
	45,987	(184,137)

9. Other Operating Income

(BGN'000)

	30 June 2012	30 June 2011
Income from subsidiaries	19,938	20,469
Income from associated companies	-	-
Income from sale of coins	347	477
Dividend income	8,621	7,961
Other income, net	511	632
	29,417	29,539

Income from dividends includes dividends from BNB's participation in BIS Basle amounting to BGN 5790 thousand and from BNB's participation in BORICA-Bankservice of BGN 2831 thousand.

10. Total Administrative Expenses

(BGN'000)

	30 June 2012	30 June 2011
Personnel costs	16,171	14,626
Administrative expenses	21,958	22,205
Depreciation	12,865	12,769
Other expenses	1,953	1,251
	52,947	50,851

Personnel costs include salaries, social and health insurance costs charged under the local legislation provisions as of 30 June 2012, and social activities costs, respectively for the BNB: BGN 12,206 thousand, for the Printing Works of the BNB Corp: BGN 2480 thousand, and for the Bulgarian Mint EAD: BGN 1485 thousand. The number of employees of the Bank and its subsidiaries is 1243 as of 30 June 2012 (as of 30 June 2011: 1223), including the BNB staff of 875 as of 30 June 2012 (as of 30 June 2011: 860).

Based on actuarial calculations, the Bank has accrued compensation liabilities for personnel on retirement and for unused paid annual leave at BGN 1256 thousand (30 June 2011: BGN 1203 thousand). The retirement and unused paid annual leave compensation for the Bank's subsidiaries as of 30 June 2012 are BGN 175 thousand (30 June 2011: BGN 80 thousand).

Administrative expenses include the BNB's currency circulation expenses of BGN 3028 thousand for the period ended 30 June 2012 (30 June 2011: BGN 2101 thousand).

11. Cash and Deposits in Foreign Currencies

(BGN'000)

	30 June 2012	31 December 2011
Cash in foreign currencies	71,708	84,383
Current accounts in other banks	2,306,853	2,240,100
Deposits in foreign currencies	3,915,680	4,397,835
	6,294,241	6,722,318

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

(BGN'000)

	30 June 2012	31 December 2011
Euro area residents		
In EUR	3,323,782	4,333,864
In other currencies	1	2
	3,323,783	4,333,866
Non-euro area residents		
In EUR	1,454,765	955,697
In other currencies	1,515,693	1,432,755
	2,970,458	2,388,452
	6,294,241	6,722,318

12. Gold, Instruments in Gold, and Other Precious Metals

	30 June 2012		31 December 2011	
	'000 troy ounces	BGN'000	'000 troy ounces	BGN'000
Gold bullion in standard form	513	1,252,286	513	1,221,222
Gold deposits in standard form	770	1,879,929	770	1,832,261
Gold in other form	16	39,656	16	38,693
Other precious metals		4,154		4,018
		3,176,025		3,096,194

Gold in standard form includes gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 0.20 per cent per annum. Gold in other form includes commemorative gold coins of BGN 33,532 thousand. Other precious metals include silver commemorative coins of BGN 635 thousand and platinum commemorative coins of BGN 3519 thousand. Gold deposits are held with banks whose liabilities are rated with one of the two highest ratings given by two internationally recognised rating agencies.

13. Financial Assets at Fair Value through Profit or Loss

(BGN'000)

Securities at fair value through profit or loss	30 June 2012	31 December 2011
Foreign treasury bills, notes and bonds	17,612,258	16,252,939
	17,612,258	16,252,939

Securities comprise both coupon and discount securities denominated in euro. The maximum coupon interest of the EUR-denominated securities was 2.72 per cent as of 30 June 2012 (31 December 2011: 2.98 per cent).

The value of securities pledged as collateral on futures transactions amounts to BGN 29,398 thousand as of 30 June 2012 (31 December 2011: BGN 30,284 thousand).

