



Bulgarian National Bank

ANNUAL REPORT • 2011



 **BANQUE NATIONALE DE BULGARIE** 



Bulgarian National Bank

ANNUAL REPORT • 2011

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

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

Under the provisions of Article 1, paragraph 2 and Article 51 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's 2011 Annual Report.

A handwritten signature in black ink, appearing to read 'Ivan Iskrov', written over a horizontal line.

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

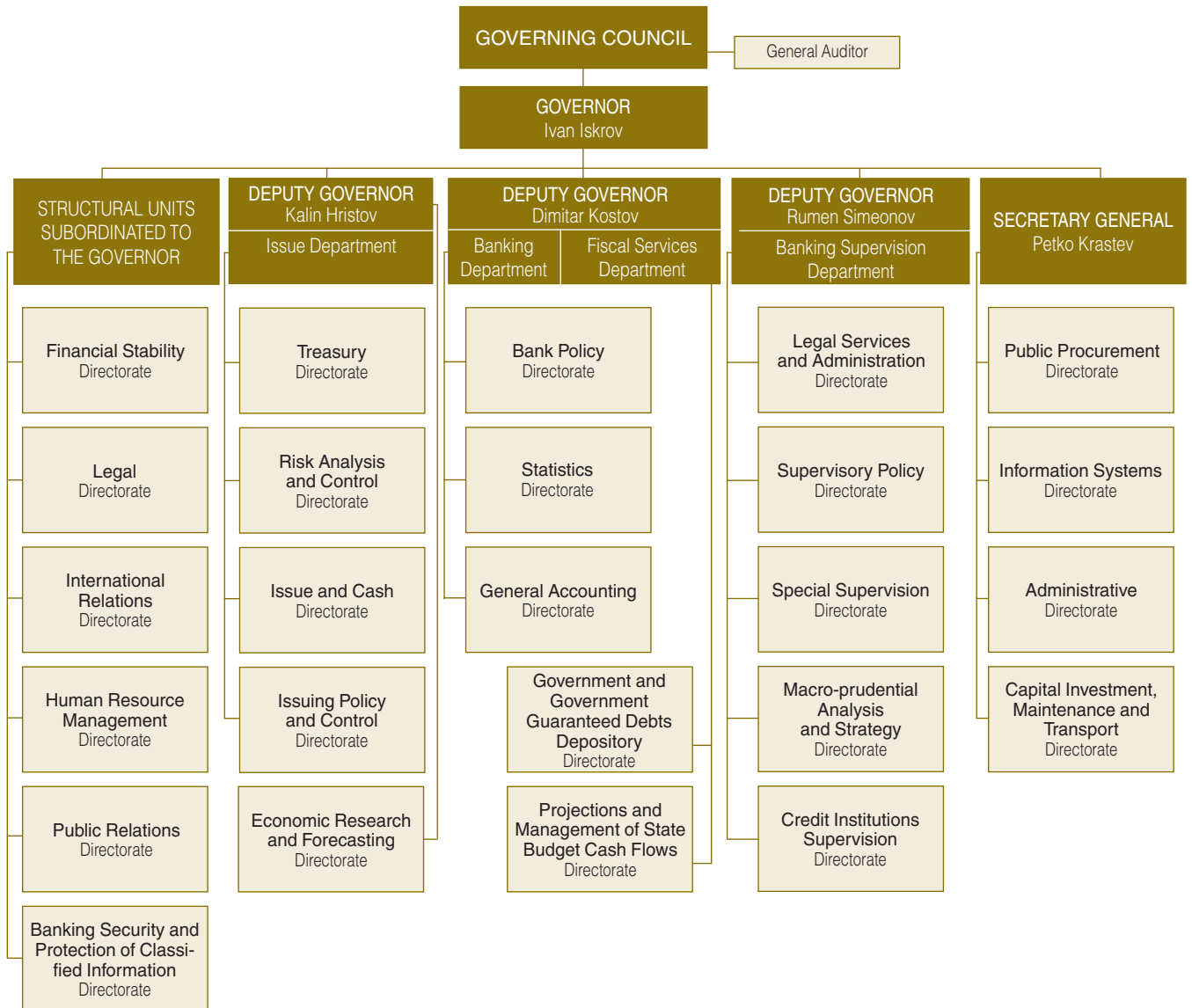
Issue Department

Penka Kratunova

Statty Stattev

Oleg Nedyalkov

Organisational Structure of the BNB



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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 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
FSC	Financial Supervision Commission
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

The review year saw mixed world economic developments. In the first quarter growth was recovering rapidly, only to dip sharply in following quarters, especially in the developed world. Continuing political tensions in the Middle East exerted an upward pressure on fuel prices. The March natural disasters in Japan and floods in Thailand in the second half of the year interrupted deliveries, disrupting several industries and international trade. Tense economic and political developments in Greece and doubts whether the IMF and the euro area would continue backing that country caused continuing market uncertainties. In early April Portugal followed Greece and Ireland, which sought financial assistance in 2010, formally requesting financial support from the European Union and the International Monetary Fund. World food and energy price rises boosted consumer inflation which, together with continuing tensions on international financial markets, sapped business and consumer confidence, curbing growth and delaying recovery.

Bulgaria's annual real GDP growth rose to 1.7 per cent in 2011 on 0.4 per cent in 2010. This was mostly down to net exports, while the contribution of domestic demand to growth was negative. Real growth of goods and services exports declined slightly as the international environment worsened. Facing a rapidly changing international environment, companies continued curbing costs, mostly by shedding staff: employment went down 4.2 per cent on 2010, while unemployment rose slightly to 11.2 per cent on average over the year. The growth of nominal unit labour costs slowed to 1.1 per cent in 2011 from 5.6 per cent in 2010. Overall productivity grew strongly by 6.1 per cent, mainly due to manufacturing where it rose 12.1 per cent. Household savings remained high. Effective fiscal consolidation by government contributed to further rise of the national savings rate, the consolidated state budget deficit contracting 43.2 per cent on the prior year to BGN 1582.2 million or 2.1 per cent of GDP.

International energy and food price rises, which had significant repercussions on inflation in 2010, continued driving Bulgarian consumer prices in 2011. Average annual inflation was 3.4 per cent from 3.0 per cent in 2010, dropping to 2.0 per cent at the close of the year from 4.4 per cent a year earlier.

The overall current and capital account balance improved further, with a surplus of 2.2 per cent of GDP in 2011. The trade deficit squeeze contributed most based on 30 per cent nominal annual export growth and a moderate 21.2 per cent annual import growth. Bulgaria ended the year with an overall external debt of EUR 35.4 billion (92.1 per cent of GDP) or EUR 1610.9 million less than in December 2010, mainly due to repaid intercompany loans of the non-bank sector and reduced external liabilities of commercial banks. Rising deposits due to pronounced household propensity to save, confidence in banks, and high liquidity allowed banks to continue paying back on their external debt.

Monetary aggregates climbed in 2011 reflecting the gradual recovery of economic activity and significantly increased resident bank deposits. Banks cautiously increased credit, particularly to non-financial corporations, as demand rose. Claims on the non-government sector accelerated by 3.9 per cent over the year from 1.3 per cent growth for 2010.

The unstable external environment and its impact on Bulgarian economic activity recovery posed considerable challenges to the BNB. In 2011 the Bank marshalled potential and capacity into its primary goal of maintaining price stability through national currency stability and implementing the monetary policy provisioned in the Law on the

Bulgarian National Bank. The BNB invested its gross international reserves to prudent principles. It regulated and supervised banks in Bulgaria to safeguard banking stability and protect depositors' interests. It assisted the formation and function of efficient payment systems and oversaw them. It regulated and supervised Bulgarian payment system operators, payment institutions, and electronic money institutions. It printed banknotes, minted coins, and safeguarded or destroyed uncirculated or withdrawn banknotes and coins. It acted as a fiscal agent and depository to the state. The Bank actively participated in the European System of Central Banks (ESCB) and EU institutions' activities.

In the key task of managing gross international reserves, the Bank coped with unstable global financial markets and anticipated Bulgarian balance of payments flows. External current, capital, and financial transactions increased gross international reserves by EUR 158.7 million in 2011, pending valuation adjustments. After valuation adjustments, changes in the market value of international reserves in the BNB Issue Department balance sheet increased reserves by EUR 372.1 million to EUR 13.349 million at the end of 2011.

Persistent international financial market tensions brought new constraints and tightened existing limits on investing BNB gross international reserves to mitigate risks. Constraints introduced in 2010, such as the ban on debt instruments issued or guaranteed by countries with worsened fiscal positions and high public debt, and limits on eligible debt issuing countries divided into three credit risk groups, remained in place. In early 2011 a new Credit Risk Management Methodology fundamentally changed credit risk assessment and reporting for foreign BNB counterparty banks and for debt issuers into whose instruments the BNB invests reserves. The Methodology notably raised the number of internationally recognised credit rating agencies whose evaluations the BNB uses, diversifying ratings. Investment constraints on the gross international reserves and international financial market opportunities marshalled 61 per cent of funds into assets with the highest AAA long-term credit rating. Income from international reserve investment was EUR 157.29 million: 1.37 per cent annual rate of return. Net income from international reserve management, including gold price and exchange rate valuation changes over the year was EUR 333.49 million or 2.93 per cent annual net rate of return.

Safeguarding banking stability is a Bank priority that contributes to macroeconomic and financial stability and maintains confidence in banks. By the end of 2011 banking system assets reached BGN 76.7 billion: up BGN 3 billion or 4.1 per cent on 2010, their growth matching that of attracted funds. Funds attracted domestically offered stable financing and fully offset declining non-resident funds. Individual and household deposits rose by BGN 3.9 billion (13.8 per cent), their share in total attracted bank funds reaching 48.5 per cent. Despite a reported slowdown in the growth of classified loans, by the end of 2011 non-performing loans past due over 90 days accounted for 14.97 per cent of the total credit portfolio from 11.92 per cent at the end of 2010. Banks' ability to generate stable revenue remained subdued and their 2011 profits were BGN 474 million: BGN 126 million less than in 2010. Return on assets was 0.63 per cent and return on balance sheet equity and reserves was 4.93 per cent.

The banking system retained capital stability. Increased equity reflected banks' policy of maintaining higher tier one capital, more conservative profit distribution, and strict supervision. By the end of 2011 banking system capital adequacy rose to 17.55 per cent from 17.39 a year earlier. The increase boosted tier one capital adequacy to 15.73 per cent. All banks maintained tier one capital above the 10 per cent recommended by the BNB. System liquidity was relatively high, the liquid asset ratio rising to 25.53 per cent by the end of 2011 on 24.35 a year earlier.

Payment systems functioned smoothly, ensuring payment flow integrity. The BNB-operated real-time interbank gross settlement system (RINGS) processed 86 per cent

of payments. In 2011 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), live since 2010, increased 56.25 and 57.86 per cent respectively. Limiting system risk and improving Bulgarian payment system reliability and efficiency were the major goals of payment systems overseers.

The BNB prints banknotes, mints coins, and is in charge of the preservation and destruction of uncirculated and withdrawn banknotes and coins. By the end of 2011 cash in circulation came to BGN 8728.9 million in nominal terms: up BGN 426.4 million, or 5.14 per cent on end-2010. Banknotes were worth 97.94 per cent of the total value of cash in circulation, dropping 0.03 percentage points on a year earlier. The BGN 20 banknote occupied the largest share at 32.87 per cent while the share of low-value coins (BGN 0.01, BGN 0.02, and BGN 0.05) was 66.13 per cent. The average value of banknotes in circulation is BGN 26.78, and that of coins BGN 0.13. The Bank pursued a comprehensive policy for counteracting and preventing the spread of non-genuine Bulgarian currency. In 2011 retained non-genuine Bulgarian banknotes represented 0.0009 per cent of all banknotes in circulation, while retained non-genuine coins represented 0.00008 per cent of coinage.

Under market-term contracts with the Ministry of Finance, the BNB implements its role as a fiscal agent and depository to the state. Here, the Bank uses six information systems whose functionality improved continually.

In 2011 the EU made a number of political and statutory moves in areas where the global economic and financial crisis revealed deficiencies. The year saw launch of the European Systemic Risk Board, agreement on the Euro Plus Pact, the adoption of the package targeted at improving EU and euro area economic governance, better coordination between Member States' economic policies, and moves to boost competitiveness. By actively participating in the committees and working groups of the ESCB, European Commission, EU Council, the European Systemic Risk Board, and the Council for European Affairs, the BNB contributed to the formulation of the Bulgarian standpoints on these important matters. Welcoming the Euro Plus Pact in principle, the Bank consistently maintains that new initiatives and regulations in finance and economic governance ought to provide greater flexibility for national policies and take into account national specifics.

In 2011 the ESRB made three recommendations on foreign currency lending, funding credit institutions in US dollars, and the macro-prudential mandates of national authorities. The BNB maintains that the risks addressed in the recommendations on foreign currency lending depend on monetary regimes and overall national macro-economic frameworks. Lev and euro equality is a basic monetary policy principle in Bulgaria, resting on a currency board and an exchange rate fixed to the euro. Hence, denominating loans in euro should not be deemed foreign currency lending. On systemic risks in US dollar funding of credit institutions, the Bank notes that they attend mainly large European bank groups due to their specific business models and that Bulgarian banks need no additional measures to contain them. The recommendation on national macro-prudential mandates proposes guidelines on independence and sufficient powers for national macro-prudential authorities in the EU. The BNB supports the guiding principles.

Over the year the ESRB examined the macro-prudential aspects of a proposed EC directive and regulation on capital requirements. The ESRB stressed that national authorities should be free to act on accumulated systemic risks. In its opinion, supported by the BNB, the ESRB identified three principles: flexibility allowing a wide range of actions, freedom for national supervisors to act early and effectively, and efficient coordination of actions between Member States. The BNB views the freedom of competent national authorities to impose tighter requirements supplementing the common European supervisory regime as being of prime import in keeping national banking systems stable and capitalised.

Promoting financial stability and European prospects in the Balkans, the BNB enhanced cooperation with regional central banks. A two-year BNB-managed twinning project for Montenegro ended successfully in November 2011. BNB experts took part in a Twinning Project with the Central Bank of Albania. The Bank provided technical assistance to the Central Bank of Bosnia and Herzegovina on the Treaty on the Functioning of the European Union in a country with a currency board and central banking law. The BNB hosted two study missions by experts from the Serbian and Albanian central banks.

I. Economic Development in 2011

1. The World Environment

In 2011 the global economy continued recovering, yet more slowly than in the prior year. The March natural disasters in Japan and the Thailand flood in the second half of the year greatly disrupted several industrial sectors. Continuing turmoil in the Middle East hiked fuel prices. Persistent euro area debt crises hit capital flows and business financing, destabilising international financial markets. Food price rises had a negative effect on consumer confidence and expenditure over the first half of the year.

Euro area and United States' growth moderated on the prior year at 1.4 and 1.7 per cent.¹ China's real GDP grew 9.5 per cent. Industrial output increased globally by some 5.4 per cent² on 2010. World trade rose 5.7 per cent on an annual basis.

Major Macroeconomic Indicators (Period Averages)

(per cent)

	Growth			Inflation			Unemployment		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
EU-27	-4.3	2.0	1.5	1.0	2.1	3.1	8.9	9.6	9.7
Euro Area 17	-4.3	1.9	1.4	0.3	1.3	2.7	9.4	10.1	10.2
EU-7	-3.2	2.3	3.2	3.8	3.1	4.2	9.9	11.5	9.4
EU-3	-4.6	2.5	1.3	2.1	3.1	3.9	7.3	7.9	7.9
United States	-3.5	3.0	1.7	-0.4	1.6	3.2	9.3	9.6	8.9
Japan	-5.5	4.4	-0.9	-1.4	-0.7	0.1	5.1	5.1	4.6
China	7.8	10.6	9.5	-0.7	3.3	5.4	4.3	4.1	4.0

Note: The EU7 are countries joining since 2004 less those now in the euro area. The EU3 are the United Kingdom, Sweden, and Denmark. EU7 and EU3 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 EU27 in HICP calculated by Eurostat (for inflation).

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

In 2011 real euro area GDP growth slowed, declining 0.3 per cent in the fourth quarter on the prior quarter, private demand and investment dropping 0.4 and 1.7 per cent in real terms. Continuing sovereign debt problems in some euro area countries fuelled the downward GDP trend, causing persistent financial market tension. Industrial output contributed to growth in some sectors, Germany making the highest contribution to euro area GDP at 3 per cent on the prior year. Euro area unemployment increased 0.1 percentage points on 2010 to 10.2 per cent.

In the United States, real GDP rose 1.7 per cent in 2011. In the first half of the year Japanese deliveries to the US automotive industry were disrupted. Rises in crude oil prices amid Middle East turmoil hit household and business expectations. In the second half of the review year economic growth accelerated as consumer demand and business investment picked up. Unemployment fell on 2010, remaining at the relatively high level of 8.9 per cent. Consumer demand gradually recovered, alongside contracting consumer credit.

In 2011 average global inflation accelerated from 3.4 to 4.5 per cent³ across developed and developing economies. Main drivers were energy, food, and some commodity prices. Average annual euro area inflation rose from 1.3 to 2.7 per cent, core inflation up from 1.0 to 1.4 per cent. US inflation measured by the consumption ex-

¹ Data as of 26 March 2012.

² Based on data of CPB Netherlands Bureau for Economic Policy Analysis.

³ Based on IMF data from 8 March 2012.

penditure deflator rose from 1.6 in 2010 to 3.2 per cent in 2011, core inflation rising from 1.0 to 1.4 per cent.

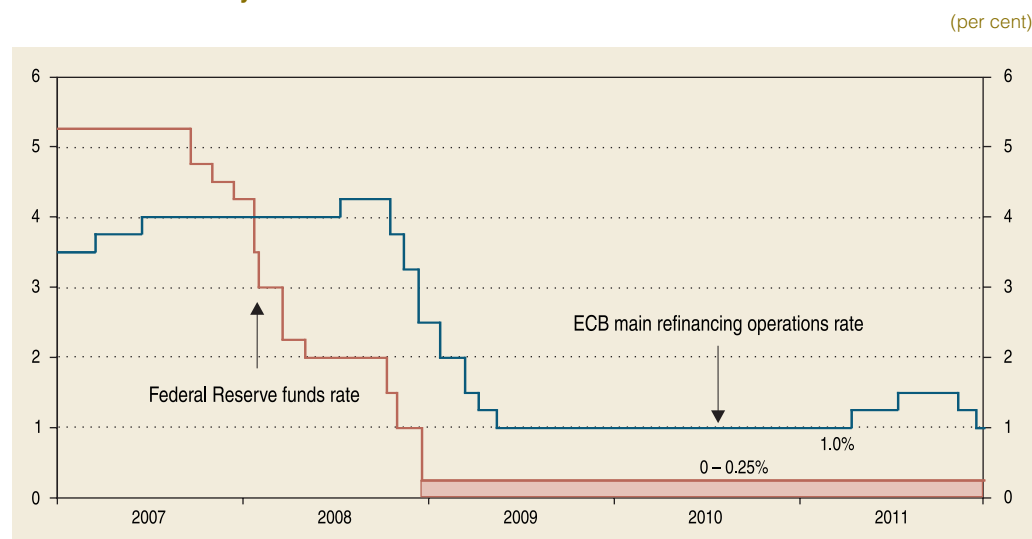
Brent crude oil appreciated until mid-year from USD 96.3 (EUR 72.1) *per* barrel in January 2011 to USD 116.5 (EUR 81.6) in July, after which it fell gradually to USD 107.9 (EUR 81.9) in December. Food prices rose 23.9 per cent on 2010. Major commodity prices rose, metals surging 14.4 per cent on 2010: tin at 27.7 per cent, copper at 17.6 per cent, lead at 11.8 per cent, and steel at 15.7 per cent.

Microeconomic improvements and rising inflation in the first half of 2011 prompted the ECB to raise interest on main refinancing operations in April and July. Deepening euro area debt crises and recession fears made the ECB cut interest in November and December to early 2010 levels.

In October 2011 the ECB announced it would continue offering unlimited liquidity on main and one-month refinancing operations until at least the end of the sixth maintenance period on 10 July 2012. In December the ECB Governing Council acted to bolster euro area bank lending and liquidity through two longer-term refinancing operations with a maturity of three years (21 December 2011 and 29 February 2012) with the option of early repayment after a year, halving the 2 per cent reserve ratio for the reserve maintenance period starting 18 January 2012, broadening the scope of security, and discontinuing one-day fine-tuning operations at the close of maintenance periods.

Liquidity measures boosted the ECB balance sheet to EUR 2.7 trillion by 30 December 2011, up 36 per cent in a year. The difference between ECB refinancing operations and required reserves plus autonomous factors was EUR 483 billion. Banks deposited the liquidity surplus with the ECB, funds on the ECB deposit facility reaching EUR 414 billion by 30 December 2011. Rising banking liquidity depressed euro area money market interest. On 29 December 2011 EONIA overnight interest fell to 0.399 per cent, the spread between it and the ECB deposit facility interest narrowing to 14.9 basis points. The December measures bolstered euro area sovereign debt markets, and yield spreads *vis-à-vis* German treasury bonds began contracting.

Federal Reserve System and ECB Interest Rates



Sources: ECB, Federal Reserve System.

In 2011 the US Federal Reserve System left reference interest at 0 to 0.25 per cent, intending to keep it low at least into 2013. Following conclusion of the US bond purchase programme and the US credit rating downgrade by Standard and Poor's (S&P),⁴ the Federal Open Market Committee (FOMC) acted to stimulate growth. At its Septem-

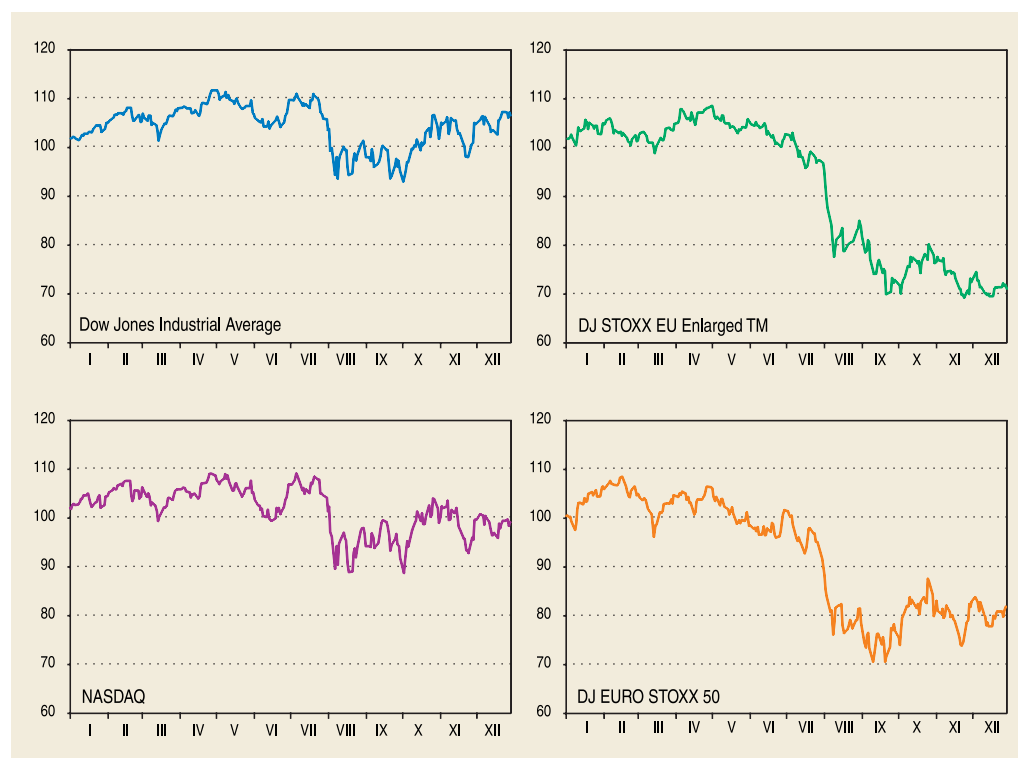
⁴ On 5 August 2011 Standard & Poor's downgraded the US credit rating from the highest AAA to AA+ with a negative prospect for the first time in the history of US ratings.

ber meeting, it launched a nine-month programme to extend the average maturity of Federal Reserve System portfolio assets to July 2012. The USD 400 billion programme involves offering three-month to three-year US government bonds from the Federal Reserve portfolio, with earnings re-invested into buying back six to 30 year government securities.

International financial markets remained tense in 2011. Over the past two years the inability of Greece, Ireland, and Portugal to finance their budget deficits and service government debts led them to seek financial support from the EU and IMF. In the second half of 2011 there were signs of a debt crisis spillover into other euro area countries, including Italy and Spain.⁵

In 2011 US stock market indices rose slightly, while European ones dipped. The US indices reached highs in the second quarter, dipping in summer due to political uncertainty on the US debt limit.⁶ In the fourth quarter optimism and growth expectations improved. In December 2011 the Dow Jones grew 5.4 per cent on December 2010. In Europe, the intensification of euro area fiscal and debt problems hit the stock markets, the EURO STOXX 50 and EURO STOXX EU Enlarged TM dipping 19.2 per cent and 28.6 per cent in December 2011 on a year earlier.

Major Stock Market Indices in 2011



Note: US dollars; December 2010 = 100.

Source: Bloomberg.

⁵ For more details, see Section II.

⁶ See *Economic Review* 3/2011, p 19.

2. The Bulgarian Economy

In 2011 real GDP rose 1.7 per cent on 2010. Net exports contributed most, goods and services exports continuing to grow fast in real terms at 12.8 per cent. Goods and services imports also grew in real terms from 2.4 per cent in 2010 to 8.5 per cent in 2011.

Real GDP Growth

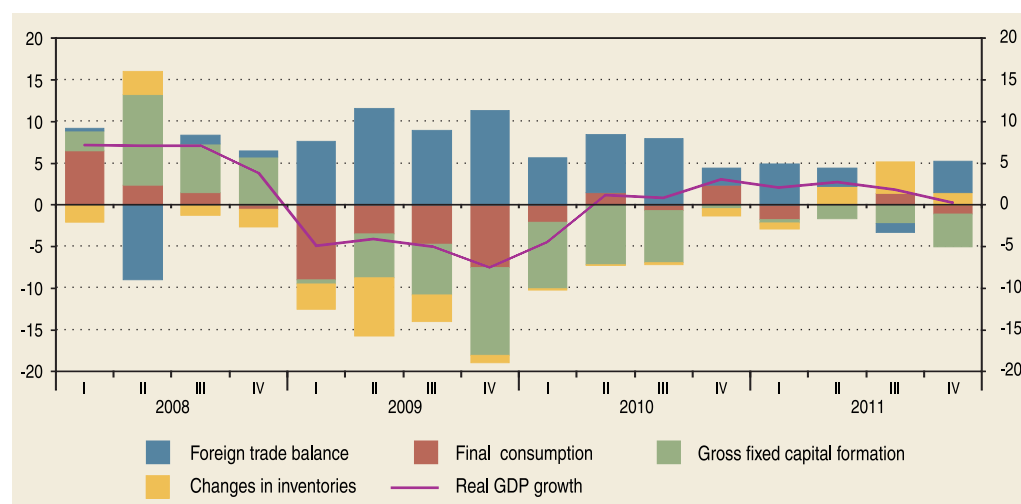
(year on year, non-seasonally adjusted data)

	2010		2011	
	Change (per cent)	Contribution, percentage points	Change (per cent)	Contribution, percentage points
Produced GDP	0.4	0.4	1.7	1.7
Final consumption	0.5	0.4	-0.3	-0.3
Household consumption	0.1	0.1	-0.6	-0.4
Final consumption expenditure of General Government*	4.7	0.4	3.0	0.2
Collective consumption	-0.5	0.0	-1.8	-0.1
Gross fixed capital formation	-18.3	-5.3	-9.7	-2.2
Physical changes in inventories	-	-0.4	-	1.8
Exports (goods and services)	-	5.6	-	2.3
Imports (goods and services)	14.7	7.0	12.8	7.3
Exports (goods and services)	2.4	-1.4	8.5	-5.1

Sources: NSI, BNB.

Contribution to Real GDP Growth by Component of Final Consumption

(per cent, percentage points on prior year's corresponding quarters)



Sources: NSI, BNB.

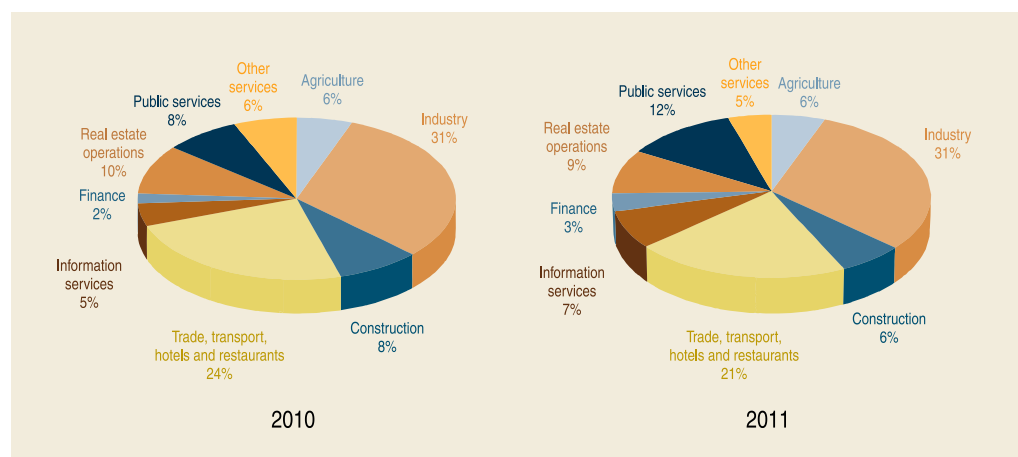
Consumer demand dipped 0.6 per cent in real terms in 2011 after a relatively stable 2010. The poor world environment hit expectations of a recovery, especially in employment. In early 2011 consumer expectations of the economy and household finances for the next 12 months declined⁷, unemployment concerns reviving in mid-year. Data confirmed these concerns, with growth slowing and employment continuing to fall. These were the main reasons for subdued consumer expenditure.

Fixed capital investment continued falling in real terms in 2011. Investment demand contracted further in the second half of the year amid growing financial instability and uncertainty. Investment into fixed assets (gross fixed capital formation) fell 9.7 per cent in real terms, eroding real GDP growth by 2.2 percentage points. NSI preliminary data for 2011 show nominal fixed asset expenditure growing 3.3 per cent on 2010.

⁷ See Consumer Survey (January 2011), NSI.

Public, financial, and information services contributed most to GDP growth, their fixed asset expenditure rising 59.4, 85.4, and 69.1 per cent. Following two successive and significant annual drops, fixed asset expenditure in industry rose 1.5 per cent. Investment into the construction, trade, transport, and hotels and restaurants sectors contracted further. Relative economic buoyancy boosted inventories which made a major 1.8 percentage point contribution to GDP growth.

Structure of Fixed Asset Expenditure by Sector



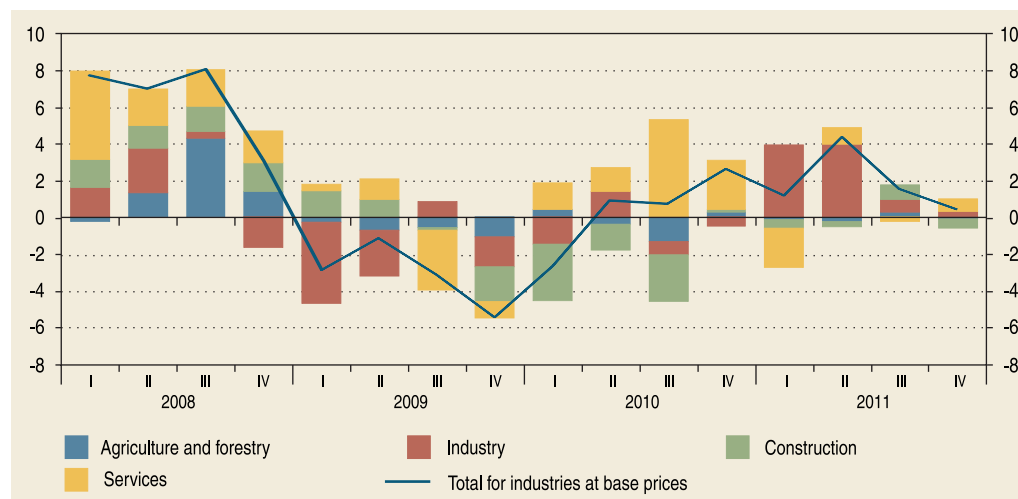
Note: Preliminary data for 2011.

