Bulgarian National Bank

ANNUAL REPORT • 2006

BANQUE NATIONALE DE BULGARIE

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

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

Under the provisions of Article 1, paragraph 2 and Article 51 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's 2006 Annual Report.

Ivan Iskrov
Governor
of the Bulgarian National Bank

BNB Governing Council

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

Governing Council

Ivan Iskrov
Governor

Emiliya Milanova
Deputy Governor
Banking Supervision Department

Tsvetan Manchev
Deputy Governor
Issue Department

Dimitar Kostov
Deputy Governor
Banking Department

Nikolay Nenovsky

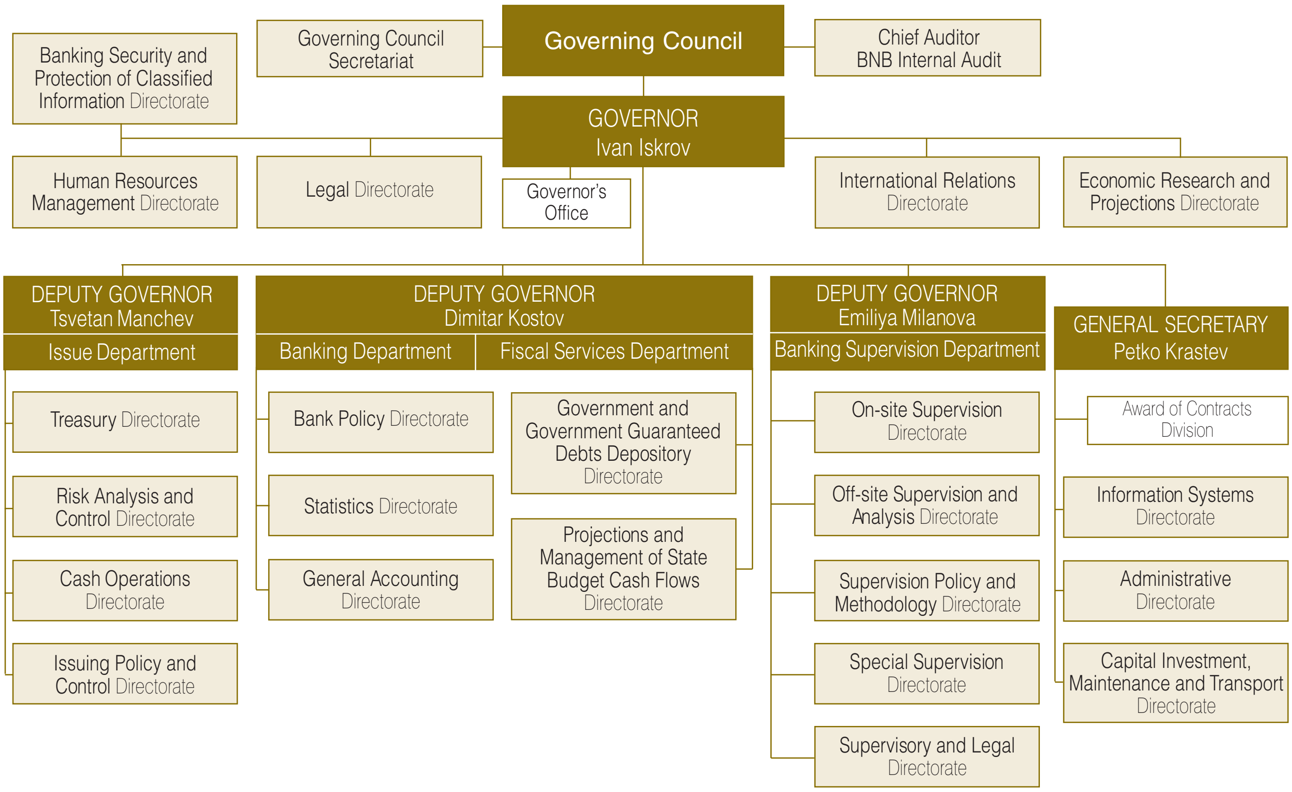
Statty Stattev

Oleg Nedyalkov*

* By Decree No. 469 of the President of the Republic of Bulgaria, Oleg Nedyalkov was appointed Member of the BNB Governing Council to replace Borislav Borisov as from 4 December 2006 (Darjaven Vestnik, issue 98 of 5 December 2006).

Organizational Structure of the BNB

(as of February 2007)



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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
CB	Commercial Banks
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
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IFO	Institute of Economic Research, Germany
IFI	International financial institutions
ILO	International Labour Organization
IMF	International Monetary Fund
MF	Ministry of Finance
NHIF	National Health Insurance Fund
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 major objective of the Bulgarian National Bank is to maintain price stability by ensuring national currency stability. The Bank maintains banking system stability and protects depositors by managing international reserves, organizing and overseeing payment systems, cash circulation and currency issuing, and regulating and supervising Bulgarian banks.

Preparing for Bulgaria's accession to the European Union entailed new tasks and duties for all BNB units. Alongside government, the BNB drafted position papers and statements on documents related to negotiated EU membership commitments. In 2006, the year preceding Bulgaria's EU accession, the Bank concentrated on completing the harmonization of Bulgarian banking and finance legislation with EU law.

The Law on Credit Institutions in force from 1 January 2007 ensures comprehensive compliance between Bulgarian law and European directives on credit institutions. The Bank's supervisory ordinances were amended and brought into line with the Law and with *acquis communautaire.* Another important milestone was the harmonization of BNB cash operations with EU standards under Ordinance No. 18 on the Control over Quality of Banknotes and Coins in Cash Circulation. Consistent improvement of regulations and control over banknote and coin authenticity and fitness contributed to the prompt identification and effective withdrawal of non-genuine banknotes.

The launch of international bank account numbers (IBAN) in June 2006 helped smooth the integration of the Bulgarian financial market into international financial markets.

Building capacity for new duties stemming from Bulgaria's EU and ESCB membership was a major BNB priority. The Bank spent resources on staff training and qualification improvement, enhancing internal organization and business effectiveness, and modernizing its infrastructure. Duties arising from Bulgaria's January 2007 EU accession were discharged without increasing staff, which numbered 928 against 932 in 2005.

Information technology accounted for 73.3 per cent of the BNB investment programme. Several projects were completed in 2006, improving information systems security, international reserve management, trading in book-entry government securities and the Register of Pledges, building a single data depository for the Banking Supervision Department, and monetary statistics. A communication link to the ESCB was completed and commissioned.

Dynamic economic development and sizable capital inflows into Bulgaria raised the requirements for the Bank to boost efficiency in dispensing its Law on the Bulgarian National Bank duties. Positive business expectations related to EU membership from 1 January 2007, intensive restructuring, and high returns on investment attracted considerable foreign investment and external loans to Bulgaria's economy. Foreign direct investment reached EUR 4104.5 million or 16.4 per cent of GDP in 2006, while real GDP growth came to 6.1 per cent and inflation dropped to 6.1 per cent by the year's end. The sizable inflows boosted gross international reserves by 21.07 per cent on the close of 2005 to EUR 8925.4 billion.

During the year, monetary aggregates picked up dynamically amid buoyant trading and rising international reserves under a currency board. Cash and non-cash payments grew fast and banks diversified the financial instruments they offer to expand market shares.

International reserve management followed the requirements and constraints of the Law on the Bulgarian National Bank and opportunities offered by world financial markets. Since euro assets had the largest share of reserves, ECB monetary policy affected reserve management most. In 2006 the ECB raised its refinancing rate in five steps to 3.50 per cent by the close of the year. Market analyses and expectations of ECB rate rises prompted the BNB to curb interest rate risk by cutting the maximum duration of euro assets to 0.5 years at the close of the first quarter. To improve efficiency and control, a standardized IT product connecting everyone in international reserve management went live in 2006.

Implementing, operating and overseeing efficient payment systems remained an important central bank duty. Payments through the Bank's RINGS system continued rising to 0.69 per cent by number and 72.9 per cent by value in 2006, cutting payment risks. The BNB took further technical and functional measures to improve the system.

The favourable international environment and positive Bulgarian economic expectations were the major reasons behind growing credit demand by corporations and households. To limit banking system risks, the Bank consistently enforced measures for more moderate corporate and household credit growth. Some of them include stricter supervision, while temporary administrative measures target credit growth directly. Since mid-2006, when a 24.2 per cent annual increase in bank loans to the non-government sector was reported, the BNB gradually eased the administrative measures which restricted growth in lending to the non-government sector.

By the end of 2006 banking system assets went up by 28.3 per cent, the major financing source of its activities being the 30.7 per cent increase in the deposit base. Banking sector's own funds grew at rates close to those of assets and system revenue remained high. The share of classified loans to non-financial corporations fell to a nine year low of 6.1 per cent.

The major international event of 2006 was the 13th Meeting of Governors of La Francophonie Central Banks on *Financial Stability and Economic Integration*, held between 11 and 13 May 2006 in Sofia at the invitation of the BNB Governor. ECB President Jean-Claude Trichet took part.

I. Economic Development in 2006

Accelerating global growth in 2006 brought price pressures on basic raw materials traded on international markets. Rising global inflation was mainly attributable to oil and significant rises of non-ferrous metal and food prices. The Federal Reserve System increased federal funds' interest rates in four steps to 5.25 per cent and by the end of 2006 key ECB rates on main refinancing operations went up to 3.50 per cent from 2.25 at the beginning of the year.

The Bulgarian economy sustained its growth, with real GDP up by 6.1 per cent in 2006. Inflation fell compared with 2005 to 6.1 per cent, mainly because of higher tobacco excise duty scheduled to reach the required EU minimum excise duty rates.

The positive outlook related to Bulgaria's EU accession on 1 January 2007, dynamic restructuring, and high return on investment attracted considerable foreign direct investment and lending, further boosting growth. In 2006 foreign direct investment increased by EUR 1 billion to EUR 4104.5 million, or 16.4 per cent of GDP according to preliminary data: enough to cover the balance of payments current and capital account deficits.

Financial inflows resulted in a 2006 balance of payments positive by EUR 1785.6 million, with a EUR 1505.8 million increase in BNB reserve assets excluding exchange rate adjustments.

Amid growing international reserves, currency outside banks grew by 15.5 per cent over the year and broad money increased by 26.9 per cent, with high returns on almost all deposits. Favourable macroeconomics and positive expectations for the Bulgarian economy underpinned a high credit demand by corporations and households; however, bank lending was checked by BNB measures which cut the growth of claims on the non-government sector to 24.6 per cent at the end of 2006 from 32.4 per cent a year earlier. The decrease was partly due to banks selling their credit portfolios to resident non-bank financial institutions and non-resident institutions.

Corporate and municipal bond turnover increased by 16 per cent on 2005 to BGN 323.3 million. Over the year stock exchange indices increased greatly: the *SOFIX* from 822.97 to 1224.75 and the *BG40* from 133.26 to 199.88. The total increase in equity prices and the admission of new companies into the stock exchange doubled market capitalization to BGN 15,265 million (31.2 per cent of GDP) by the end of the year.

1. The External Environment

The global economy enjoyed accelerated and comparatively balanced growth in 2006. The leading US and euro area economies saw stronger than expected growth. Major Asian economies (China, India and Japan) also posted high growth.

Major Macroeconomic Indicators (average annual change)

(%)

	Growth			Inflation			Unemployment		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
EU-25	2.4	1.7	2.9	2.1	2.2	2.2	9.1	8.8	7.9
Euro area (12)	2.0	1.4	2.6	2.1	2.2	2.2	8.8	8.6	7.8
Newly acceded countries (10)	5.0	4.5	5.8	4.0	2.5	2.4	14.2	13.4	12.3
USA	3.9	3.2	3.3	2.7	3.4	3.2	5.5	5.1	4.6
Japan	2.7	1.9	2.2	-0.3	0.0	0.2	4.7	4.4	4.1
China	10.1	9.9	10.7	4.0	1.8	1.5	4.2	4.2	

Note: Inflation in newly acceded countries is measured by weighing individual Harmonized Index of Consumer Prices (HICP) by the EU-25 weights in HICP.

Sources: Eurostat, Bureau of Labor Statistics, Bureau of Economic Analysis, The Japanese Statistics Bureau, The National Bureau of Statistics of China, BNB estimates.