The securities issued by foreign governments and other issuers or relevant issuers with credit rating graded by at least two of the six internationally recognised credit rating agencies employed by the Bank are disclosed as follows:

(BGN'000)

	Issuer's credit rating	30 June 2012	31 December 2011
Investment graded securities by the emission/ issuer credit rating	*AAA*	15,004,137	12,001,433
	AA+	545,568	1,831,948
	AA	448,253	540,800
	AA-	1,550,493	1,826,299
	A+	63,807	52,459
		17,612,258	16,252,939

14. Financial Assets Available for Sale

(BGN'000)

	30 June 2012	31 December 2011
Republic of Bulgaria's quota in the IMF	1,509,259	1,485,699
Equity investments in international financial institutions	30,098	30,098
Investments in Associates	25,923	25,923
	1,565,280	1,541,720

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 80,393 thousand of the Republic of Bulgaria's quota in the 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 an average rate of 0.13 per cent.

Equity investments in international financial institutions include the equity investment in the Bank for International Settlements (BIS), Basle, and 25 per cent of the equity investment in BIS Basle is paid up. As of 30 June 2012 the current value of 10,000 thousand shares in SDR amounts to BGN 23,207 thousand while as of 31 December 2011 it was BGN 23,207 thousand (ref. note 28(a). 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. Equity investments in international financial institutions do not exceed 10 per cent of the subscribed share capital of the respective institution. Investments in international financial institutions also include BNB's equity investment in ECB. BNB is a member of ESCB. In accordance with the 2010 amendments to the regulatory frameworks of the national central banks of the countries which have not adopted the euro, these pay effectively 3.75 per cent of the subscribed equity investment. The BNB's capital contribution in the ECB is EUR 3505 thousand or BGN 6855 thousand.

The Bank holds 100 per cent and 95.6 per cent, respectively, of the capital of Bulgarian Mint EAD and Printing Works of the BNB Corp.

The Bank exercises significant influence on the financial and operational policies of the associated companies listed below, and its investments in domestic companies can be analysed as follows:

Name of institution	Share holding per cent	Principal activity
Associated companies		
BORICA–Bankservice AD	36.11	Interbank card payments
International Bank Institute OOD	42.31	Financial training and research
Cash Services Company AD	20.00	Handling of sealed parcels of Bulgarian coins and banknotes transferred from the BNB and the banks

15. Tangible Assets

(BGN'000)

	Land and buildings	Plant and equipment	IT equipment	Office equipment	Other equipment (including motor vehicles)	Tangible assets in progress	Total
As of 1 January 2012	184,803	111,192	34,348	9,142	6,653	2,343	348,481
Additions	10	937	30	26	46	7,360	8,409
Disposals	-	(360)	(1,613)	(24)	0	(251)	(2,248)
Transfers	13	245	2,086	21	0	(2,365)	-
As of 30 June 2012	184,826	112,014	34,851	9,165	6,699	7,087	354,642
Depreciation and Impairment loss							
As of 1 January 2012	(23,256)	(64,066)	(25,710)	(5,142)	(5,088)	-	(123,262)
Charge for the period	(2,899)	(4,116)	(2,667)	(499)	(236)	-	(10,367)
On disposals	-	359	1,613	24	-	-	1,996
As of 30 June 2012	(26,155)	(67,823)	(26,764)	(5,567)	(5,324)	-	(131,633)
Net book value as of 30 June 2012	**158,671**	**44,191**	**8,087**	**3,598**	**1,375**	**7,087**	**223,009**
Net book value as of 31 December 2011	**161,547**	**47,126**	**8,638**	**4,000**	**1,565**	**2,343**	**225,219**

(BGN'000)

	Land and buildings	Plant and equipment	IT equipment	Office equipment	Other equipment (including motor vehicles)	Tangible assets in progress	Total
As of 1 January 2011	184,917	111,706	30,551	9,104	6,346	2,346	344,970
Additions	43	10,648	14	38	105	5,735	16,583
Disposals	(157)	(12,073)	(602)	(174)	(52)	(14)	(13,072)
Transfers	-	911	4,385	174	254	(5,724)	-
As of 31 December 2011	184,803	111,192	34,348	9,142	6,653	2,343	348,481
Depreciation and Impairment loss							
As of 1 January 2011	(17,435)	(57,655)	(21,084)	(4,385)	(4,688)	-	(105,247)
Charge for the period	(5,822)	(8,077)	(5,226)	(926)	(452)	-	(20,503)
On disposals	1	1,666	600	169	52	-	2,488
As of 31 December 2011	(23,256)	(64,066)	(25,710)	(5,142)	(5,088)	-	(123,262)
Net book value as of 31 December 2011	**161,547**	**47,126**	**8,638**	**4,000**	**1,565**	**2,343**	**225,219**
Net book value as of 31 December 2010	**167,482**	**54,051**	**9,467**	**4,719**	**1,658**	**2,346**	**239,723**