Sources: NSI, BNB.

Gross value added rose 1.8 per cent in real terms. Industry, whose value added grew 9.1 per cent, made the main contribution. Weak domestic demand hit services value added which fell 0.1 per cent in 2011 after growing 4.4 per cent in 2010. The trade, transport, hotels and restaurants, and culture, sports and entertainment sectors detracted most. The information and professional services, and research, administrative, and ancillary services sectors, all less affected by the crisis, contributed most.

Gross Value Added Change in Real Terms* and Sectoral Contributions

(per cent, percentage points on prior year corresponding quarter)



* The NSI uses the term physical volume.

Sources: NSI, BNB.

Real Gross Value Added Growth

	2010		2011	
	Change, per cent	Contribution, percentage points	Change, per cent	Contribution, percentage points
Gross value added	0.5	0.5	1.8	1.8
Agriculture and forestry	-6.2	-0.3	-1.1	-0.1
Industry (incl. construction)	-6.3	-2.0	6.6	2.0
Services	4.4	2.8	-0.1	-0.1

Sources: NSI, BNB.

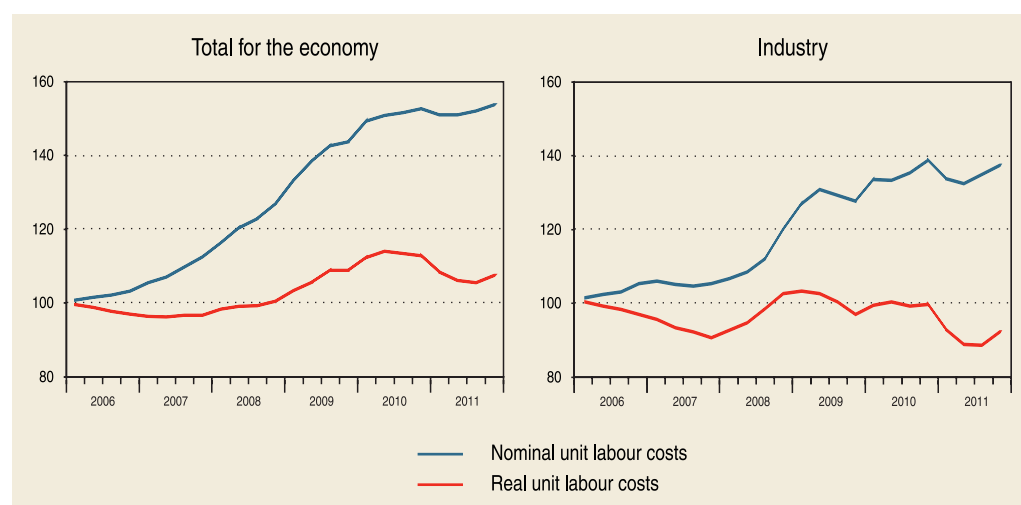
In 2011 labour market situation continued to worsen and employment fell 4.2 per cent after a 4.7 per cent drop in 2010. In 2010 industry led the fall, while in 2011 services (mainly trade, transport, and hotels and restaurants) detracted most, cuts in industry moderating.

The NSI Labour Force Survey shows slightly higher unemployment in 2011 on 2010, though at the relatively stable 11.2 per cent level. Employment Agency labour exchange registrations followed a similar trend, stabilising at some 10.1 per cent in 2011.

First and second quarter unemployment growth reflected rising long-term (over a year) unemployment, which reached 56 per cent of all unemployed according to the Labour Force Survey. The increased number of unemployed (up to a year) contributed to the fourth quarter rise in unemployment. Weaker labour demand and limited job opportunities continued eroding the motivation of working age people. The number of discouraged people rose slightly on the prior year to 237,000. This cut the economic activity rate of 15 to 64-year-olds from 66.5 per cent in 2010 to 66 per cent in 2011.

Nominal wage growth (compensation *per* employee) reflected business efforts to cut labour costs. After 11.2 per cent growth of 2010, pay rose 7.3 per cent in 2011. In the first half-year compensation *per* employee rose 5.5 per cent on an annual basis. A September minimum wage increase hiked annual pay growth to 9 per cent for the second half-year. Meanwhile, nominal financial and insurance pay fell by a further 1.8 per cent after a 7.5 per cent 2010 fall. Nominal compensation *per* employee growth picked up slightly to 5.7 per cent in the second half-year after a 0.4 per cent drop in the first half-year, against 5.1 per cent growth in 2010.

Unit Labour Costs (moving average, 2005 = 100)



Sources: NSI, BNB.

Average annual basis labour productivity continued growing by 6.1 per cent against 5.3 per cent in 2010.⁸ Industry contributed most at 12.1 per cent along with relatively high value added growth. Unit labour cost cuts continued, boosting labour productivity in this sector. Significant job cuts in trade, transport, and hotels and restaurants offset falling value added, sector productivity growing 4.1 per cent over the year.

In 2011 nominal unit labour cost growth slowed further to 1.1 per cent, from 5.6 per cent in 2010 as productivity grew and compensation *per* employee moderated. Nominal unit labour costs fell in 2011 in industry and in trade, transport, and hotels and restaurants. Real unit labour costs for the economy fell 3.7 per cent from 2.7 per cent growth in 2010.

World energy and food prices, which drove 2010 inflation, continued pushing up Bulgarian consumer prices in 2011.⁹ Average annual inflation was 3.4 per cent, from 3.0 per cent in 2010, declining at the close of the year to 2 per cent, from 4.4 per cent a year earlier. Early 2011 world food and fuel price rises spilled over rapidly to end prices through production costs of firms. Given the high weight of food and fuel in the consumer basket, this contributed most to annual consumer price rises. As world prices stabilised later in the year, food and fuel prices moderated, though still contributing most to accumulated inflation for the year at 0.96 and 0.28 percentage points. Tobacco, whose excise duty rose in early 2010, made a major contribution to first quarter inflation, helping the slowdown in second quarter inflation due to static duty in 2011. Accumulated administratively controlled goods and services inflation reached 4.1 per cent by the end of 2011, contributing 0.63 percentage points to overall inflation. Main drivers were higher hospital charges and general practitioner fees (the latter relating directly to minimum wage changes), and energy price rises.

Core inflation in non-food products (excluding fuels) and services had no significant effect on consumer price inflation. By the end of 2011 it came to 0.4 per cent, contributing 0.2 percentage points to accumulated inflation and average annual inflation. Industrial goods prices (excluding fuels) fell a further 0.4 per cent by December, driven by falling durables prices. Services prices rose 1.1 per cent, contributing 0.3 percentage points to consumer price inflation. Food and fuel prices affected catering and transport services.

Accumulated Inflation since January and Contributions by Major Goods and Services

	2010		2011	
Inflation (%)	4.4		2.0	
	Inflation by group (%)	Contribution, percentage points	Inflation by group (%)	Contribution, percentage points
Foods	3.9	0.84	4.0	0.96
Processed foods	5.7	0.74	5.5	0.85
Unprocessed foods	1.1	0.10	1.2	0.10
Services	0.2	0.07	1.1	0.28
Catering	2.2	0.27	3.8	0.19
Transport	-0.8	-0.04	5.0	0.18
Telecommunications	-1.3	-0.05	-1.8	-0.08
Other services	-1.1	-0.11	-0.1	-0.01
Energy commodities	18.7	1.74	4.0	0.29
Transport fuels	20.5	1.71	4.0	0.28
Industrial goods	-1.0	-0.19	-0.4	-0.08
Administratively controlled prices	4.3	0.65	4.1	0.63
Tobacco products	33.9	1.33	-0.3	-0.02

Notes: The structure corresponds to the Eurostat classification; tobacco and administratively controlled prices are shown separately and the latter are calculated through the elementary aggregates level in the consumer basket.

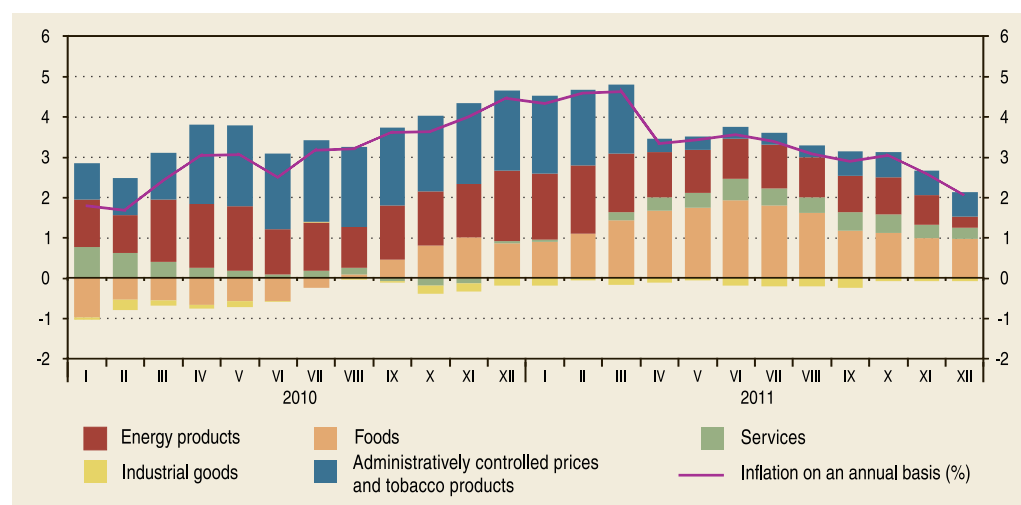
Sources: NSI, BNB.

⁸ Overall productivity measured by real GDP. Sectoral productivity measured by real terms sectoral value added.

⁹ Analysis based on HICP data.

Annual Inflation and Contributions by Major Goods and Services

(per cent, percentage points)



Sources: NSI, BNB.

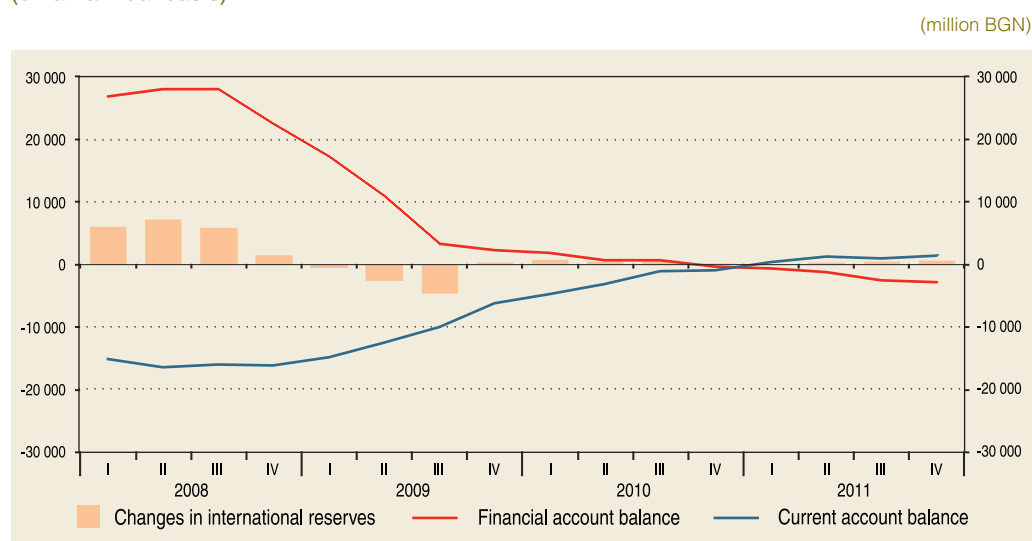
In 2011 the total current and capital account balance was in surplus by EUR 855.3 million (2.2 per cent of GDP) against a EUR 84.9 million deficit (-0.2 per cent of GDP) in 2010. The trade deficit fall contributed most. In 2011 it totalled EUR 1974.6 million, a nominal decrease of EUR 789.0 million on the prior year. The services and current transfers balance also improved. The surplus in services reached EUR 2287.2 million on EUR 1616.7 million in 2010, mainly due to higher transport and travel earnings and lower external services costs (other business services). The current transfers balance also improved by EUR 187.4 million to EUR 1692.8 million, mainly because of EUR 150.2 million greater receipts by the general government sector. The income balance deteriorated, its deficit growing to EUR 1644.0 million in 2011 on EUR 1134.3 million in the prior year. This was because of higher foreign direct investment (up EUR 481.2 million). Increased net EU fund receipts pushed up the capital account balance to EUR 493.9 million in 2011, up EUR 203.0 million on 2010.

In 2011, 30 per cent higher nominal exports continued outpacing the 21.2 per cent import growth, cutting the negative trade balance. All commodity groups contributed to export growth, with base metals and related products (7.6 percentage points), machines, vehicles, appliances, instruments and miscellaneous (5.4 percentage points), and mineral products and fuels (4.9 percentage points) leading. Lower external demand cut export growth gradually. All import groups (by use) also grew positively, with raw materials (9.7 percentage points) and energy commodities (5.7 percentage points) leading.

Preliminary balance sheet data show a EUR 1341.2 million positive direct investment inflow into Bulgaria in 2011 (3.5 per cent of GDP), from EUR 1208.5 million (3.4 per cent of GDP) in 2010. The last two years' relatively low net figures reflect lower attracted funds and intercompany loan repayments. The highest net receipts were in transport, storage and communications (EUR 498.4 million) and trade (EUR 223.2 million), with net outflows from manufacturing (EUR 69.6 million).

The balance of payments financial account deficit grew to EUR 1194.3 million in 2011. Resident banks, which increased foreign assets by EUR 695.8 million and reduced external obligations by EUR 1204.5 million, contributed most. Consumer propensity to save and spend less, and confidence in banks, significantly boosted deposits. Enjoying high liquidity, banks cut their gross external debt by a further EUR 1202.5 million, its share of total gross external debt falling from 18.5 per cent in December 2010 to 16 per cent a year later.

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

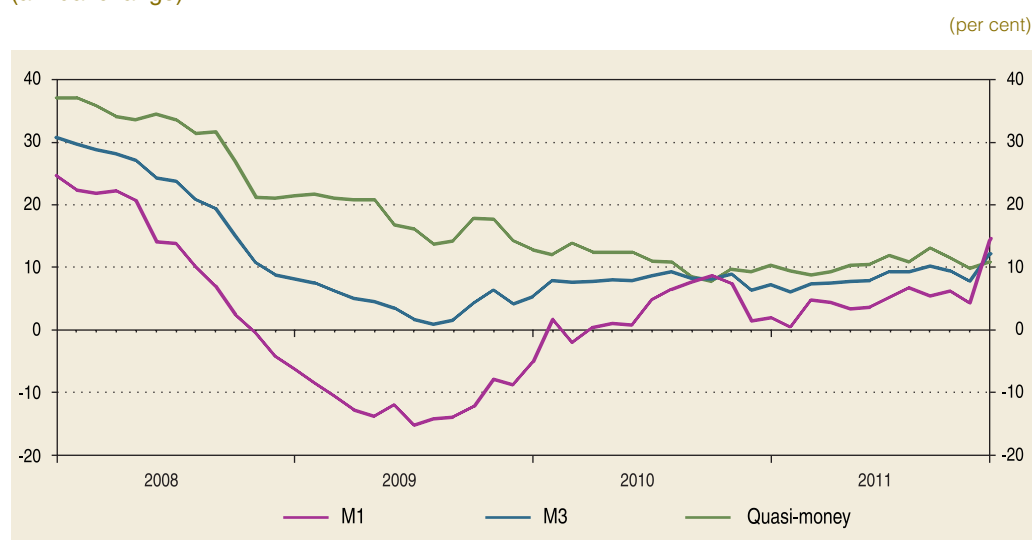


Source: BNB.

Gross external debt fell EUR 1666.8 million to EUR 35.4 billion (91.9 per cent of GDP) by December 2011. All sectors cut external obligations. Intercompany loans in the non-bank sector contracted by EUR 127.6 million to EUR 14,786.8 million. In 2011 loans and deposits came to EUR 4494.3 million,¹⁰ with principal of EUR 6031.5 million serviced. Over the year public and publicly guaranteed debt declined by EUR 102.2 million.

All external current, capital, and financial transactions boosted BNB international reserves by EUR 158.7 million in 2011, valuation adjustments excluded. Changes in international foreign reserves on the BNB Issue Department balance sheet, including revaluation adjustments, boosted them by EUR 372.1 million.

Monetary Aggregates (annual change)



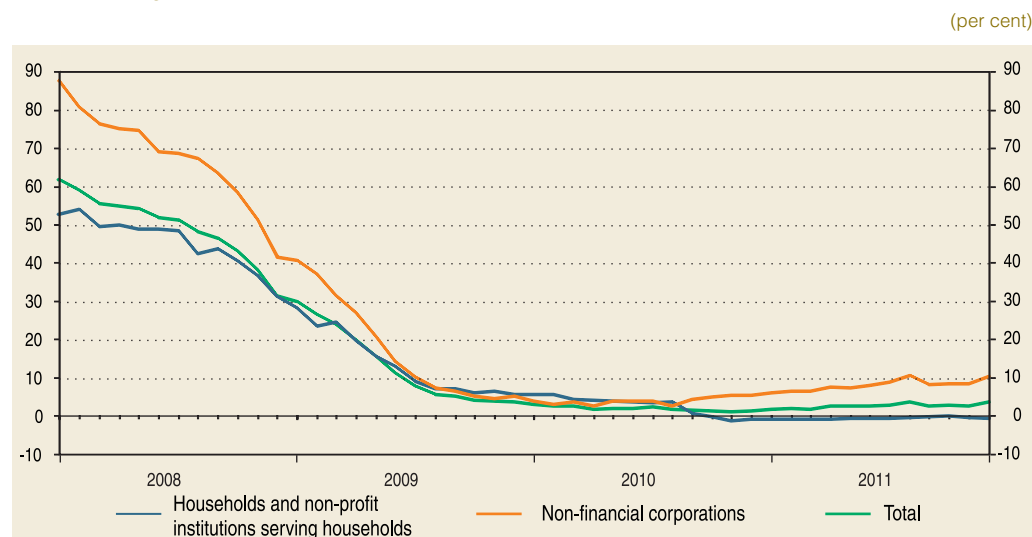
Source: BNB.

Monetary aggregates followed an upward pattern in 2011 reflecting the gradual recovery and growing resident bank deposits. By December 2011 broad money grew

¹⁰ Revolving and trade loans excluded.

12.2 per cent, from 6.4 per cent a year earlier. Quasi-money contributed most at up 10.9 per cent. The narrow money aggregate M1 rose 14.4 per cent, from 1.4 per cent a year earlier, mainly due to the base effect of 2010.¹¹ Currency outside banks continued growing at 5.9 per cent by the end of the year.

Claims on the Non-Government Sector (annual change)



Source: BNB.

Growth prompted a 3.9 per cent rise in claims on the non-government sector, from 1.3 per cent by the end of the prior year.¹² The volume of new corporate and households loans¹³ grew 43.8 per cent on 2010 to BGN 18.1 billion.¹⁴ Corporate credit grew in line with exports and services. The annual growth of claims on corporations was 6.4 per cent on 2.5 per cent in 2010. Consumer credit contracted 0.4 per cent by the year's end. Overdrafts and consumer loans fell 9.5 and 0.7 per cent, while housing loans grew 1.1 per cent. In the first half-year banks eased lending criteria, to tighten them again in the second half-year citing credit risk, the business climate in sectors with large shares of the credit portfolio, security-related risk, and the macroeconomic environment. Credit growth slower than GDP growth in 2011 cut the claims on non-government sector to GDP ratio by 2.0 percentage points to 72.1 per cent by the year's end.

Bulgarian banks continued financing their credit activity by deposits from residents (households and non-financial corporates). They grew by BGN 3.5 billion and BGN 1.6 billion in 2011. Overall resident deposits grew by BGN 5.2 billion, non-resident deposits falling by BGN 2.2 billion.¹⁵ Rising residents' deposits provided high liquidity,¹⁶ allowing banks to invest into external assets and service foreign obligations.

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 against euro at the fixed exchange rate under the Law on the Bulgarian Na-

¹¹ Upon entry into force of the 2011 State Budget Law of the Republic of Bulgaria, cash holdings in the National Health Insurance Fund's BNB bank and deposit accounts were transferred to the central budget. This greatly cut social insurance funds' overnight deposits by the end of the year and curbed M1 growth to a minimum on an annual basis in December 2010.

¹² Lending in this section analysed using BNB monetary statistics data.

¹³ New loans refers to the new business statistical category.

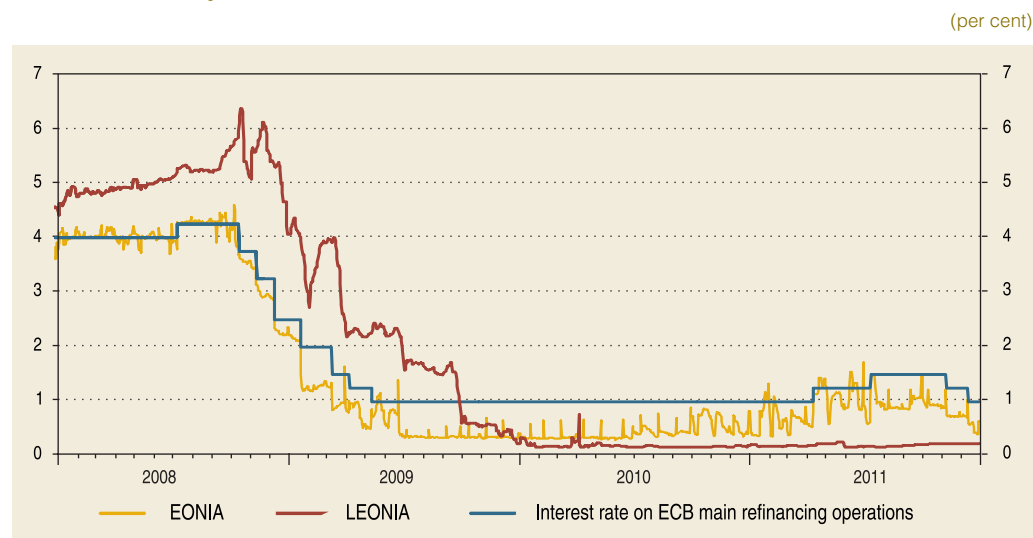
¹⁴ Data on consumer deposits and credit include NPISH deposits and loans in line with the monetary statistics classification.

¹⁵ BNB monetary statistics data.

¹⁶ Banking system liquid assets ratio was 25.53 per cent in December 2011.

tional Bank.¹⁷ Total foreign currency market turnover in 2011 was EUR 434 billion,¹⁸ up 21.9 per cent on 2010. It comprises three main segments: turnover between banks, transactions between the BNB and banks, and trading between banks and final customers. Turnover between banks (excluding the BNB) rose by EUR 174.6 billion. The interbank currency trading structure remained unchanged, interbank transactions (excluding the BNB) in euro continued rising by 2.0 per cent entirely at the expense of a drop in USD transactions.

Interbank Money Market Interest Rates



Sources: BNB, ECB.

In 2011 interbank money market liquidity remained high, with interest rates dropping, especially for longer maturities. Average interbank deposit and repo interest fell from 0.28 per cent in 2010 to 0.24 per cent over the review period. The spread between LEONIA and EONIA remained negative for the whole period, almost tripling from 25 basis points in 2010 to 67 basis points in 2011. In November and December the spread started contracting due to rising euro area interest rate levels,¹⁹ reaching a 41 basis points average in December. Bulgarian interest rates were much less volatile than euro area money market levels.

Interbank money market transactions rose 13.1 per cent on 2010 to BGN 86.8 billion. Deposits comprised 69.7 per cent of turnover and government securities repos 30.3 per cent. Overnight transactions dominated deposits at 82.9 per cent.

Recovering tax revenue and effective spending limits were the main drivers of the budget deficit improvement over the year. ECOFIN²⁰ assessed fiscal measures as adequate to correct the excessive deficit under ECC'95 within the deadline. The cash balance on the consolidated fiscal programme for 2011 was BGN -1487.7 million (-2.0 per cent of GDP): BGN 475.3 million lower than the BGN 1963.0 million deficit target in the State Budget Law.²¹ The budget deficit contracted by BGN 1335.1 million (47.3 per cent) on the prior year. Total revenue and grants for 2011 were BGN 25,378.6 million. The 6 per cent increase on 2010 was entirely because of higher tax collectability. This, and the recovery of economic activity, were the main reasons for the 8.3 per cent tax revenue increase. Revenue rises from social insurance (2.3 percent-

¹⁷ See Section II.

¹⁸ 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.

¹⁹ See Section I in this chapter.

²⁰ The ECOFIN Council meeting of 15 February 2011.

²¹ Preliminary data.

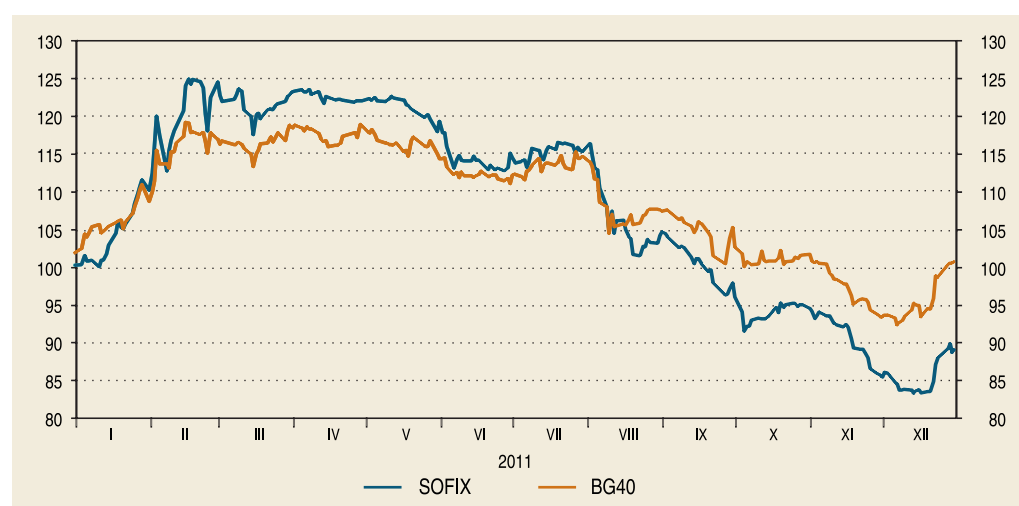
age points), value added tax (1.4 percentage points) and excise duty (1.2 percentage points) contributed most. Consolidated fiscal programme expenditure for 2011 (including the EU budget contribution) was BGN 26,866.3 million: a 0.7 per cent annual rise. The 16.1 per cent reduction of capital costs²² on the prior year was most pronounced. Wage and operating expenditure stayed close to prior year levels, growing by 0.1 and 0.4 per cent respectively. By the year's close fiscal reserves were BGN 4998.8 million, down BGN 1013.0 million on December 2010.

There was continuing investor interest in government treasury bills and bonds offered by the Ministry of Finance (MF). The average total annual yield of government securities placed in 2011 declined 0.77 percentage points on 2010 to 4.21 per cent. Average primary market yield fell on the prior year across all maturities, helping government to finance part of the budget deficit more cheaply than in 2010, with BGN 539.6 million of positive net issuance on the domestic market. The increase in government securities in circulation and higher average issue volumes promoted the development and liquidity of the government debt instrument secondary market.²³

By the end of the review period EUR-denominated global bonds maturing in 2013 were quoted at 105.1 per cent (2.42 per cent yield) and USD-denominated global bonds maturing in 2015 at 112.0 per cent (4.01 per cent yield).²⁴ As in 2010, USD-denominated ZUNK bond prices hovered around nominal.

Over the first quarter of 2011 the SOFIX and BG40 indices were buoyant, reflecting the improving economic situation. Subsequent quarters saw declines mainly due to growing uncertainty on debt problems in some EU countries. By the year's end SOFIX and BG40 declined by 11.1 and 0.9 per cent on late 2010, following leading markets. Secondary market trading fell 12.5 per cent to BGN 480.3 million, while *bourse* bond turnover fell 1.1 per cent to BGN 122.9 million. There were BGN 737.1 million²⁵ of over-the-counter transactions in equity and BGN 36.4 million in bonds. The capitalisation of the Bulgarian Stock Exchange, Sofia, market was BGN 12.4 billion or 16.5 per cent of GDP by the year's end, against 15.3 per cent of GDP at the close of 2010.

Bulgarian Stock Exchange Indices (December 2010 = 100)



Sources: BNB, Bulgarian Stock Exchange.

²² Capital costs include also changes in government reserve assets.

²³ For more information on the government securities primary and secondary market, see Section VIII of the Report.

²⁴ Reuters data.

²⁵ Major exchange-traded and over-the-counter transactions involved, *inter alia*, Energoni AD (BGN 285 million), Petrol AD, Black Sea Investment ADSITs, Chimsnab Bulgaria AD, DZI, Bulgartabac Holding, Corporate Commercial Bank, Prime Property BG ADSITs.

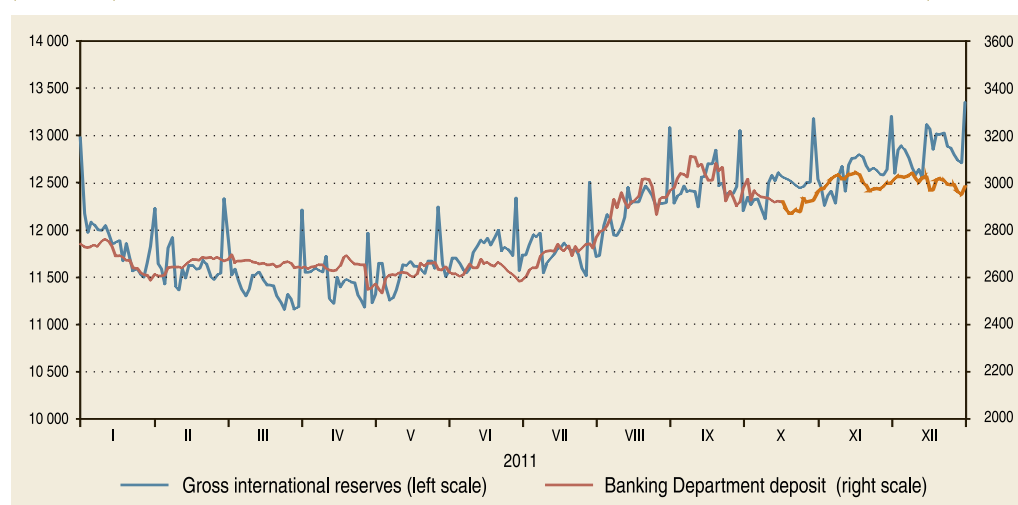
II. Gross International Reserves

The Law on the Bulgarian National Bank closely provisions gross international reserve management, which also takes account of investment constraints, procedures, and methodologies, and world financial markets opportunities.¹ The Law defines what the Bank's gross international reserves are. They have to cover all monetary liabilities under the fixed exchange rate of the lev set by the Law.² 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.³

Gross International Reserves and Banking Department Deposit

(EUR million)

(EUR million)



Note: The chart shows 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 610.9 million received by the BNB in August and September 2009 after IMF general SDR allocation.

Source: BNB.

1. Gross International Reserve Amount and Structure

At the end of 2011 the market value of gross international reserves was EUR 13,349 million, up EUR 372.1 million in a year.⁴ In the first half of 2011 this went down by some 5 per cent due to foreign currency cash outflows and a negative market revaluation of gold. In the second half, a large positive market revaluation of gold and inflows into

¹ There were no Law on the Bulgarian National Bank (LBNB) amendments concerning gross international reserve management in 2011.