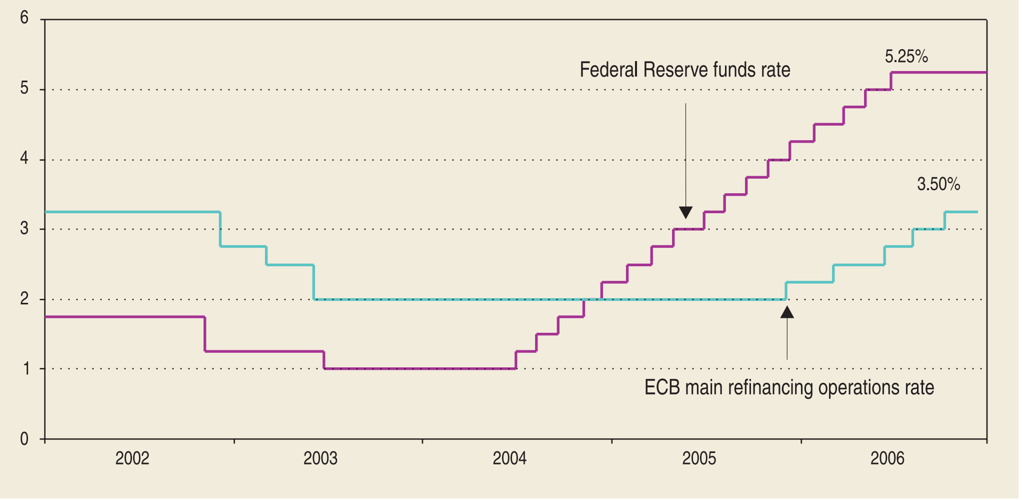
Global economic activity indicators marked a spurt in the first half of 2006, slowing down in the second half, especially in industry. Lower oil prices helped conserve optimism in the services sector. Significant improvements in the euro area and EU business climate showed in 2.6 and 2.9 per cent respective growth. Buoyant retailing and falling negative net exports supported American growth, largely offsetting the drop in house building investment. Supported by large investment and positive net exports, the Chinese economy sustained its high growth, reaching 10.7 per cent.

Crude oil prices were the main factor behind global inflation in 2006. High demand, limited production, and increased geopolitical uncertainty were the key factors driving the rise in energy prices over the first half of 2006. By the end of June a barrel of Brent crude cost USD 75, but by the end of the third quarter it fell under USD 60. Geopolitical change was the key factor here, the drop slowing inflation towards the end of 2006. In turn, food prices, up by 9.7 per cent, boosted inflation. Demand for ethanol production drove up sugar prices alone by 49.5 per cent. Grain prices went up by 17.6 per cent in anticipation of a very poor Australian harvest.

High Chinese demand, limited supplies, and speculation by big hedge funds increased non-ferrous metal prices. Zinc, copper, nickel, and aluminum rose respectively by 137.1, 82.7, 64.5 and 35.4 per cent. Steel fell back by 2.4 per cent due to global production exceeding demand.

Key Federal Reserve System and ECB Interest Rates

(%)



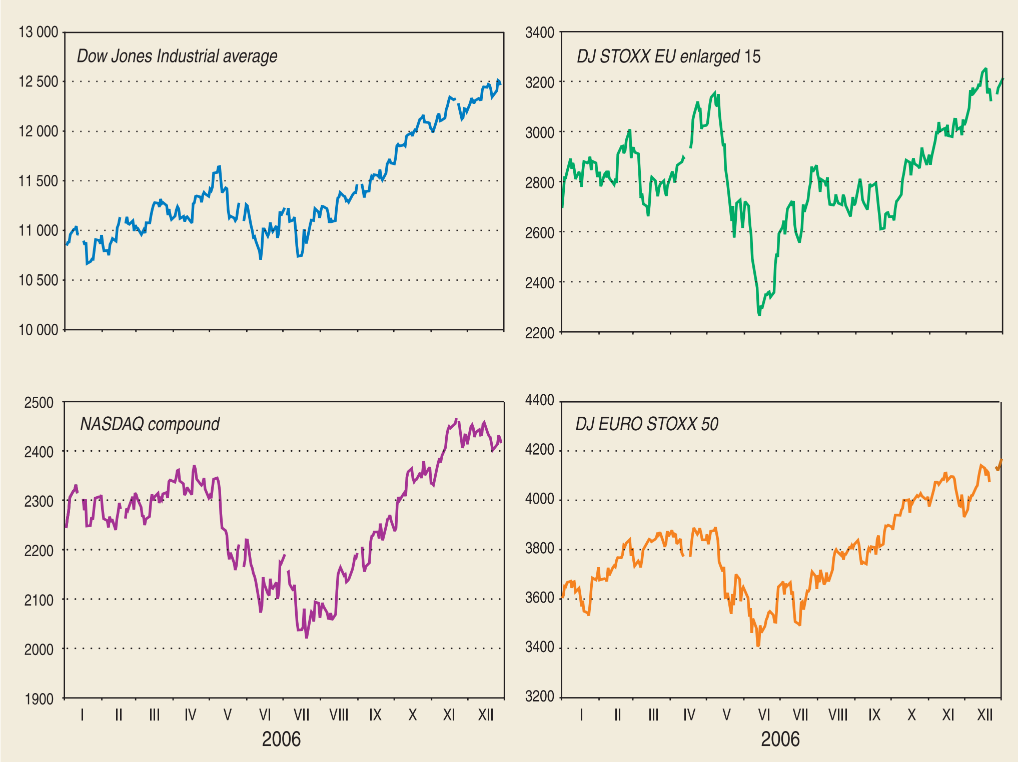
Source: US Federal Reserve System, ECB.

The Federal Reserve and the ECB gradually raised interest rates to curb inflation resulting from the rise in energy prices. The federal funds rate increased by 100 basis points in four 25-point steps, reaching 5.25 per cent. The ECB increased its main refinancing operations rate to 3.50 per cent in five 25-point steps.[1]

Leading stock market indices sustained their positive growth, being mostly on the upside throughout 2006. Record public companies' profits, high growth, and a more favourable economic environment, especially in the euro area, backed this. A slight decline came amid the second quarter when much of the increase posted by leading indices over the year was wiped out in a fortnight. This general adjustment reflected a shift to lower-risk assets and cashing in accumulated profits. It followed simultaneous Federal Reserve, European Central Bank, and Bank of Japan announcements of coming rate increases.

[1] Key ECB rate increases were on 8 March, 15 June, 9 August, 11 October, and 13 December 2006. The bid rate on main refinancing operations went up from 2.25 per cent in January to 3.50 per cent at the end of the year. On 12 March 2007 the ECB increased its minimum main refinancing operations bid rate by 25 basis points to 3.75 per cent.

Major Stock Indices



Sources: Dow Jones, STOXX, NASDAQ.

2. The Bulgarian Economy

Economic Activity and Inflation

Bulgaria continued enjoying high growth in 2006. Real GDP went up 6.1 per cent and *per* capita GDP grew by 15 per cent to EUR 3260 on EUR 2830 in 2005. Robust domestic demand retained its high growth from the previous year. Household consumption contributed 5.3 percentage points to GDP growth. Growth of investment in fixed assets remained buoyant, as did the upward trend in these assets' GDP share. Gross capital formation contributed 6.5 percentage points to GDP growth, of which 4.2 points from gross fixed capital formation and 2.3 points from inventories. Export growth accelerated but stronger imports pushed up the negative effect of foreign trade to GDP.

Growing incomes underpinned by employment growth drove accelerated household consumption in 2006. Labour market conditions improved, employees increasing by 4.3 per cent[2], and real pay increasing by 3.6 per cent[3], with 4.7 and 6.1 per cent equivalent annual growth in the third and fourth quarter.

Real GDP Growth by Final Use Constituents

(%)

	2005	2006
GDP	**6.2**	**6.1**
Household consumption	6.1	7.6
Government consumer expenditure	0.6	3.2
Collective consumption	4.1	1.7
Gross fixed capital formation	23.3	17.6
Exports of goods and services	8.5	9.0
Imports of goods and services	13.1	15.1

Source: NSI.

[2] NSI workforce survey.
[3] Deflated by the CPI.

Growth and buoyant trading attracted people to the labour market. The economic activity ratio of people aged 15 and over went up to 51.3 per cent in 2006, having been below 50 per cent for seven consecutive years. Expectations are of this upward trend continuing in coming years. Unemployment continued falling to an annual rate of 9 per cent, down 1 percentage point on 2005.

Investment into Bulgaria was strong. Profitable and cash-rich businesses used own funds for investment, while high rates of return attracted foreign direct investment and long-term debt. Foreign inflows and the rise in domestic borrowing further diversified the economy with new businesses, manufactures, technologies, and products.

In acquiring tangible fixed assets manufacturing had the greatest relative spend. It has been among the investment leaders over the last two years, in 2006 coming second only to trade. High investment in fixed capital broadened production capacity scope and improved economic efficiency. Technological upgrades further enhanced competitiveness. Regardless of the increase in pay, unit labour cost, a key competitiveness indicator, continued growing moderately in nominal terms and halting or falling in real terms. This trend was quite marked in manufacturing where even nominal unit labour cost continued falling. Improving cost competitiveness in trade contributed to the comparatively high export growth.

In 2006 imports increased but the proportion between them, investment, and production, remained unchanged. Raw materials, energy commodities, and investment goods contributed most to imports.

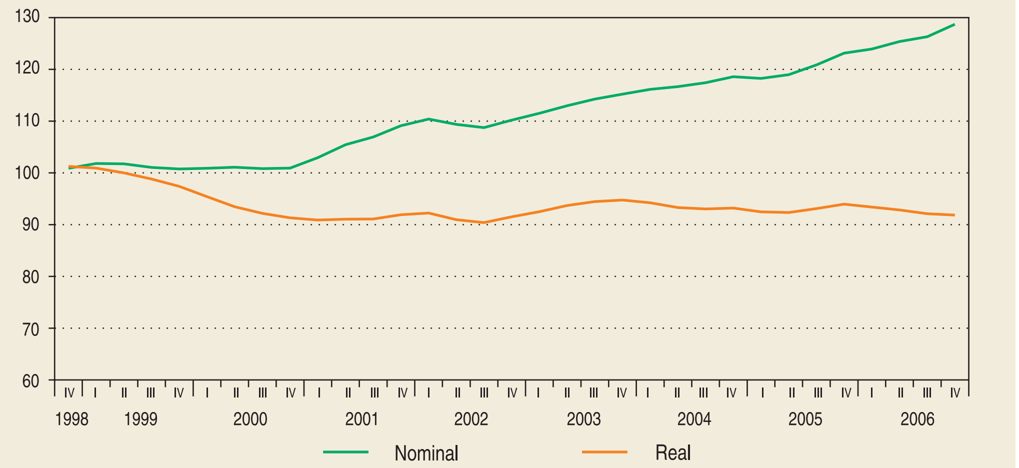
Gross Value Added Real Growth

(%)

	2005	2006
Agriculture and forestry	-8.5	-1.9
Industry	4.7	8.3
Services	8.3	6.1
Total (base prices)	**5.3**	**6.0**

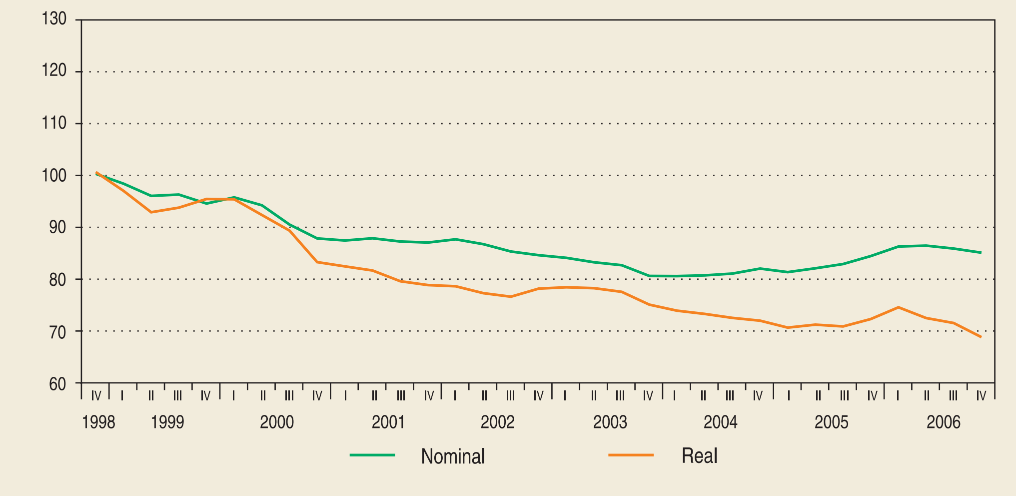
Source: NSI.

Unit Labour Cost (Total Economy)
(four-quarter moving average)
(1998 = 100)



Sources: NSI, BNB.

Unit Labour Cost (Manufacturing)
(four-quarter moving average)
(1998 = 100)



Sources: NSI, BNB.