16. Intangible Assets

(BGN'000)

	Software	Other intangible assets	Intangible assets in progress	Total
As of 1 January 2012	41,326	152	-	41,478
Additions	-	-	938	938
Disposals	(18)	-	-	(18)
Transfers	930	-	(930)	-
As of 30 June 2012	42,238	152	8	42,398
Depreciation and Impairment loss				
As of 1 January 2012	(33,717)	(74)	-	(33,791)
Charge for the period	(2,485)	(13)	-	(2,498)
On disposals	19	-	-	19
As of 30 June 2012	(36,183)	(87)	-	(36,270)
Net book value as of 30 June 2012	**6,065**	**65**	**8**	**6,128**
Net book value as of 31 December 2011	**7,609**	**78**	**-**	**7,687**

Software includes, as of 30 June 2012, licenses purchased by the BNB to the total amount of BGN 360 thousand (31 December 2011: BGN 372 thousand), and software products to the amount of BGN 579 thousand (31 December 2011: BGN 1354 thousand).

(BGN'000)

	Software	Other intangible assets	Intangible assets in progress	Total
As of 1 January 2011	38,604	42	948	39,594
Additions	-	127	1,922	2,049
Disposals	(148)	(17)	-	(165)
Transfers	2,870	-	(2,870)	-
As of 31 December 2011	41,326	152	-	41,478
Depreciation and Impairment loss				
As of 1 January 2011	(28,325)	(39)	-	(28,364)
Charge for the period	(5,414)	(52)	-	(5,466)
On disposals	22	17	-	39
As of 31 December 2011	(33,717)	(74)	-	(33,791)
Net book value as of 31 December 2011	**7,609**	**78**	**-**	**7,687**
Net book value as of 31 December 2010	**10,279**	**3**	**948**	**11,230**

Software includes, as of 31 December 2011, licenses purchased by the BNB to the total amount of BGN 372 thousand (31 December 2010: BGN 815 thousand), and software products to the amount of BGN 1354 thousand (31 December 2010: BGN 1815 thousand).

17. Other Assets

(BGN'000)

	30 June 2012	31 December 2011
Cash held by subsidiaries with local banks	41,946	42,149
Commemorative coins for sale	333	357
Inventories	17,918	15,023
Accounts receivable	4,181	3,271
Deferred charges	891	1,623
Other receivables	3,746	975
	69,015	63,398

Cash held by subsidiaries with local banks comprises BGN 37,205 thousand of Printing Works of the BNB Corp and BGN 4741 thousand of Bulgarian Mint EAD.

18. Banknotes and Coins in Circulation

(BGN'000)

	30 June 2012	31 December 2011
Banknotes in circulation	8,339,669	8,548,706
Coins in circulation	183,705	180,044
	8,523,374	8,728,750

19. Due to Banks and Other Financial Institutions

(BGN'000)

	30 June 2012	31 December 2011
Demand deposits from banks and other financial institutions		
– in BGN	4,155,795	4,417,459
– in foreign currency	2,585,450	1,762,139
	6,741,245	6,179,598

The Bank does not pay interest on demand deposits from banks and other financial institutions. Demand deposits include BGN 4863 million representing the required reserves, which all local banks are required to maintain on accounts with the BNB (31 December 2011: BGN 4636 million).