² Article 28, paragraph 3 of the Law on the BNB lists what may comprise gross international reserves: monetary gold; Special Drawing Rights; freely convertible foreign currency; freely convertible foreign currency held by the BNB at foreign central banks or other financial institutions 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, except collateralised debt; the balance on accounts receivable and payable on forward or repo agreements with (or guaranteed by) foreign central banks, public international financial organisations with one of the two highest ratings from two internationally recognised credit agencies; and BNB futures and options binding non-residents and payable in freely convertible foreign currency. Assets are estimated at market value in compliance with the Law.

Article 26, paragraph 2 of the Law on the BNB lists all the Bank's monetary obligations: circulating currency and all BNB account balances held by other persons with the BNB except those of the IMF.

³ Article 28, paragraph 1 of the Law on the BNB stipulates that "the aggregate amount of monetary liabilities of the BNB shall not exceed the lev equivalent of gross international reserves," that equivalent set based on the fixed exchange rate of the lev.

⁴ Further in this Chapter SDR 610.9 million received by the BNB in August and September 2009 as a result of general SDR allocation made by the IMF were not included in the analysis of BNB gross international reserves. For further details see BNB Annual Report, 2009, p. 30.

deposits within the Issue Department balance sheet offset the decrease, boosting reserves on the prior year.

External Foreign Currency Cash Flows

(million EUR)

	2011	2010
I. Euro purchases and sales		
at tills	-11	-16
in banks	-532	-306
bank purchases	33 698	57 241
bank sales	-34 230	-57 547
Subtotal I	-543	-321
II. Currency outflows to banks, the MF, and others		
Minimum Required Reserves	-128	-385
Government and other depositors (Total)	647	243
Subtotal II	520	-141
Total I+II	-24	-463

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

Source: BNB.

Positive balances receipts on government accounts and other depositors totalling EUR 647 million (mostly receipts on European Commission account with the BNB) contributed most substantially to the value of external flows in 2011. Net sales of reserve currency to banks forming an outflow of EUR 532 million are also of significant importance. This trend is similar to the 2010 trend with flows having the same directions but smaller in volume. Net funds on banks' accounts amounting to EUR 128 million were refunded consistent with minimum required reserves to be maintained by commercial banks with the BNB.

The structure of gross international reserves changed with an increased share of gold. This reflected higher average gold prices in 2011. The share of assets in euro was 86.76 per cent for the year.

Currency Structure of Gross International Reserves

(%)

Currency	Issue Department Balance Sheet	
	2011	2010
EUR	86.76	88.51
USD	0.10	0.53
XAU	12.79	10.60
XDR	0.33	0.34
CHF	0.01	0.01

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

Source: BNB.

Over the year there was no great change to the structure by financial instrument. The share of cash dropped to 5.95 per cent and of securities to 71.57 per cent in favour of deposits.

Gross International Reserves by Financial Instrument

(%)

Financial instrument	2011	2010
Vault cash*	5.95	7.61
Deposits**	22.49	16.45
Securities**	71.57	75.95

* Account balances and payments.

** Including instruments in foreign currency and gold.

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

Source: BNB.

There was no significant change in average values from 2010 in the structure of gross international reserves by residual maturity. Most assets remained in the up to a year maturity sector (current accounts, short-term deposits in foreign currency and gold, and short-term securities), its proportion rising to 70.92 per cent at the expense of longer-term maturity sectors.

Gross International Reserves by Residual Term to Maturity

(%)

Maturity Sector	2011	2010
Up to a year	70.92	64.24
One to three years	22.05	23.95
Three to five years	5.33	9.14
Five to ten years	1.49	2.15
Over ten years	0.22	0.52

Notes: 1. Average 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 2011 euro area financial markets were turbulent, with lower risk tolerance. In April 2011 the cost of financing Portuguese debt rose unsustainably and that government followed Greece and Ireland in seeking EU and IMF help. In the second half of 2011, euro area debt crises deepened, widening spreads on Italian, Spanish, Belgian, and French government bonds compared with the yield of reference German government bonds. Differentiation between euro area Member State sovereign debts widened. Greater demand for low-risk assets (flights to quality) cut German and Dutch reference bond yields, short-term discount bond yields even going negative at the year's close. Comparable Italian and Spanish yields rose, with relatively high spreads by late November; the two countries continued obtaining finance from the international markets, completing issue programmes.

Government Bond Yield Curves

The flight to quality pressured 2011 German and US reference yields. In most months, the curve flattened. Drivers in the euro area were the debt crises and ECB policy.⁵ The opinion of the US Federal Reserve Open Market Committee that the policy of keeping low interest rates in the USA should be sustained at least until the end of 2013 had a strong downward effect on the yield in the short-term segment of the yield curve of US government securities. At the same time, the long end of the money market yield curve was under the pressure of the programme for extending the average maturity of assets in the Federal Reserve portfolio (twist operation), accompanied by a decrease in the yield.⁶

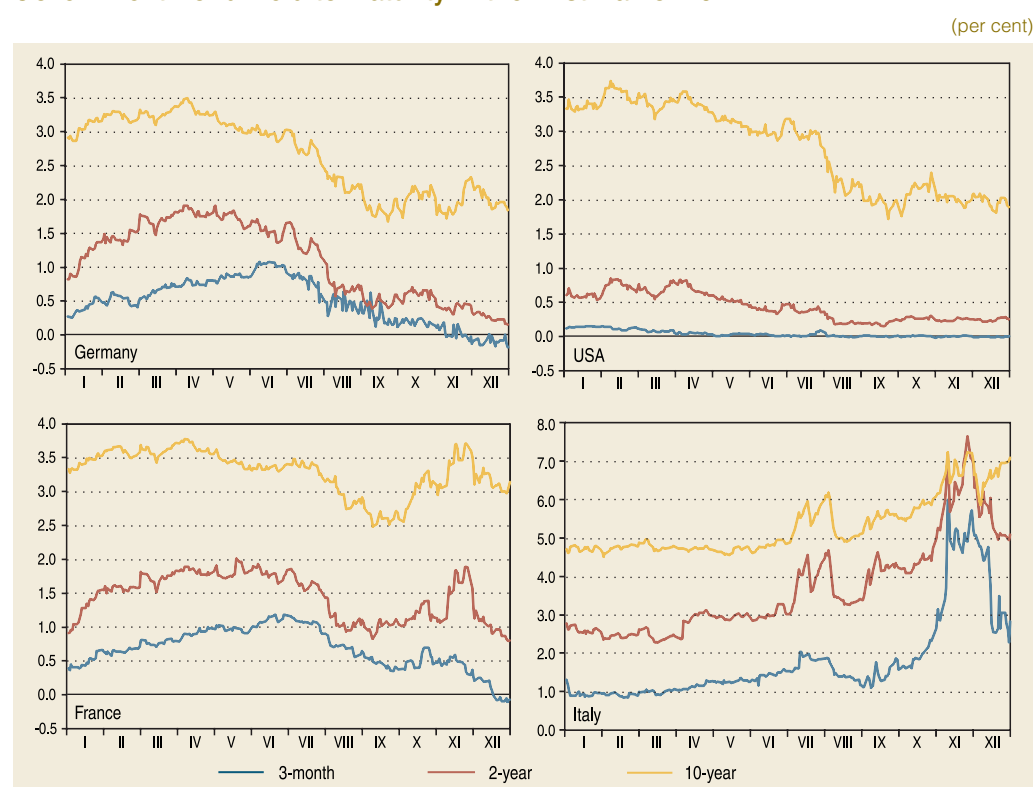
In the first quarter of 2011 reference German government bond yields rose, more in short and medium maturities. Two year yields rose almost a percentage point to a 1.91 per cent high on 8 April. This reflected euro area inflation concerns and the ECB's April and July 25 percentage point increments of main refinancing operations interest. In mid-second quarter, yields started a slow fall which hastened early in the third quarter and continued to the year's end. Amid signals of an economic slowdown in the euro area and increased financial market uncertainty as a result of public debt crisis, the ECB cut interest rates in the last quarter. By late December two-year reference German bonds yield fell to just 0.14 per cent, with negative yields at the under-a-year end. Slope measured by spread in the two- and ten-year segments narrowed to 169 basis points from 210 by the end of the previous year.

⁵ For further details on ECB policy see Chapter I.

⁶ For further details on the US Federal Reserve policy, see Chapter I.

Meanwhile, government bond yields of the so-called euro area periphery rose in the euro area sovereign debt market alongside increasing differentiation between countries. In mid-2011 there were signs of a debt crisis spillover to Italy, Spain, Belgium, and even France. To calm markets, in August 2011 the ECB Governing Council re-launched the Securities Markets Programme (SMP) temporarily halted in April, extending its scope. The ECB intervention helped temporarily calm down government securities market but new tension in late November pushed two-year Spanish bond yields to over 5 per cent and Italian bonds to 7 per cent. Belgium's government crisis and increasing concerns of French banking exposure to the euro area periphery hiked French and Belgian yields. In December tension began subsiding after ECB commitment to unlimited long-term bank refinancing and euro area liquidity.

Government Bond Yield to Maturity in the First Half of 2011



Source: Bloomberg.

After a moderate increase in the first quarter of 2011 US treasury bond yield fell, especially in the third quarter. By 19 September yield in the two year maturity sector reached a 0.15 per cent low, ten year yield falling to 1.95 per cent. In the last quarter short-term yield stabilised at low levels, falling anew in the medium and long-term sectors. The stronger decline in the long end of the curve flattened it significantly, two to ten year yield spread falling from 270 to 164 basis points in a year to almost match the euro area.

Gold and Exchange Rates

In 2011 the US dollar appreciated cumulatively 3.1 per cent on the single European currency. The USD/EUR rate moved within the wide range of 0.67 to 0.77 with strong fluctuations. This reflected risk aversion, concerns about the ability of some euro area countries to refinance debt, and the monetary policies pursued by the US Federal Reserve System and the ECB. In the second half of the year the differential between the interest rates on US government securities and benchmark German bonds strongly influenced the USD/EUR rate.

The USD/EUR Exchange Rate



Source: Bloomberg.

Troy Ounce Gold Price in US Dollars



Source: Bloomberg.

Troy Ounce Gold Price in Euro



Source: Bloomberg.

Major Types of Risk

The US dollar and euro gold price rose to September 2011 highs, with gold sought as an investment haven. Through the year the price moved within the wide band of USD 1313.5 to USD 1900.2 per troy ounce. Gold appreciated 10.1 per cent in US dollars and 13.7 per cent in euro to USD 1564.9 and EUR 1206.8 per troy ounce by the year's end.

In 2011 the BNB invested gross international reserves to the BNB Governing Council's long-term risk tolerance criteria on the net value⁷ in the Issue Department balance sheet: $-10.00 \text{ per cent} \leq \text{VaR} \leq 0 \text{ per cent}$ on an annual basis and at 95 per cent confidence level.⁸

Interest rate risk measured by reserves' average modified duration was 0.77 years: slightly under the 0.78 years' average modified duration in 2010.

The Law on the Bulgarian National Bank provisions that the sum of the absolute values of open foreign currency positions⁹ in currencies other than euro, SDR, and monetary gold, should not exceed 2 per cent of the market value of monetary liabilities in these currencies constrained **currency risk**. There were minimal open currency positions in currencies other than euro over the year, the open gold position posing the main currency risk.

In 2011 **credit risk** reflected the prior year's concerns about fiscal and debt problems in some euro area countries and their ability to service debt. The year saw European debt markets under sustained pressure, with growing differentiation between government securities issued by the so-called periphery and core EU Member States.

Continued market uncertainty prompted additional measures, mostly in managing credit risk of BNB international reserves intended to subdue the risk for the bank. In early 2011 a new Credit Risk Management Methodology fundamentally changed assessment and reporting of foreign BNB counterparty banks and debt issuers into whose debt the Bank could invest. The Methodology raised the number of internationally recognised credit rating agencies whose evaluations the BNB uses to diversify ratings. Financial institutions get internal ratings based on credit rating agency ratings and basic performance ratios. Credit rating agencies' positive/negative watch or long-term outlook ratings now form part of institutions' credit risk profiles.

The Bank continued 2010 measures to constrain government bond credit risk. In early 2011 it reaffirmed the ban on debt issued or guaranteed by countries with worsened fiscal positions and high public debt. The measure applied to portfolios managed both by the BNB and external BNB managers. It also retained the mid-2010 conditional division of issuers into three credit risk groups based on the involved credit risk of government debt securities. A minimum of 30 per cent of reserves is in the least risky group. The Bank cut exposure to the riskiest group from 20 in 2010 to 15 per cent in early 2011, the longest maturity cut to three months. Since early 2011 there have been 20 in 2010 and 10 per cent international reserve market value concentration limits to individual counterparties in the second and third groups. In mid-2011 the concentration limit to individual issuers in the riskiest group halved to 5 per cent. The maximum maturity of all newly purchased assets from other issuers of debt instruments dropped from 30 to 10 years, and to three years in the third quarter. Over the year, some 61 per cent of funds were invested into assets with the highest AAA long-term credit rating.

Strict observance of international reserve management investment restrictions, business procedures, and best practice contained **operational risk**.

⁷ "Net value" means the Issue Department balance sheet item "Banking Department deposit".

⁸ Net value risk measured by $\text{VaR} = -X\%$ ($X > 0$) 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.

⁹ An open foreign currency position is the difference between the value of assets and liabilities in any currency other than the euro.

Return and Efficiency

Net income from assets in euro is the sum of income from 1) investing gross international reserves in original currency; 2) currency imbalance yield¹⁰; and 3) spending on liabilities. In 2011 the Bank earned EUR 157.29 million from gross international reserve investment, or 1.37 per cent rate of return. The income from net open currency positions of EUR 186.67 million resulted entirely from changes in the euro price of monetary gold. Interest expenditure on Issue Department balance sheet liabilities was EUR 10.47 million. Net earnings from international reserve management were EUR 333.49 million, or 2.93 per cent net annual rate of return.

International Reserves Earnings and Profitability in 2011

(million EUR; per cent)

Quarter	(1)+(2)+(3) Net income	(1) Investment income	(2) Gains on currency revaluations of assets and liabilities	(3) Expenditure (interest) on liabilities
First quarter	-65.88	0.33	-64.72	-1.49
Second quarter	66.54	41.46	28.50	-3.42
Third quarter	307.51	81.25	230.56	-4.29
Fourth quarter	25.32	34.26	-7.67	-1.27
Total income, EUR million	333.49	157.29	186.67	-10.47
Total rate of return, per cent	2.93	1.37	1.67	-0.11

Source: BNB.

International reserves are split operationally into portfolios by currency and investment goal, each with a benchmark, investment goals, and limits. Below are the major BNB portfolios and results from their management:

Portfolio Profitability and Risk in 2011

(EUR, USD)

Portfolio	Earnings		Volatility (risk) ¹		Information ratio ⁴
	Absolute (%)	Relative ² (b.p.)	Absolute (b.p.)	Relative ³ (b.p.)	
Investment 1, EUR	1.72	-23	64	48	-1.87
Investment 2, EUR	1.64	-31	83	82	-1.52
External manager A, EUR	2.78	8	111	15	2.21
External manager B, EUR	2.62	-17	101	22	-3.12
Liquidity, EUR	0.76	5	8	8	
Liquidity, USD	0.06	3	22	22	

¹ Risk means yield standard deviation.² The positive/negative relative yield of a given portfolio is profit against the respective benchmark yield. Relative yield is rounded to 1 basis point; within the -0.5 to 0 band it is "-0" and within the 0 to 0.5 band, "+0".³ Relative risk against benchmark indicates deviation of portfolio risk characteristics from benchmark because of active management. Risk is annual.⁴ The information coefficient indicator is the ratio between portfolio annual relative yield and annual relative risk.

Source: BNB.

External managers at international financial institutions managed some 6.2 per cent of BNB international reserves in 2011. This provided diversification and helped boost Bank expertise. Liquid portfolios assisted immediate payment needs. To diversify management styles and reduce operational risk, most euro-denominated assets continued to be in two investment portfolios with identical benchmarks and investment limits, managed by different BNB teams.

¹⁰ Currency imbalance yield is the result of the effects of exchange rate movements on assets' and liabilities' open foreign currency positions.

III. Payment Systems

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. The Bank's major goals were to curb systemic risk and facilitate Bulgarian payment system integration into the euro area payment infrastructure.

Bulgaria's lev settlement systems are:

- RINGS, a real-time gross settlement system, run by the Bulgarian National Bank;
- RINGS payment systems:
 - BISERA, a system for servicing customer transfers to be settled at a designated time, operated by BORICA–Bankservice AD;
 - BORICA, a system for servicing payments initiated by bank cards in the territory of Bulgaria, operated by BORICA–Bankservice AD;
 - SEP, a mobile telephone electronic payment system, operated by SEP Bulgaria AD.

Bulgaria's euro settlement systems are:

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

Bulgaria's securities settlement systems 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. Lev Payment Systems and Securities Settlement Systems

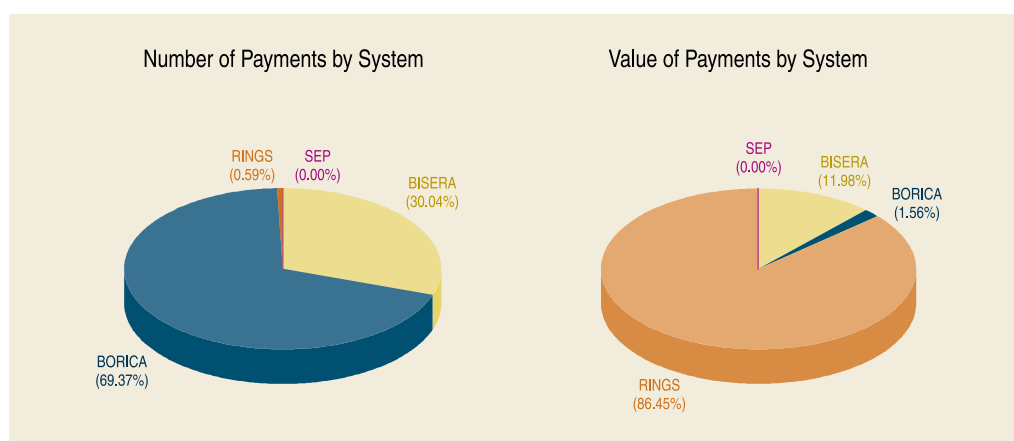
In 2011 Bulgarian payment system shares remained largely as in 2010. RINGS processed 86 per cent of payments. Values around 80 per cent are considered optimal for real-time gross settlement systems. RINGS also processed 0.59 per cent of non-cash payments.

BORICA payments rose on 2010 by 5.90 per cent in value and 2.27 per cent in number. The number of POS terminal transactions rose 9 per cent on 2010. BISERA transactions grew 9.58 per cent in value and 4 per cent in number on 2010.

Equity market declines in 2011 eroded 4.42 per cent of the number and 10.57 per cent of the value of Central Depository transactions.

In 2011 transactions through SEP, which presently includes only seven domestic banks, declined 33.07 per cent in number and 21.33 per cent in value on the prior year.

Distribution of Payments in Bulgaria by Payment System in 2011



Source: BNB.

RINGS Real-Time Gross Settlement System

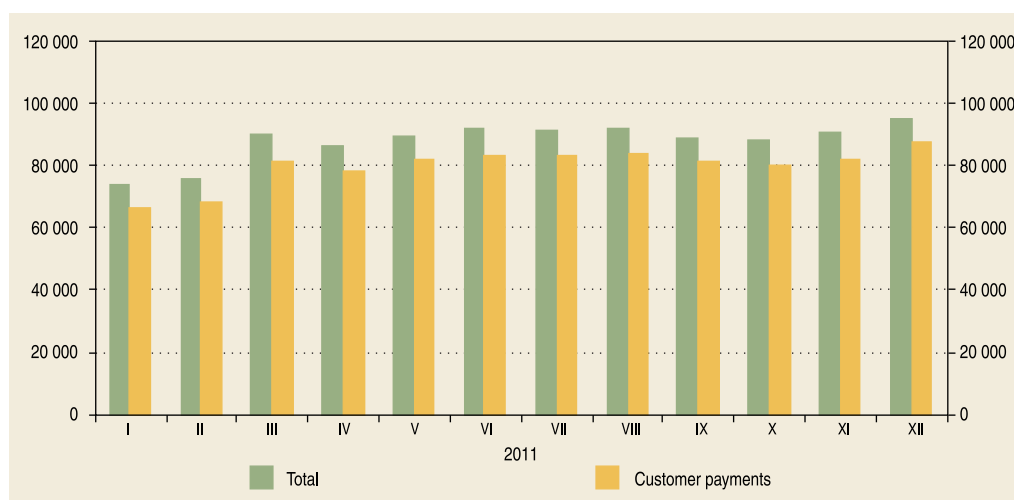
In 2011 RINGS processed most Bulgarian payments. This cut payment system risks: one of the major goals of a central bank. RINGS processed 1,056,376 payments for BGN 682,067 million. The increases in number and value were 6.25 per cent and 15.22 per cent respectively. Customer payments numbered 958,970, or 90.78 per cent of total payments, for BGN 159,652 million (23.41 per cent of the value of all payments). The daily average number of payments was 4192 and daily average value was BGN 2707 million.

Over the year 67.22 per cent of payments were processed by noon and 86.32 per cent by 2:30 pm. As regards system traffic, 84.60 per cent of payments were effected by 2:30 pm.

As of 31 December 2011, 32 banks (including the BNB) participated in RINGS. On 25 July 2011 İşbank GmbH Sofia Branch entered the RINGS system after receiving a licence to conduct bank operations in Bulgaria.

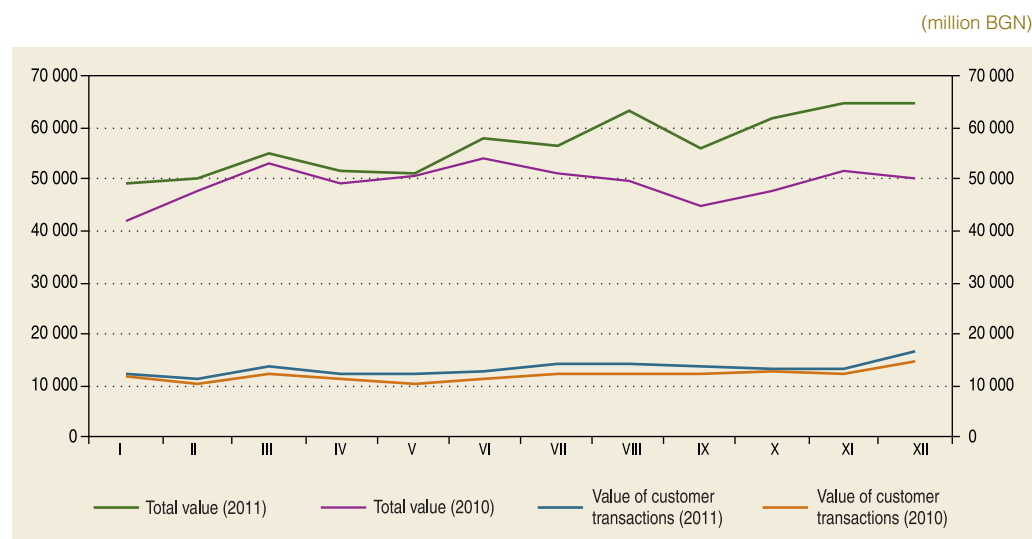
From 13 June 2011 the system day schedule included a third settlement cycle in the BISERA payment system within the RINGS system day. The timespan for accepting customer payments increased.

Number of Payments Processed in RINGS



Source: BNB.

Value of Executed RINGS Transactions in 2010 and 2011



Source: BNB.

The increased number of BISERA settlement orders optimised customer payments by spreading them more evenly through the system day and facilitated banks' liquidity management in servicing customers and the budget.

In 2011 no payments were rejected by the close of the RINGS' system day due to insufficient funds on participants' accounts, indicating good liquidity management by banks. There was no recourse to the Reserve Collateral Pool: an interbank mechanism guaranteeing settlement of payment and securities system operators' orders. RINGS offered 99.98 per cent availability¹.

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, each connected central bank operating a 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. On 31 December 2011 the ECB and 23 EU central banks were in TARGET2.

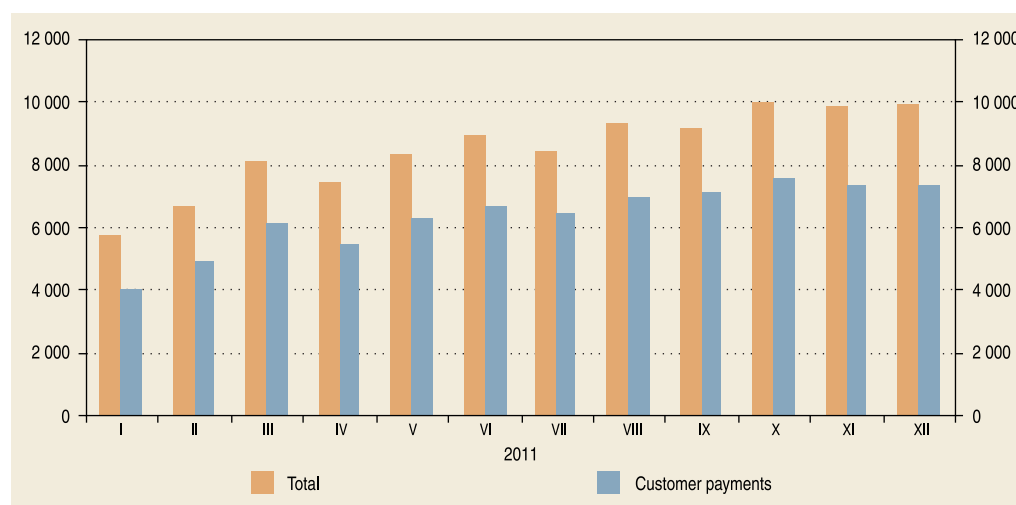
TARGET2-BNB went live on 1 February 2010. It includes the BNB, 17 direct participant banks, three addressable BIC holders, and the BISERA7-EUR ancillary system for servicing customer transfers in euro to be settled at a designated time. BORICA-Bank service AD processes SEPA credit transfers and SEPA direct debits with BISERA7-EUR.

Over the year TARGET2-BNB processed 102,099 payments worth EUR 285,979 million. There were 76,502 customer payments (74.93 per cent of all payments) worth EUR 3925 million (1.37 per cent of the value of all payments effected *via* TARGET2-BNB). Payment number increased 56.25 per cent on 2010, reflecting increased interbank and customer payments (65.09 and 53.50 per cent respectively). Overall value rose 57.86 per cent due to increased interbank and customer payment value (58.51 and 21.94 per cent respectively).

Payments by other system components to banks remained steady at 87.36 per cent of the number and 92.7 per cent of the value. There were 397 average daily payments through TARGET2-BNB, up 44.70 per cent in a year, worth an average of EUR 1113 million, up 46.19 per cent on 2010. The daily numbers peak was 688 and the value peak was EUR 2921 million.

¹ The ratio of time when TARGET is fully operational to overall operating time.

Number of Payments Ordered by TARGET2-BNB Participants



Source: BNB.

Value of Payments Ordered by TARGET2-BNB Participants

(million EUR)



Source: BNB.

The BISERA7-EUR ancillary system processes designated time euro customer transfers. It includes 14 banks. In 2011 this system processed 10,190 payments worth EUR 84,427 million, an increase of 148.78 per cent in number and 163.58 per cent in value on 2010. The growth was largely due to the link with the Deutsche Bundesbank SEPA Clearer. This allowed reciprocal exchanges of SEPA credit transfers between the Bulgarian and German banking communities. At the year's close, SEPA linked with the leading European card and payment operator Equens.

3. Regulatory Changes

In 2011 amendments to the Law on Payment Services and Payment Systems transposed Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems, Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims, and Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and pru-

dential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

Amendments to Directive 98/26/EC introduced the concepts of interoperability and system operator and clarified payment and securities settlement system operator duties. They limit systemic risk stemming from moment-of-irrevocability rules in interoperable systems.

Directive 2009/110/EC sets a clear legal framework and provides adequate prudential supervision on electronic money issue. Amendments offer a clear technically neutral definition of electronic money. This encompasses electronic money, no matter whether in a payment device owned by an electronic money holder or distantly stored on a server and managed by the electronic money holder *via* a special electronic money account. Nominal value redemption is open at any time with no option of negotiating thresholds.

Amendments to Ordinance No 3 on the Terms and Procedure for the Execution of Payment Transactions and Use of Payment Instruments reflect the amended Law on Payment Services and Payment Systems.

In March 2011 the Governing Council amended Ordinance No 16 on Payment Institutions, Electronic Money Institutions and Payment System Operators Licensing with updated capital and reporting requirements and new licensing requirements for electronic money institutions, their capital, and reporting. The amendments entered into force on 30 April 2011.

4. Bulgarian Payment and Settlement System Development

In 2011 BORICA–Bankservice AD published its first compliance assessment of BISERA7-EURO with SEPA to the four Eurosystem criteria on payment infrastructures: ability to process SEPA payment instruments; interoperable rules (interface specifications and business procedures for exchange of SEPA credit transfers and SEPA direct debits between banks and infrastructures); a free infrastructure choice for processing SEPA payments based on service and price; SEPA-wide reachability (technical ability for sending or receiving euro payments to and from all banks in the euro area.²

BISERA7-EUR meets the first three criteria. As regards SEPA-wide reachability, since late 2010 the system has linked with the Deutsche Bundesbank SEPA Clearer, allowing reciprocal SEPA credit transfer exchanges.

On 12 December 2011 a link for SEPA payments exchanges between BORICA–Bankservice AD and Equens went live, expanding BISERA7-EUR reach to over 2500 SEPA credit transfer participants (some 55 per cent of all SEPA participant banks), mostly across Germany, Greece, Italy, Netherlands, Poland, and Switzerland. This opens new opportunities to the Bulgarian banking community.

EMV³ rollout into the card payments infrastructure is almost complete, with 56.54 per cent of all ATM cards migrated to EMV, including 53.07 per cent of debit and 91.94 per cent of credit cards. The share of ATM terminals compliant with the standard is 99.98 per cent and that of POS terminals 95.82 per cent.

5. Payment System Oversight

Limiting system risk and improving Bulgarian payment systems' reliability and efficiency were the major goals of payment systems overseers. They monitored observance of standards and recommendations by the Bank for International Settlements,

² See *Terms of reference for the SEPA-compliance of infrastructures* on the ECB website.

³ 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.

the International Organization of Securities Commissions, the European Central Bank, and the European System of Central Banks.

On finding that M Secured OOD had not operated since licensing under Resolution No 88 of 7 October 2008, on 15 March 2011 the Governing Council revoked its license to operate a money remittance business under Article 15, paragraph 1, item 1 of the Law on Payment Services and Payment Systems.

Finding that the conditions of the same Law's Article 10, paragraph 4 were not met, on 28 April 2011 the Governing Council refused an Article 14 payment services license to NTC-Pay AD under Article 4, item 7.

Finding that the conditions of the same Law's Article 10, paragraphs 4 and 5 were not met, on 9 June 2011 the Governing Council refused an Article 14, items 1 and 2 payment services license to Euromoney Transfer OOD (in formation) under Article 4, item 6.

In the first half of 2011 the BNB inspected services offered by two companies *via* terminal devices under the same Law's Article 115, paragraph 3.

Finding that the conditions of the same Law's Article 10, paragraph 4, items 3, 5, 6, 7, and 9 were not met, on 7 July 2011 the Governing Council refused an Article 14 payment institution license to QIWI Bulgaria OOD to provide payment services under Article 4, item 7.