HICP Inflation at Year-end and Contribution

	2005	2006
Inflation, %	7.39	6.08
Contribution, percentage points		
Foods	1.68	1.38
Non-foods	2.26	2.60
Transportation fuels	1.45	-0.18
Public catering	0.64	0.61
Services	2.82	1.49
Transport services	0.98	0.30
Accommodation services	0.32	0.21
Goods and services with administratively set prices*	1.97	2.91
Controlled-price goods		
Tobacco products	0.22	2.25
Controlled-price services		
Telephone services	0.33	0.01
Electricity and heating	0.38	0.10

* In 2005 and 2006 goods and services with administratively set prices comprised tobacco, medicines and other pharmaceutical products; water supply; refuse collection and disposal; sewerage collection and water purification services; electricity; heat energy; medical services; remuneration of physicians under contract with the NHIF; hospital services; fees in respect of personal transport equipment; passenger railway transport; interurban transportation; postal services; installation and subscription costs of telephone equipment; fixed phone calls and other telephone and telefax services; state college and university education fees; social services; transport insurance; legal services; administrative fees.

Sources: NSI, BNB.

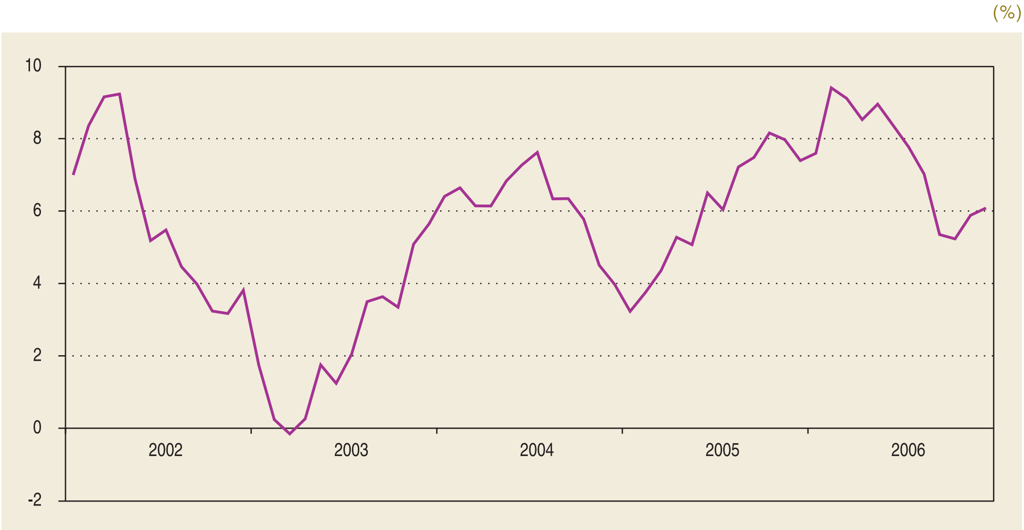
Gross value added growth was mostly in manufacturing (up 11 per cent), trade (up 11 per cent), construction (up 10 per cent), and transport (up 6.2 per cent). Export growth and increased domestic sales boosted the industrial sector, led by metallurgy, manufacture of non-metal mineral materials and metal products, food and drinks, and electrical machines and appliances.

The NSI business survey showed that the upward trend in capacity utilization, which reached 75 per cent at the end of 2006, was sustained.

By the end of 2006 inflation measured by the Harmonized Index of Consumer Prices (HICP) fell by 1.3 percentage points on 2005 to 6.1 per cent.[4] Compared with 2005 when fuel prices and transportation services were key drivers, in 2006 fuel's contribution was negative. The drop in fuel prices resulted from domestic competition despite import price increases and higher excise duty from the start of 2006.

[4] HICP is compiled by EUROSTAT on the basis of a standardized methodology. It is used as a measure for consumer goods and services inflation and is calculated using comparable criteria for the EU and euro area. Under a BNB Governing Council Resolution of 15 February 2007, the BNB uses HICP as a basic measure of Bulgarian inflation (*Economic Review, 1/2007*).

HICP Inflation
(on an annual basis)



Sources: NSI, BNB.

A programme to reach EU tobacco excise rates put duty up by 74.8 per cent, contributing most to inflation at 2.25 percentage points.

Food contributed less to inflation than in the previous year. It reflected the 31.9 per cent hike in sugar prices due to world price rises in late 2005 and early 2006 and registered bread price rises in late 2006. Clothing and household goods and appliances had a greater relative influence than in the prior year, with a new environmental tax on electrical appliances strengthening the effect. Mail prices came second after tobacco as an inflationary factor, increasing by 23.6 per cent on 1 January 2006. Other controlled price goods and services driving inflation included heating prices and urban transport fares, up by 6.7 and 5.5 per cent respectively. The uniform daily power charge since October decreased electric power prices by 0.16 per cent.

Core inflation declined to 4.2 per cent reflecting lower contributions by oil, food, and services in 2006.[5]

The Balance of Payments

Growth anticipations relating to Bulgarian EU membership from 1 January 2007, intensive restructuring, and high returns attracted significant foreign direct investment and loans. Foreign direct investment increased by EUR 1 billion to EUR 4104.5 million, or 16.4 per cent of GDP (preliminary data), covering the balance of payments current and capital account deficit of EUR 3798.4 million.[6] The net balance of payments financial account surplus was EUR 5395.6 million against EUR 1835.4 million in 2005.

The rise in the balance of payments trade deficit to EUR 5390.1 million was mainly due to imported investment goods and energy commodities. In 2006 goods imports increased by 25.3 per cent, the most sizable contributions being by crude oil and gas (6.2 percentage points), ores (2.8 percentage points), and machines and appliances (1.6 percentage points). World crude oil prices were estimated to have contributed EUR 251.1 million to the trade deficit.

Non-ferrous metals contributed most (by 8 percentage points) to the 26.6 per cent rise in exports, alongside petroleum products (6.5 percentage points) and cast iron, iron and steel (1.3 percentage points). Greater demand and competitiveness were the main drivers behind exports, alongside transient factors like capacity restructuring in metallurgy and crop failures.

Significant finance inflows resulted in a positive overall 2006 balance of payments to the tune of EUR 1785.6 million, with BNB reserve assets growing by EUR 1505.8 million

[5] Core inflation is calculated by excluding administratively set and approved prices.
[6] Net flow of capital transfers to the tune of EUR 179.5 million was recorded on the capital account.

without taking foreign exchange fluctuations into account. The balance of payments did not require any exceptional financing. Net repayments to the IMF totaled EUR 279.8 million.

Some inward finance in 2006 represented borrowings. By December gross external debt reached EUR 19,669.9 million, up by EUR 4580.3 million or 30.4 per cent more on the end of 2005. Public and publicly guaranteed external debt decreased by EUR 663.1 million after repayments to the IMF and the World Bank, to comprise 22.9 per cent of total debt. Non-guaranteed private debt went up by EUR 5243.4 million (52.8 per cent) to EUR 15,169.3 million including intercompany loans and foreign direct investment, occupying 38 per cent of private non-guaranteed external debt.

Public Finance

Consolidated fiscal programme cash flow by the end of 2006 was 3.6 per cent of GDP and the primary surplus reached 4.9 per cent of GDP. Total revenue and grants amounted to BGN 20,034 million (40.8 per cent of GDP) and expenditure, to BGN 18,286.3 million (37.3 per cent of GDP). Increased domestic demand and higher collectability underlay buoyant tax revenue growth by 12.7 per cent on an annual basis. Apart from good performance on the revenue aspect of the consolidated fiscal programme, the restriction on non-interest expenditure in the State Budget Law helped the cash surplus.

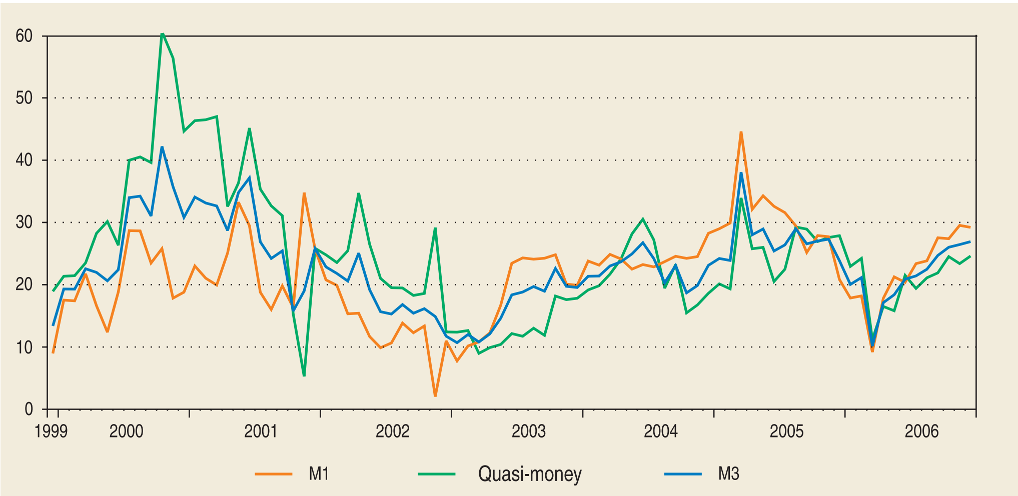
By the end of 2006 the fiscal reserve came to BGN 5845.7 million or 12 per cent of GDP. Despite early repayments of BGN 374.9 million and BGN 323.5 million to the World Bank and the IMF, the fiscal reserve increased sharply by BGN 1334.1 million on 2005, mostly because of the large cash surplus and BGN 737.9 million privatization revenues. The ratio of *government and government guaranteed debt to GDP* fell by 6.8 percentage points to 24.7 per cent of GDP, with that dynamics being driven by a decrease in external debt by 6.2 percentage points to 18.7 per cent of GDP. Domestic debt in total debt picked up from 21.2 per cent to 24.4 per cent.

The Financial Sector

In 2006 monetary aggregates sustained their relatively high growth rates reflecting growing demand for transaction cash, balance of payments capital inflows, and greater banking system deposits. By the end of the year broad money increased by 26.9 per cent. M1 grew by BGN 3635.5 million (29.2 per cent), including currency outside banks by BGN 835.2 million (15.5 per cent), and overnight deposits by BGN 2800.3 million (39.7 per cent). Quasi-money went up by BGN 3148.4 million (24.6 per cent), deposits with maturity of up to two years' by BGN 2654.5 million (25.3 per cent), and those redeemable at notice of up to three months by BGN 493.9 million (21.4 per cent).

Monetary Aggregates (Annual Growth)

(%)

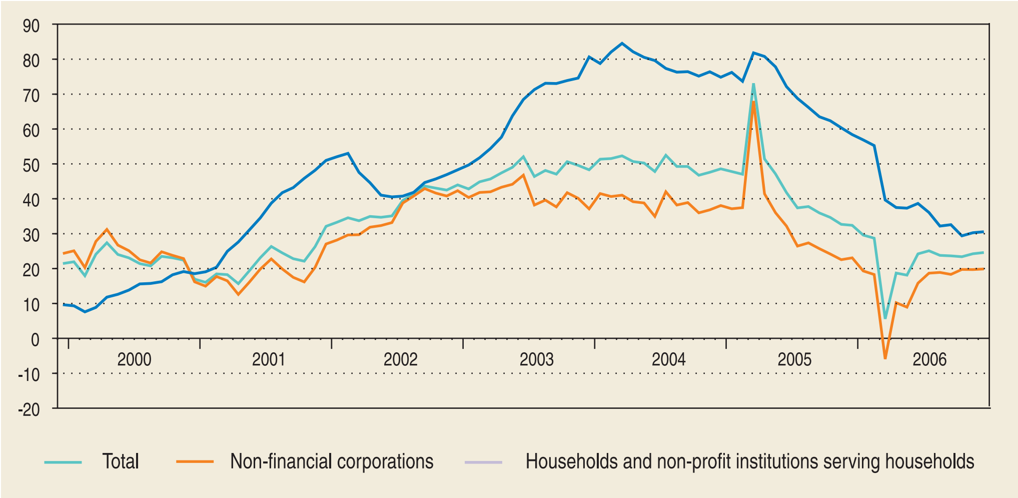


Source: BNB.

While favourable macroeconomic environment kept pushing credit demand by corporations and households, BNB measures to moderate credit growth had a strong effect. In 2006 non-government sector claims increased by BGN 4593.4 million but their annual growth fell to 24.6 per cent on 32.4 per cent by the end of 2005. Claims on non-financial corporations grew by BGN 2273.7 million (19.9 per cent) and those on households, by BGN 2116.7 million (30.6 per cent). The moderate growth of claims on the non-government sector was partly due to banks transferring lending to foreign banks and non-bank financial institutions; the total amount of loans disbursed over the year reached BGN 3279 million. From early June the BNB rolled back its additional required reserves by removing the progressive scale and at the end of October the central bank took a decision of lifting all administrative restrictions on lending from 1 January 2007.