20. Liabilities to Government Institutions and Other Liabilities

(BGN'000)

	30 June 2012	31 December 2011
Current accounts		
– in BGN	2,236,532	1,379,232
– in foreign currency	494,073	389,454
Time deposit accounts		
– in BGN	2,620,000	2,434,000
– in foreign currency	480,329	1,031,346
	5,830,934	5,234,032

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organisations. No interest is payable on the current accounts. Government deposit accounts in euro and in levs earn annual interest of 0.00 per cent.

21. Borrowings against Bulgaria's Participation in International Financial Institutions

The borrowings against Bulgaria's participation in the IMF as of 30 June 2012 amount to BGN 1,385,694 thousand: SDR 604,475 thousand (as of 31 December 2011: BGN 1,289,622 thousand: SDR 604,475 thousand).

Borrowings from the IMF are denominated in SDRs. Borrowings related to Bulgaria's quota in the IMF are non-interest bearing with no stated maturity. This note includes account No 1 of the IMF for administrative expenses in levs amounting to BGN 3721 thousand (as of 31 December 2011: BGN 3463 thousand).

The Bank's borrowings from the IMF of the general and special allocation of SDRs amount to SDR 474,586,534 and SDR 136,289,102, respectively. Repayment will take place on IMF's demand. Under Article XX of IMF Statute, the Bank receives interest on the existing SDRs and pays a fee on its borrowings from the general and special allocation at the same interest rate.

22. Other Liabilities

(BGN'000)

	30 June 2012	31 December 2011
Funds of EU institutions and bodies	127,806	130,486
Salaries and social security payable	3,039	1,916
Deferred income	718	1,680
Other liabilities	17,146	30,545
	148,709	164,627

"Funds of EU institutions and bodies" include European Commission's funds and European Investment Bank's funds. Pursuant to Article. 9 of Council Regulation No 1150 of 2000 and Bulgaria's participation in the funding of the EU budget, the Bank opened accounts of the European Commission. As of 30 June 2012 the funds on these accounts were BGN 66,287 thousand. As of 30 June 2012 the funds on EIB accounts with the Bank under a financial agreement between the Bulgarian government and EIB were BGN 61,519.

23. Capital and Reserves

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

Non-monetary asset revaluation reserves comprise the net change in fair value of property, equity investments and other non-monetary assets.

Pursuant to Article 36 of the Law on the Bulgarian National Bank, unrealised gains/losses arising from the revaluation of assets and liabilities denominated in foreign currencies or gold are transferred to a special reserve account and form special reserves.

Other reserves include the transfers to reserves of 25 per cent of the annual excess of revenue over expenditure after the allocation to special reserves, upon a decision of the BNB Governing Council.

As of 30 June 2012 the profit distribution in accordance with the profit distribution policy disclosed in note 5 (h) is as follows:

(BGN'000)

	30 June 2012	30 June 2011
Profit for the period	**234,969**	**(4,408)**
Allocation to special reserve under Article 36 of the Law on the BNB:		
Unrealised (gains)/losses from gold revaluation	(78,749)	59,088
Unrealised (gains)/losses from revaluation of financial assets at fair value through profit or loss	(68,303)	59,148
Unrealised foreign currency valuation (gains)/losses	(1,242)	3,313
Other unrealised losses	-	-
Result after allocation to special reserve	**86,675**	**117,141**

24. Non-controlling Interest

Printing Works of the BNB Corp is a joint-stock company with two shareholders: the BNB and the Government represented by the Ministry of Finance. The BNB holds 95.6 per cent of the company's capital. In 2005 the State represented by the Minister of Finance acquired 4.4 per cent of the company's capital.

25. Monetary Liabilities and Gross International Reserves

(BGN'000)

	30 June 2012	31 December 2011
Gross international reserves		
Cash and deposits in foreign currencies	6,294,241	6,722,318
Monetary gold and other instruments in gold	3,132,216	3,053,483
Security investments	17,612,258	16,252,939
Equity investments and quota in the IMF	80,393	79,138
	27,119,108	26,107,878
Monetary liabilities		
Currency in circulation	8,523,374	8,728,750
Due to banks and other financial institutions	6,737,205	6,177,657
Liabilities to government institutions	4,747,086	4,359,186
Other liabilities	1,215,694	1,007,273
	21,223,359	20,272,866
Surplus of gross international reserves over monetary liabilities	5,895,749	5,835,012

Interest receivable and interest payable are carried to the relevant financial assets and liabilities.