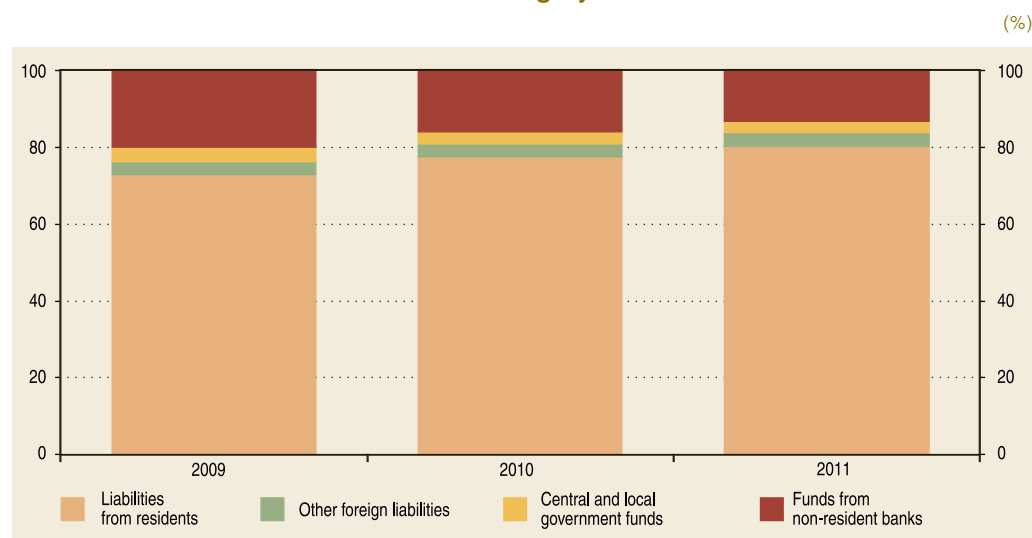
On the grounds of the same Law's Article 77 in connection with Articles 10 to 17 and Article 137, paragraph 1, on 21 July 2011 the Governing Council issued electronic money licences for InterCard Finance AD and TBI Credit EAD to issue, distribute, and redeem electronic money.

A system for collecting and processing Law on Payment Services and Payment Systems reporting forms launched in August 2011 accelerates and automates payment service provider, operator, participant, and electronic money issuer reporting. In 2011 the public register of licensed payment institutions and their branches and agents under Article 17 of the said Law comprised 441 Easypay AD agents and 36 InterCard Finance AD agents. Seven agents of both companies dropped out in 2011, while 43 payment institutions from elsewhere in the EU and operating in Bulgaria went onto the register under BNB Ordinance No 16 of 16 July 2009. Under Article 39 of the Ordinance, 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 listed 12 companies in 2011.

IV. Bank Reserves with the BNB

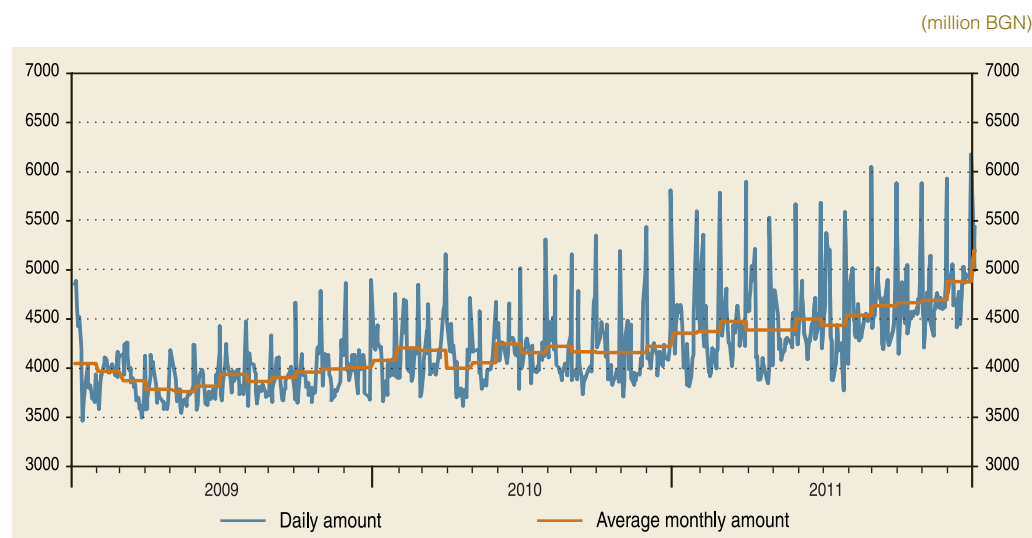
Ordinance No 21 on the Minimum Required Reserves Maintained by Banks at the Bulgarian National Bank stayed unchanged in 2011. The average daily value of attracted bank funds for minimum required reserve calculation purposes rose 7.2 per cent on 2010, including 17.4 per cent and 0.7 per cent growth in lev and foreign currency liabilities respectively. Funds from residents (excluding central and local government accounts) rose 10.9 per cent and those from non-resident fell 7.1 per cent. Central and local budget liabilities grew 2.6 per cent.

Structure of Attracted Funds in the Banking System



Source: BNB.

Bank Reserves with the BNB



Source: BNB.

Changes in the structure of funds attracted in 2011 led to an increase in the effective implicit rate of minimum required reserves to 8.9 per cent from 8.7 per cent in the prior year¹. Reserve assets covering this ratio include funds on bank accounts with the BNB (7.6 percentage points) and half of cash balances recognised as reserves (1.2 percentage points). The foreign currency structure of reserve bank assets changed in 2011, with BGN-denominated assets increasing 31.0 per cent on 2010 and their absolute amount trebling the funds required to cover payments. Foreign currency reserve assets fell 27.8 per cent on the prior year, their share varying between 20.6 per cent in March and 24.9 per cent in September. Over the year the average daily share of excess reserves in the total amount of reserves maintained by banks reached 3.0 per cent, from 4.4 per cent in 2010.

¹ Ordinance No 21 sets 10 per cent of banks' domestic deposit base and 5 per cent of their foreign deposit base as minimum required reserves, except government and local budget funds.

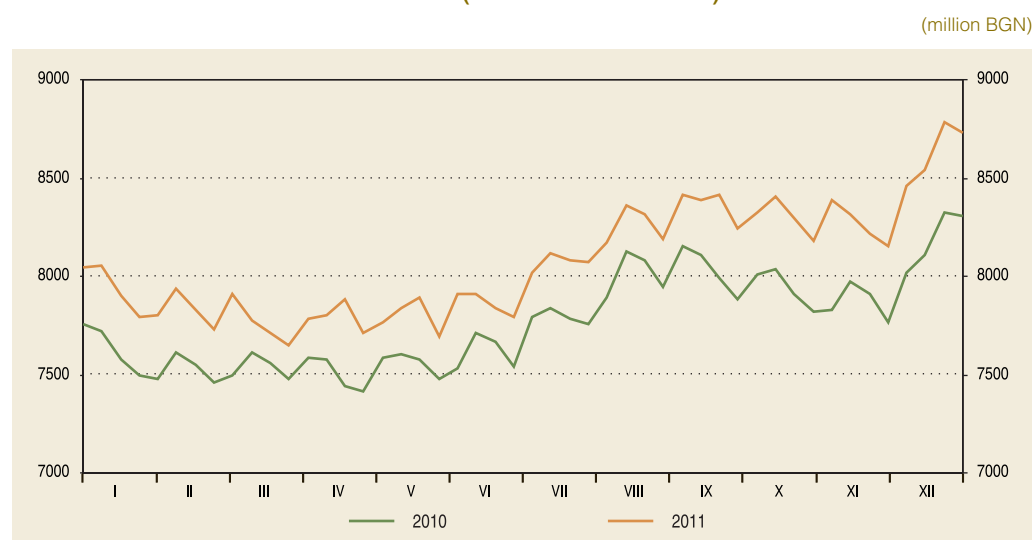
V. Cash in Circulation

The Bulgarian National Bank has a monopoly on Bulgarian cash issue¹. The Bank's cash is legal tender mandatorily acceptable as payment at full face value without restriction. The BNB prints banknotes, mints coins, and safeguards uncirculated and withdrawn cash.

Banknotes and Coins in Circulation (Outside BNB Vaults)

Circulating cash² at the end of 2011 was worth BGN 8728.9 million, up BGN 426.4 million or 5.14 per cent in a year. Banknotes accounted for 97.94 per cent of that, posting a 0.03 percentage point decrease in favour of coins.

Banknotes and Coins in Circulation (Outside BNB Vaults)



Source: BNB.

Over the year the number of circulating banknotes increased faster than in 2010 to 319.2 million worth BGN 8548.8 million, up 5.9 million (1.89 per cent) in a year. Their nominal value grew by BGN 414.9 million (5.10 per cent). In 2010 the percentage growth of banknotes was less at 0.90 per cent in number and 3.06 per cent in value.

By the end of 2011 the BGN 20 banknote was most common at 32.87 per cent of all banknotes or 104.9 million pieces, up 0.03 percentage points on 2010. The shares of BGN 100, BGN 50 and BGN 2 banknotes increased 0.58, 0.69, and 0.07 percentage points respectively.

By the end of 2011 the BGN 50 banknote occupied the largest share in the structure of circulating banknotes at 34.79 per cent, followed by BGN 100 and BGN 20 banknotes at 30.47 and 24.55 per cent.

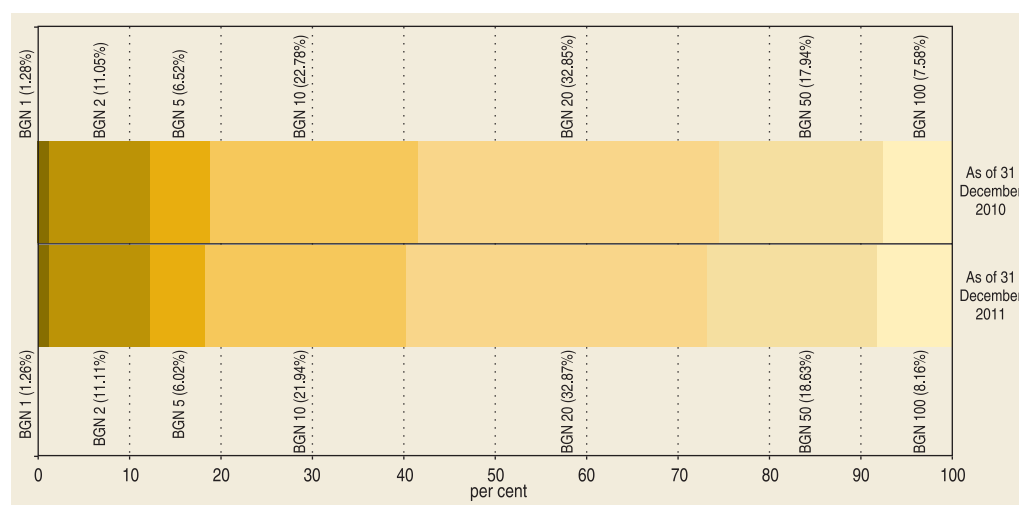
The average value of a circulating banknote was BGN 26.78, up BGN 0.82 or 3.15 per cent, mainly due to the growing number of high-value banknotes, giving BGN 100 and BGN 50 a lead.

¹ Article 2, paragraph 5 and Article 25 of the Law on the Bulgarian National Bank.

² Banknotes and circulating and commemorative coins issued after 5 July 1999.

Share of Individual Denominations in the Total Number of Circulating Banknotes

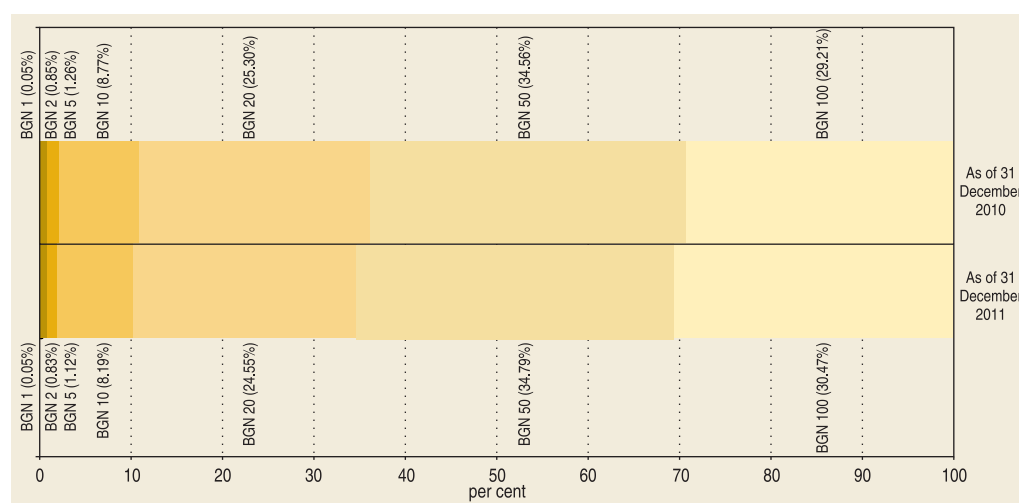
(share of total number)



Source: BNB.

Share of Individual Denominations in the Total Value of Circulating Banknotes

(share of total value)

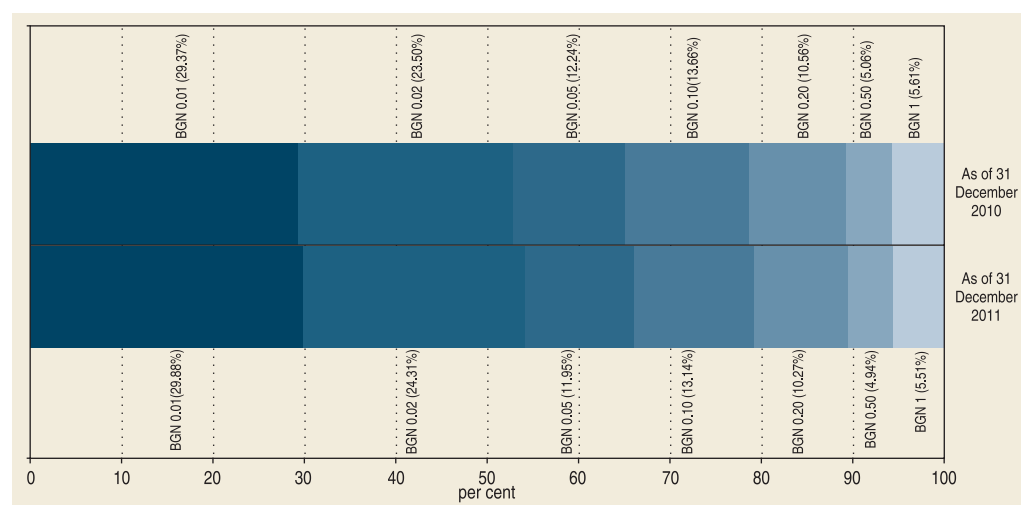


Source: BNB.

By 31 December 2011 the share of circulating coins reached 2.0 per cent of the value of circulating cash. At the end of 2011, the number of coins in circulation stood at 1369.6 million, with a total value of BGN 174.4 million. Within a year, their number grew by 114.0 million (9.08 per cent) and their value by BGN 11.2 million (6.86 per cent). This reflects demand for low-value coins. Changes in the structure of circulating coins show a two-year trend towards increasing shares of BGN 0.01 and BGN 0.02 coins at the expense of others. The share of low-value coins (BGN 0.01, BGN 0.02, and BGN 0.05) in the total number of coins in circulation was 66.13 per cent.

Share of Individual Nominal Values in the Total Number of Circulating Coins

(share of total number)



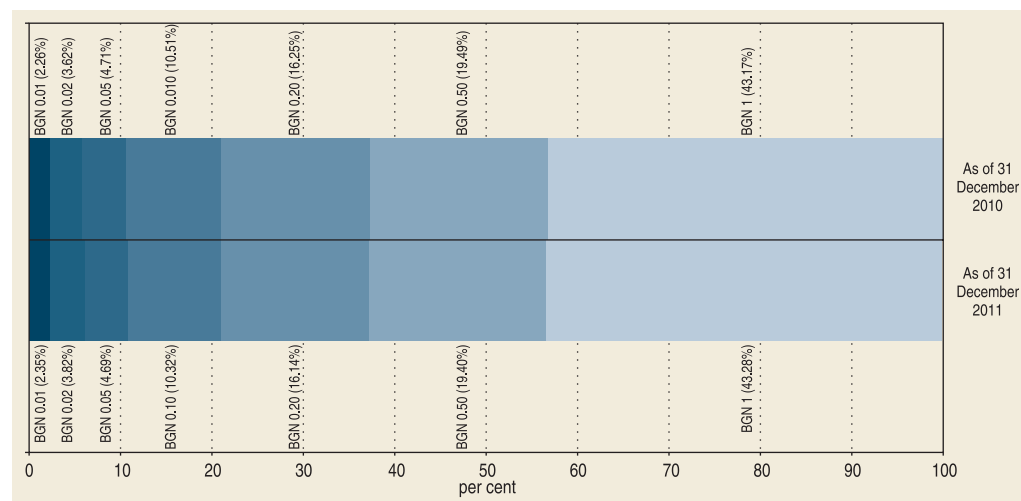
Source: BNB.

In a year, the share of BGN 0.01 and BGN 0.02 coins in circulating coins rose 0.50 and 0.81 percentage points, while that of BGN 0.05, 0.10, 0.20, 0.50, and BGN 1 declined 0.30, 0.51, 0.28, 0.13 and 0.10 percentage points.

At the end of 2011 BGN 1 coins had the largest share at 43.28 per cent of the total value of circulating coins, followed by BGN 0.50 and BGN 0.20 coins at 19.4 and 16.14 per cent.

Share of Individual Nominal Values in the Total Value of Circulating Coins

(share of total value)



Source: BNB.

Despite the progressively growing number of BGN 0.01 and BGN 0.02 coins, their low nominal value had no effect on the value of the average coin in circulation. Since 2009 it has stayed at BGN 0.13.

Commemorative coins held their value share in circulating cash at the 0.06 per cent level of 2011.

Non-genuine Banknotes and Coins

The BNB National Analysis Centre retained 2860 non-genuine Bulgarian banknotes in 2011, of which 2596 had entered circulation: 7469 fewer retained banknotes than last year. The share of retained non-genuine Bulgarian banknotes remained very low for the year at 0.0009 per cent of circulating banknotes; in 2010 it was 0.0033 per cent. The insignificant number of non-genuine banknotes indicates that cash circulation security remained high.

The BGN 20 banknote had the largest share of all retained non-genuine banknotes at 62.80 per cent, followed by BGN 50 (28.53 per cent). Non-genuine BGN 2, BGN 5, BGN 10, and BGN 100 banknotes numbered 248 (8.67 per cent of all retained non-genuine banknotes).

The BNB continued familiarising the public with the security features of Bulgarian and euro banknotes. Professional cash handlers are offered continuous training and information updates were released to support the fight against counterfeiting of the Bulgarian currency.

The year saw authenticity evaluations of 1080 non-genuine coins, including 231 BGN 1, 843 BGN 0.50 and six BGN 0.20 coins. The relative share of non-genuine Bulgarian coins retained in 2011 in the total number of circulating coins was 0.00008 per cent in 2011.

As regards foreign banknotes and coins, in 2011 the National Analysis Centre retained 7126 euro banknotes, 4197 US dollar banknotes, and 392 assorted foreign non-genuine banknotes.

The Bank continued its comprehensive policy to counteract and prevent the spread of non-genuine Bulgarian coins and banknotes. Late 2011 amendments adopted by the BNB Governing Council to Ordinance No 18 on the Control over Quality of Banknotes and Coins in Cash Circulation expanded the scope of authenticity checks. From 1 January 2012 banks, financial institutions, exchange bureaux and service suppliers have evaluated all incoming Bulgarian and foreign banknotes and coins which they intend to put back into circulation and retained those suspected as non-genuine or altered. Banknote and coin authenticity is evaluated by specially trained staff or sorting and customer-operated machines.

BNB Issue and Cash Activities

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

In 2011 the Bank supplied 60.0 million new banknotes and 95 million new coins worth BGN 121.8 million under contracts with producers. The BNB launched the five commemorative coins planned in its 2011 minting programme under Article 25, paragraph 1 of the Law on the BNB³.

Banknote and coin deposits and withdrawals from the BNB totalled BGN 22,928.3 million in 2011. Banks deposited BGN 11,251.1 million of cash: up BGN 603.8 million or 5.67 per cent on 2010. Over the same period Bulgarian banknotes and coins worth BGN 11,677.2 million were withdrawn from the BNB: up BGN 776.9 million or 7.13 per cent on the prior year.

In 2011 banknotes recirculated through BNB tills an average of 2.15 times a year. High-value banknotes had lower return frequencies: BGN 100 and BGN 50 denominations return 0.45 times and 1.05 times respectively. BGN 10 and BGN 20 banknotes recirculated more often through BNB tills (2.78 and 3.34 times respectively), since they are most commonly used in ATM terminals.

³ For information on new banknote, circulating, and commemorative coin issues, see the BNB website.

In 2011 sorting machines at the BNB and Cash Services Company⁴ tested 642.6 million banknotes and 142.8 million circulating coins. Compared with 2010, the number of processed banknotes increased by 2.80 per cent, while that of processed circulating coins by 26.91 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.

Banknotes retained as unfit in processing numbered 76.7 million: down 18.9 million (19.73 per cent) on 2010. The share of unfit banknotes in total banknotes processed in 2011 was 11.94 per cent. Processing and fitness checks revealed 0.6 million unfit coins, up 161.75 per cent in a year. The share of unfit coins in total circulating coins processed in 2011 was 0.41 per cent.

In 2011 BNB reserve currency purchases came to EUR 1.1 million, including EUR 0.7 million from budget organisations and EUR 0.4 million from individuals. Over the same period BNB reserve currency sales were EUR 12.2 million, including EUR 7.2 million to budget organisations and EUR 5 million to individuals.

The BNB also oversees regulations on banknote and coin quality and recycling. To this end, the Bank performed six full and 38 spot on-site checks at credit institutions and professional cash handlers to ensure compliance with Ordinance No 18 on the Control over Quality of Banknotes and Coins in Cash Circulation and test cash sorting machines. The BNB regularly updates its website list of sorting machines and customer-operated machines tested successfully by manufacturers and the Bank to identification and fitness standards.

The late 2011 amendments to Ordinance No 18 on the Control over Quality of Banknotes and Coins in Cash Circulation provided more detail on claiming Bulgarian banknotes for subsequent exchange. The Law on Measures against Money Laundering requires claimants of banknotes for subsequent exchange to declare the origin of funds. The amended Ordinance 18 sets new requirements on personnel training, sorting machines, and customer-operated banknote and coin dispensers. The Ordinance requires banks and service suppliers to exchange Bulgarian banknotes damaged by anti-theft devices.

⁴ 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

Major banking indicators remained stable in 2011. The capital base and liquid assets increased and profits came to BGN 474 million. Attracted funds, credit, and assets grew. Increasing non-performing exposures amid slow credit growth limited banks' opportunities to boost core revenue. Lower interest income from loans and financial instruments was the main reason for lower returns, unlike the previous two years when it was high impairment costs. The banking system continued maintaining an overall capital ratio of over 17 per cent and had sufficient capital buffer to cover credit risk. Banks' attention to sound capitalisation further strengthened regulatory capital in 2011. The overall banking capital ratio reached 17.55 per cent with 15.73 per cent primary capital adequacy. Average capital indicators remained much healthier than those of the entire EU banking system. More than half of newly attracted funds were invested into liquid assets, boosting liquidity.

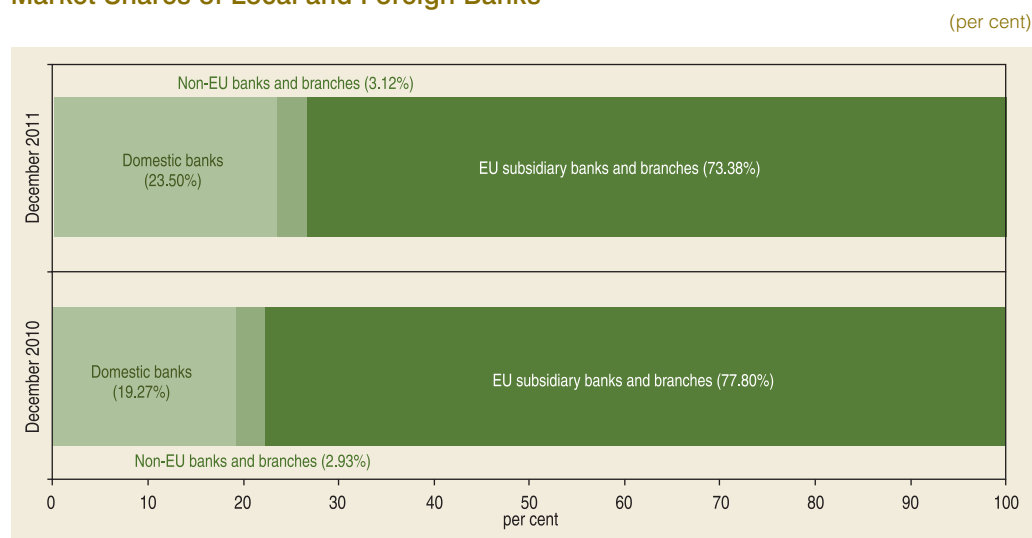
Structural Changes in the Banking System Balance Sheet

By the close of the year banking assets totalled BGN 76.7 billion. In 2011 they grew 4.1 per cent to BGN 3.0 billion, their growth matching that of attracted funds.

Low credit demand and reliance on domestic resources impacted balance sheet indicators. The share of loans and advances in the asset structure fell slightly to 78.6 per cent. The share of claims on credit institutions (placements) rose to 10.8 per cent of total assets. The BGN 281 million increase in the cash volume provided additional liquidity and helped keep its share of banking system assets at 9.9 per cent. Securities portfolios rose 9.1 per cent to BGN 492 million, most acquired as tradable assets.

Funds attracted from domestic sources provided stable financing, fully covering the decline of non-residents' funds. Growing deposits of individuals and households led the increase in attracted funds. The share of non-residents' funds fell 4.4 percentage points due to maturity of parent companies' funds. The share of residents' funds reached 80.8 per cent.

Market Shares of Local and Foreign Banks



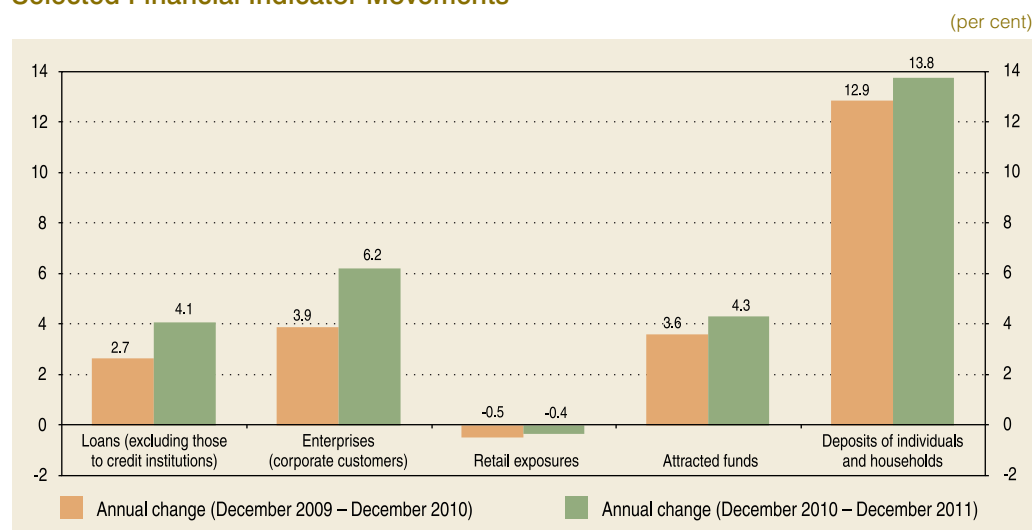
Source: BNB.

The assets of the big five banks comprised 51.8 per cent of system's balance sheet figure at the end of 2011. The share of EU subsidiaries fell to 69.6 per cent. Domestic banks improved their market position by 4.2 percentage points to 23.5 per cent of banking assets. The shares of the remaining institutions (banks outside the EU and foreign bank branches from the EU and outside it) did not change much. In 2011 credit institutions in Bulgaria increased from 30 to 31.

Lending

Despite weak demand gross loans (excluding those to credit institutions) grew faster in 2011, rising 4.1 per cent to BGN 2201 million. Domestic banks enjoyed stronger growth, mostly in the corporate segment, contributing most to growth. Banking system corporate loans grew 6.2 per cent or BGN 2113 million: faster than in the prior year's 3.9 per cent. Retail exposures went down 0.4 per cent or BGN 65 million through contracting consumer credit (1.8 per cent) and a weak (1.1 per cent) housing mortgage loan increase. Central government borrowed 18.1 per cent (BGN 91 million) more and non-credit institutions, 8.1 per cent (BGN 62 million) more. Claims on credit institutions rose 8.5 per cent or BGN 653 million, with funds mostly invested into foreign parent companies. The rising trend in EUR-denominated loans continued. By the end of the year gross loans in euro accounted for 61.2 per cent, those in levs 34.0 per cent, and in other currencies 4.8 per cent.

Selected Financial Indicator Movements



Source: BNB.

Attracted Funds

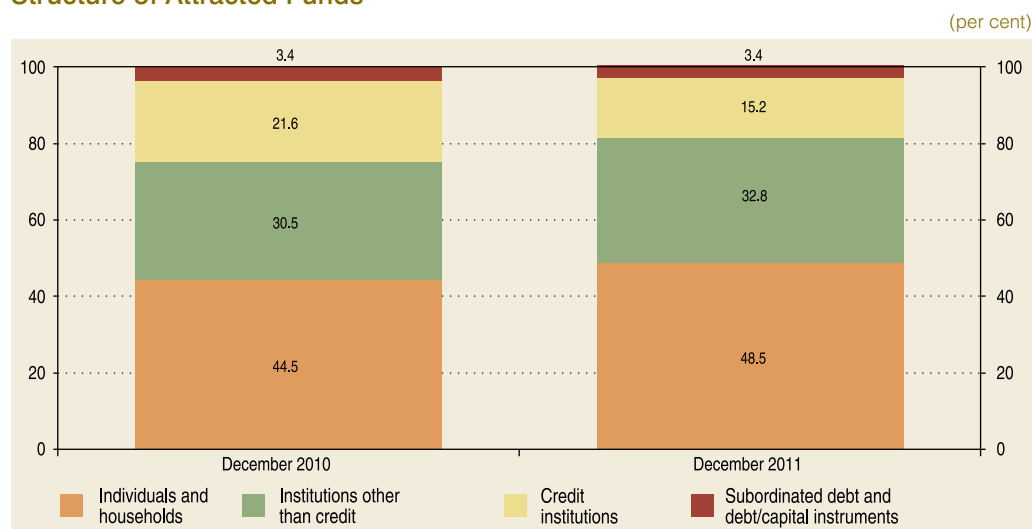
Attracted funds increased 4.3 per cent to BGN 65.7 billion. Banking stability and continuing confidence in credit institutions were the main reasons for the sustainable growth of deposits of individuals and households. The 13.8 per cent (BGN 3.9 billion) growth strengthened their leading role in total attracted funds to 48.5 per cent by the end of 2011. The share of resources from non-credit institutions rose to 32.8 per cent. Deposit growth increased the total funds protected by the Deposit Insurance Fund.¹

Growing domestic resource entirely offset the continuing fall in credit institution funds, their share falling to 15.2 per cent of total financing funds. As obligations to foreign parent companies declined, the significance of non-residents' resources decreased. By the end of 2011 their share was 19.2 per cent of all attracted funds. At the same time, increasing domestic funds boosted the weight of levs and fixed interest resources. By the end of the year 80.8 per cent of attracted funds had fixed interest rates. The lev component rose to 45.1 per cent of the currency structure of attracted

¹ The guaranteed amount of deposits and accrued interest which would be paid to depositors within reporting periods.

funds and euro resources fell 3.9 percentage points to 48.1 per cent. The share of other currencies remained almost unchanged at 6.8 per cent.