Claims on Non-government Sector (Annual Change)

(%)

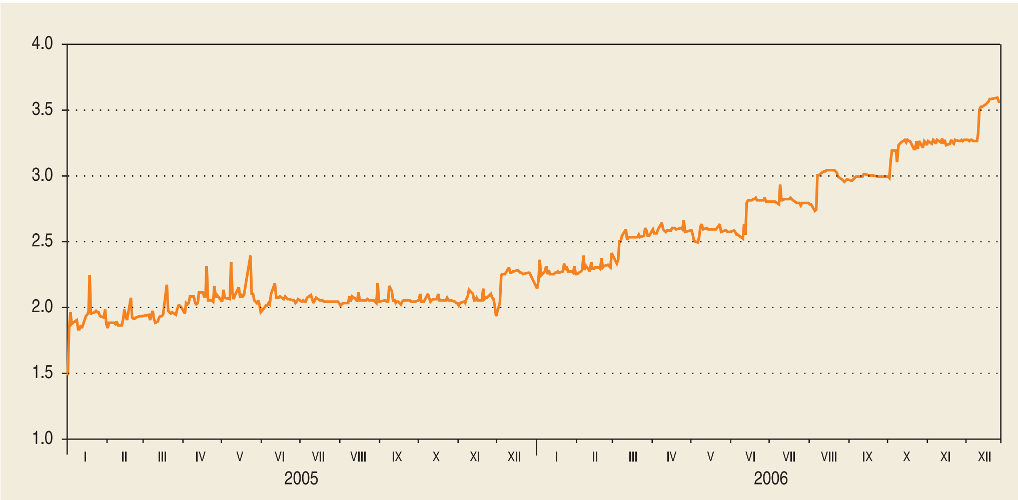


Source: BNB.

Interbank money market transactions in 2006 grew by 21.8 per cent on the previous year. Deposits occupied 96.2 per cent of turnover, with repo operations 1.4 per cent, and outright transactions in government securities 2.4 per cent. The interest rate on transactions was 2.79 per cent for the year, with monthly fluctuations between 2.27 per cent in January and 3.46 per cent in December reflecting ECB hikes in main refinancing operations' interest rates.

Average Interest Rate on Interbank Money Market

(%)



Source: BNB.

In 2006 foreign exchange market turnover increased by 57.1 per cent on the prior year to EUR 78,571.1 million[7]. Trading grew both with final customers (by 20.8 per cent) and between banks, including the BNB (82.2 per cent).

In 2006 BGN-denominated government securities issues included three-month discount treasury bills and three, five and ten-year fixed rate treasury bonds. Three-month discount government securities issues became less frequent (three against six in 2005) and the total nominal value of placements fell to BGN 65 million on BGN 95 million in 2005. The nominal value of three-year government securities placements fell to BGN 127.7 million (down 14.9 per cent) while five and ten-year bonds grew to BGN 155 million (55 per cent) and BGN 170 million (13.3 per cent).

Judging by current accounts at the BNB, outright transactions in domestic government securities between banks (including investment intermediaries approved as primary dealers) in the secondary government securities market totaled BGN 1587.1 million at market value: down by 0.1 per cent on 2005. BGN-denominated bond turnover picked up by 5.5 per cent to BGN 1507.8 million because of the increase in long-term bonds. EUR-denominated bond turnover fell by 59.1 per cent to BGN 65.1 million, while trade in USD-denominated bonds issued under ZUNK went up to BGN 14.2 million.

In March 2006 the Moody's international rating agency uprated Bulgarian foreign and local currency long-term government bonds and the ceiling on foreign currency bank deposits to Baa3, and that of local currency bank deposits to Baa1. In October Standard & Poor's Rating Services also uprated Bulgarian foreign currency long-term loans from BBB to BBB+, and confirmed the BBB+ rating on local currency loans.

EUR-denominated eurobonds maturing in 2007 closed the year at a price less than 101 per cent; EUR-denominated global bonds maturing in 2013 fell to 117 per cent and USD-denominated global bonds maturing in 2015 closed below 119 per cent. The price of USD-denominated bonds under ZUNK was around 100 per cent.

The turnover of corporate and municipal bonds traded on the stock exchange totaled BGN 323.3 million: up by 16 per cent compared with 2005. The volume of the primary market equity traded on the Bulgarian Stock Exchange, Sofia came to BGN 12.3 million from shares and BGN 10.1 million from rights on shares. The primary offering of shares on the OTC market was BGN 32.7 million. The turnover of shares on the secondary market picked up by 34.3 per cent on 2005 and came to BGN 2822.9 million on the stock exchange and BGN 8.2 million on the OTC market. Over the review year stock exchange indices posted sizable increases: the SOFIX from 822.97 to 1224.75, and the BG40 from 133.26 to 199.88.

The overall increase in share prices and the enlistment of new companies on the stock exchange doubled market capitalization, which by the end of 2006 reached BGN 15,265 million or 31.1 per cent of GDP.

[7] The turnover includes banks' (including BNB) transactions in foreign currency against levs with up to two business days value date.

II. Gross International Reserves

The BNB manages gross international reserves in line with the requirements and constraints of the Law on the Bulgarian National Bank and opportunities offered by world financial markets. The period under review saw no amendments to the Law on the BNB concerning gross international reserve management. BNB gross international reserves comprise the assets on the Issue Department's balance sheet. Their role is to provide complete cover for monetary liabilities under the fixed exchange rate.[8] The excess of gross international reserves over monetary liabilities forms the *Banking Department Deposit* item or the net value in the Issue Department's balance sheet.[9]

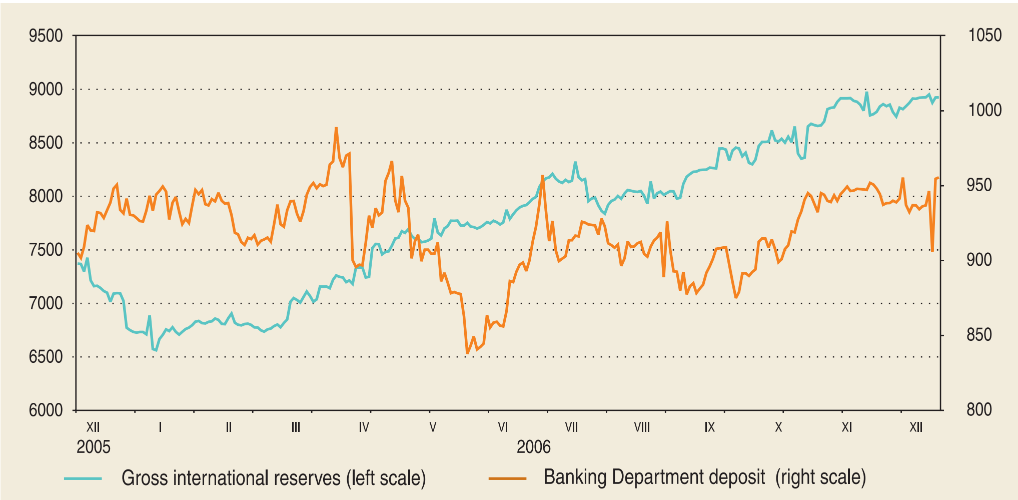
In 2006 priority went to the project on adopting a management system for international reserves. Its main goal was to select and introduce an off-the-shelf product used by many EU central banks. The new information system covers all units involved in international reserve management, thus boosting Bank efficiency while considerably cutting manual processing. The system measures in real time the correspondence of risk exposures given as benchmarks and automatically monitors set investment limits. It provides for future introductions of new financial instruments in accordance with the Law on the Bulgarian National Bank.

1. The Amount and Structure of Gross International Reserves

By 31 December 2006 the market value of gross international reserves came to EUR 8925.4 million, an increase of EUR 1554.2 million or 21.07 per cent on the end of 2005. The change resulted from three major factors: net monetary inflows of EUR 1360.3 million, earnings of EUR 140.5 million from investing international reserves, and EUR 53.4 million revenue from foreign currency revaluations.

Gross International Reserves and Banking Department Deposit

(million EUR)



Source: BNB.

[8] Article 28, paragraph 3 of the Law on the BNB comprehensively lists assets which may comprise gross international reserves: monetary gold; Special Drawing Rights; banknotes and coins in freely convertible foreign currency; funds in freely convertible foreign currency held by the BNB on accounts with foreign central banks or other financial institutions with one of the two highest ratings by two internationally recognized credit rating agencies; BNB debt instruments issued by foreign countries, central banks, other foreign financial institutions, or international financial organizations assigned one of the two highest ratings by two internationally recognized credit rating agencies; the balance on accounts receivable and payable on BNB forward or repo agreements with (or guaranteed by) foreign central banks, public international financial organizations or other foreign financial institutions with one of the two highest ratings from two internationally recognized credit agencies; and BNB futures and options which bind non-residents and which are payable in freely convertible foreign currency. The Law stipulates that these assets are estimated at market value.

[9] According to Article 28, paragraph 1 of the Law on the BNB, "the aggregate amount of monetary liabilities of the Bulgarian National Bank shall not exceed the lev equivalent of gross international reserves," with the lev equivalent determined by the fixed exchange rate.

The table below shows the more significant 2006 sources which comprised the EUR 1360.3 million net inflows. At the start of the year advance repayments of government debt to the World Bank totaled EUR 147 million and USD 57 million, and to the IMF, EUR 151 million.

Largest Cash Flows in 2006

A)	**Euro purchases and sales:**	**EUR 1720 million**
	Net purchases from commercial banks, incl.:	EUR 1746 million
	Euro purchases from commercial banks	EUR 12,962 million
	Euro sales to commercial banks	EUR 11,216 million
	Net sales at tills*	EUR 26 million
Б)	**Flows on commercial bank and government accounts**	**EUR -360 million**
	(only larger external flows)	
	To increasing international reserves	
	Revenue from servicing government and other BNB customer accounts	EUR 601 million
		USD 69 million
		SDR 16 million
	Net revenue from minimum required reserve accounts of commercial banks	EUR 524 million
	To decreasing international reserves	
	Foreign currency payments on government and other BNB customer liabilities	EUR 1270 million
		USD 314 million
		JPY 2.7 billion
		SDR 17 million

* Including net sales of euro banknotes to commercial banks at tills in the amount of EUR 4.45 million.
Source: BNB.

During 2006 the currency structure of international reserves changed, with euro and gold-denominated assets growing at the expense of US dollars and Swiss francs. The increase in euro-denominated assets reflected mainly BNB net purchases of reserve currency from commercial banks to the amount of EUR 1746 million. In line with regulations on commercial banks' minimum required reserves (including additional reserves), another EUR 524 million was deposited with the BNB. The increase in the market value of gold assets reflected entirely gold price rises on international markets. Decreases in USD-denominated assets were due to external debt repayments by the Ministry of Finance.

Currency Structure of International Reserves

(%)

Currency	Issue Department balance sheet assets	
	2005	2006
Euro	88.40	90.94
US dollar	3.53	0.54
Gold	6.56	7.96
SDR	0.60	0.53
Swiss franc	0.92	0.02

Note: Average data for the period.
Source: BNB.

Monetary liabilities denominated in levs and euro exceeded 99.5 per cent on average of the BNB's total liabilities.

Changes in the structure of assets by financial instrument reflected BNB responses to international financial market trends, prompted mainly by interest rate moves by leading world banks and greater world economy fluctuations. Internal factors did not change the structure by financial instrument. Constraints on maximum duration of assets in euro and higher limits on maximum exposure in prime rate banks (see table) boosted the share of cash and deposits with foreign banks at the expense of securities. Changes in the share of gold reflected gold price rises on international markets. On average, over the review period almost two-thirds of international reserves were invested in securities.

Structure of Gross International Reserves by Financial Instrument

(%)

Instruments	2005	2006
Vault cash*	11.66	16.07
Deposits**	10.25	14.60
Securities**	75.47	66.14
Gold in the vault	2.62	3.19

* Financial instruments with a maturity of up to three days, including all overnight deposits.
** Including instruments in foreign currency and gold.

Note: Average data for the period.

Source: BNB.

Investment policy reorientation in terms of financial instruments changed the structure of assets by residual term to maturity. Constraints adopted early in the second quarter of 2006 increased the share of assets with the shortest residual term to maturity of up to a year to more than 80 per cent. This led to a considerable decrease in the proportions of assets in all other maturity sectors.

Structure of Gross International Reserves by Residual Term to Maturity

(%)

Maturity sectors	2005	2006
Up to 1 year	59.14	80.80
From 1 to 3 years	15.83	10.01
From 3 to 5 years	12.84	3.77
From 5 to 10 years	11.66	5.18
From 10 to 30 years	-	0.24

Note: Average data for the period.

Source: BNB.

2. Gross International Reserves Risk and Income

The Market Environment

With EUR-denominated assets comprised the largest share in gross international reserves, the most important international markets were those for EUR-denominated government bonds. In 2006 the ECB raised its main refinancing operations interest rates on five occasions: by 25 basis points in each of the first three quarters and twice by 25 basis points in the fourth quarter to 3.50 per cent.[10] The ECB policy of raising its main interest rates pushed deposit facility rates to 2.50 per cent and marginal lending facility rates to 4.50 per cent. In 2006 ECB monetary policy featured a high degree of transparency and market participants largely anticipated increases. There were no dramatic changes in the amplitude of financial instrument trading immediately before or after ECB resolutions, since markets had already based prices on expected ECB actions. Markets experienced uncertainty only between the 6 December 2005 increase and the first increase in 2006, on 8 March, impacting revenue from BNB international reserves.