Monetary gold and other instruments in gold are revalued on a daily basis based on the euro fixing of the London Bullion Market closing price.

26. Related Party Transactions

Bulgarian Government

International Monetary Fund

All the borrowings of the Government of the Republic of Bulgaria from the IMF are undertaken (on-lent) through the BNB. The Government's borrowings from the IMF are matched by a receivable from the Government. For the Bank to eliminate any exchange rate fluctuations, the Government receivables are denominated also in SDR.

Interest on these borrowings is paid by the Government. Accordingly, no interest is charged on the receivables from the Government, nor is any interest expense included on the Government's portion of the IMF borrowings.

As of 30 June 2012, the Republic of Bulgaria has not received funds under IMF agreements.

The Republic of Bulgaria's quota in the IMF is secured by promissory notes jointly signed by the Bank and the Government (ref. note 21).

Government bank accounts

Government budget organisations have current accounts and time deposits with the Bank (ref. note 20).

Fiduciary activities

In accordance with the Law on the BNB and under the terms agreed upon with the Minister of Finance, the BNB acts as an agent in government or government-guaranteed debts. 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 commission for providing these services. These government securities are not assets or liabilities of the BNB and are not recognised in its consolidated statement of financial position. The Bank is not exposed to any credit risk relating to government securities as it does not guarantee them. As of 30 June 2012, the par value of the government securities held in custody was BGN 4856 million (31 December 2011: BGN 4473 million).

27. Subsidiaries

(%)

Ownership interest	30 June 2012	31 December 2011
Bulgarian Mint EAD	100	100
Printing Works of the BNB Corp (ref. note 24)	95.6	95.6

The net income from subsidiaries for the period comprises net profit of BGN 430 thousand from the Bulgarian Mint EAD (30 June 2011: BGN 1,383 thousand) and BGN 1666 thousand from the Printing Works of the BNB Corp (30 June 2011: BGN 734 thousand).

28. Commitments and Contingencies

(a) Participation in the Bank for International Settlements

The Bank holds 8000 shares of the capital of BIS, Basle, each amounting to SDR 5000. Twenty-five 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 of 30 June 2012 is BGN 69,620 thousand (31 December 2011: BGN 69,620 thousand).

(b) IMF quota and borrowings

The IMF quota is secured by promissory notes jointly signed by the Bank and the Government of the Republic of Bulgaria amounting to BGN 1,385,694 thousand.

(c) Capital commitments

As of 30 June 2012 the Bank has committed to BGN 232 thousand to purchase non-current assets (31 December 2011: BGN 43 thousand).

(d) Other commitments and liabilities

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

29. Events Occurred after the Reporting Date

There are no events after the reporting date that would require additional disclosure or adjustments to the Bank's Financial Statements.

Major Resolutions of the BNB Governing Council

26 January

The BNB Governing Council issued a license for carrying out activities as an operator of a payment system with settlement finality in euro to BORICA – Bankservice AD.

23 February

The Governing Council of the BNB issued a license to Euromoney Transfer OOD for executing cash transfers as a payment institution.

As of 19 March 2012 the Bulgarian National Bank put in circulation copper commemorative coin '125th Anniversary of Dimcho Debelyanov's Birth' of the 'Bulgarian Artists' series with a nominal value of BGN 2, issue 2012.

15 March

The BNB Governing Council approved the Report on the BNB Budget Implementation as of 31 December 2011.

As of 23 April 2012 the Bulgarian National Bank put in circulation a silver commemorative coin 'Chudnite Mostove' with a nominal value of BGN 10, issue 2012.

5 April

The BNB Governing Council adopted Ordinance on Amendment of BNB Ordinance No 22 on the Central Credit Register.

24 April

The BNB Annual Report for 2011 was approved.

15 May

As of 11 June 2012 the Bulgarian National Bank put into circulation a partially gold-plated silver commemorative coin '250 Years of Slavo-Bulgarian History' with a nominal value of BGN 10, issue 2012.