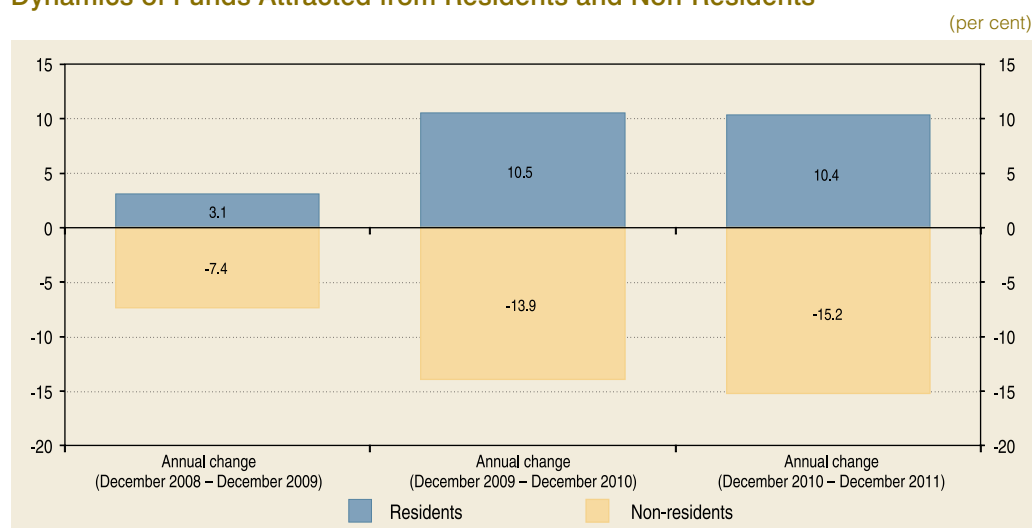
Structure of Attracted Funds



Note: The total does not add up to 100 due to rounding.

Source: BNB.

Dynamics of Funds Attracted from Residents and Non-Residents



Source: BNB.

Balance Sheet Equity

Banking system balance sheet equity rose 3.2 per cent or BGN 321 million through the year to BGN 10.3 billion. Issued capital (BGN 287 million) and reserves, including retained earnings (BGN 187 million), contributed most to balance sheet equity growth. Lower premium reserves, revaluation reserves, and lower incomes detracted somewhat.

Despite declining income from core operations and still high impairment costs banking made BGN 474 million profit in 2011. Though BGN 126 million less than in 2010, this reflected the capacity of credit institutions to generate acceptable income in a tough environment.

System Risk Profile

Credit risk remained the main challenge as the system faced asset impairment, conservative lending, and limited new business opportunities. Core operations earnings at many institutions almost matched impairment and operating costs. Proactive bank measures and BNB supervision helped maintain banking's capital position. Liquidity was managed effectively, most newly attracted funds invested into liquid instruments.

Asset Quality

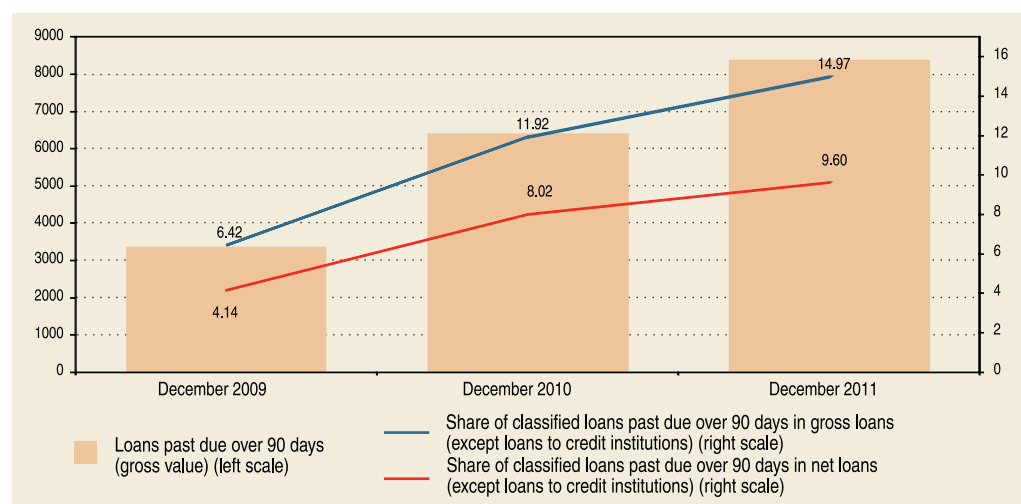
In 2011 the quality of assets continued to worsen, yet much more slowly than in 2010. Classified exposures grew 13.7 per cent annually, with the classified corporate loans rising 13 per cent. The economic environment affected also the quality of household exposures. In 2011 non-performing loans past due over 90 days rose 30.2 per cent, reaching 14.97 per cent² relative weight in the gross loan portfolio of the banking system (excluding loans to credit institutions). The net non-performing loans past due over 90 days to net loans ratio³ increased to 9.6 per cent. This was calculated by reducing the gross value of these loans by impairment costs.

Construction, property operations, and hotelry and restaurant services found it hardest to service debt. Base metals and metal products, agriculture, forestry and fishing, advertising, and veterinary medicine did better than last year.

Classified Loans Past Due over 90 Days

(million BGN)

(per cent)



Source: BNB.

By the end of 2011 accumulated provisions in the form of impairment costs and specific provisions for credit risk were adequate. International Accounting Standards impairments, provisions for credit risk, and capital surplus (capital over regulatory minima) covered 103.5 per cent of the gross value of non-performing loans past due over 90 days. The high levels and quality of security on loans should be borne in mind when addressing impairment costs and specific provisions for credit risk. At 38 per cent, corporate loan cover remained unchanged from recent years. Mortgage Loan-to-Value security of 62.4 per cent covers 160.4 per cent of loans with the value of mortgages. Banks have thus erected an additional firewall against loan quality worsening by providing significant eligible collateral.⁴

The quality of assets other than loans remained good. Growing investment in government securities boosted their share in the debt instrument portfolio to 71 per cent. The share of bonds with nil credit risk weight fell to 13 per cent by the end of 2011.

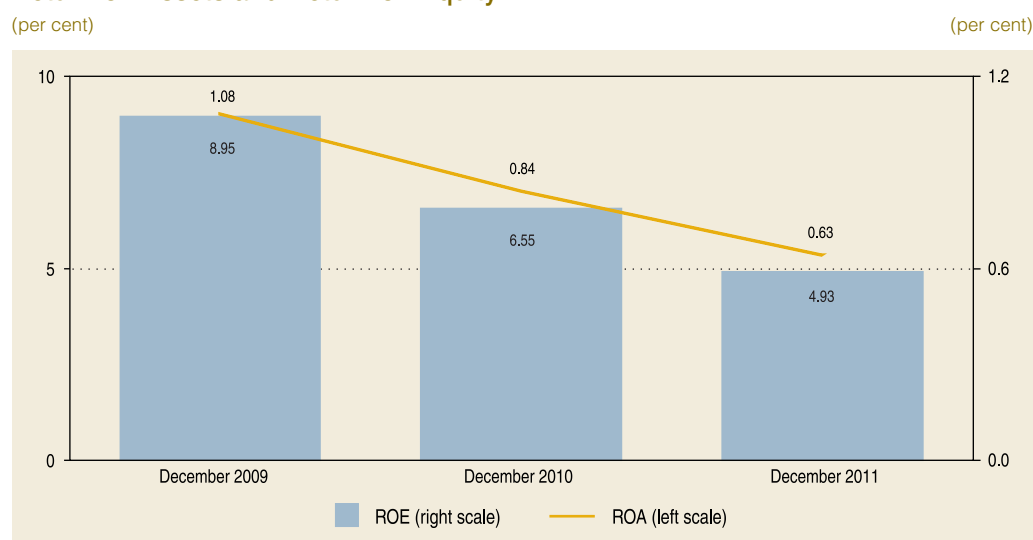
² Mechanical comparison should be avoided in international analysis of the "relative weight of loans past due over 90 days indicator in the banking system gross loan portfolio". It should be considered in the context of the structure of balance sheets of individual banking systems. For example, there are no sizeable portfolios of instruments for trade which are sensitive to market impairment (including also those triggered by debt crisis) in the structure of the Bulgarian banking system balance sheet. In contrast to some European banking groups and systems banks in Bulgaria did not suffer losses from these portfolios. Concurrently, EU leading banks maintaining a low share of non-performing loans incurred losses from debt securities which then required their recapitalisation.

³ The *non-performing loans (past due over 90 days) to credit portfolio* ratio shows the gross value of loans, including risk already reported in the income statement through impairment.

⁴ As an element of its policy in respect of credit standards in extending loans not only to individuals but also to corporations, banks required provision of sufficient collateral. For the purposes of supervisory regulations only a portion of collateral is treated as eligible. This had a direct effect on determining both the amount of impairments and specific provisions for credit risk, and the amount of capital coverage. On the other hand, the larger amount of collateral allows credit institutions to realise cash flows from sale both of loans classified as non-performing and collateral on them. This practice is specific for the Bulgarian banking system compared with other EU banking systems and allows for accumulation of additional buffer in banks' operations.

Profitability

In 2011 credit risk eroded profitability. Banks made audited profits of BGN 474 million: BGN 126 million or 21 per cent less than in 31 December 2010. ROA declined to 0.63 per cent and ROE (return on balance sheet equity and reserves) to 4.93 per cent. The results reflect BGN 46 million or 1.6 per cent lower net interest income than last year, mainly due to lower interest on problem and new loans. Higher interest income on individual financial instrument portfolios failed to offset the lower core operations income. Interest expenditure remained close to last year's at BGN 2.2 billion. Banks did not reduce administrative costs significantly, though staff numbers fell. Lower administrative costs would boost banks' financial results.

Return on Assets and Return on Equity

Source: BNB.

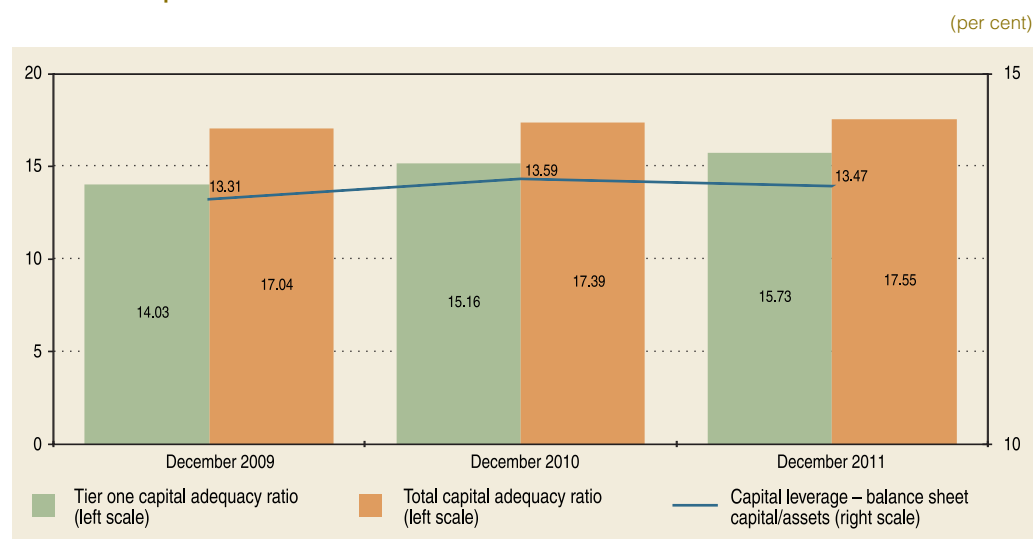
Equity

Capital position amount and quality remained at levels which allow expansion in banking intermediation. Total capital adequacy reached 17.55 per cent by the end of December and was higher than last year. Primary capital, the highest quality part of own funds, strengthened and the primary capital to capital requirement ratio reached a 15.73 per cent high since the start of the crisis. The increased equity was a result of the effect of two groups of factors: the sustained ambition of credit institutions to maintain higher minimum level of primary capital and to adhere to a more conservative policy in distributing profit (dividends), as well as to continued proactive supervisory requirements. These factors were a prerequisite to increase the system's capital surplus. At 13.47 per cent, the leverage ratio (balance sheet equity to gross assets) was lower than last year.

The increase in regulatory capital was a result of several factors. On the one hand, the decrease in some instruments in tier two capital and additionally allocated specific provisions for credit risk decreased the amount of equity. At the same time strengthening of the registered and paid-in capital had also a favourable effect on the banking sector's reserves.

Structural analyses of capital requirements for different risk types (credit, market, and operational) show no great change in 2011. Credit risk accounted for 58.2 per cent of total capital requirements. The standardised approach assessed 88.7 per cent of capital requirements for this risk and the Internal Rating Based Approach 11.3 per cent. Both approaches attributed the major and increasing share of capital requirements for credit risk to corporates. Retail exposures and those secured by property had a larger weight. Operational risk accounted for 7.9 per cent of capital requirements and position, foreign currency and commodity risks for 0.5 per cent.

Selected Capital Indicators



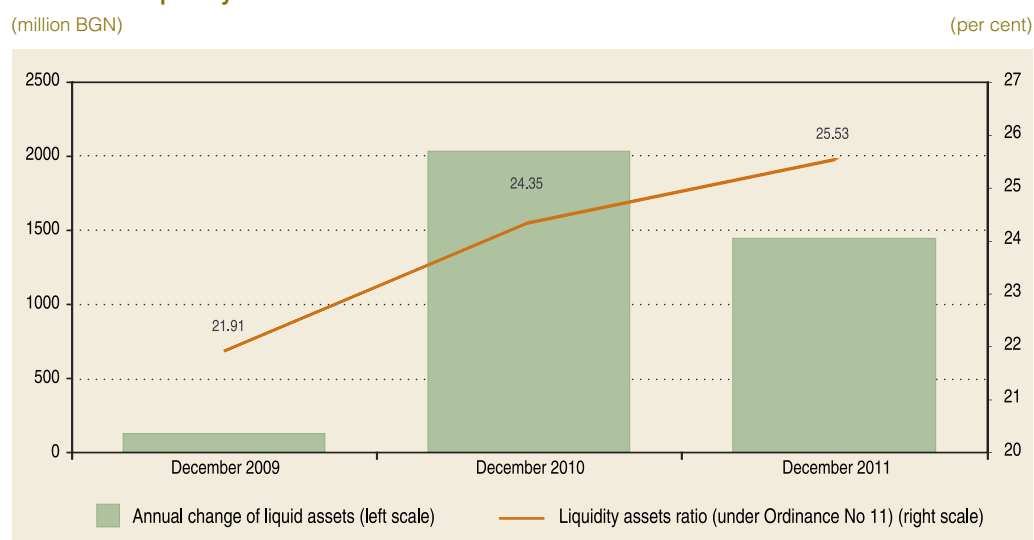
Source: BNB.

Liquidity

The structure of banking sector assets and liabilities kept liquidity stable throughout the year. The liquid assets ratio ranged between 24 and 26 per cent, low credit growth helping maintain liquidity. The annual growth rate of liquid assets exceeded that of liabilities and the liquid assets ratio rose to 25.53 per cent by the close of the year. Liquid assets increased 9.4 per cent or BGN 1.4 billion to BGN 16.8 billion. The BGN 1.1 billion growth of cash on current accounts and interbank deposits of up to seven days played the main role. Cash also increased, reflecting the continuing growth of domestic resources and hence minimum required reserves.

Cash led liquid assets at 45.2 per cent, with balances on current accounts with banks and interbank deposits up to seven days following at 39.8 per cent and rising. Liabilities (outflow) increased 4.3 per cent or BGN 2.7 billion. The deposit base increased despite continuing concerns about higher sovereign risk in countries with subsidiary banks and branches in Bulgaria. Sufficient liquidity remained the top BNB priority. BNB Ordinance No 11 on Bank Liquidity Management and Supervision changed in late 2011 with a more conservative macroprudential approach to liquidity analysis.

Selected Liquidity Indicators



Source: BNB.

2. Compliance with Prudent Banking Requirements

Bank supervision evaluates banks' risk profiles and aims to maintain their stability and ability to withstand shocks. An important priority of banking supervision is to control compliance of credit institutions with regulatory requirements for prudential bank operations. Reviewing performance through regular analyses of reports and on-site inspections highlights regulatory breaches and deviations leading to supervisory action. Proactive macro-prudential action aimed at additional firewalls against external impact.

Capital Adequacy

The stability and sensitivity of banks' capital positions and the accuracy of capital adequacy reports were analysed. No banks reported dips under the 12 per cent statutory minimum total capital adequacy. Measures were taken against one bank for increasing its capital base.

Large Exposures

There was continuous monitoring of risk concentrations attending large exposures. Inspections found cases of concentrations close to regulatory maxima for exposures to individual customers or economically related persons. These exposures are under strict continuous control.

3. Performance of Financial Institutions Registered under Article 3, Paragraph 2 of the Law on Credit Institutions

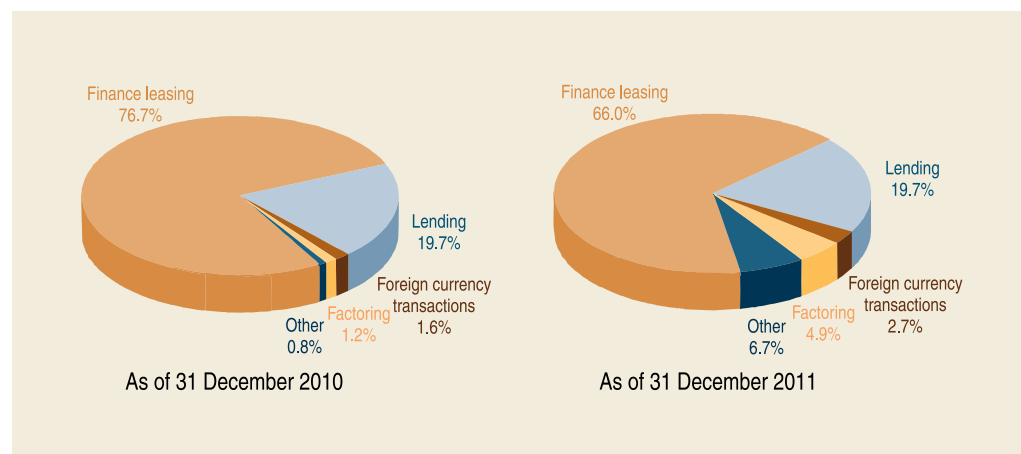
By the end of the year there were 267 financial institutions conducting mostly financial leasing and lending using own funds. Nine companies were wound up. Total assets grew 3.6 per cent to BGN 6.9 billion by the end of 2011: 9 per cent of all banking assets. The balance sheet figure of the 20 largest financial institutions mostly lease companies, was BGN 4.8 billion accounting for 69.6 per cent of the assets of all financial institutions. Despite eroding from 76.7 to 66 per cent, lease companies continued to have the largest market share in this sector. Lenders kept their 19.7 per cent share. The share of factoring services corporations increased greatly to 4.9 per cent mainly due to new registrations in the last quarter. The share of consultants and companies conducting guarantee transactions rose from 0.8 to 6.7 per cent. In assets, loans and receivables (including financial leases) dominated at 73.3 per cent. Foreign currency reserves show euro-denominated claims leading at 61.4 per cent. By the end of 2011 financial lease claims accounted for 66.3 per cent of the credit portfolio, business loans for 19.8 per cent, and consumer loans for 13.5 per cent. Over the year cash picked up 30.6 per cent, with the top 20's funds accounting for three quarters.

The year saw a worsening of financial institutions' assets with gross impaired loans (including financial leases) remaining at BGN 2.6 billion. Impaired consumer and business loans grew, while financial leases fell from 80 to 72.6 per cent. Allocated impairment provisions increased 10.1 per cent (to BGN 822 million) on BGN 746 million in 2010.

Companies continued funding operations using funds from banks (BGN 4.3 billion) which accounted for more than three quarters of total attracted funds (BGN 5.5 billion). Though attracted funds in euro declined from 2010 in favour of a lev increase, they had a 72.4 per cent share.

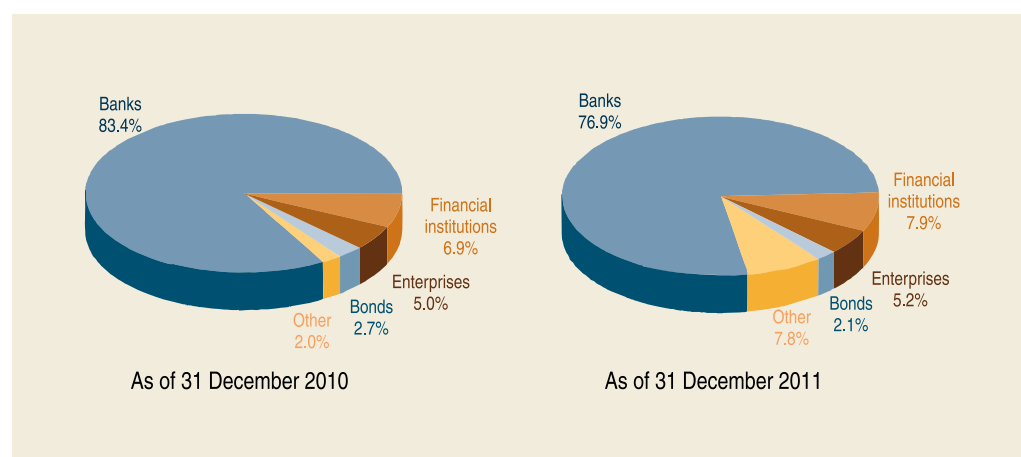
Registered institutions' BGN 1.1 billion equity went up 31 per cent or BGN 254 million on 2010. This reflected effective capital increases by some companies and new registrations. The top 20's equity was BGN 652 million or 60.7 per cent of sector equity. Foreign equity was 59.7 per cent of registered capital, Bulgarian investors holding 40.3 per cent.

Assets of Individual Groups of Financial Institutions under Article 3, Paragraph 2 of the Law on Credit Institutions



Source: BNB.

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



Source: BNB.

The financial result in 2011 was BGN 147 million on BGN 5.9 million last year. Lease companies managed to overcome losses. Companies concluding transactions in foreign currency made more profit than lenders. ROA and ROE were 2.13 on 0.1 per cent in 2010 and 13.7 on 0.7 per cent in 2010. Sector total current liquidity of 16.9 per cent, based on the current assets to current liabilities ratio, rose from 13 per cent last year.

4. Banking Supervision

In the course of work in 2011 the Banking Supervision Department used effectively its entire capacity and powers to maintain the banking system stability.

Supervisory Policy

In 2011 the BNB supervisory policy was aimed to harmonise national regulatory framework with the changed EU one and to converge bank supervision practice. The Bank supports EU and EU supervisory bodies moves towards anti-cyclical measures providing banking stability and resilience.

In early 2011 the BNB amended Ordinance No 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk. Amendments eased the pressure on banks' capital position without affecting accumulated capital buffers greatly. A package of statutory moves stemming from the EU Directive on the Capital Adequacy of Banks (CRD III) was ready later in 2011 to come into force from the year's end. This involved amendments to BNB Ordinance No 8 on the Capital Adequacy of Credit Institutions and to COREP supervisory reporting.

BNB guidelines on capital adequacy framework technical standards evolved through 2011 to European Banking Authority (EBA) recommendations. The guidelines help credit institutions apply the principles and requirements of bank remuneration. They establish rules for apportioning the costs and rewards of liquidity risk management. The Bank revised guidelines on stress-testing within supervisory reviews and on concentration risk management highlighting the establishment of economic relatedness and underlying asset exposures. They help further develop the supervisory framework and provide additional guidelines to banks to apply enhanced principles and requirements for improving the internal risk management.

The EU debated the draft of the CRD IV package introducing the Basel III capital framework to EU banks, with active BNB participation and an exchange of expert opinions to protect Bulgarian interests.

Late in the year the EBA and the European Systemic Risk Board (ESRB) clarified recommendations on liquidity management and foreign currency lending, particularly to unprotected or unhedged borrowers,⁵ taking into account Bulgarian specifics.

Over the year, supervisory financial reporting evolved to give more detail. Changes harmonised EU supervisory information and will highlight processes associated with the onset of the current global financial and economic crisis.

Credit Institutions Supervision

The year saw intensive and effective supervision. Regular accounting and on-site inspections clarified the risk profiles and financial performance of individual banks. Monthly analyses of regular financial reporting based on financial ratio and indicator reports indicated changes to banks' performance, risk profiles and solvency. Off-site reviews led to on-site inspections to establish the level and quality of risk management and warnings of underestimated risks or threats to solvency.

The year saw 16 supervisory inspections. They focused on credit and liquidity risk management and capital adequacy. Most were full inspections covering market and operating risk and Basel II Pillar 2 risks. The comprehensive supervisory review showed that adequate risk management, sufficient liquidity, and solvency higher than regulatory required. The continuous supervisory review found 170 formal statutory breaches and resulted in some 150 recommendations to banks. Supervision issued two administrative enforcement measures and advised several banks of necessary corrective measures in writing. Four supervisory inspections addressed internal capital adequacy. Results were adequate.

Macro- prudential Analyses and Strategies

Supervisory macroanalyses assess banking sector stability by monitoring system and individual bank parameters. To this end, financial parameters of the entire banking system and individual credit institutions were continuously monitored and analysed. Macro-prudential analyses identify risks early. Debt problems at neighbouring countries hosting banks with Bulgarian subsidiaries focused intensive attention on parent banks.

As external factors increased bank risk sensitivity, the scope of stress testing for credit, liquidity, and market risk progressively broadened. Data sets and tools for as-

⁵ For the BNB stance on this see Chapter 9.

sessing systemic risk improved. Tools for checking bank resilience to diverse shocks saw active use.

Between April and June 2011 there was a national stress-test under the EBA framework for bank resilience to shocks. Though Bulgarian banks were outside the scope of the pan-European stress-test, their credit risk resilience was tested to the top-down approach. Interest and market risks sensitivity was tested to the bottom-up approach. Employing the two approaches together combines the advantages of each and focuses attention on the credit risk central to banking stability.

There were regular liquidity stress-tests. Results prompted specific supervisory measures and to elaborate the BNB's comprehensive anti-cyclical policy.

Based on the regular reporting information provided by credit institutions analytical tests were prepared and results were published in various BNB publications.

Special Supervision

Special supervision parries risks stemming from unstable world conditions. Sustainable bank growth depends directly on equity holder stability. Bank equity structures are monitored continuously to assess shareholder ability to support capital. There were no deviations from good bank practice on equity holder structure, transparency, and fund origins.

Consistent measures were applied against money laundering and terrorist financing and financial fraud. Adopted additional requirements to the bank sector intensified the monitoring of cash payments. Generally, it was found that banks adhered to international standards on counteracting money laundering and financial fraud and implemented effective procedures and policies to minimise risk of transferring funds of unclear criminal nature through the banking system.

Regular contact with bodies fighting fraud and money laundering developed to European Commission and other international body guidelines. Measures, discussions, and information exchanges addressed cross-border financial crime. Active partnership boosted the effectiveness of the fight against the use of the banking system for transferring criminal funds.

International cooperation helped elaborate the Bulgaria's 2011 to 2015 Money Laundering Countering Strategy and a sizeable project to strengthen administration analytical capacity in terms of corruption risks associated with euro funds.

European supervisors initiated the convergence of practice against money laundering, terrorist financing, and financial fraud. In 2011 work involved drafting a paper on supervisory cooperation in monitoring bank groups on measures against money laundering, training banks and financial institutions, and amending Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

There was specific action to determine banks' precise deposit bases, with recommendations to inspected banks. The importance of the issue prompted moves to elaborate common practice and synchronise BNB and Deposit Insurance Fund work.

Legal requirements and corporate management trends improved and converged practice. Banks' custodian functions also received supervisory attention. Trust organisation and procedures were evaluated with the Financial Supervision Commission. Breaches resulted in recommendations on the control functions of custodian banks and statutory constraints on investing corporate assets.

Registering entities operating as financial institutions continued. Lenders and financial lease companies were most numerous. Target reviews of the conditions and characteristics of the products and services offered by financial institutions to users were conducted. Given the fact that their activity is addressed to public, the goal is to provide clear, adequate and exact information, including for all accompanying costs by product and service.

**Supervisory
Administration,
Licensing,
and Permits**

There were no new licensing procedures in 2011. İşbank GmbH's Sofia Branch, Germany opened for business. The Central Cooperative Bank continued acquiring Eastern European banks.

There were significant ownership changes at several banks. Recapitalisation of the Allied Irish Banks since 2010 resulted in indirect acquisition of equity by the state represented by the Minister of Finance in the Bulgarian-American Credit Bank AD. CSIF AD of Sofia then acquired 49.99 per cent of equity. The other large shareholder, Gramercy Group, restructured its equity without changing its amount greatly. NLB Banka Sofia became sole owner of TBI Financial Services of the Netherlands and changed its name to TBI Bank EAD. The International Asset Bank AD acquired a new minority shareholder with a 10 to 20 per cent stake.

There were significant changes in bank management bodies. Elections of 83 new board members were approved and 21 domestic banks and a foreign bank branch from a third country revamped management bodies. Four banks restructured equities.

Seventeen Member State credit institutions advised the BNB of intentions to provide cross-border services in Bulgaria, their number reaching 196, excepting electronic money institutions now on the payment institutions register.

An Order of 10 November 2011 deprived several minority shareholders in the Municipal Bank of voting rights for six months. Following the Order the major shareholder moved changes to the Articles of Association and the supervisory board at the general shareholder meeting. An Order of 20 December 2011 restored voting rights to all shareholders. The initial Order was appealed before the Supreme Administrative Court. An institution which failed to act on 2010 supervisory instructions was subjected to supervisory measures, a penalty, instructed to increase equity significantly, and submit to the BNB plans to restructure its credit portfolio and improve management. Milder supervisory action addressed nine other banks. The deepening Greek crisis prompted a recommendation to banks with Greek parents to restrain from investing in government debt or debt instruments issued by Greek banks and to advise the Banking Supervision Department of any such investment decisions. The year saw the imposition of BGN 70,000 of penalties.

Though BNB supervisory powers under the Law on the BNB aimed at banking system stability and protecting depositor interests and do not involve protecting financial service users, in 2011 the Bank continued monitoring relations between banks and their customers, establishing and analysing repeated complaints. Claimants again focused on the unilateral increases in loan costs, interest rates and charges, hindrances to early repayment, loan insurance issues, the manner of collecting overdue receivables, and distraint account issues. Supervisory attention achieved higher transparency in working with clients and clearer information.

VII. The Central Credit Register

The Central Credit Register (CCR) lists borrower debt to lenders. The Bulgarian National Bank runs the Register under Ordinance No 22 of 16 July 2009 whose Article 4 mandates lenders to submit debt information.

The CCR lists all loans by banks and financial institutions. Loans to government and the BNB are exempt, as are agreed overdrafts under BGN 1000 classified as standard under Ordinance No 9 on the Evaluation and Classification of Risk Exposures of Banks and Allocation of Specific Provisions for Credit Risk.

Upon listing into the Ordinance No 26 and the Law on Credit Institutions Article 3, paragraph 2, Banking Supervision Department Public Register, Law on Credit Institutions Article 56 lenders have to apply for inclusion into the CCR.

As of 31 December 2011, 160 of the 180 financial institutions on the Public Register were also in the CCR. Only two financial institutions were exempt from the CCR under Ordinance No 22, Article 8 in relation with Ordinance No 26, Article 9, paragraph 1, item 1.

On 31 December 2011 the CCR listed 4,044,976 loans (3,979,775 by 31 December 2010) for BGN 61,044 million (BGN 57,524 million on 31 December 2010). During the year lenders (banks and financial institutions) reported 2,091,889 borrowers: 1,981,784 individuals, 98,979 legal entities, 8040 sole traders, and 3086 foreign persons. Given these numbers, CCR data offer opportunities for precise credit risk analyses and assessments thus facilitating the operation of banks and financial institutions and enhancing credit risk management.

Provided in real time, customer debt information includes loan status, arrears, and repaid loans for five years back, plus borrower histories. Information is by classification groups to ease analyses and preventive measures and help pinpoint reliable customers. In 2011 lenders conducted 4,323,000 digital certificate searches on 3,197,000 individuals and 1,126,000 legal entities, or 735,000 more than in 2010 (3,588,000 inspections). There were some 360,000 monthly searches on average.

Ordinance No 22 also opens Register data to individuals and legal entities. A tariff of fees grants individuals one free access to CCR data a year. By 31 December 2011 there were 5493 applications from individuals and 216 from legal entities, compared to 4957 applications (4800 from individuals and 157 from legal entities) in the prior year. From 1 August 2011 the Register offers express statements against a fee. The Law on Credit Institutions Chapter 8 Bank and Professional Confidentiality licences the BNB to provide CCR data to judicial and government authorities.