ECB policy transparency allowed most market participants to foresee changes in euro area base rates and minimize market risk. The BNB shortened the duration of its euro portfolio to cut capital losses.

In 2006 European benchmark government bond yield rose in all sectors of the yield curve, most buoyantly in those with maturities of three months to five years. In the two-year maturity sector, yield picked up from 2.73 to 3.85 per cent or 101.4 basis points, and from 3.33 to 3.95 per cent or 62.8 basis points in the ten-year one. The yield curve flattened through the year and the spread between securities with two-year and ten-year maturities fell from 45.3 basis points at the year's start to 4.5 points at its end. The spread of one and five-year maturities also narrowed dramatically from 38.8 in early 2006 to 4.3 basis points. The yield on two-year bonds rose over the year, following closely ECB increases in euro area repo interest rates by 14.3 basis points in the first quarter, 29.7 basis points in the second quarter, 26.7 basis points in the third quarter, and 30.7 basis points in the fourth

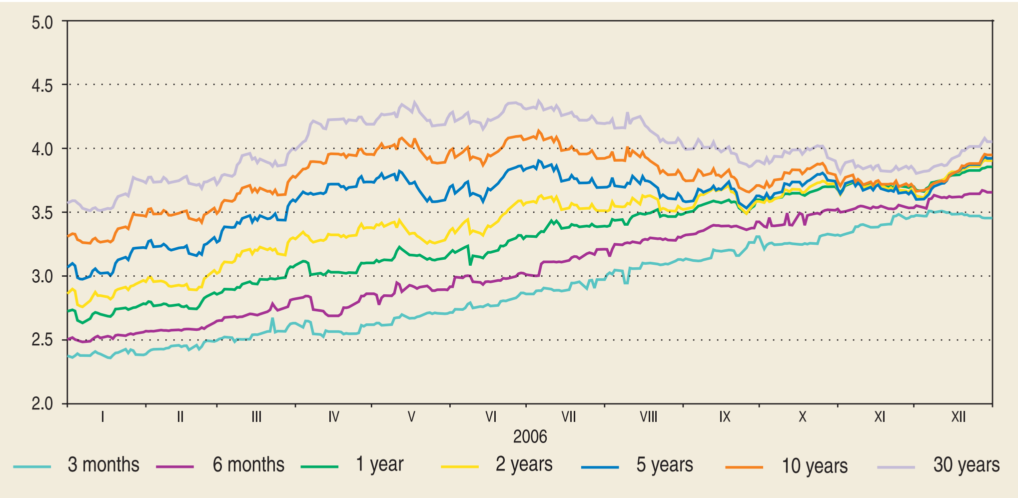
[10] See footnote 1 in Section I, *Economic Development in 2006.*

quarter. The yield on ten-year bonds went up by 16.3 basis points in the first quarter, 45.0 basis points in the second quarter and 24.5 basis points in the fourth quarter, dropping in the third quarter by 23 basis points along with falling euro area inflationary expectations. By the year's end yield in all maturity sectors followed an upward trend due to stable expectations of a further 25 basis point rise in repo rates in the first quarter of 2007.

At the beginning of 2006 the previous year's upward trend in the price of gold continued and on 11 May futures hit a record high of EUR 562.05 *per* troy ounce. On this date the increase was 68 per cent, reflecting enhanced investment demand due to high geopolitical risk, fluctuating oil prices and US dollar falls against the euro. Iran's nuclear programme and the probability of sanctions on this, one of the largest oil producers, retained high correlations between the crude oil and gold prices, with the change in US inflationary expectations underlying demand for gold as a hedge. During the summer market participants maintained the balance with the price of the precious metal following closely energy commodity prices; however, in the fourth quarter the correlation decreased owing mainly to the growing effect of recovering physical demand for gold. Federal Reserve System policy, and most of all the retained reference interest rate in the second half of the year, determined speculative interest in gold as a savings instrument. Unlike the previous year, in 2006 the US dollar values of the euro and gold moved in parallel, with the technical link between them becoming stronger.

Yield Curve Dynamics of Government Securities in EUR

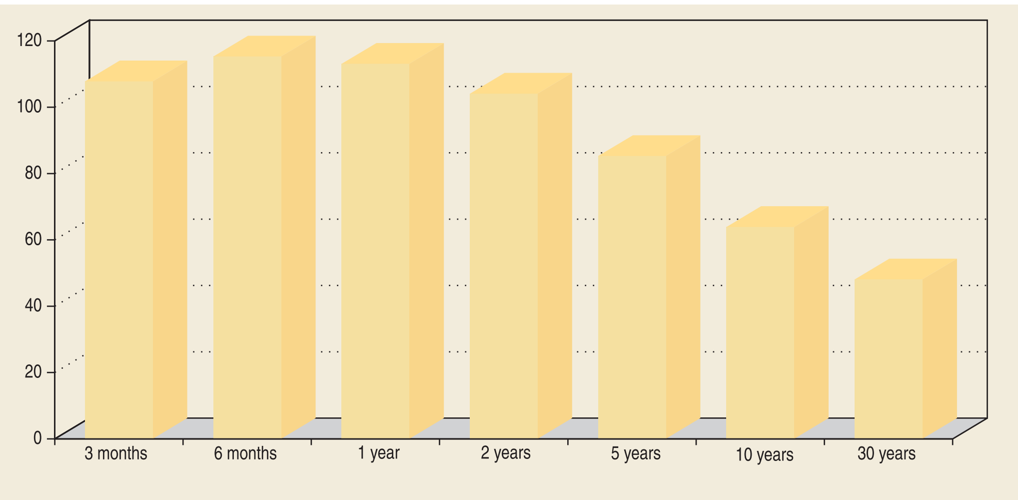
(%)



Source: BNB.

EUR Government Securities Yield Curve Change

(b.p.)



Source: BNB.

One Troy Ounce Gold Price in US Dollars

Source: BNB.

US Dollar Price in Euro

Source: BNB.

One Troy Ounce Gold Price in Euro

Source: BNB.

The gold price subsided to the range of EUR 450 to EUR 500 *per* troy ounce following the May high and subsequent sales in June. By the end of 2006 gold futures were EUR 483.37 *per* troy ounce or a 10 per cent annual increase; their average price in 2006 was EUR 482.37 *per* troy ounce, up by 34 per cent on the previous year.

Within 2006 the US currency rate fell gradually. The major factor behind this was changed market expectations of US and euro area interest rates, prompted by macroeconomic data. Foreign currency trading fluctuated most in May and December, bringing strong depreciations for the US currency against the euro. Revised market expectations of interest rate differentials supported the US dollar exchange value at the year's close.

Major Risk Types

In early 2006 the Governing Council confirmed that risk tolerance of international reserves during the year would be set on the basis of greatest permissible risk to net asset value, set at VaR[11]=-2.5% at 95 per cent confidence level. The BNB did not exceed the set risk tolerance over the review period.

Over the reporting period international reserve interest rate risk measured by the average *modified duration* of reserves for the review period was 0.78: far below the 2005 level (1.69), mainly due to the restriction on interest rate risk imposed early in the second quarter of 2006.

Currency risk was constrained by the Law on the BNB stipulation that the sum of the absolute values of open foreign currency positions[12] 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. Minimal open currency positions were maintained in such currencies and immediate buying or selling against euro followed any excess of the 2 per cent limit. The open foreign currency position of BNB monetary gold posed the major risk to the bank.

Credit risk was managed through minimum credit ratings for BNB counterparties and issuers of debt into which the Bank may invest. Maximum and minimum exposures to eligible asset classes were also set. An average of 60.2 per cent of funds was invested in highest credit rating assets (AAA). Over the period exposure to banks increased to 30.3 per cent of total assets against 23.5 per cent in 2005, mostly because of the increased 40 per cent limit on maximum exposure to foreign banks.

Operational risk was managed in strict compliance with international reserve management procedures.

Profitability and Efficiency

At the end of the first quarter the BNB constrained interest rate risk and set a maximum duration of 0.5 years for euro assets. This reflected market environment analyses and rising market expectations of rises in key ECB rates and euro area yield curve levels and low risk tolerance. As exposure to long and medium-term government securities was cut, limits for maximum exposure in deposits with prime rated banks were raised from 30 to 40 per cent of the market value of assets. This offered an opportunity for the bulk of international reserves to be placed as short-term deposits with minimum interest rate risk. The limits remained in force until the end of 2006.

An analysis shows that after the decision of the beginning of the second quarter to shorten the duration of euro assets and given the materialized projections for higher euro area yield, the BNB portfolio yield was practically unchanged. However international reserve risk was halved.

BNB income from international reserve investment came to EUR 140.53 million: 1.68 per cent yield. Currency imbalance yielded EUR 60.72 million[13] mainly due to the open position in gold and the rising gold price in euro. Interest on Issue Department balance sheet liabilities was EUR 48.42 million. Net 2006 earnings from BNB international reserves came to EUR 152.83 million or 2.02 per cent profitability.

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

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

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

International Reserves Earnings

(million EUR)

Quarters	Earnings, net (1)+(2)+(3)	Investment earnings (1)	Earnings from currency imbalance between assets and liabilities (2)	Expenditure (interest) on liabilities (3)
I	41.78	-13.40	61.70	-6.52
II	12.01	34.93	-13.52	-9.39
III	45.97	56.45	3.49	-13.95
IV	53.06	62.56	9.05	-18.56
2006, total	152.83	140.53	60.72	-48.42
2006, total, %	**2.02**	**1.68**	**0.94**	**-0.61**

Source: BNB.

The change in the *Banking Department Deposit in the Issue Department balance sheet* net value resulted from two major factors: a net international reserve contribution of EUR 152.83 million (19.08 per cent yield for the period), and a financial 2005 contribution to the state budget of some EUR 77.21 million.

International reserves are split operationally into portfolios by currency, each with an investment goal and benchmark. Portfolios and results from their management are presented in the table below.

In 2006 most euro assets continued to be split into two portfolios managed by different teams to diversify management styles and reduce operational risk. Euro and US dollar liquid portfolios were formed to assist immediate payment needs.

In the review period the BNB continued having part of its international reserves (7.18 per cent by the end of the reporting period) managed by international financial institutions. Alongside diversification, external managers exchange international market expertise.

Risk and Profitability of Portfolios

Portfolio	Portfolio base currency	Profitability		Risk		Information coefficient***
		Absolute (%)	Relative (basis points)*	Absolute (%)	Relative (basis points)**	
Investment 1	EUR	1.77	3	0.53	5	0.49
Investment 2	EUR	1.77	1	0.55	4	0.18
Liquidity	EUR	3.03	12	0.12	5	2.36
Liquidity	USD	4.94	-14	0.18	3	-4.37
Gold	XAU	0.08	8	0.30	30	0.33
External manager A	EUR	1.70	-3	0.80	27	-0.11
External manager B	EUR	1.38	-2	1.10	17	-0.09

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

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

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

Source: BNB.

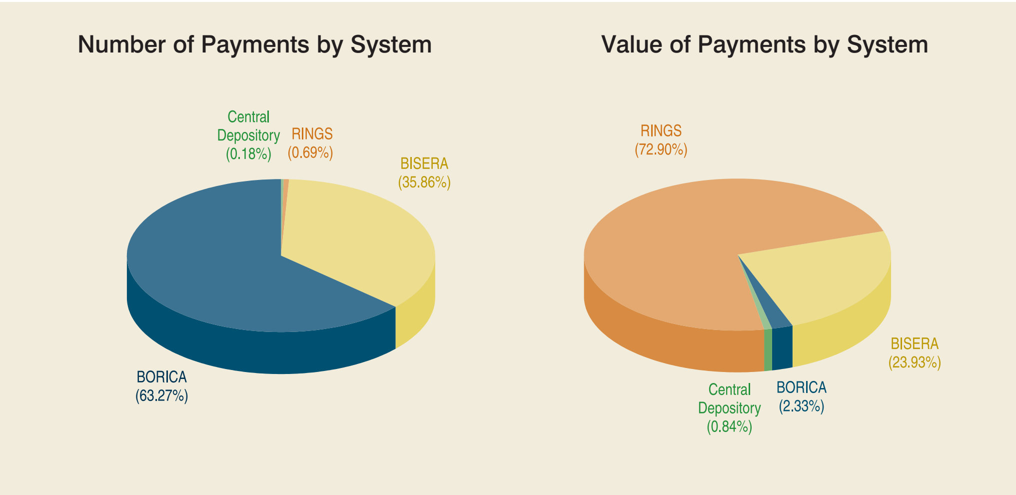
III. The National Payment System

The Law on the Bulgarian National Bank makes the Bank responsible for payment system support, development and oversight. The BNB monitors individual systems for settlement of payments and securities and judges their effectiveness to prevent or limit negative consequences to the national payment process.

Pursuant to the 2005 Law on Funds Transfers, Electronic Payment Instruments and Payment Systems on 26 January 2006 the BNB granted licenses to Bankservice AD and BORICA AD to trade as payment system operators within Bulgaria. Bankservice operates a system for servicing customer payments initiated for execution at a designated time (BISERA), while BORICA services payments by cards issued by domestic Bulgarian banks.

Under existing legislation, beside Bankservice (BISERA) and BORICA, participants in the national payment system are the BNB and all commercial banks, the Central Depository AD's System for Servicing Payments on Transactions in Book-entry Government Securities, the BNB's System for Servicing Payments on Government Securities Transactions, and the BNB's RINGS (the Real-time Interbank Gross Settlement System). In 2006 the number of RINGS participant banks fell to 32 after the acquisition of the Piraeus Bank AD Sofia Branch by Piraeus Eurobank AD.

Distribution of Payments in Bulgaria



Source: BNB.

During the review period RINGS processed 0.69 per cent of total payments, comprising 72.9 per cent by value. The trend towards increasing the value and number of RINGS payments continued, helping cut risk. Payments through the other two system operators also grew on 2005: BORICA by 19.37 per cent with value up by 16.87 per cent, and BISERA by 13.69 per cent with value up by 19.25 per cent. These data indicate that the upward trend in the number and value of payments matched buoyant economic activity in Bulgaria.

1. RINGS (The Real-time Interbank Gross Settlement System)

The growing volume and value of RINGS cashless transactions required prompt BNB action to improve the system's technical and functional infrastructure. A new version of RINGS software with the improved functionality required by the BNB, banks, and system operators, went live in January 2006 after testing. Launching IBAN in Bulgaria also entailed changing RINGS to allow greater payment automation, SPT processing, and reducing payment failures due to minor errors.

Processing a larger proportion of the value of payments in real time helps cut national payment system risk by decreasing interbank exposure. In 2006 RINGS payments numbered 983,273, totaling BGN 230,002 million. Compared with 2005, daily average payments increased by 26.12 per cent, and their daily average value by 40.95 per cent. Data reveal acceleration in the growth of processed payments' value and a slowdown in the growth of their number mainly due to the increasing average value *per* payment. These trends point to increasing trading and financial turnover.

In 2006, 44.95 per cent of RINGS payments were effected by noon and 73.92 per cent by 2:30 pm. Compared with 2005, there was a slight growth in the number of payments processed in the later hours of the system day. This reflected rising interbank transfers owing to buoyant interbank operations and the increased volume of EUR/BGN transactions with the BNB, concentrated in the later hours of the RINGS day. As regards system traffic, 92.42 per cent of RINGS payments were effected by 2:30 pm.

The RINGS system operated by the BNB functioned effectively and no payments failed by the close of a system day due to insufficient funds on any participant's account. No radical measures were taken to provide participants with liquidity. Banks' resilient liquidity management and high payment system liquidity precluded recourse to the Reserve Collateral Pool established as an interbank insurance mechanism to guarantee settlement of system operators' orders.

In the period under review RINGS offered 99.85 per cent availability.[14] This was slightly higher than in 2005 and in line with TARGET (the euro area large payments processing system). Any operational problems were handled under contingency rules and procedures.

2. Launching the International Bank Account Number (IBAN)

Applying broadly accepted standards to the payment process is a major condition for establishing a single financial services market in the EU. Launching IBAN in Bulgaria and using SWIFT to process small payments were step changes in synchronizing national banking with the euro area. The national payment system operated smoothly due to the efforts of the entire banking and financial community and payments were not disrupted despite the significant changes in payment infrastructure.

The IBAN project began in early 2005 and ended successfully on 5 June 2006 when the banking system implemented IBANs. The following day the European Payments Council listed Bulgaria in the register of IBAN countries. IBAN implementation was prompted by pending Bulgarian accession to the European Union and the ensuing need to adapt the national payment infrastructure to the European one, as well as by genuine benefits for banks and end users.

Launching IBAN entailed changing some 10 million bank accounts and affected international and domestic payments. It allowed greater payment automation and cut payment delays and failures considerably. Confidence in transactions and their safety increased reflecting better validation and identification mechanisms ensuring easier, faster, and safer payments for customers.

[14] The time during which the system was serviceable as part of total time.

The project proceeded alongside other payment process changes to modernize the payment system. The SWIFT medium for transmitting BISERA messages was introduced, cutting spending on different interfaces to individual systems. Payments in the budget sphere were facilitated and banks' service to end users improved through boosting transfer efficiency, quality, and speed, and by cutting risk.

The project involved adapting participants' rules to the new legal framework, changing their internal systems, restructuring information on budget payments, retraining staff, coordinating changes among participants, and running a sizable media awareness campaign. Banks, system operators, the Association of Commercial Banks, the Customs Agency, the Social Assistance Agency, the National Revenue Agency, and the National Insurance Institute all took part. The BNB was responsible for initiation, general planning, coordination, and legal aspects.

Guidelines to BNB *Ordinance No. 3 on drafting payment documents, operational rules, and access and data exchange through BISERA* came into force on 5 June 2006. The BNB and MF instruction on bank services to budget-supported entities was updated. It was addressed to the MF, the BNB, commercial banks, the SEBRA operator, budget-supported entities, and organizations servicing budget-supported entities' payments through SEBRA (servicing organizations). Rules and procedures for operating the Real-time Gross Settlement System and drafting and exchanging payment messages were also adapted to changes in payment systems, payments, and payment instruments legislation.

On 15 October 2006 an instruction supplemented BNB *Ordinance No. 16 on compiling information submitted by bank card and electronic money issuers and accepting banks*. Rules and procedures for operating the Real-time Gross Settlement System and drafting and exchanging payment messages were also adapted to changes in the legal framework on payment systems, payments and payment instruments.

In October 2006 the BNB worked with the Banca d'Italia on integrating national payment infrastructures with European ones under the twinning covenant between the BNB and the Italian, French, and Dutch central banks. Future participation in TARGET2, meeting SEPA criteria, and assistance in introducing and adapting European payment instruments feature in the covenant.

3. Payment Systems Oversight

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

The review saw inspections under the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems as follows:

- The System for Servicing Customer Payments Initiated for Execution at a Designated Time (BISERA) operated by Bankservice AD. In line with the provisions of § 3, paragraph 2 of the Transitional and Final Provisions of the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems, Bankservice AD was required to accumulate the minimum capital required for a system operator under that Law within three years of its adoption;
- The System for Servicing Bank Card Payments managed by BORICA AD. In line with the provisions of § 3, paragraph 2 of the Transitional and Final Provisions of the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems, BORICA AD was required to accumulate the minimum capital required for a system operator under that Law within three years of its adoption;
- The System for Servicing Payments on Transactions in Book-Entry Government Securities operated by the Central Depository AD. The results from the inspection of the Central Depository AD showed that as a whole its system complied with the *Core Principles for Systemically Important Payments Systems of the Committee on*

Payment and Settlement Systems and the Committee on Payment Systems and the International Organization of Securities Commissions (IOSCO)'s *Recommendations to Securities Settlement Systems.* To improve system efficiency, reliability, safety, and stability, specific recommendations on further developing the legal framework and the system were issued to the Central Depository AD.

- The Piraeus Bank Bulgaria AD in connection with the credit pool available to cards issued by Transkart AD. The BNB recommended bringing the process into line with the new provisions of the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems.
- The Transkart AD, in connection with credit card issue. The BNB made recommendations on future credit card issue procedures to bring the process into compliance with the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems. In line with this, all credit cards financed by Piraeus Bank Bulgaria AD were withdrawn from 1 October 2006.
- The United Bulgarian Bank as owner-operator of a card authorization centre. The BNB recommended updating the bank's internal documents to reflect the new provisions of the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems and its statutory instruments.

IV. Commercial Bank Reserves with the BNB

The 2005 policy of curbing credit growth by using additional minimum required reserves continued in 2006. Additional reserves over the maintenance period between 4 May and 3 August 2006 were determined by the BNB's November 2005 decision on introducing a progressive scale of minimum required reserves. As it became clear that the measure had played its role and the results were satisfactory, in June the BNB Governing Council adopted a decision to restore the initial requirements whereby minimum required reserves were double the excess over the set lending limit.

In 2006 banks' borrowed funds grew considerably. The monthly average amount of lev deposits went up by 32.74 per cent on the prior year, while the lev equivalent of those in foreign currency grew by 28.07 per cent.

In 2006 the monthly average amount of additional minimum required reserves came to BGN 588,927 thousand against BGN 294,787 thousand between August and December 2005 when additional reserve rules came into force. The doubling mainly reflected the progressive scale applied between 4 May and 3 August 2006 when they reached BGN 997,511 thousand.

Average lev-denominated reserve assets rose by 8.09 per cent, their absolute amount exceeding settlement needs twice over. EUR-denominated reserve assets grew even more (by 113.65 per cent), their share of total maintained reserves in individual months fluctuating between 48.32 per cent and 65.97 per cent. Foreign currency sales to the BNB and overnight interbank market transactions were the major source of banks' short-term liquidity; the volume of interbank market transactions rose by 24.41 per cent on 2005.

In individual months, excess reserves stayed at between 0.5 per cent and 1.2 per cent of total reserve assets, while in absolute terms their average monthly amount reached BGN 35.5 million: up by 33.87 per cent on the previous year. Ministry of Finance principal and interest payments on ZUNK in January also contributed to the early-year boost to excess reserves, further enhancing banking liquidity.

In 2006 four banks failed to fulfil their obligations to maintain minimum reserves and two banks used more than 50 per cent of reserve assets on a single day. Penalties of BGN 12,200 were imposed on banks violating the statutory provisions under BNB Ordinance No. 21.

In the year under review 13 banks deposited additional minimum required reserves. One had to maintain additional minimum required reserves through the year, seven – in four of the five maintenance periods, and the remaining five – in a single period.

V. Cash in Circulation

The Bulgarian National Bank has a monopoly on banknote and coin issue in Bulgaria.[15] Banknotes and coins issued by the Bank are legal tender and are mandatorily acceptable as payment at full face value without restriction. The BNB prints banknotes and mints coins, and safeguards uncirculated and withdrawn banknotes and coins.

In compliance with the 2005 amendments to Article 27 of the Law on the Bulgarian National Bank, in late March 2006 the BNB adopted *Ordinance No. 18 on the Control over Quality of Banknotes and Coins in Cash Circulation*. The Ordinance regulates reproducing Bulgarian banknotes and coins, exchanging mutilated or damaged banknotes and coins, retaining, checking and evaluating suspect banknotes and coins, and using sorting machines and customer-operated banknote and coin machines. The Ordinance largely reflects similar ECB regulations.

To implement the Ordinance, the BNB set identification and fitness standards for Bulgarian banknotes and coins. These standards set out public information on the characteristics and counterfeit protection features of genuine Bulgarian banknotes and circulating coins, as well as requirements for retaining unfit Bulgarian banknotes and circulating coins. The standard for identifying Bulgarian banknotes and circulating coins is applied to all Bulgarian banknotes and circulating coins accepted by banks, finance houses, exchange bureaux, and service suppliers. The fitness standard is applied only by banks and service suppliers processing Bulgarian banknotes and circulating coins. Relevant legal framework training was provided to staff engaged in cash operations with the assistance of the International Bank Institute; by the close of 2006, 1890 people had been trained.

On 1 May 2006 the BNB *General Terms for Supplying Banknotes and Coins at an Announced Value* and a *Tariff of Fees for Banknote and Coin Supply* entered into force following the Government Council approval.

In line with the *Strategy for Bulgarian National Bank Development between 2004 and 2009* and the *Cash Circulation Strategy* which focuses on the issue, the BNB continued its dialogue with market participants on launching new, safer, and more effective ways of monitoring the authenticity and fitness of circulating banknotes and coins.

In accordance with the Strategy, the BNB continued its consistent integration into European structures as regards protection against currency counterfeiting, as well as close cooperation with the ECB, providing technical information and data on non-genuine euro banknotes registered at the National Analysis Centre. In 2006 the BNB signed an agreement with the OLAF (the European Anti-fraud Office of the EU) for exchanging information on non-genuine euro coins registered in Bulgaria.

Banknotes and Coins in Circulation (Outside BNB Vaults)

By the end of 2006 cash in circulation[16] came to BGN 6888.5 million nominal value, up by BGN 1021.3 million or 17.41 per cent on the end of 2005.