Article 56 of the Law on Amendment to the Law on Credit Institutions (the *Darjaven Vestnik*, Issue 105 of 29 December 2011) mandated payment institutions and electronic money institutions granting loans under the Law on Payment Services and Payment Systems Article 19 to join the CCR.

VIII. The Fiscal Agent and State Depository Function

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

The Bank continually develops and improves relevant systems: the GSAS system for conducting government securities auctions, the ESROT electronic system for registering and servicing government securities trading, the SDK 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 2011 agency fees and commissions came to BGN 1,627,200: a 9 per cent annual drop. This reflected mainly lower revenues from processing auction papers, primary market government securities registration and settlement, and issue maturities of BGN 817,200 (BGN 946,400 in 2010).

Information Service

Duties under the MF agreement entail presenting (*via* IOBFR) regular statements on budget entities' (to municipality level) budget, extra budgetary, deposit, foreign currency, and letter-of-credit accounts with the BNB and other Bulgarian banks. The Bank also monitors State Budget Law security pledged by budget servicing banks and tallies it with balances.

In summary, on 31 December 2011 the total balance of budget entities' accounts in the 21 servicing banks (including the BNB) was BGN 6042.5 million¹ against BGN 6906.2 million a year earlier. Of this, 28 per cent or BGN 1683.4 million was with domestic banks, up 11.7 per cent in a year. This mainly reflected increased municipalities' balances, which accounted for 56 per cent of the total. At the close of 2011 five banks held almost 60 per cent² of the funds, as a year earlier.

Over 80 per cent of budget funds were in accounts³ included in the fiscal reserve. MF data put the fiscal reserve at BGN 4998.8 million on 31 December 2011 against BGN 6011.8 million on 31 December 2010. BNB data show that on 31 December 2011 BGN 3458.2 million of the fiscal reserve (against BGN 3272.6 million on 31 December 2010) were in the Silver Fund, MF National Fund, State Agricultural Fund⁴, and Teachers' Pension Fund accounts.

BNB commitments to the MF and standing joint instructions by the Minister of Finance and the BNB Governor resulted in 862 statistical reporting forms for the budget, including 340 for the fiscal reserve: up 3 per cent on the same period of 2010. The increase reflected mainly the MF requirement since early 2011 for municipalities' account statements to be at set times each quarter. Alongside this, 196 summarised quarterly reports on first-level budget spending entities were certified in 2011.

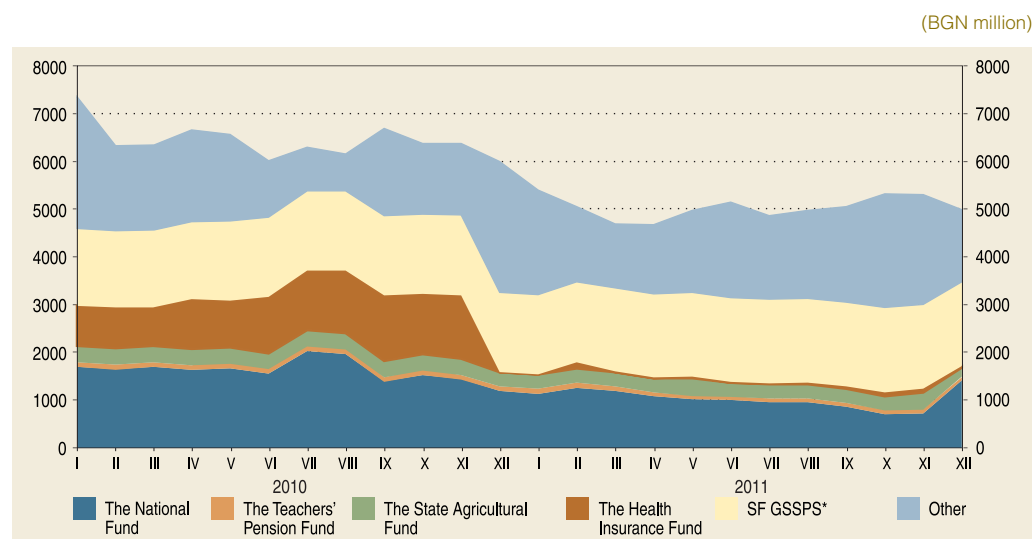
¹ Balances on foreign currency accounts are shown in levs at the BNB exchange rate for the relevant currency on 31 December 2011.

² Excepting balances on budget entities' accounts with the Bulgarian Development Bank.

³ Council of Ministers' Order No 334 of 2010 on Implementing the 2011 Republic of Bulgaria State Budget defines the scope of bank accounts whose balances form part of the fiscal reserve.

⁴ On 31 December 2011, the total balance of the Agricultural State Fund's accounts was BGN 193.4 million against BGN 301.9 million on 31 December 2010.

Fiscal Reserve Structure



*The National State Pension System Stability Fund (the Silver Fund).

Source: MF, BNB.

The MF advised of a new European Investment Bank loan for listing by AS ROAD, its EUR 52.4 million first tranche received over the review period. At the same time, 31 regular payments of EUR 197.6 million⁵ (EUR 52.5 million principal and EUR 145.1 million interest) were made in coordination with the MF on the basis of up-to-date information on government foreign obligations which the Bank calculates and settles. By 31 December 2011 total obligations in AS ROAD were EUR 2438.4 million⁶ *vis-à-vis* EUR 2414.5 million on 31 December 2010. Structurally, as in the prior year, euro-denominated debt had the largest share at 64.4 per cent, followed by USD-denominated at 34.5 per cent and JPY-denominated at 1.1 per cent.

Servicing Government Securities Trading

The year saw 31 auctions *via* GSAS: five more than in 2010. All the prior year's auctions were for government securities against payment, while this year saw an auction for sale against payment and/or replacement, three for reverse repurchasing prior to maturity against payment, and two for repurchasing one issue by replacement from another. Six auctions (three for repos against payment, one for repos by replacement, and two for straight sales) were unlisted in indicative quarterly issue schedules, while three scheduled ones, all for euro-denominated issues, were cancelled by the issuer.

Eight government securities issues with diverse maturities and denominations were offered: four tap fixed-rate issues and four discount issues. The average-weighted residual term to maturity of the sold issues was five years, nine months, ten days. The new ten-year-and-six-month reference issue with most openings (seven) was used to calculate the long-term interest rate for assessing the degree of convergence. The Minister of Finance raised the limit of non-competitive bids set in MF and BNB Ordinance No 5 (20 per cent of the total offer amount) in each action held. In almost two-thirds of auctions, it was 30 per cent and in the rest 50 per cent.

The MF offered a total nominal value of BGN 1225.5 million in 2011, up BGN 277.1 on 2010. Almost a third was denominated in euro. The volume of bids fell by BGN 276.7 million on 2010, mainly due to lower demand by banks (primary and non-primary dealers), whose bids were almost three-quarters of the total volume. In 2010 they bid for BGN 2291 million, bids' volume declining by BGN 254 million in 2011 to BGN 2037 million. This lowered the average bid-to-cover ratio to 2.33, from 3.31 in the prior year. Primary dealers' bids *per* auction fell slightly to 82 against 91 in 2010 on average.

⁵ The payments total was recalculated in euro at the BNB rate for 31 December 2011.

⁶ The debt total is in euro at the BNB rate for 31 December 2011.

Pension funds, the Bank Deposit Insurance Fund, insurance corporations, the Employees' Pay Guarantee Fund, and the National Insurance Institute were among the most active non-bank institutions, all with a clear preference in longer-term issues.

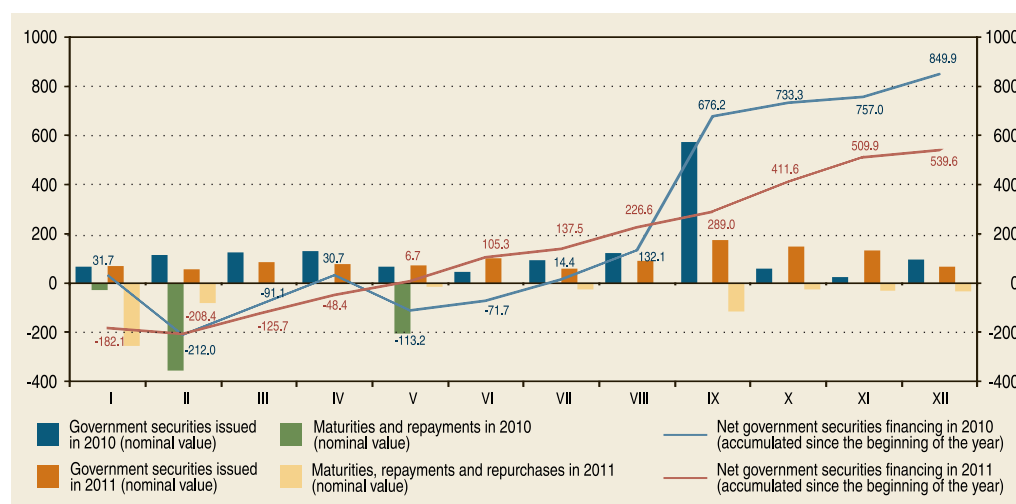
Changes in MF approval conditions of seven auctions resulted in BGN 1067.8 million of total nominal value of approved bids (including the lev equivalent of EUR 144 million): BGN 157.7 million less than offered. For comparison, the total value of issues sold in 2010 was BGN 1508.1 million. More than half the approved bids were by banks, though their absolute amount fell by BGN 296 million on 2010.

The Minister of Finance approved all bond repurchase by replacement bids and BGN 58.6 million of securities was repurchased, including BGN 56.3 million by replacement with other issues.

Actual budget revenue from government securities sales in 2011 was BGN 1115.2 million. Expenditure on repayments, including repurchases of BGN 575.7 million prior to maturity, resulted in BGN 539.6 million of positive net financing against BGN 849.9 million in 2010.

State Budget Financing by Domestic Government Securities in 2010 and 2011

(million BGN)



Source: BNB.

The average annual yields of three-month, six-month, 3.5-year, five-year, seven-year and 10.5-year issues attained at auctions were: 0.85 per cent, 1.38 per cent, 3.43 per cent, 4.03 per cent, 4.38 per cent, and 5.36 per cent respectively: declines in all maturity sectors on the prior year.

Over 90 per cent of the 2011 auction bids were *via* the web-based bid system with universal electronic signatures, and the rest *via* SWIFT. During the auctions, there were no GSAS disruptions and system availability was 100 per cent.⁷

ESROT registered BGN 1882.4 million⁸ of initial acquisitions of government securities, repos, and repayment on maturing issues, down 18.6 per cent on 2010. The decrease was mainly due to the lower volume of newly issued securities. Principal and interest payments on maturing securities totalled BGN 699.6 million, including BGN 529.2 million principal and BGN 170.4 million interest. At the close of 2011, six medium-term (one to five years) and 19 long-term issues circulated. Their total nominal value was BGN 4473 million⁹, including BGN 2993.1 million of lev-denominated issues redeemable in levs, BGN 1231.5 million of euro-denominated issues redeemable in euro, and

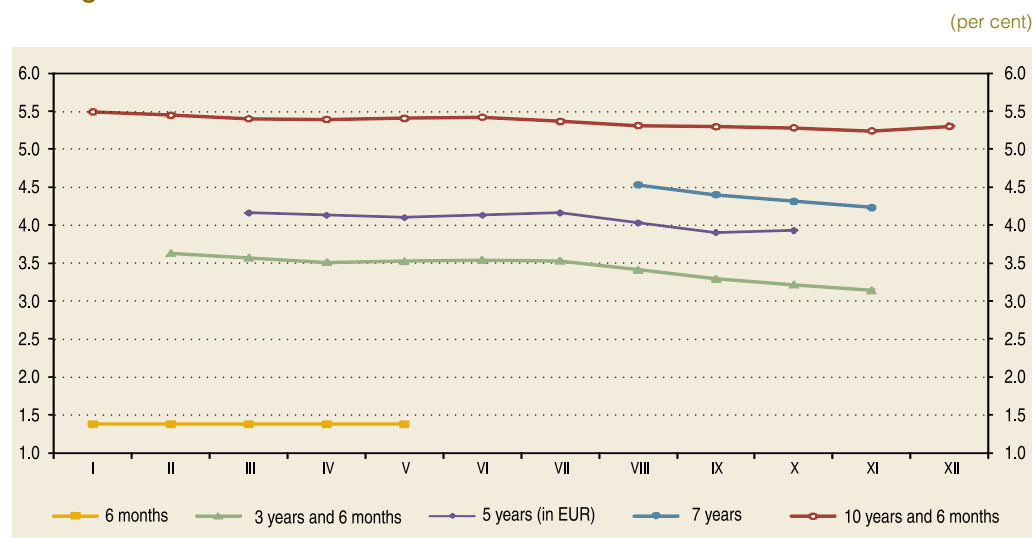
⁷ See footnote 1, p 34.

⁸ Lev equivalents of payments on foreign currency denominated government securities are at the BNB rate on the date of payment.

⁹ The debt total is in levs at the BNB rate for 31 December 2011.

BGN 248.4 million of euro- and US dollar-denominated issues redeemable in leva. Euro-denominated issues redeemable in euro comprised 27.53 per cent of total outstanding debt against 24.14 per cent on 31 December 2010.

Average Annual Yield Attained at Domestic Government Securities Auctions

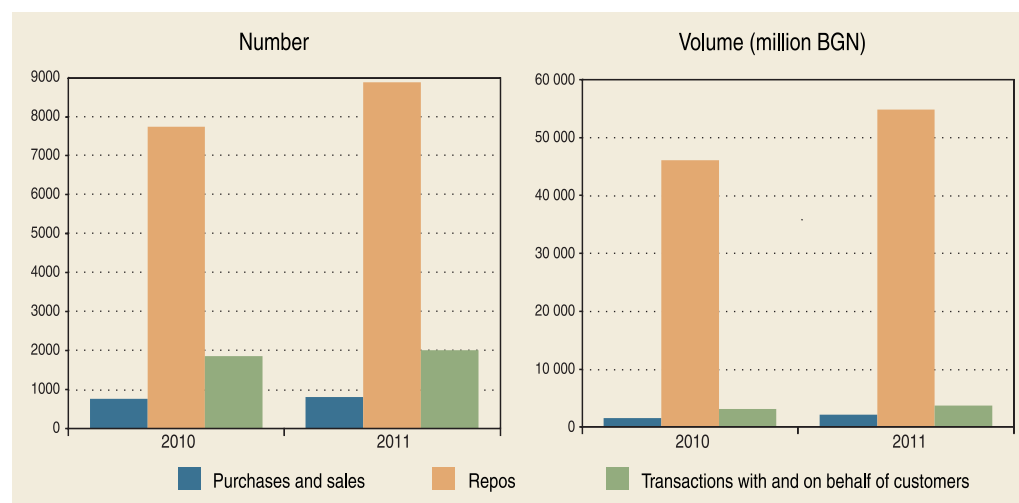


Notes: 1. There were two auctions (7 February and 18 April) for three-month government securities, the Ministry rejecting all bids at the second. No data on these issues feature in the Chart. 2. Since the MF rejected all bids at the 5 December 2011 five-year EUR bond auction, data on the chart exclude the average annual yield attained then.

Source: BNB.

In 2011 the total nominal volume of ESROT-registered secondary market transactions in government securities was BGN 77,557.9 million. Repos had the largest share (70.7 per cent), followed by blocking and unblocking transactions (21.7 per cent), operations with or between ESROT participants' customers (4.8 per cent) and outright purchases and sales (2.8 per cent). Secondary market bond transaction volume rose 20 per cent to BGN 60,732.6 million. Blocking and unblocking operations' volume fell significantly to BGN 16,825.4 million, from BGN 25,401.3 million in 2010.

Types of Government Securities Issued and Traded in the Domestic Market over 2010 and 2011

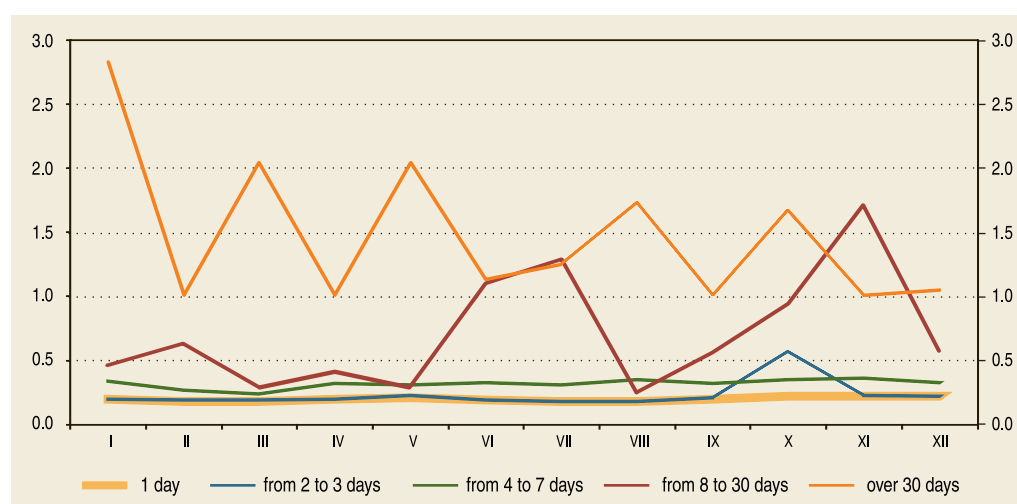


Source: BNB.

Repo agreements with a flow of funds on current accounts had the largest share (82.1 per cent) of the total volume, those for one-day being most attractive (56.5 per

cent). Average-weighted annual yield was 0.20 per cent for one-day transactions, 0.23 per cent for two to three-day transactions, 0.32 per cent for four to seven-day transactions, 0.47 per cent for eight to 30-day transactions, and 1.46 per cent for over 30-day transactions. Yields for over 30-day transactions fluctuated most (between 1.01 and 2.83 per cent). The share of free of payment (FOP) repos fell on 2010, most of them for government securities denominated and redeemable in euro.

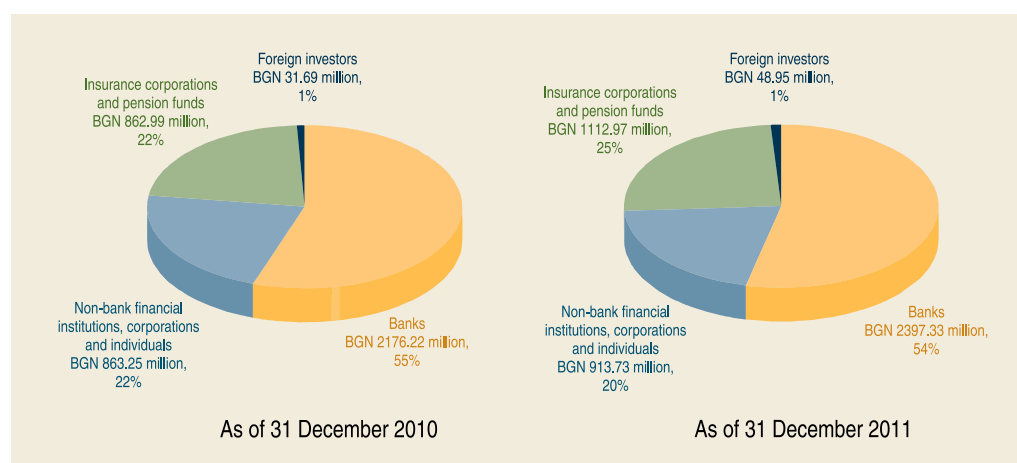
Average-weighted Annual Yield of Repo Agreements in Domestic Government Securities in 2011



Source: BNB.

The volume of outright purchases and sales and operations with or between ESROT participants' customers rose 40.3 per cent and 19 per cent on 2010. The whole yield curve was traded, long-term issues attracting most interest. Average annual yield of the ten-year-and-six-month long-term reference issue in the secondary market fell marginally from 5.56 per cent to 5.23 per cent. Liquidity ratio¹⁰ in the secondary government securities market was 13.6 per cent on 12.9 per cent in 2010.

Holders of Government Securities Issued in the Domestic Market



Source: BNB.

¹⁰ The ratio between the volume of secondary market government securities dealing in 2011 and the volume of government securities circulating at the year's close.

The issuer cancelled USD 400,000 of government securities under ZUNK¹¹ over the year, the MF accepting them in settlement of obligations to the government under this Law.

The year saw 17,345 ISO 15022 notifications and requests for registering transactions in government securities, up 1.4 per cent on 2010. Most (92 per cent) were through the ESROT web interface with universal electronic signatures and just 8 per cent through SWIFT. There were no refusals due to insufficient funds on participants' current accounts.

By 31 December 2011 banks' portfolios held 54 per cent of government securities issued in the domestic market, insurance corporations and pension funds held 25 per cent, non-bank financial institutions, corporations and individuals held 20 per cent, and foreign investors held 1 per cent. Government bonds with insurance and pension funds increased 29 per cent in a year to BGN 1113.0 million, most of them (85 per cent) long-term.

Most blocking and unblocking of domestic government securities related to securing funds in budget entities' bank accounts under § 23 of the Transitional and Final Provisions of the Republic of Bulgaria 2011 State Budget Law¹². These operations helped banks regulate security in real time. There being few dramatic daily fluctuations in budget balances at banks, blocking and unblocking operations declined significantly (34 per cent) on 2010. Nevertheless, average daily nominals of ESROT blocked government securities increased to BGN 985.8 million, EUR 145.0 million and USD 30.6 million (on BGN 817.7 million, EUR 99.9 million and USD 32.4 million in the prior year). In securing budget balances, servicing banks also blocked government securities not registered in ESROT (those on external debt) by transfer into dedicated BNB accounts. In 2011 their average daily nominals were BGN 73.7 million, EUR 77.3 million and USD 215.0 million: a decrease in lev- and euro-denominated bonds on the prior year.

On 31 December 2011 BGN 69.2 million of government securities were blocked in ESROT under the Law on Registered Pledges: down 15.6 per cent on December 2010 (BGN 82.0 million).¹³

Over the year ESROT offered 99.6 per cent availability, outages handled under BNB system backup contingency rules. With the new participants (Emporiki Bank Bulgaria and Alpha Bank Bulgaria), system participants became 30: 25 banks, three investment intermediaries, the Reserve Collateral Pool, and the MF. All ESROT participant banks perform subdepository functions.

The year saw 1336 accounts kept with the government securities settlement system under BNB Ordinance No 31. Of them, 25 were for government securities of the issuer (the MF), 530 for participants' own government securities portfolios, 424 for government securities market participants' customers, and 357 for encumbered government securities. Bonds in these accounts were nominally worth BGN 4473 million.

System Development

Work continued on the IOBFR Fiscal Reserve Module with tests involving servicing banks following end of year internal tests. The Module will enable banks to enter account balances included in the fiscal reserve, significantly cutting operational risk.

GSAS upgrades offered automatic ESROT updates with government bond registration and settlement in auction sales against payment and/or replacement and in repurchases involving replacement with other issues.

¹¹ The Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990.

¹² Under the Republic of Bulgaria 2011 State Budget Law Transitional and Final Provisions § 23, paragraphs 2 and 5, funds in all budget entity (including municipal) bank accounts, deposits and letters of credit in levs and foreign currency are secured by servicing banks in favour of the MF through blocking Bulgarian domestic and external debt government securities. Government bonds are blocked at the BNB, with the legal effect of a special pledge on them in favour of the MF. Only government securities free of encumbrances or security are blocked.

¹³ The lev equivalent of blocked/unblocked foreign currency-denominated government securities is calculated at the BNB rate on the date of transaction.

Work began on a BNB government securities settlement and registration ancillary system for inclusion into TARGET2-BNB 2011. The Delivery versus Payment (*DvP*) principle will apply to primary and secondary market government bond transactions denominated and payable in euro *via* bank accounts in TARGET2.

The Government Securities Depository took part in public consultations on the European Commission's proposed central securities depositories regulation (the CSDs Regulation). This, and the Securities Law Directive, will establish investor rights relating to government securities holding and disposal.

To create system participants' awareness of European securities settlement initiatives and promote debate, the Bank published a paper on Developing the BNB Securities Settlement System. This includes a short overview of the system and a detailed look at European moves with a focus on the ECB project for a single IT platform for settling virtually all securities in Europe (TARGET2-Securities or T2S). The paper is available to market participants *via* the government securities settlement and registration system operated by the government securities depository. It will change as relevant regulations evolve.

In line with requirements for transparent depository and settlement system operation, the BNB participated in international projects on information collecting and disclosure. Association of Global Custodians and Thomas Murray Questionnaires were completed. Periodically updated questionnaires outline the legal framework, major parameters of securities registration and settlement systems, and moves to develop them to international standards and recommendations on securities post-trade (clearing and settlement) services.

IX. Participation in the ESCB and in EU Institutions' Activities

In 2011 the EU made a number of political and regulatory moves addressing the global economic and financial crisis. The Euro Plus Pact ushered tighter economic policy coordination and aimed to enhance competitiveness. A package of moves to improve EU and euro area economic governance was endorsed in late 2011. The year saw the launch of the new European supervisory framework, particularly the European Systemic Risk Board and the three new European supervisory authorities (ESAs): the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) which, with national supervisors, form the European System of Financial Supervisors (ESFS). BNB representatives helped elaborate Bulgarian positions at the European System of Central Banks, the EC and EU Council committees and working groups, the ESRB, and the Council for European Affairs¹.

European System of Central Banks

The BNB Governor is on the European Central Bank General Council and sits on its meetings with EU central bank governors and the ECB President and Vice-President. BNB representatives sit on 12 ESCB committees and 34 working groups,² the Human Resources Conference (HRC), and the ESCB Macro-Prudential Research Network. The Bank designated representatives on the ESCB Financial Stability Committee established in early 2011.

Through ESCB bodies³ the Bank helps elaborate ECB instruments on monetary and banking infrastructure, payment and settlement systems, statistics, and sundry central banking issues. The BNB was active in developing ECB positions on proposed deposit guarantee and investor compensation directives, legislative proposals on economic policy cooperation and economic governance, the proposed bank reorganisation framework, the proposed residential credit Directive, and Member State legislative proposals.

EU Member States consult the ECB (in writing) on relevant legislation. The Ministry of Finance consulted the ECB on amendments to the Law on Public Offering of Securities and the Law on Investment Schemes and Other Collective Investment Undertakings.

ESCB communications policy cooperation involved publishing the 2010 ECB Annual Report and chapter summaries of ECB Monthly Bulletins in Bulgarian. Between September and November the Bank and the ECB hosted Bulgaria's first Euro exhibition. This drew 10,000 visitors and 973 entrants with over a thousand works into essay and painting competitions.

In 2011 the BNB hosted three ESCB meetings: the Statistics Committee working group on government finance statistics on 26 and 27 May, the Internal Auditors Committee between 29 June and 1 July, and the Legal Committee between 10 and 13 September.

¹ The Council for European Affairs (CEA) is a Council of Ministers' consultative body comprising Deputy Ministers in charge of European affairs and working group heads and chaired by a Deputy Minister of Foreign Affairs. A Deputy Governor represents the BNB at relevant meetings. The same Deputy Governor co-chairs Working Group 11 Economic and Monetary Union.

² The ESCB committees are consultative bodies established by the Governing Council under Article 9 of the ECB's Rules of Procedure to assist ECB decision-making. Committee mandates are laid down by the Governing Council and members are national central bank experts.

³ 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).

**European
Systemic
Risk Board,
European
Banking
Authority,
Colleges and
Supervisors**

The European Systemic Risk Board (ESRB) for EU financial system macro-prudential oversight started work in early 2011. It monitors systemic risks and issues warnings and recommendations.

The BNB participated in all ESRB General Council meetings in 2011, deliberating forthcoming EU legislation, cooperation with European bodies in line with mandatory reporting requirements, and macro-prudential instruments required by national authorities and the Board. BNB representatives on the ESRB Advisory Technical Committee elaborated information to identify and monitor systemic risks.⁴

In 2011 the ESRB made three recommendations on foreign currency lending, funding credit institutions in US dollars, and the macroprudential mandates of national authorities.

The recommendation on foreign currency lending addresses risks attending mainly consumer lending in foreign currency. The BNB has consistently maintained that these risks depend on monetary regimes and overall national macroeconomic frameworks. The euro should not be deemed a foreign currency for countries outside the euro area, especially ones with currency boards and exchange rate fixed to the euro. Lev and euro equality is a leading monetary policy principle in Bulgaria. Hence, the BNB's position is that borrowing in euro does not threaten financial stability.

The second ESRB recommendation addressed systemic risks attending US dollar funding of credit institutions. The BNB shares the view that EU credit institution dependence on US dollar financing might entail risk to short and long-term liquidity and impact the real economy in the medium term. The BNB also notes that these risks attend mainly large European bank groups due to their specific business models and that Bulgarian banks need no additional measures to contain such risk.

The recommendation on national macro-prudential mandates proposes guidelines on independence and sufficient powers for national macro-prudential authorities. The recommendation underlines the leading role of national central banks in macro-prudential oversight. The BNB supports the guiding principles and shares the view that they offer a basis for establishing sound national macro-prudential frameworks.

The ESRB examined the macro-prudential aspects of a proposed EC directive and regulation on capital requirements. The Board stressed that national authorities should be free to act on accumulated systemic risks. In its opinion, supported by the BNB, the Board identified three principles: flexibility allowing a wide range of actions, freedom for national supervisors to act early and effectively, and efficient coordination of actions between Member States. The BNB views the freedom of national authorities to impose tighter requirements supplementing the common European supervisory regime as being of prime import in keeping national banking systems stable and capitalised.

The BNB exchanges regular information on banking supervision and financial stability with the ESRB, the EBA, and the European Banking Committee. The new structures strengthen EU financial stability. BNB representatives took part in international fora on the EU banking system and European supervision. Amendments to the Capital Requirements Directive formed the foci of debate, with analyses and statistics on Bulgarian banks presented at diverse ESRB, EBA, and European Banking Committee working groups.

BNB representatives took part in four EBA executive committees and 16 groups and subgroups. BNB supervision experts continued working on cross-border bank groups operating in Bulgaria. There was regular supervisory information exchange under memoranda of understanding and cooperation, joint assessments with consolidating supervisors of risks to banks with Bulgarian subsidiaries, and joint assessments of group level own equity.

⁴ The Advisory Technical Committee has six working groups, with the BNB represented on three.

**European
Council,
Ecofin Council and Economic and
Financial
Committee**

In 2011 a series of EU initiatives tackled economic governance and the effects of the financial and economic crisis. An early year milestone was Bulgaria's entry into the Euro Plus Pact for EU members outside the euro area. Denmark, Lithuania, Latvia, Poland, and Romania also joined. The Pact strengthens the economic pillar of the Economic and Monetary Union, tightens economic policy coordination, and boosts competitiveness to speed convergence. The goals of the Pact tally with the principles of economic growth under strict macroeconomic, fiscal, and financial discipline followed in Bulgaria for years. Supporting the Pact in principle, the Bank consistently maintains a position, shared by government, that Bulgaria ought to pursue its national priorities, and that economic governance initiatives ought to provide greater flexibility for national policies and take into account national specifics, and in particular the effect of convergence on macroeconomic indicators in countries like Bulgaria. The deviation of individual indicators from values deemed customary in advanced euro area economies ought not to be viewed as macroeconomic imbalance or loss of competitiveness and ought not to draw restrictive responses.⁵ As regards the common consolidated corporate tax base — an issue tackled in the Euro Plus Pact and one on which the EC has proposed a directive — the Bank feels that national tax policy independence ought to endure to keep Bulgarian taxes at the most advantageous level.⁶

At its meeting of 24–25 March the European Council agreed the principles of the future permanent European Stability Mechanism (ESM),⁷ and in December 2011 heads of government agreed to hasten its treaty. This awaits ratification by Member States representing 90 per cent of the capital commitments; the process should be complete by July 2012. In debates Bulgaria opposed the proposed equity algorithm for determining national subscriptions to ESM capital. Efforts by several countries, Bulgaria among them, changed the capital key, countries with *per capita* GDPs under 75 per cent of the EU average enjoying reductions for 12 years after euro area entry.⁸

The Bank is represented at the highest level in informal ECOFIN meetings. These tackled issues such as the EU economy and the government securities markets, efforts to resolve debt crises at the European and national levels, major risks to financial stability, and measures to strengthen and stabilise the financial sector. Discussions also addressed bank stress testing. The BNB maintained that elaborating reliable support for financial institutions should follow European-level decisions on crisis prevention, funds for the resolution of failing banks, and cost distribution.