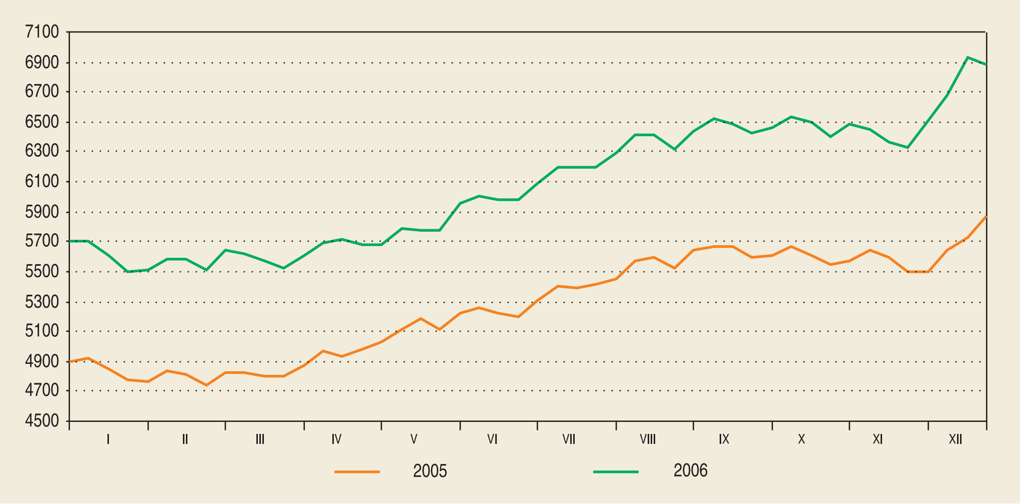
By the close of 2006, 292 million banknotes worth BGN 6781.5 million were in circulation. Their number rose by 38.1 million or 15.03 per cent and their value by BGN 1007.5 million or 17.45 per cent on 2005. By 31 December 2006 the value of banknotes came to 98.45 per cent of the total value of banknotes and coins outside BNB vaults. The average banknote in circulation by 31 December 2006 was worth BGN 23.22, up BGN 0.48 or 2.11 per cent. The upward trend in the average value of banknotes in circulation in recent years reflects the use of higher denomination banknotes in payments.

[15] Article 2, paragraph 5 of the Law on the Bulgarian National Bank.

[16] Banknotes and circulating and commemorative coins issued after 5 July 1999. Under BNB Governing Council Resolution No. 110 of 6 October 2005, banknotes and coins in circulation whose exchange term had not expired and which had not been returned to BNB vaults were deducted from cash in circulation. To allow genuine comparisons, the lev value of these banknotes has also been deducted from the amounts of cash in circulation for previous periods.

Banknotes and Coins in Circulation

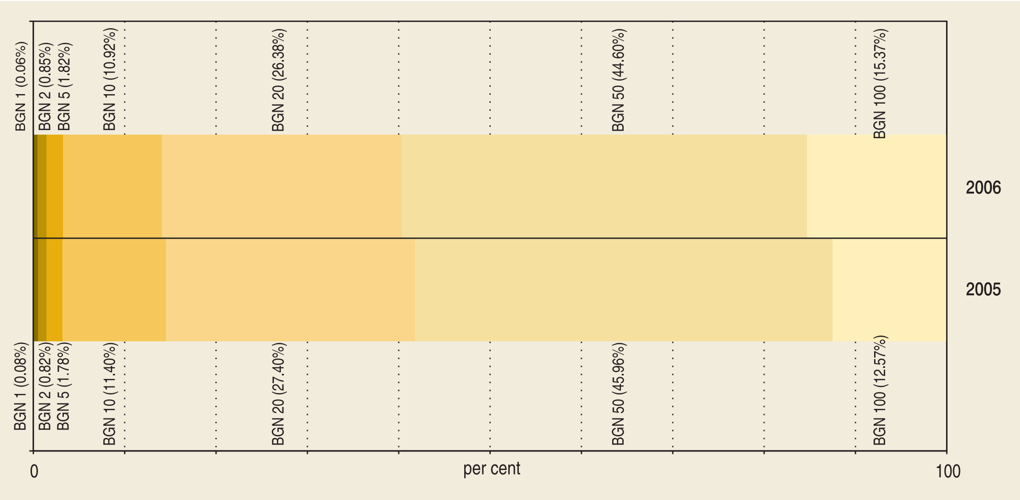
(million BGN)



Source: BNB.

Denomination Composition of Circulating Banknotes

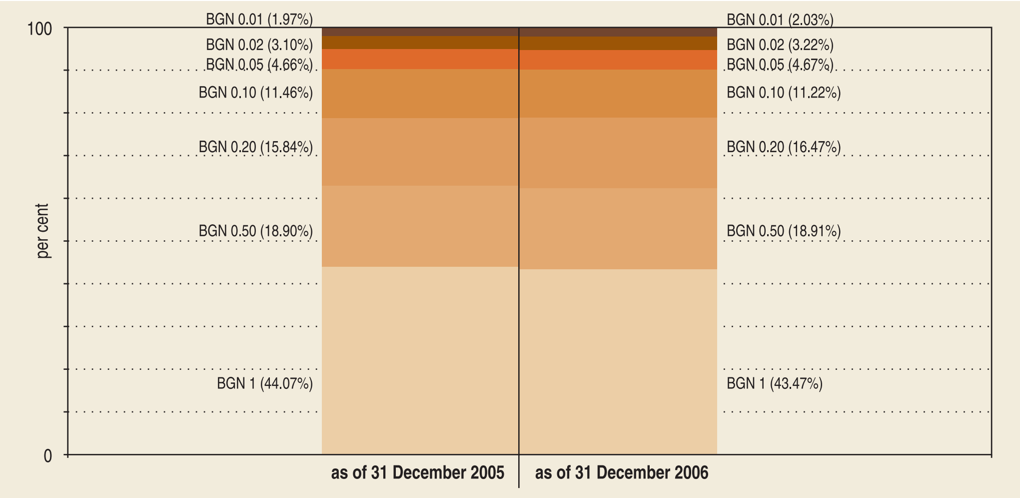
(as of 31 December of the corresponding year) (share of total value, %)



Source: BNB.

Structure of Circulating Coins by Nominal Value

(share of total value, %)



Source: BNB.

By the end of 2006 coins in circulation numbered 760.7 million, worth BGN 103.7 million. Compared with end-2005, their number grew by 109.7 million (16.84 per cent) and their value by BGN 13.4 million (14.81 per cent). The value of circulating coins accounted for 1.50 per cent of the total value of banknotes and coins outside BNB vaults by 31 December 2006. The average coin in circulation over the review period matched its end-2004 level at BGN 0.14. Commemorative coins comprised 0.05 per cent of the total value of cash in circulation.

Non-genuine Banknotes and Circulating Coins

Over the review period the BNB National Analysis Centre performed authentication checks and evaluation of 15,771 suspect Bulgarian and foreign banknotes and 2548 coins referred by financial institutions, the Ministry of the Interior, and the legal system.

In 2006 non-genuine Bulgarian banknotes registered with the BNB numbered 4576. Non-genuine banknotes seized prior to entering circulation numbered 214, with 4362 having entered circulation. Compared with 2005, the number of non-genuine banknotes grew by 2479 or 118.22 per cent. Non-genuine banknotes of BGN 10 nominal value had the largest share (54.13 per cent) of registered and retained non-genuine banknotes, followed by BGN 20 banknotes (34.11 per cent) and BGN 50 banknotes (8.28 per cent). Reported BGN 2, BGN 5 and BGN 100 non-genuine banknotes totaled 159 accounting for 3.48 per cent. Non-genuine BGN 10 banknotes grew most at 1788 or 259.51 per cent.

National Analysis Centre expert evaluations in 2006 registered 2489 non-genuine circulating coins, of which 2415 were of BGN 0.50 nominal value and 74 of BGN 1.

Whenever a new type of non-genuine banknote or coin is reported within Bulgaria, the BNB's National Analysis Centre circulates information on their features and methods of identifying them to banks, finance houses, exchange bureaux, and BNB cash centres.

Evaluating foreign banknotes and coins retained within Bulgaria, in 2006 the Bank's National Analysis Centre retained 5586 euro banknotes, 1301 US dollar banknotes, and 102 assorted foreign banknotes as non-genuine.

BNB Cash Operations

Cash operations conducted by the BNB included supplying and retrieving banknotes and coins in valuable packages to and from commercial banks, keeping uncirculated fit and unfit banknotes and coins, sorting, counting, and destroying banknotes, counting coins, monitoring the authenticity and physical properties of banknotes and coins accepted by the BNB, servicing customers in levs and reserve currency at tills, servicing first level budget spending entities in levs and reserve currency at the Sofia Regional Cash Centre, and selling commemorative coins at tills.

In 2006, 144.4 million newly printed banknotes and 119.2 million newly minted coins worth BGN 3993.6 million were supplied under contracts with producers. Implementing its minting programme, the BNB circulated four commemorative coin issues.[17]

In 2006 the BNB processed 400 million banknotes and 111 million coins worth BGN 5769 million: a 67.3 million (20.25 per cent) increase in banknotes and an 18.5 million (19.90 per cent) increase in coins on 2005. BGN 10 and BGN 20 banknotes and BGN 1, BGN 0.20 and BGN 0.10 coins had the largest shares in the structure of banknotes and coins processed by the BNB. Over the review period 99.6 million banknotes were retained in processing as unfit[18]: up 23.1 million or 30.14 per cent on 2005.

Banknotes and coins launched into and withdrawn from circulation by commercial banks totaled BGN 12,174.6 million in 2006. Commercial banks deposited with the BNB 393.2 million Bulgarian banknotes and 27.9 million coins worth BGN 5612 million, up by BGN 1151.1 million or 25.80 per cent on 2005. Over the review period commercial banks withdrew from the BNB 426.7 million Bulgarian banknotes and 151.1 million circulating coins totaling BGN 6562.7 million: an increase of BGN 1354.1 million or 26 per cent.

[17] News of new issues of banknotes and circulating and commemorative coins is published on the BNB website.

[18] Under BNB Ordinance No. 18, an unfit banknote shall mean a banknote which has undergone physical and chemical changes during its use in currency circulation and as a result it has been contaminated, soiled, with deleted relief, crumpled, with a changed size and faded colours.

BNB reserve currency purchases through its regional cash centres totaled EUR 2.1 million, including EUR 1.6 million from individuals and EUR 0.5 million from budget organizations. Reserve currency sales amounted to EUR 28.9 million, including EUR 17.5 million to individuals, EUR 7 million to budget organizations, and EUR 4.4 million to commercial banks. BNB reserve currency purchases declined by EUR 0.8 million (27.02 per cent) on 2005, while reserve currency sales grew by EUR 13.9 million (92.41 per cent).

The growing number of circulating banknotes and coins and consistent improvements in regulations and the quality of authenticity and fitness monitoring contributed to faster identification and effective withdrawal of non-genuine banknotes. The shares of non-genuine Bulgarian banknotes and coins in the total number of circulating banknotes and coins were 0.00156 per cent and 0.0003 per cent respectively. Compared with other EU countries, data show that the quality of cash in circulation is properly guaranteed by the BNB. At the same time, measures to improve Bulgarian banknotes' counterfeit protection included launching in July a banknote with a nominal value of BGN 50, issue 2006, with improved protection features. Counterfeit protection of the BGN 20 banknote was also boosted, with the new issue expected in circulation in 2007.

VI. Maintaining Banking System Stability

1. State of the Banking System

By the end of 2006 banking assets increased by BGN 9315 million or 28.3 per cent to BGN 42,201 million. The ten largest banks continued aggressive marketing and increased their balance sheet figure by BGN 7064 million or 29.2 per cent. Borrowed funds from financial and non-financial institutions remained banks' major source of finance. Banks' deposit base rose by BGN 7807 million or 30.7 per cent, of which BGN 5773 million went to Group I banks. Over the review period banks used 368 million of additional short and long-term finance, an increase of 14.3 per cent. Though the second half of 2006 saw the phased removal of effective administrative constraints on lending growth to the private sector, the BNB succeeded in curbing lending growth to the 24 per cent target in Ordinance No. 21. For the first time since the start of credit expansion, 12-month loans growth was less than assets and own funds growth. Gross bank lending rose by BGN 4392 million or 23.9 per cent: an absolute and relative slowdown on the previous year's BGN 4575 million and 33.2 per cent.[19]

Lending constraints prompted a 47.6 per cent (BGN 2786 million) rise in claims on financial institutions and cash (41.2 per cent or BGN 1333 million). By the end of 2006 net claims on financial institutions were 20.5 per cent of banks' balance sheet assets: 3 percentage points up on 2005. The increased interest rate on ECB main refinancing operations redirected free funds to foreign banks, mostly in the EU. At the close of 2005, 65 per cent of deposits were abroad; a year on this was three quarters.