In September 2011 Ecofin reached agreement on outstanding issues related to the six legislative proposals on EU economic governance. The legislative package was finalised in October and entered into force in December. It improves monitoring and coordination of public finances and macroeconomic imbalances. In negotiations Bulgaria objected to some passages and the package reflects the general position of the BNB and the Bulgarian government. A major objection related to the mechanism for pinpointing emerging macroeconomic imbalances.⁹ The Bank argued that the proposed automatic response based on a checklist with a limited set of economic and financial indicators could not reflect differing degrees of convergence in different countries and that it could issue misleading signals about national economies, leading to false alarms.¹⁰ This partly made its way into the Regulation on the prevention and correction of macroeconomic imbalances.

⁵ See *Economic Review*, 3/2011 pp 12–15 and 4/2011 pp 68–76.

⁶ See *Economic Review*, 1/2011 pp 13–15.

⁷ See *Economic Review*, 1/2011 pp 11–14.

⁸ *Ibid.*

⁹ The EC presented its first report on the early warning mechanism on 14 February 2012.

¹⁰ See also footnote 5, p 84.

BNB representatives sat on Economic and Financial Committee (EFC) meetings.¹¹ Debate focused on economic situation and financial market analyses, the creation of a reliable framework for crisis management and resolution, the coordination of EU positions for the G-20, the IMF, and the Financial Stability Board, and restoring confidence in banking. Another topic was cooperation between EU bodies and the new supervisory authorities. BNB representatives contributed to the work of the Economic and Financial Committee *ad hoc* working group on crisis management. BNB experts and members of the EFC debated the Council Recommendation on the 2011 Bulgarian National Reform Programme and the updated 2011 to 2014 Convergence Programme.

The Convergence (2011 – 2014) and National Reform (2011 – 2015) Programmes of the Republic of Bulgaria were presented to the EC by mid-April 2011 as part of the new European Semester: EU economic policy coordination instrument. Within its purview the Bank helped elaborate and coordinate them. On 7 June 2011 the EC published a technical assessment with country-specific recommendations approved by the Ecofin Council on 20 June and endorsed by the European Council on 23 and 24 June, marking the end of the first European Semester. Seven recommendations addressed Bulgaria: two on continuous measures to correct the excess deficit and improve fiscal governance and five on pension system reform, competitiveness in convergence and linking pay with productivity, promoting social inclusion and protecting the most vulnerable, improving the business climate, and enhancing administrative capacity. Publication of the EC Annual Growth Review in November 2011 marked the beginning of the second European Semester.

In 2011 the EC published a Green Paper on corporate governance and proposed a Directive of the European Parliament and of the Council on credit agreements relating to residential property.¹² The BNB took part in its first two EC public consultations:¹³ on a EU bank recovery framework and on introducing new financial sector levies.

On the EU framework for bank recovery and resolution the Bank supported greater national supervisory powers and stated a preference for a minimum level of harmonisation and preserving national competences of proven effectiveness. The Bank called for Member State freedom in designating bodies responsible for bank recovery and resolution and called for supervisors or specialised authorities to be able to block cross-border asset transfers which might threaten financial stability.

In September the EC proposed a Directive on a common system of financial transaction tax. The BNB and government are not in favour of new financial sector taxes or transaction levies which would hit Member States with less developed financial sectors. Expected revenues from these taxes would not offset putative investment slumps in the sector, the decline in growth resources, and the rising cost of finance. The financial services sector is extremely flexible and launching such levies in the EU without agreement on global introduction would jeopardise EU financial sector competitiveness and might prompt a withdrawal of financial services from Europe and hence a decline in corporate tax revenues. Additional taxes are not justified in countries like Bulgaria where the financial sector has not received government support in crises, rather remaining a factor for economic stability and recovery.

The Bank regularly exchanges views and information with Bulgarian MEPs on legislative initiatives within the Bank's competence.

¹¹ The Committee was established under the Treaty on the Functioning of the European Union (TFEU) Article 134 to encourage coordination of Member State policies for the single market. It comprises senior Member State officials (one from the ministry of finance and one from the national central bank), the EC and the ECB. The Committee reviews the economic and financial status of Member States, draws up guidelines on implementing common European policy, prepares the Ecofin Council, and establishes the framework for dialogue between the Council and the ECB.

¹² In July 2011 the EC adopted a Recommendation on access to a basic payment account and a Proposal for a Directive and a Regulation on capital requirements (CDR IV)

¹³ EC public consultations involve a wide range of stakeholders: citizens, market participants, investors, advisory service providers, national governments, agencies, regulatory authorities, and academics. The aim is for the widest possible set of stakeholders to express opinions and help the EC develop regulations.

X. International Issues

International Financial Institutions

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 at 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 BNB Governor represented the Bank at the BIS General Shareholder Meeting in late June 2011 which set dividend, the BNB receiving SDR 2.4 million (EUR 2.6 million).

As member of the IMF Board of Governors, the Governor headed the Bulgarian delegation to the Annual IMF and World Bank Group Meetings in September 2011. In late 2010 the IMF Board approved Resolution 66-2 on the Fourteenth General Review of Quotas and Amendment of the Articles of Agreement of the IMF on the Reform of the Executive Board. All countries' quota doubled by SDR 238.4 billion nominal (some SDR 256.1 million for Bulgaria). Executive Board reform includes elections for all board members, ending member appointments by major members, a new manner of setting executive director numbers, doubling alternate executive directors for multi-country constituencies, and two more directors from developing — at the expense of developed — countries.

In its Decision No 860 of 2 December 2010 the Council of Ministers mandated the BNB Governor to vote for Resolution 66-2. Bulgaria supports the EU position and commitments on overall IMF reform. Resolution 66-2 committed all members to reflect the October 2012 IMF Board Meeting in national legislations. The Bulgarian National Assembly is expected to ratify the proposed increase of Bulgaria's IMF quota and Executive Board amendments to the IMF Statute.

A BNB Deputy Governor is Alternate Governor for Bulgaria in the World Bank Group. In March 2011 the EBRD and the International Financial Corporation launched the new Country Partnership Strategy for Bulgaria. Its main objective, based on the national reform programme, is promoting sustainable economic and institutional capacity growth. The Bank helped coordinate the Strategy within its purview.

A BNB Deputy Governor is Alternate Governor for Bulgaria in the European Bank for Reconstruction and Development and headed the Bulgarian delegation to the EBRD Annual Meeting in May 2011. The same month saw a review of the EBRD Country Strategy for Bulgaria for 2011-2014. EBRD priorities are supporting reforms and enhancing the role of the private sector. The Bank helped coordinate the Strategy within its purview.

In 2011 the BNB paid its annual contribution of USD 8500 to the International Accounting Standards Committee Foundation.

Cooperation with Central Banks and Technical Assistance

Promoting financial stability and European prospects in the Balkans, the BNB works with regional central banks on technical assistance and EU funded projects, bilateral agreements, training, and seminars. The Bank provides specialised technical assistance aligned to national specifics and individual tasks.

The Bank participates in the Central Bank Governors' Club of the Central Asia, Black Sea Region and Balkan Countries. Founded in 1998, it aims to strengthen financial cooperation, enhance regional cooperation, and promote peace and stability. On 9 April

2011 the People's Bank of China became the Club's twentieth member. The BNB is also in the Group of Banking Supervisors from South Eastern Europe.

The two-year Montenegro twinning project managed by the BNB ended successfully in November 2011. It helped harmonise Montenegrin law with banking, securities, pensions, insurance, money laundering, and financial stability *acquis communautaire*, boosted cooperation between beneficiary institutions, and enhanced their administrative capacities. The project was an important step to Montenegrin EU membership.

The Bank's three-year cooperation programme with the Central Bank of Egypt focused mainly on the quantitative aspects of the new capital requirements framework. The BNB hosted two study missions to pinpoint major issues of supervisory capital requirements and coming Basel III capital framework changes.

The Bank also hosted two study missions by experts from Serbia and Albania. The first was part of a technical cooperation programme with the Central Bank of Serbia. Launched in February 2011 and managed by the European Central Bank with 21 European central banks, this offers expertise on EU accession, legislative harmonisation, internal coordination and organisation, technical cooperation, and helps elaborate an EU and ESCB accession plan.

BNB experts worked on a twinning project with the Central Bank of Albania on harmonising national and European law, communications on European integration, the negotiation process, coordinating ESCB membership, and technical assistance.

The Bank provided technical assistance to the Central Bank of Bosnia and Herzegovina on implementing the Treaty on the Functioning of the European Union in a country with a currency board and advice on central bank law.

The BNB offers technical assistance through the TAIEX instrument in, *inter alia*, countering money laundering (AML), countering terrorist financing (CTF), and statistics.

XI. Statistics

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

Monetary and interest rate statistics are implementing new 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.

Preparations are in hand for the new European System of Accounts (ESA '2010) due for launch in 2014. It should shed more light on economic sectors and financial instruments.

In 2011 balance of payments and international investment position statistics used information collected directly from residents. The Bank started collecting such information in early 2010 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. The BNB raised the threshold for balance of payments settlement-based reporting for service providers to BGN 100,000 under Regulation No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payment in the Community.

The growing demand for external statistics poses a challenge to reporting units and to BNB processing and verification. In 2011 work continued on a new integrated statistics system to automate data receipt, control, processing, and dissemination of balance of payments, international investment position, and non-banking statistics.

Currency Law provisions on balance of payments statistics and the international investment position changed in late 2011 to adopt European legal definitions and cut data duplication at ministries, agencies, the Central Depository, investment intermediaries, and notaries. The BNB now collects and verifies the statistics listed by Article 6 of Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the European Central Bank.

Work advanced to introducing the sixth edition of the Balance of Payments Manual (IMF, 2008) by 2014. Preparations are complex due to the need to harmonise the new balance of payments methodology with 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 the definitions and presentation of balance sheet and international investment position items.

Working with the ESCB, the BNB progressed the Centralised Securities Database, statistics on securities holdings, and the future Bulgarian securities database. In 2011 the Bank surveyed the costs and benefits of securities holdings statistics to optimise reporting and reduce the burden on reporting units.

In 2011 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 finances to ECB

requirements. A methodology for compiling flows statistics was elaborated in parallel with work on regular data compiling and transmission of quarterly financial accounts statistics for all economic sectors (stock data) to Guideline ECB/2002/7 on the statistical reporting requirements of the ECB.

With NSI assistance, the Bank continued sending macroeconomic indicator information to the ECB and the BIS. 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. In 2011 the Bank sent statistical data series of indicators to Eurostat for the European Commission early-warning indicator scoreboard boosting EU macroeconomic surveillance.

XII. Research

Economic research, analyses of Bulgarian economic developments, and macroeconomic forecasts support the Bank's management in making decisions and formulating economic policy. In 2011 research reflected the BNB priority of successful participation in the ESCB and EU institutions. Work focused on studying economic agents' behaviour through microdata, financial sector, and fiscal policy modelling, and developing macroeconomic forecasting models.

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 short-term forecasting. Also tackled were the dynamic stochastic general equilibrium model 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 macroeconomic forecasting continued. Research results featured in technical reports and at seminars for experts from relevant bodies, academia, and non-governmental organisations.

Through its Discussion Papers research series, in 2011 the BNB continued to encourage the research potential of Bulgarian economic science and practice in macroeconomics, finance, and economic history. In 2010 the Discussion Papers Editorial Board reviewed seven submissions of which five for the Macroeconomics and Finance section.

Through the *Monthly Bulletin*, *Economic Review*, *Banks in Bulgaria*, and *Government Securities Market* periodicals, the BNB raises public awareness of Bulgarian economic developments and the national banking and financial system.

XIII. Information Infrastructure

BNB information infrastructure development entails upgrading technology, operating systems smoothly and reliably, and integrating them with those of the ESCB. In 2011 work focused on developing ECB/ESCB projects, migrating the BNB Cash Centre website to new servers and duplicating its information structure, preparing the DS8100 and DS8700 storage systems and creating information stores in two locations, updating communications and information infrastructure, and developing information security policies and procedures.

BNB databases and applications developed in several main directions: broadening scope and expanding functionality of the existing applications, developing new systems, and drawing up requirements and project paperwork. The Single Data Depository/Banking Supervision Reports information system, the Credit Institutions File and Financial Institutions File systems, and the ESROT and Government Securities Auctions systems received significant upgrades.

Future participation of the BNB government securities settlement and registration system in TARGET2-BNB as an ancillary passed the following stages: functionality analyses and technical specifications, prototype user interface, and business continuity functions guaranteeing transaction completion with missing or disrupted system links.

A gradual transition of SAP systems to new hardware began, along with work on expanding functionalities. Smooth operations were maintained for RINGS, the Bulgarian component of TARGET2 (TARGET2-BNB) for payments in euro and related Swift Alliance services and products, and the updated file processing application for payments through TARGET2-BNB after changes in November 2011. The SWIFT Alliance successfully migrated to new servers.

End user maintenance calls drew prompt and high quality response. Legal information systems were upgraded, and the administrators of the document management and legal information systems launched new APIS and SIELA 5 versions. Migration to new servers was launched in 2011. Financial information systems (Reuters and Bloomberg) were maintained at the requisite level.

A number of specialised software packages and hardware products were delivered in 2011. Public Procurement Law procedures involved experts from relevant structural units providing advice on drawing up requirements, specifications, and related paperwork.

XIV. Human Resource Management

In 2011 human resource policy continued to pursue solid administrative and analytical capacity attuned to challenges stemming from BNB tasks and responsibilities. Major priorities involved enhancing recruitment processes with a view to optimise staff age structure and staff qualifications, link pay with performance, promote training and professional development, improve internal rules, and provide a healthy and safe working environment.

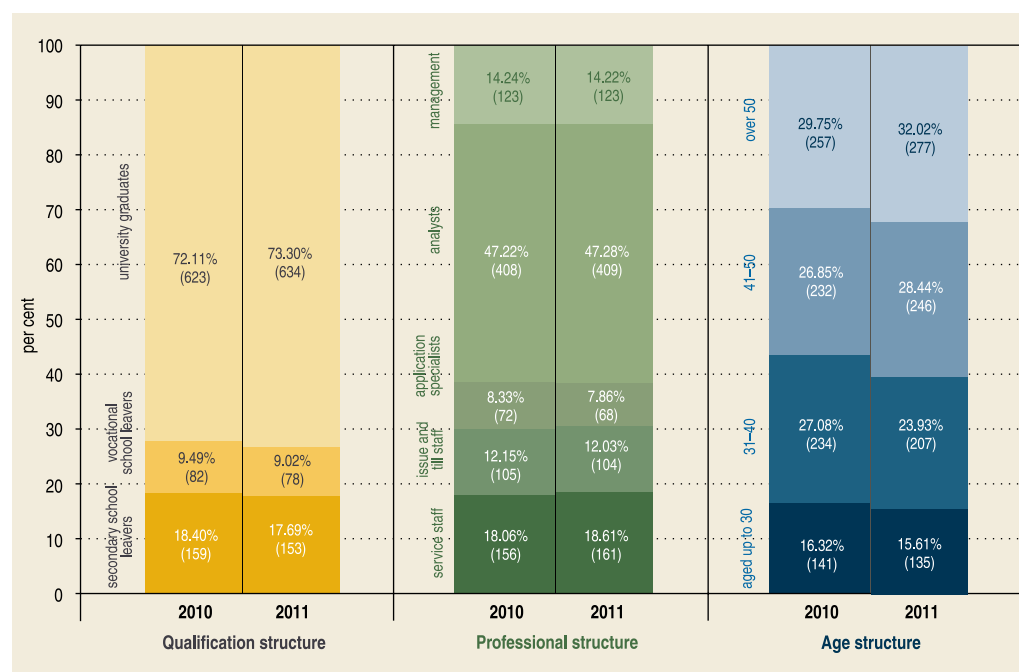
The year saw several amendments to human resource-related internal rules and procedures. BNB job classifications changed to reflect the revised National Classification of Occupations. Staff assessment procedures changed in line with recent quality and efficiency requirements.

Amendments to the Labour Code resulted in annual holiday entitlement taken to employer-approved schedules, with an electronic module developed to improve efficiency. As an exception, in 2011 there were schedules in March for 2011, and in December for 2012.

Staff recruitment and retention results continued improving, with turnover dropping to reflect good working conditions at the Bank and overall developments in the labour market.

Staff Structure

(per cent, number)



Source: BNB.

The number of employees remained steady in 2011 at 865, with 47 employees joining against 67 in 2010. Of the 47 employees who left, 18 retired; in 2010, 49 left, 23 of whom retired.

The steady trend of recent years has been to recruit predominantly under-30s with relevant degrees. Of the new employees, 25, or 53 per cent of all new employees for the year, are under 30. This reflects the Bank's human resource aim of employing and

retaining young, well qualified, and motivated staff. The significant share of graduates answers the need for an increasing number of analytical specialists.

Internal and external career mobility continued to be available to staff. Six employees moved to other departments and five went on short-term ECB appointments. This boosted personal development and expertise and broadened the exchange of knowledge and experience within the Bank and between ESCB partners.

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

Training and qualification improvement are a major human resource management priority and remain leading motivators to Bank's employees. Under the annual schedule, employees enjoy diverse established and new training sessions, proficiency improvement training within the ESCB and European supervisory bodies, ESCB member and international financial institution courses and seminars, and internationally recognised programmes.

Induction training familiarised new employees with the Bank's corporate culture, duties, current priorities, internal rules, and administrative procedures. Three induction sessions involved 33 new employees.

In 2010–2011, 26 employees (24 in the prior period) boosted their educational attainments without discontinuing work. Seven of them graduated and 19 continued reading for degrees.

There was continuing interest in distant learning programmes, predominantly international ones. In 2011, 30 employees took part in six such programmes. For the first time, Bank experts participated in the Certified Managers' programme for financial risk management and in the certified programme for information system risk management and control.

The BNB continued working with European counterparties and international financial institutions offering specialised central banking courses. In 2011, 230 employees went on courses, seminars, and conferences abroad. Employees continued to participate in seminars, training courses, and workshops on ESCB committees and working groups. BNB employees participated in a number of regional projects on building and developing administrative capacity at host countries and institutions.

Foreign languages received special attention. This aimed at providing minimum language proficiency consistent with job descriptions for all employees and high proficiency for BNB representatives on EU bodies. In 2011, over 100 employees attended language courses.

Specialised training focused on providing basic skills with specialised software to optimise external service costs. National and EU law also called for training on operating, servicing, and maintaining equipment requiring competence certificates.

To safeguard staff health and safety, 2011 saw continuous attention to the identification, management, and elimination of workplace hazards, including occupational risk management, safety instruction, and accident prevention sessions.

The BNB continued to develop its internship programme. In mid-March the Bank made its fourth appearance at the National Career Days exhibition. The year saw 143 trainee applications, 62 of them approved. Trainees' interest focused mainly on international foreign currency markets, monetary policy and payment instruments, reserve management risk analysis, macroeconomic policy, and international economic relations. The one-week summer internship gave 20 students the opportunity to get acquainted with major BNB functions and operations.

Student scholarships awards continued in 2011, three students pursuing Master's Degrees winning the BNB competition.

XV. Facilities Management

The BNB mainly trades from owned premises and properties. This provides the degree of independence, security, and protection required of a central bank. Property management spending was in line with the BNB budget during 2011 and included new construction, refurbishment and modernisation, deliveries and equipment, repairs, vehicles, supplying assets and cash processing consumables, and optimising power, heating, and water use at BNB premises.

Over the year the BNB granted two vehicles to budget organisations and purchased four new vehicles under Public Procurement Law procedures, as planned in the fleet development strategy.

Since a property in Obzor, Nessebar Municipality was not needed, and to optimise maintenance costs, in the first half of 2011 the BNB granted it to the state through the Burgas Regional Administration.

XVI. Internal Audit

There were four audits and three commitments to follow-up recommendations from previous audits under the BNB Governing Council 2011 Annual Audit Programme, plus three audit commitments under the ESCB Internal Auditor Committee programme.

Two audit commitments of BNB cash operations examined implementation of recommendations from 2010 audits of the State Mint EAD coin and medal management and control system and the BNB Printing Works banknote management and control system. Auditors focused on risk prevention effectiveness.

An audit of the supervision and financial stability function assessed effective function delivery, its contribution to efficient, reliable, and stable banking, planning efficiency, division of responsibilities within the team, and the reliability and integrity of significant information.

In information and communication technology, an audit addresses IT project portfolio management adequacy, effectiveness, and efficiency. Attention focused on organisation, internal rules, compliance with good practice and its appliance to IT project management.

An audit of the Fiscal Services Department, which acts as fiscal agent and depository of the government, sought reasonable assurance of management and control system adequacy and efficiency.

BNB consolidated financial statements as of 30 June 2011 were audited to evaluate BNB financial statement accuracy and scope, reliability, compliance with Bank accounting policy, and control system adequacy.

Recommendations from previous audits were followed up to assess response adequacy, effectiveness, and timeliness of the measures undertaken by the managers of the relevant units.

Audits Performed under the BNB Internal Audit Programme

No	BNB Functions	Audits and Commitments
1	Banknotes and Coins	Implementation of recommendations from prior BNB Printing Works audits
2	Banknotes and Coins	Implementation of recommendations from prior State Mint EAD audits
3	Supervision and Financial Stability	Legal services and administration
4	Information and Communication Technology	Project management
5	Bank services to government and public organisations	The BNB as the state's fiscal agent and depository
6	Financial Accounting and Financial Statements	BNB Consolidated Financial Statements for the Year Ending on 30 June 2011
7	BNB Internal Audit	Implementation of recommendations by the Chief Auditor and Internal Audit Unit

Source: BNB.

There were three audits under the ESCB Internal Auditor Committee annual programme. An audit of the banknote and coin function sought reasonable assurance of adequate and efficient risk management, process control, and management by the BNB in combating euro counterfeiting.

An audit of the statistics function sought reasonable assurance of the adequacy and efficiency of risk management and control in general government statistics.

Administration of the ECB Governing and General Councils was audited under the management structures secretariat function to obtain reasonable assurance of the adequacy and efficiency of corporate governance, risk management, and control over the administrative service of the ECB Governing and General Councils.

Audits under the ESCB Internal Auditors Committee Programme

No	BNB Functions	Audits
1	Banknotes and Coins	Fighting euro counterfeiting
2	Statistics	General government statistics
3	Management Structures Secretariat	Administration of the ECB Governing and General Councils

Source: BNB.

In 2011 the BNB Chief Auditor organised and coordinated Internal Audit Unit work with external auditors KPMG Bulgaria.

Internal auditors issued opinions on draft internal rules on issue and cash operations and banking operations.

Training at the ESCB, EU central banks, and the Institute of Internal Auditors in Bulgaria acquainted Internal Audit employees with the latest guidelines and professional practice. Training was aligned with auditors' qualification improvement needs, expertise, and skills.

Operational risk management policy followed the Operational Risk Management Committee plan for 2011. Preparations for a BNB operational risk management system continued in line with the BNB Operational Risk Management Policy and the Guidelines on its implementation. All 33 units to be included in the system took part, 31 completing all mandatory stages. Risk self-evaluation for 2011 ended on time. The Governing Council approved the consolidated report on BNB operational risk in late November.

Tenders for operational risk management process automation software were called in November. It will standardise processes and improve data processing efficiency to boost analysis quality. The project should end in late 2012.

In 2011 BNB delegates took part in the sixth ESCB conference on operational risk management and business process continuity and two seminars held by ESCB central banks. They exchanged experience with colleagues from other central banks and learned the ECB methodology.

XVII. Budget Performance

The Governing Council adopted the BNB budget on 4 November 2010 by Resolution No 106. This report comprises two sections pursuant to the BNB Governing Council's Internal Rules on Setting, Implementing, and Reporting the BNB Budget: Operating Expenditure and the Investment Programme.

1. Operating Expenditure

The BNB spent BGN 71,623,000 or 86.4 per cent of its budget on 2011 operations.

Currency circulation cost BGN 9,551,000 or 89.6 per cent of budget and 13.4 per cent of operating spending. Producing new banknotes and coins cost BGN 8,984,000 or 93.2 per cent of budget. This included BGN 5,534,000 or 96.5 per cent of projections on banknotes. Coin minting cost BGN 3,450,000, of which BGN 2,761,000 on circulating coins. The Commemorative Coin Programme cost BGN 689,000 or 67.5 per cent of budget. Designing new banknotes and coins cost BGN 28,000 or 46.7 per cent of projections, including five design competitions for 2012 commemorative coins. Spending on machines for servicing circulating cash was BGN 116,000 or 58 per cent of budget. Cash processing consumables cost BGN 261,000 or 63.7 per cent of budget. Renting premises at the BNB Cash Services Company and the State Mint cost BGN 162,000 or 55.5 per cent of projections.

Materials, services, and depreciation spending was BGN 36,480,000 or 83.1 per cent of budget. Materials cost BGN 938,000 or 72.7 per cent of projections and 1.3 per cent of operating spending. Fuel and spares for the transport fleet (BGN 411,000) and office consumables (BGN 283,000) had the largest share. Inventories cost BGN 94,000 or half of projections.

External services spend was BGN 15,842,000 or 76.1 per cent of budget and 22.1 per cent of operating spending. Significant items were software maintenance subscriptions at BGN 3,079,000, mandatory TARGET2 modules at BGN 1,087,000, Bloomberg, Reuters, internet and other systems at BGN 933,000, and BORICA–Bankservice subscriptions at BGN 489,000 or 35.3 per cent of external service spending. Equipment maintenance cost BGN 1,317,000. Mail, telephone and telex spend was BGN 683,000, with a trend towards voice service optimisation.

Property and refuse collection levies were BGN 1,791,000. Electric bills were BGN 674,000, and heating and water spending was BGN 250,000. Property insurance came to BGN 150,000. The Bank spent BGN 2,493,000 on security and fire protection, or 76.7 per cent of budget. Major building maintenance cost BGN 1,810,000 or 81.5 per cent of budget.

Consultancy services cost BGN 242,000 or 21.8 per cent of budget. They involved, *inter alia*, obtaining technical passports for BNB premises, analysing wireless communications between them, legal services, and running the Programme Council for Banking and Finance History.

Depreciation was BGN 19,700,000 or 90.4 per cent of budget and 27.5 per cent of operating expenditure.

Payroll, social, and healthcare spending was BGN 20,759,000 or 97.4 per cent of the 2011 budget and 29 per cent of the operating spend. The Bank listed BGN 297,000 of current retirement obligations and unused paid leave here under IAS 19, Income of Hired Persons. Social spending was BGN 1,996,000, or 91.8 per cent of budget.

Miscellaneous administrative spending was BGN 1,377,000 or 61.4 per cent of budget and 1.9 per cent of operating expenditure. Inland travel at BGN 64,000 involved mainly regional cash centre cash logistics and checks.

Foreign travel covered participation in seminars and staff training at BGN 283,000 or 45.9 per cent of budget. Distance learning, professional courses, and seminars at foreign banks and international financial institutions under the BNB Staff Education and Professional Training Programme cost BGN 669,000.

Bank representative and protocol spend was BGN 349,000 or 0.49 per cent of operating expenditure. The Bank spent BGN 1,460,000 (56.1 per cent of budget and 2 per cent of operating spend) on ESCB participation. Spending on BNB participation on ESCB committees and working groups and other EU bodies was BGN 632,000.

Telecommunication line rental cost BGN 270,000, with staff training costs of BGN 50,000. The annual European Banking Authority membership fee was BGN 421,000. The Sofia meetings of the ESCB Internal Auditors Committee, ESCB Legal Committee, and the ESCB Statistics Committee Working Group on Government Finance Statistics cost BGN 88,000.

2. Investment Programme

The investment budget for 2011 was BGN 15,344,000 and BGN 7,218,000 or 47 per cent was spent.

Under the construction, refurbishment and modernisation item, BGN 100,000 or 10.6 per cent went on a new drainage system and an architectural project for the restoration of the Plovdiv BNB Cash Centre building façade. Further spending under this item awaits a survey and a technical passport, either of which might involve additional commitments. The year saw a contractor selected to survey the premises and obtain technical passports.

Machine and equipment, vehicle, and sundry equipment investment came to BGN 811,000 or 32.7 per cent of Programme funds. Currency circulation machines and equipment cost BGN 339,000, including BGN 157,000 on label printers for BPS banknote handlers and BGN 93,000 on protection sensors and finishing sets for BPS 216 banknote handlers. Delivery contract finalisation in late 2011 deferred spending under this item.

The Bank invested BGN 194,000 into four cars, BGN 60,000 into fire resistant doors at regional cash centres, BGN 56,000 into photocopiers, and BGN 44,000 into hydraulic freight lifts.

Investment into information systems came to BGN 6,272,000 or 53.5 per cent of budget and 86.9 per cent of 2011 investment. Funds went mostly into keeping the information and communication technology infrastructure up to date. A 2011 investment funds optimisation changed priorities and reordered projects. Hardware costs of BGN 4,546,000 went on computer (BGN 3,326,000) and communications equipment (BGN 1,220,000). Software spending of BGN 1,726,000 was on licences (BGN 372,000) and functionality expansion for existing systems (BGN 1,354,000).

ESCB participation entailed investing BGN 35,000 on access licenses and maintenance for the DARWIN document and record management system.

BNB Budget Performance on 31 December 2011

Indicator	Spend 30 December 2011 (BGN'000)	Budget 2011 (BGN'000)	Takeup (per cent)
Section I. Operating expenditure	71,623	82,912	86.4
Currency circulation	9,551	10,657	89.6
Materials, services, and depreciation	36,480	43,917	83.1
Staff	20,759	21,315	97.4
Social	1,996	2,175	91.8
Sundry administrative	1,377	2,244	61.4
ESCB membership	1,460	2,604	56.1
Section II. Investment programme	7,218	15,344	47.0
Construction, Refurbishment, Modernisation	100	947	10.6
Machines, Vehicles, Equipment	811	2,481	32.7
Computers	6,272	11,720	53.5
ESCB Membership	35	196	17.9

* Pursuant to the Internal Rules on Setting, Implementing, and Reporting the BNB Budget, adjustments were made in the funds under 2011 budget indicators.

Source: BNB.

XVIII. Bulgarian National Bank Consolidated Financial Statements for the Year Ended 31 December 2011

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KPMG Bulgaria OOD
45/A, Bulgaria Boulevard
Sofia 1404
Bulgaria

Telephone +359 (2) 9697 300
Telefax +359 (2) 9805 340
E-mail bg-office@kpmg.com
Internet www.kpmg.bg

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

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Bulgarian National Bank and its subsidiaries ("the Bank") which comprise the consolidated statement of financial position as at 31 December 2011, the consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



Opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Bank and its subsidiaries as at 31 December 2011 and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

Report on Other Legal and Regulatory Requirements

Annual report of the activities of the Company prepared in accordance with the requirements of article 33 of the Accountancy Act

As required under the Accountancy Act, we report that the historical financial information disclosed in the consolidated annual report of the activities of the Bank, prepared by Management as required under article 33 of the Accountancy Act, is consistent, in all material aspects, with the consolidated financial information disclosed in the audited consolidated financial statements of the Bank as of and for the year ended 31 December 2011. Management is responsible for the preparation of the consolidated annual report of the activities of the Bank which was approved by the Governing Council of the Bank on 24 April 2012.

KPMG Bulgaria OOD

KPMG Bulgaria OOD

Sofia, 24 April 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.

A handwritten signature in black ink, appearing to read 'Ivan Iskrov', enclosed within a large, horizontal, oval-shaped stroke.

Ivan Iskrov
Governor of the BNB

Consolidated Statement of Comprehensive Income for the Year Ended 31 December 2011

(BGN'000)

	Note	2011	2010
Interest income	7	435,230	413,068
Interest expense	7	(26,422)	(14,267)
Net interest income		408,808	398,801
Fee and commission income		8,220	7,988
Fee and commission expense		(3,654)	(3,659)
Net fee and commission income		4,566	4,329
Net profit from financial assets and liabilities at fair value through profit or loss	8	269,585	498,495
Other operating income	9	54,016	50,781
Total income from banking operations		736,975	952,406
Administrative expenses	10	(107,328)	(105,760)
Profit for the period		629,647	846,646
Other comprehensive income			
Other comprehensive income		(524)	(1,292)
Other comprehensive income, total		(524)	(1,292)
Total comprehensive income for the period		629,123	845,354
Profit attributable to:			
Equity holder of the Bank		629,410	846,495
Non-controlling interest		237	151
Profit for the period		629,647	846,646
Total comprehensive income attributable to:			
Equity holder of the Bank		628,886	845,203
Non-controlling interest		237	151
Total comprehensive income for the period		629,123	845,354

The accompanying notes on pages 91 to 115 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Financial Position as of 31 December 2011

(BGN'000)

	Note	31 December 2011	31 December 2010
ASSETS			
Cash and deposits in foreign currencies	11	6,722,318	5,685,791
Gold, instruments in gold and other precious metals	12	3,096,194	2,708,138
Financial assets at fair value through profit or loss	13	16,252,939	16,947,991
Financial assets available for sale	14	1,541,720	1,508,629
Tangible assets	15	225,219	239,723
Intangible assets	16	7,687	11,230
Other assets	17	63,398	54,094
Total assets		27,909,475	27,155,596
LIABILITIES			
Banknotes and coins in circulation	18	8,728,750	8,302,428
Due to banks and other financial institutions	19	6,179,598	5,812,535
Liabilities to government institutions and other liabilities	20	5,234,032	5,833,592
Borrowings against Bulgaria's participation in international financial institutions	21	2,824,412	2,761,464
Other liabilities	22	164,627	94,983
Total liabilities		23,131,419	22,805,002
EQUITY			
Capital	23	20,000	20,000
Reserves	23	4,753,965	4,326,740
Non-controlling interest	24	4,091	3,854
Total equity		4,778,056	4,350,594
Total liabilities and equity		27,909,475	27,155,596

The accompanying notes on pages 91 to 115 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Cash Flows for the Year Ended 31 December 2011

(BGN'000)

	Note	2011	2010
Operating activities			
Net profit		629,647	846,646
Adjustments:			
Dividend income		(7,961)	(12,732)
Depreciation	15, 16	25,969	26,160
(Profit)/loss on disposal of tangible assets		(689)	195
(Profit) on financial assets and liabilities arising from market movements		(350,658)	(485,111)
(Profit) of associates		(61)	(5,387)
Other adjustments		(66)	-
Net cash flow from operating activities before changes in operating assets and liabilities		296,181	369,771
Change in operating assets			
(Increase) in gold, instruments in gold and other precious metals		(485)	(56)
Decrease in financial assets at fair value through profit or loss		687,636	1,987,441
Decrease/(increase) in other assets		606	(2,436)
Change in operating liabilities			
Increase in currency in circulation		426,322	253,328
Increase in due to banks and other financial institutions		367,063	887,559
(Decrease) in due to government institutions and other liabilities		(599,560)	(1,556,628)
Increase in borrowings from IMF of total allocation of SDR		-	-
Increase / (decrease) in other liabilities		69,644	(42,162)
Net cash inflow from operating activities		1,247,407	1,896,817
Investing activities			
Purchase of tangible and intangible assets		(8,217)	(9,099)
Dividends received		7,961	12,732
Other investments		200	(185)
Net cash flow used in investing activities		(56)	3,448
Financing activities			
Payments to the Government		(200,914)	(354,710)
Net cash flow used in/(from) financing activities		(200,914)	(354,710)
Increase in cash and cash equivalents		1,046,437	1,545,555
Cash and cash equivalents at beginning of period		5,718,030	4,172,475
Cash and cash equivalents at end of period	11, 17	6,764,467	5,718,030

The accompanying notes on pages 91 to 115 form an integral part of the Consolidated Financial Statements.

Consolidated Statement of Changes in Equity for the Year Ended 31 December 2011

(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 2010	20,000	138,381	3,697,866	3,856,247	3,703	3,859,950
Profit for the period	-	-	846,495	846,495	151	846,646
Other comprehensive income:						
- other income	-	(1,267)	(25)	(1,292)	-	(1,292)
Other comprehensive income, total	-	(1,267)	(25)	(1,292)	-	(1,292)
Total comprehensive income/(loss) for the period	-	(1,267)	846,470	845,203	151	845,354
Other movements	-	2,930	(2,930)	-	-	-
Contributions by and distributions to owners:						
- contribution to the budget of the Republic of Bulgaria	-	-	(354,710)	(354,710)	-	(354,710)
Transactions with owners, total	-	-	(354,710)	(354,710)	-	(354,710)
Balance as of 31 December 2010	20,000	140,044	4,186,696	4,346,740	3,854	4,350,594
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	-	-	629,410	629,410	237	629,647
Other comprehensive income:						
- other income	-	(524)	-	(524)	-	(524)
Other comprehensive income, total	-	(524)	-	(524)	-	(524)
Total comprehensive income for the period	-	(524)	629,410	628,886	237	629,123
Other movements	-	(747)	-	(747)	-	(747)
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 31 December 2011	20,000	138,773	4,615,192	4,773,965	4,091	4,778,056

The accompanying notes on pages 91 to 115 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;
- regulation and supervision of the activity of payment system operators, payment institutions and electronic money institutions in the country;
- the Bank shall not extend credit and guarantees in any form whatsoever, including thought purchase of debt instruments, to the Council of Ministers, municipalities, as well as to other government and municipal institutions, organisations and enterprises;
- 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 reserves;
- the Bank shall act as the fiscal agent and depository of the State.

The Governing Council of the BNB approved the Consolidated Financial Statements, set out on pages 83 to 115, on 24 April 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), which are the functional currency of the Bank. 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 policies of an enterprise so as to obtain benefits from its activities. The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. All receivables and payables, income and expenses, as well as intragroup profits resulting from transactions between Group companies are eliminated unless they are immaterial. The 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 expense 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

(i) Classification

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

Financial instruments at fair value through profit 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 can not 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.

(ii) 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.

(iii) 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.

(iv) 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 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.

(v) 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.

(vi) *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.

(vii) *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.

(viii) 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.

(ix) 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; they 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 when 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:

	(per cent)
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 31 December 2011 and 31 December 2010 are as follows:

Currency	31 December 2011	31 December 2010
US dollars	1 : BGN 1.51158	1 : BGN 1.47276
Euro	1 : BGN 1.95583	1 : BGN 1.95583
Special drawing rights	1 : BGN 2.32068	1 : BGN 2.26809
Gold	1 troy ounce : BGN 2380.35	1 troy ounce : BGN 2081.32

(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 2011, 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 that are not yet effective and have not been implemented so far, which the EC has endorsed for adoption

- Amendments to IFRS 7 Disclosures – Transfers of Financial Assets effective for the first financial year beginning after 1 July 2011.

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 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. So far, the size of the potential effect has not been estimated.
- 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. 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 IAS 12 Deferred Tax: Recovery of Underlying Assets (issued in December 2010) in effect as of 1 January 2012 – management does not expect that these amendments will have an impact on the Bank's Financial Statements.
- Amendments to IAS 1 Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters (issued in December 2010) in effect as of 1 July 2012 – management does not expect that these amendments will have an impact on the Bank's Financial Statements.
- In June 2011, IASB issued Presentation of Items of Other Comprehensive Income (Amendments to IAS 1) with effective date 1 July 2012.
- In June 2011, IASB issued amended IAS 19 Employees Benefits with effective date 1 January 2013.
- In December 2011, IASB issued amendments to IFRS 7 Disclosures – Offsetting Financial Assets and Financial Liabilities with effective date 1 January 2013.
- In December 2011, IASB issued amendments to IAS 32 Offsetting Financial Assets and Financial Liabilities with effective date 1 January 2014.
- Interpretation IFRIC 20 Stripping Costs in the Production Phase of a Surface Mine will become effective as of 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 maximising 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 reserve 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. The rules and procedures are included in the Manual of Business Procedures for Foreign Currency Reserve Management.

(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 or bankruptcy of a BNB's counterparty or the bankruptcy or insolvency of an issuer, in whose debt instruments the Bank has invested its own funds. The internal documents *Methodology of Credit Risk Management and Investment Guidelines and Benchmarks for the Management of the Gross International Reserves* set out the BNB's credit risk management policy and respectively the specific limits and measures for conducting it. The approved types of financial instruments for investment of funds in managing the international reserves according to the *Investment Limits* are as follows:

- central banks' investment programmes;
- automatic borrowing/lending of securities with the main depository;
- deposits in foreign currency (time deposits and funds on current accounts) with counterparties and/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 financial institutions – issuers of covered bonds. From the middle of 2011 the maximum term of newly purchased assets has been reduced from 30 to 10 years, while in the recent quarter it has changed to up to 3 years. 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;
- futures – interest rate and bond, traded on the regulated markets.

The *Methodology of Credit Risk Management* sets out the following principles and rules for controlling credit risk to counterparties the BNB can have exposures to and issuers of debt in which the Bank can invest:

- the ratings used are those assigned by six internationally recognised credit rating agencies: Standard&Poor's, Moody's, Fitch Ratings, Japan Rating and Investment Information, Japan Credit Rating Agency, and Dominion Bond Rating Service.
- each counterparty-institution or issuer is assigned an internal rating based on numerical values corresponding to the long-term ratings given by the credit rating agencies by also taking into account the positive/negative short-term watch or long-term outlook for this institution.
- the counterparties, to which the BNB can have credit exposure, are allocated to five 'risk groups' based on their individual internal ratings and two accounting indicators: capital adequacy ratio (Tier1) and leverage ratio (assets to equity ratio). Each risk group is linked to a limit in percentage of foreign currency reserves (concentration limit on 'commercial bank' asset class), which is the maximum acceptable daily exposure to the institution with a corresponding maximum term to maturity of the loaned funds.
- crucial to determining the credit rating of approved issuers is the credit rating of the securities issue eligible for purchase by the BNB.
- rules are defined for treating issuers and counterparties in the event of change in their internal credit ratings and risk groups.

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 the Bank 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 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

(BGN'000)

As of 31 December 2010	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	5,392,112	293,679	-	-	-	-	5,685,791
Gold, instruments in gold, and other precious metals	-	1,601,618	-	-	-	1,106,520	2,708,138
Financial assets at fair value through profit or loss	800,156	3,346,464	5,869,467	6,655,475	276,429	-	16,947,991
Financial assets available for sale	76,928	-	-	-	-	1,431,701	1,508,629
Total financial assets	6,269,196	5,241,761	5,869,467	6,655,475	276,429	2,538,221	26,850,549
Financial liabilities							
Banknotes and coins in circulation	-	-	-	-	-	8,302,428	8,302,428
Due to banks and other financial institutions	5,812,535	-	-	-	-	-	5,812,535
Liabilities to government institutions and other borrowings	4,129,571	863,786	840,235	-	-	-	5,833,592
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	2,761,464	2,761,464
Total financial liabilities	9,942,106	863,786	840,235	-	-	11,063,892	22,710,019
Asset-liability maturity mismatch	(3,672,910)	4,377,975	5,029,232	6,655,475	276,429	(8,525,671)	4,140,530

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 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
As of 31 December 2010							
Banknotes and coins in circulation	8,302,428	8,302,428	-	-	-	-	8,302,428
Due to banks and other financial institutions	5,812,535	5,812,535	5,812,535	-	-	-	-
Liabilities to government institutions and other borrowings	5,833,592	5,836,123	4,129,729	864,356	842,038	-	-
Borrowings against Bulgaria's participation in international financial institutions	2,761,464	2,761,464	-	-	-	-	2,761,464
	22,710,019	22,712,550	9,942,264	864,356	842,038	-	11,063,892

(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 risk limits set in the *Investment Limits 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.

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

(BGN'000; per cent)

	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)
	As of 31 December 2010	Average	Maximum	Minimum
Currency risk	(27,365)	(24,452)	(62,044)	(5,743)
Interest rate risk	(5,117)	(6,167)	(18,016)	(797)
Correlation (per cent)	(0.07)	(0.06)	0.64	(0.56)
Overall risk	(26,427)	(30,043)	(59,974)	(4,009)

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 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
As of 31 December 2010					
Interest-earning assets					
Cash and deposits in foreign currencies	5,576,186	1,423,858	3,858,954	293,374	-
Gold, instruments in gold and other precious metals	1,601,613	-	-	1,601,613	-
Financial assets at fair value through profit or loss	16,855,601	1,295,612	765,348	3,329,520	11,465,121
Financial assets available for sale	76,928	-	76,928	-	-
Other interest-earning assets	32,239	3,286	6,229	11,138	11,586
Total	24,142,567	2,722,756	4,707,459	5,235,645	11,476,707
Interest-bearing liabilities					
Due to banks and other financial institutions	5,812,535	-	5,812,535	-	-
Liabilities to government institutions and other borrowings	4,325,526	-	2,622,012	863,514	840,000
Borrowings against Bulgaria's participation in international financial institutions	1,385,521	1,385,521	-	-	-
Total	11,523,582	1,385,521	8,434,547	863,514	840,000
Interest-bearing assets/liability gap	12,618,985	1,337,235	(3,727,088)	4,372,131	10,636,707

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 are 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 31 December 2011	(138,134)	138,134	177,533	113,485
As of 31 December 2010	(80,298)	80,298	122,359	95,831

Currency risk

For the Bank a currency risk exists where there is a mismatch between the currency structure of assets and that of liabilities. From an accounting point of view, 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 lev, 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)

	31 December 2011	31 December 2010
Assets		
Bulgarian lev, euro and currencies of euro area countries*	21,906,659	21,548,031
US dollar	19,195	73,208
Japanese yen	220	156
Pound sterling	212	884
SDR	2,927,098	2,861,358
Gold	3,053,483	2,669,424
Other	2,608	2,535
	27,909,475	27,155,596
Liabilities, Capital and Reserves		
Bulgarian lev, euro and currencies of euro area countries	25,062,368	24,318,033
US dollar	19,154	73,283
Japanese yen	-	-
Pound sterling	-	-
SDR	2,825,351	2,761,743
Other	2,602	2,537
	27,909,475	27,155,596
Net position		
Bulgarian lev, euro and currencies of euro area countries	(3,155,709)	(2,770,002)
US dollar	41	(75)
Japanese yen	220	156
Pound sterling	212	884
SDR	101,747	99,615
Gold	3,053,483	2,669,424
Other	6	(2)

* 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

(i) *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 ac-

counting 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.

(ii) **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
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
31 December 2010			
Cash and deposits in foreign currency	5,685,791	-	5,685,791
Gold, instruments in gold and other precious metals	2,708,138	-	2,708,138
Financial assets at fair value through profit or loss	16,717,083	230,908	16,947,991
Total	25,111,012	230,908	25,341,920

7. Interest Income and Expense

(BGN'000)

	2011	2010
Interest income		
– on securities	399,463	399,226
– on deposits	35,558	13,759
– on other	209	83
	<u>435,230</u>	<u>413,068</u>
Interest expense		
– on deposits	26,380	14,265
– on other	42	2
	<u>26,422</u>	<u>14,267</u>

Interest paid on government deposits demoninated in levs as of 31 December 2011 are BGN 12,267 thousand and BGN 3,586 thousand in foreign currency. Interest paid on deposits in levs of other government organisations as of 31 December 2011 are BGN 1984 thousand and BGN 1387 thousand in foreign currencies.

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

(BGN'000)

	2011	2010
Net (losses) from operations in securities	(137,592)	(178,949)
Net gains from operations in foreign currency	566	594
Net revaluation (losses) on futures	(1,857)	(4,417)
Net revaluation gains /(losses) on securities	19,297	(94,171)
Net revaluation gains on foreign currency assets and liabilities	1,600	4,488
Net revaluation gains on gold	387,571	770,950
	<u>269,585</u>	<u>498,495</u>

9. Other Operating Income

(BGN'000)

	2011	2010
Income from subsidiaries	43,252	30,445
Income from associated companies	61	5,387
Income from sale of coins	1,027	926
Dividend income	7,961	12,732
Other income, net	1,715	1,291
	<u>54,016</u>	<u>50,781</u>

Income from dividends includes dividends from BNB's participation in BIS Basle amounting to BGN 5111 thousand and from BNB's participation in BORICA-Bankservice of BGN 2850 thousand.

10. Total Administrative Expenses

(BGN'000)

	2011	2010
Personnel costs	30,769	29,756
Administrative expenses	46,966	47,461
Depreciation	25,969	26,160
Other expenses	3,624	2,383
	<u>107,328</u>	<u>105,760</u>

Personnel costs include salaries, social and health insurance costs charged under the local legislation provisions as of 31 December 2011, and social activities costs, respectively for the BNB: BGN 22,755 thousand, for the Printing Works of the BNB Corp: BGN 5091 thousand, and for the Bulgarian Mint EAD: BGN 2923 thousand. The number

of employees of the Bank and its subsidiaries is 1230 in 2011 (2010 – 1233), including the BNB staff of 865 in 2011 (2010 – 864).

Based on actuarial calculations, the Bank has accrued compensation liabilities for personnel on retirement and for unused paid annual leave at BGN 297 thousand (31 December 2010 – BGN 187 thousand). The retirement and unused paid annual leave compensation for the Bank's subsidiaries as of 31 December 2011 are BGN 207 thousand (31 December 2010: BGN 95 thousand).

Administrative expenses include the BNB's currency circulation expenses of BGN 9551 thousand for the year ended 31 December 2011 (31 December 2010: BGN 18,803 thousand).

11. Cash and Deposits in Foreign Currencies

(BGN'000)

	31 December 2011	31 December 2010
Cash in foreign currencies	84,383	108,049
Current accounts in other banks	2,240,100	1,422,158
Deposits in foreign currencies	4,397,835	4,155,584
	<u>6,722,318</u>	<u>5,685,791</u>

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

(BGN'000)

	31 December 2011	31 December 2010
Euro area residents		
In EUR	4,333,864	3,113,775
In other currencies	2	19
	<u>4,333,866</u>	<u>3,113,794</u>
Non-euro area residents		
In EUR	955,697	1,116,301
In other currencies	1,432,755	1,455,696
	<u>2,388,452</u>	<u>2,571,997</u>
	<u>6,722,318</u>	<u>5,685,791</u>

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

	31 December 2011		31 December 2010	
	'000 troy ounces	BGN'000	'000 troy ounces	BGN'000
Gold bullion in standard form	513	1,221,222	513	1,067,806
Gold deposits in standard form	770	1,832,261	770	1,601,618
Gold in other form	16	38,693	16	33,832
Other precious metals		4,018		4,882
		<u>3,096,194</u>		<u>2,708,138</u>

Gold in standard form includes gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 0.09 per cent per annum. Gold in other form includes commemorative gold coins of BGN 32,721 thousand. Other precious metals include silver commemorative coins of BGN 643 thousand and platinum commemorative coins of BGN 3375 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 in the Profit or Loss

(BGN'000)

Securities at fair value through profit or loss	31 December 2011	31 December 2010
Foreign treasury bills, notes and bonds	16,252,939	16,947,991
	<u>16,252,939</u>	<u>16,947,991</u>

Securities comprise both coupon and discount securities denominated in euro. The maximum coupon interest of the EUR-denominated securities was 2.98 per cent in 2011 (31 December 2010 – 3.19 per cent).

The value of securities pledged as collateral on futures transactions amounts to BGN 30,284 thousand as of 31 December 2011 (31 December 2010: BGN 29,306 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 – Standard&Poor's, Fitch Ratings, Moody's, DBRS, R&I and JCR are disclosed as follows:

(BGN'000)

	Issuer's credit rating	31 December 2011	31 December 2010
Investment graded securities by the emission/issuer credit rating	AAA	12,001,433	12,172,026
	AA+	1,831,948	818,745
	AA	540,800	460,259
	AA-	1,826,299	2,970,701
	A+	52,459	526,260
		<u>16,252,939</u>	<u>16,947,991</u>

14. Financial Assets Available for Sale

(BGN'000)

	31 December 2011	31 December 2010
Republic of Bulgaria's quota in the IMF	1,485,699	1,452,248
Equity investments in international financial institutions	30,098	29,572
Investments in associates	25,923	26,809
	<u>1,541,720</u>	<u>1,508,629</u>

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 79,138 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 0.40 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 31 December 2011 the current value of 10,000 thousand shares in SDR amounts to BGN 23,207 thousand while as of 31 December 2010 it was BGN 22,681 thousand (ref. Note 28). 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. The BNB is a member 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 ESCB 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

In 2011, the BNB sold 2000 shares, accounting for 20 per cent of the capital of Central Depository AD, to the Government of the Republic of Bulgaria. The Bank transferred the shares at *par* value.

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 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	4000	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
As of 1 January 2010	182,569	111,298	27,511	8,901	6,270	3,436	339,985
Additions	14	1,546	25	35	61	4,632	6,313
Disposals	-	(719)	(419)	(92)	(11)	(87)	(1,328)
Transfers	2,334	(419)	3,434	260	26	(5,635)	-
As of 31 December 2010	184,917	111,706	30,551	9,104	6,346	2,346	344,970
Depreciation and Impairment loss							
As of 1 January 2010	(11,603)	(50,089)	(16,624)	(3,518)	(4,201)	-	(86,035)
Charge for the period	(5,832)	(8,136)	(4,877)	(959)	(498)	-	(20,302)
On disposals	-	570	417	92	11	-	1,090
As of 31 December 2010	(17,435)	(57,655)	(21,084)	(4,385)	(4,688)	-	(105,247)
Net book value as of 31 December 2010	167,482	54,051	9,467	4,719	1,658	2,346	239,723
Net book value as of 31 December 2009	170,966	61,209	10,887	5,383	2,069	3,436	253,950

When revaluating non-current tangible assets, the Bank writes off the accrued depreciation at the expense of the gross book value of assets, and their net value is recalculated against their revaluation.

16. Intangible Assets

(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).

(BGN'000)

	Software	Other intangible assets	Intangible assets in progress	Total
As of 1 January 2010	36,425	41	346	36,812
Additions	33	3	2,750	2,786
Disposals	(2)	(2)	-	(4)
Transfers	2,148	-	(2,148)	-
As of 31 December 2010	38,604	42	948	39,594
Depreciation and Impairment loss				
As of 1 January 2010	(22,473)	(37)	-	(22,510)
Charge for the period	(5,855)	(3)	-	(5,858)
On disposals	3	1	-	4
As of 31 December 2010	(28,325)	(39)	-	(28,364)
Net book value as of 31 December 2010	10,279	3	948	11,230
Net book value as of 31 December 2009	13,952	4	346	14,302

Software includes, as of 31 December 2010, licenses purchased by the BNB to the total amount of BGN 815 thousand (31 December 2009 – BGN 1848 thousand), and software products to the amount of BGN 1815 thousand (31 December 2009 – BGN 1430 thousand).

17. Other Assets

(BGN'000)

	31 December 2011	31 December 2010
Cash held by subsidiaries with local banks	42,149	32,239
Commemorative coins for sale	357	423
Inventories	15,023	15,559
Accounts receivable	3,271	574
Deferred charges	1,623	1,508
Other receivables	975	3,791
	63,398	54,094

Cash held by subsidiaries with local banks comprise BGN 38,361 thousand of Printing Works of the BNB Corp and BGN 3788 thousand of Bulgarian Mint EAD.

18. Banknotes and Coins in Circulation

(BGN'000)

	31 December 2011	31 December 2010
Banknotes in circulation	8,548,706	8,133,861
Coins in circulation	180,044	168,567
	<u>8,728,750</u>	<u>8,302,428</u>

19. Due to Banks and Other Financial Institutions

(BGN'000)

	31 December 2011	31 December 2010
Demand deposits from banks and other financial institutions		
– in BGN	4,417,459	3,848,984
– in foreign currency	1,762,139	1,963,551
	<u>6,179,598</u>	<u>5,812,535</u>

The Bank does not pay interest on demand deposits from banks and other financial institutions. Demand deposits include BGN 4636 million representing the required reserves, which all local banks are required to maintain on accounts with the BNB (31 December 2010: BGN 5793 million).

20. Liabilities to Government Institutions and Other Liabilities

(BGN'000)

	31 December 2011	31 December 2010
Current accounts		
– in BGN	1,379,232	961,228
– in foreign currency	389,454	246,838
Time deposit accounts		
– in BGN	2,434,000	2,469,000
– in foreign currency	1,031,346	2,156,526
	<u>5,234,032</u>	<u>5,833,592</u>

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in euro and in leva earn annual interest of between 0 per cent and 1.09 per cent.

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

The borrowings against Bulgaria's participation in the IMF as of 31 December 2011 amount to BGN 1,289,622 thousand: SDR 604,475 thousand (as of 31 December 2010: BGN 1,342,143 thousand: SDR 604,659 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 leva amounting to BGN 3463 thousand (as of 31 December 2010: BGN 3603 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)

	31 December 2011	31 December 2010
Funds of EU institutions and bodies	130,486	70,135
Salaries and social security payable	1,916	1,431
Deferred income	1,680	1,690
Other liabilities	30,545	21,727
	164,627	94,983

"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 at 31 December 2011 the funds on these accounts were BGN 68,967 thousand. In 2011 the Bank opened accounts with the European Investment Bank (EIB) for the purposes of a financial arrangement between the Government of the Republic of Bulgarian and the EIB with the funds on these accounts amounting to BGN 61,519 thousand as at 31 December 2011.

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 comprises 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.

The 2011 and 2010 profit distribution in accordance with the profit distribution policy disclosed in note 5 (h) is as follows:

(BGN'000)

	2011	2010
Profit for the period	629,647	846,646
Allocation to special reserve under Article 36 of the Law on the BNB:		
Unrealised gains from gold revaluation	(387,571)	(770,950)
Unrealised loss from revaluation of financial assets at fair value through profit or loss	5,559	202,308
Unrealised foreign currency valuation losses	(1,600)	(4,488)
Other unrealised losses	1,857	4,417
Result after allocation to special reserve,	247,892	277,933
including:		
Allocation to Reserve Fund under Article 8 of the Law on the BNB	60,176	66,971
Result from consolidation and non-controlling interest	7,188	10,048
Allocation to a special-purpose fund under Article 8 of the Law on the BNB	-	-
Planned contribution to the state budget	180,528	200,914

The planned contribution to the state budget of BGN 180,528 thousand as at 31 December 2011 is a resultant value calculated based on the realised excess of revenue over expenditure in the BNB's unconsolidated Financial Statements of BGN 240,704 thousand. Pursuant to Article 8 of the Law on the BNB, 25 per cent of the annual excess of the Bank's revenue over expenditure amounting to BGN 60,176 thousand is allocated to the Reserve Fund and to other reserves, and the remainder of BGN 180,528 thousand is allocated as a planned contribution to the state budget.

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 and the State holds the remaining 4.4 per cent of the company's capital.

25. Monetary Liabilities and Gross International Reserves

(BGN'000)

	31 December 2011	31 December 2010
Gross international reserves		
Cash and deposits in foreign currencies	6,722,318	5,685,791
Monetary gold and other instruments in gold	3,053,483	2,669,424
Security investments	16,252,939	16,947,992
Equity investments and quota in the IMF	79,138	76,928
	26,107,878	25,380,135
Monetary liabilities		
Currency in circulation	8,728,750	8,302,428
Due to banks and other financial institutions	6,177,657	5,811,971
Liabilities to government institutions	4,359,186	5,399,763
Other liabilities	1,007,273	504,528
	20,272,866	20,018,690
Surplus of gross international reserves over monetary liabilities	5,835,012	5,361,445

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 31 December 2011, 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 organizations 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 31 December

2011, the par value of the government securities held in custody was BGN 4473 million (31 December 2010: BGN 3934 million).

27. Subsidiaries

(per cent)

Ownership interest	31 December 2011	31 December 2010
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 1747 thousand from the Bulgarian Mint EAD (31 December 2010: BGN 1229 thousand) and BGN 5380 thousand from the Printing Works of the BNB Corp (31 December 2010: BGN 3431 thousand).

28. Commitments and Contingencies

(i) *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 31 December 2011 is BGN 69,620 thousand (31 December 2010: BGN 68,043 thousand).

(ii) *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 1,289,622 thousand.

(iii) *Capital commitments*

As of 31 December 2011 the Bank has committed to BGN 43 thousand to purchase non-current assets (31 December 2010: BGN 496 thousand).

(iv) *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 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

17 February	As of 21 March 2011 the Bulgarian National Bank put into circulation a silver commemorative coin 'The Zograf Monastery' with a nominal value of BGN 10, issue 2011.
15 March	<p>The Report on BNB Budget Implementation as of 31 December 2010 was approved.</p> <p>The license of M Secured OOD for conducting operations as a payment institution to provide payment services under Article 4, item 6 of the Law on Payment Services and Payment Systems was revoked.</p> <p>Changes to the Tariff of Fees on Foreign Currency Transfers Charged by the BNB, effective as of 1 April 2011, were adopted.</p>
30 March	<p>Ordinance on Amendment of BNB Ordinance No 16 of 2009 on Payment Institutions and Payment System Operators Licensing was adopted.</p> <p>As of 2 May 2011 the Bulgarian National Bank put into circulation a silver commemorative three-component coin 'Gena Dimitrova' of 'The Great Bulgarian Voices' series with a nominal value of BGN 10, issue 2011.</p>
12 April	The BNB Annual Report for 2010 was approved.
28 April	The BNB refused to issue a payment institution license to NTS-pay AD for providing payment services under Article 4, item 7 of the Law on Payment Services and Payment Systems.
12 May	<p>The BNB transferred to the Ministry of Finance its shares in the Central Depository AD.</p> <p>As of 20 June 2011 the Bulgarian National Bank put in circulation a partially gold-plated silver commemorative coin 'Khan Krum' of the 'Medieval Bulgarian Rulers' series with a nominal value of BGN 10, issue 2011.</p>
9 June	<p>Ordinance on Amendment of BNB Ordinance No 9 of 2008 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk was adopted.</p> <p>Ordinance on Amendment of BNB Ordinance No 2 of 2006 on the Licenses, Approvals and Permissions Granted by the Bulgarian National Bank according to the Law on Credit Institutions was adopted.</p> <p>Ordinance on Amendment of BNB Ordinance No 3 of 16 July 2009 on on the Terms and Procedure for the Execution of Payment Transactions and Use of Payment Instruments was adopted.</p> <p>The BNB refused to issue a payment institution license to Euro-money Transfer OOD (under incorporation) for providing payment services under Article 4, item 6 of the Law on Payment Services and Payment Systems.</p> <p>The time interval in the RINGS Tariff was changed. As a result, the number of settlement cycles for BISERA increases from two to three as of 13 June 2011.</p>
7 July	<p>Ordinance on Amendment of BNB Ordinance No 13 of 16 July 2009 on the Application of International Bank Account Numbers and Bank Codes was adopted.</p> <p>Amendments to the Tariff of Fees of the Central Credit Register were approved.</p>

The BNB refused to grant a license for carrying out activities as a payment institution to QIWI Bulgaria OOD.

21 July

Ordinance on Amendment of Ordinance No. 16 on Payment Institutions, Electronic Money Institutions and Payment System Operators Licensing was adopted.

The BNB issued licenses for carrying out activities as electronic money institutions to InterCard Finance AD and TBI Credit EAD.

As of 12 September 2011 the BNB put into circulation a coloured silver commemorative coin 'Kosse Bosse' of the 'Bulgarian Folktales' series, with a nominal value of BGN 5, issue 2011.

2 August

Draft agreement for a sale of MF registered voting shares, which are the BNB share in equity of the Central Depository, was approved.

15 September

The Report on BNB Budget Implementation as of 30 June 2011 was approved.

10 November

The BNB Report for January – June 2011 was approved.

Ordinance on Amendment of BNB Ordinance No 8 on the Capital Adequacy of Credit Institutions was adopted.

Ordinance on Amendment of BNB Ordinance No 18 on the Control over Quality of Banknotes and Coins in Cash Circulation was adopted.

As of 19 December 2011 the Bulgarian National Bank will put into circulation a gold commemorative coin 'The Virgin Hodegetria' of the 'Bulgarian Iconography' series with a nominal value of BGN 20, issue 2011.

29 November

The BNB Budget for 2012 was approved.

20 December

The annual administrative expenses budget of the Deposit Insurance Fund for 2012 was approved.