With Bulgarian government bond fair value falling, investment in trading portfolio assets rose by a mere 10.3 per cent or BGN 209 million. Reduced investment into Bulgarian government securities boosted domestic corporate bonds and securities listed in Appendices 1 and 2 of the former Ordinance No. 8 on the Capital Adequacy of Banks. Investments held to maturity went down by BGN 356 million mostly at the expense of Bulgarian and foreign government bonds; those available for sale grew by BGN 795 million. The banking system investment portfolio rose by BGN 439 million or 16.3 per cent, while its share in assets fell to 7.4 per cent.

Despite the slight decline of credit in banking assets (from 53.9 per cent to 52.3 per cent) lending remained the largest balance sheet item. All banks bar two reported credit portfolio growth. At the same time, selling debt to cut credit portfolio growth continued. Over 2006 BGN 3.2 billion of credit was transferred to home and foreign banks. Thus, Ordinance No. 21 constraints reduced annual net lending growth to non-financial institutions and other customers to BGN 4345 million or 24.5 per cent.[20] Supervisory reports show the big ten increasing their share of this aggregate by BGN 3844 million (29.1 per cent), with Group II banks increasing it by BGN 1025 million (29.6 per cent). The ambition of most banks to capture greater shares of retail banking was behind the continued expansion of credit to individuals and the decline of the trade segment. Over the year the share of commercial loans went down by 2.6 percentage points to 60.5 per cent. Housing mortgage loans increased by 4.4 percentage points to 15.5 per cent of the credit portfolio. Despite vigorous impetus in the mortgage market, their annual growth fell to 73.4 per cent against 101.3 per cent in 2005. Commercial loans grew most in absolute terms, by BGN 2176 million or 18.8 per cent. New housing mortgage loans (BGN 1490 million) outstripped consumer loans (BGN 500 million) three-fold.

The foreign exchange structure of the net credit portfolio changed in favour of the lev component. Loans in national currency went up by BGN 2782 million and those in euro

[19] Discrepancies between lending growth figures here and in Section I are due to methodological differences in defining the scope of credit portfolios for supervisory and statistical purposes.

[20] The December change in exposure classification and provisioning requirements released provisions and boosted net credit.

by BGN 1938 million, while those in other currencies continued falling, this time by BGN 329 million.

By the end of 2006 lev loans represented 54.7 per cent of lending, against 52.2 per cent a year earlier. The share of euro loans was unchanged at 43.3 per cent and the shares of other currencies halved to 2 per cent. With lev loans dominant, currency risk caused fewer concerns. Just 6.4 per cent of consumer loans were in other currencies including the euro. The foreign currency share of housing mortgage loans was a third but remained relatively stable on 2005.

The banking system deposit base continued growing stably to BGN 33,235 million, of which BGN 24,419 million was in the large banks' group. Non-financial institutions' demand and time deposits contributed most to growth, rising by BGN 3042 million (37.4 per cent) and BGN 3563 million (35.9 per cent) respectively. Savings deposits rose by BGN 517 million or 21.4 per cent. Lev deposits grew faster than foreign currency ones in 2004 and 2005, yet now foreign currency deposits rose by BGN 3876 million (mostly in euro at BGN 3820 million), while national currency deposits rose by BGN 3246 million. Financial institutions' deposits increased by BGN 685 million (13.8 per cent) to BGN 5652, mostly including borrowed funds from other financial institutions (BGN 546 million). Lev deposits rose slightly to 48.4 per cent of the total and euro deposits rose from 34 to 39 per cent at the expense of other currencies (from 16.5 to 12.5 per cent).

Short-term borrowing over 2006 reflected the erratic nature of this resource. Only nine mostly medium and small banks borrowed over short terms. By the end of 2006 short-term funds rose by BGN 247 million (105 per cent) to BGN 483 million. The need for lengthier financing led to more extensive long-term borrowing which increased by BGN 121 million (5.2 per cent) to BGN 2468 million. Short and long-term loans to banks came mostly from abroad. Their weight in overall financing declined slightly to 6.8 per cent by the end of the year from 8.4 per cent in 2005.

Financing funds (deposits, short and long-term funds) grew stably by BGN 8176 million (29.2 per cent) to BGN 36,186 million. Over twelve months the system's own funds grew at 26.6 per cent or BGN 922 million, a rate matching assets. Greatest contributors to this were banks' reserves at BGN 379 million (26.4 per cent) and share issues in support of capital at BGN 290 million (23.9 per cent). By 31 December 2006 the banking sector reported BGN 786 million net profit, a BGN 213 million (37.2 per cent) increase on 2005.

Both external and internal factors affected banks' risk profiles in 2006. Internal factors stemmed from the business models followed, which for most institutions involved retail banking and extending project financing, particularly for small and medium enterprises. This involved changing prices of major credit products and seeking opportunities to broaden funding sources by offering higher interest and new deposit, savings, and investment products. External factors were associated with measures to limit credit risk. They curbed banks' aggressiveness, prompting them to seek alternative ways of retaining credit market positions. The new capital regulation, which in most cases required additional capital to cover major operations risk, also changed banks' behaviour. The institutions intensively assessed available capital resources, many taking steps to provide extra support by early 2007 when the regulation came into force. Banks' behaviour also reflected rising international market interest rates. The factors above affected banking system risk profile but did not change it significantly.

Structurally, banks' balance sheets did not change significantly. Credit remained a leading aggregate with risk sharpness, distribution by instrument, and provisioning unaffected by market factors. The change in classification structure was due to the lifting of tighter supervisory requirements for classification (a BNB response to the state of the banking system and the economic environment at the end of 2006), and to banks' improved credit risk management (particularly as regards consumer loans). The change acknowledged six months of efforts by leading banks to improve their capacity to identify, manage, and limit the risk of defaults in servicing retail banking obligations, as well as overall good loan quality.

Despite the upward corporate segment trend, securities and debt instruments remained attractive low-risk placements providing acceptable yield. Their foreign currency component and structure by issuer did not exert additional pressure on banks' capital. Banks benefited from rising interest rates at the European partners to whom most deposits went, generating low risk income. Funds preserved their reliability and structure. Their growth (mostly in the non-financial institutions' deposits segment) guaranteed low dependence on the interbank market, and the small share of target financing may rather be seen as an indicator of the system's capacity to meet customer finance needs. Profit at the end of the period exceeded that of corresponding past periods but its distribution shows that not all banks can rely on it to support 2007 operations.

The drop in credit risk sharpness[21] was the most significant system risk profile change in 2006. For the first time since the start of the credit boom classified assets showed a 12-month decline by BGN 33 million or 2.3 per cent. This drop from 4.2 per cent to 3.2 per cent reflected primarily the consumer segment, with a drop in housing mortgage loans too. The classified portion of consumer loans went down by BGN 42 million, that of housing mortgage loans by BGN 13 million, and that of commercial loans by BGN 6 million. Classified loans as a share of all loans to non-financial institutions hit a nine-year low at 6.1 per cent or BGN 1386 million against 7.7 per cent or BGN 1420 million at the end of 2005. In evaluating real risk, the 2006 transfer of over BGN 3.2 billion of debt outside banking system should be taken into account. This concerns standard loans, some securitized, which continue to be serviced through the banks where the initial risk was taken.

Banking system profitability remained good and was helped by the lifting of lending constraints from early 2007. Results for 2006 were boosted by significant reintegrated provisions due to regulatory changes. This also affected major profitability indicators: return on assets (ROA) and core ROA. Their pronounced downward trend of the last three years switched and by the end of 2006 they were higher than in the corresponding period of 2005. ROA was 2.2 per cent against 2 per cent in 2005, core ROA rose to 2.8 per cent against 2.6 per cent in 2005, and ROE reached 23.7 per cent against 21.6 per cent in 2005.

Net interest income held the largest share of net system income, reflecting the dominance of interest-bearing items and loans in the asset structure and high interest rate margin. Financial intermediation fees and commissions income still hold a lower share than the European average. This shows that the home market had potential to yield higher non-interest income from banking services. Putative changes in the quality of interest assets, economic downturns, interest rate falls prompted by competitive factors (the difference between Bulgarian and EU rates) could turn the domination of interest in income structure into a source of potentially higher vulnerability of income. Accumulated significant losses from trading portfolio securities, lower incomes from investments for sale, and substantially lower extra incomes had a subsidiary effect on profitability over the year.

Own funds kept the dynamics of assets and operational risk at a good major solvency indicator level. Capital indicators fell within acceptable limits. Market expansion was adequately supported by new investor equity and supplementary capital in the form of subordinated term debt and debt/equity (hybrid) instruments. Profit generated in 2006 was a potential source of system equity growth. A single bank reported a loss at the year's close but its solvency indicators remain above regulatory minima.

Banks continued to manage risk components and credit risk. Over the year lending growth slowed by 4 percentage points compared with own funds. Banks' capital base grew by BGN 823 million (27.6 per cent) to BGN 3808 million, while total risk component grew by BGN 6775 million (34.8 per cent). Capital adequacy declined to 14.5 per cent on 15.3 per cent a year earlier, and tier 1 capital adequacy fell to 11.8 per cent on 12.5 per cent in 2005. Capital adequacy with regard to non-identified system risks remained sufficient.

Banking system liquidity remained capable of coping with peak pressures in 2006. Bank asset structures and qualities ensured cash inflows met liquidity needs. New charges at some banks, particularly for deposits and combined savings and investment

[21] Regulatory changes to Ordinance No. 9 described in the *Banking Regulation* subsection contributed to this.

instruments, did not affect depositor behaviour. The higher liquidity was mostly because of additional reserves required from banks exceeding Regulation No. 21 lending growth limits. Tighter reserve requirements meant more liquid positions in asset structures. Where liquidity interventions were required, some banks borrowed from foreign parent banks or the interbank market. There were no confidence drops in individual banks which additionally supported good liquidity. Banks with lower indicators had no difficulties in servicing transactions.

In 2006 banks adhered to a market risk-averse behaviour model. At 3.8 per cent of total banking system risk component, market risk was lower than in 2005. Position risk continued to lead, the bulk of it formed by Bulgarian government debt instruments and prime-rate foreign issuers' debt.

2. Compliance with Prudent Banking Requirements

No formal threats to banks' financial stability were found in 2006. Short-lived regulatory deviations at individual banks were found and corrected during full supervisory inspections, with off-site supervision used in individual cases.

Capital adequacy

Capital coverage was adequate to bank risk profiles. Though declining, capital adequacy indicators remained above regulatory minimum admissible levels. A temporary dip below minimum admissible levels was reported, caused by delays in registering an equity increase.

Large exposures

Concentrations did not exceed the single exposure limit, though in isolated cases banks' ability to cover aggravated risks was marginal. Deviations from the single large exposure regulator were duly identified, with banks remedying them.

Internal loans

Full supervisory inspections found isolated cases of business relatedness. Though there were no formal regulatory violations, some institutions reported credit concentrations beyond sound business practice, raising concern about possible circumventions of internal loan provisions.

Foreign Currency Exposures

In 2006 banking system currency risk was low. All banks complied with currency position restrictions.

Investment into fixed assets

Investing into fixed assets at system and individual levels remained within admissible bounds. Two banks stayed close to the regulatory limit without exceeding it.

3. Banking Supervision in 2006

Banking Regulation

Supervision aimed at erecting a legal framework comprising the latest European directives which introduce Basel II requirements (the International Convergence of Capital Measurement and Capital Standards: a Revised Framework). Basel II rules were introduced by two European Parliament and Council instruments: Directive 2006/48/EC Relating to the Taking up and Pursuit of the Business of Credit Institutions, and Directive 2006/49/EC on the Capital Adequacy of Investment Firms and Credit Institutions. Changes include using recognized external rating agencies, applying internal credit risk ratings, explicit treatment of securitization schemes and operational risk, credit protection reporting, and supervisory reviews and information disclosure. A Basel II concept new to the EU is that supervisory reporting of assumed risks should be more closely bound with banks' internal risk assessment models.

These requirements were introduced through the new Law on Credit Institutions and several regulations. The new Law enters into force on 1 January 2007 as Bulgaria accedes to the European Union. It aims at thorough compliance between Bulgarian legislation and European directives. The Law introduces the concept of credit institutions, encompassing banks and electronic money institutions. The single license principle ensures mutual recognition of the right of credit institutions and their subsidiaries to trade within the European Union directly or through branches without additional host country permits. Relations between national supervisors in regulating international financial groups are also treated. The Law further develops the previous Law on Banks by removing some of its practical shortcomings and recognizing experience since 1997.

The new Ordinance No. 8 on the Capital Adequacy of Credit Institutions is another important regulatory element. It sets out detailed bank risk control requirements and improved credit risk management approaches. The first approach evaluates risk-weighted exposures based on external credit ratings to allow reasonable assessment of risk within a particular class of exposures. A second approach allows banks disposing of free resources to calculate credit risk to internal rating models. Significant changes affect supervisory recognition of credit risk mitigation (through, *inter alia*, guarantees, collaterals, and credit derivatives) and securitization schemes. Operational risk capital requirements are also introduced. Few amendments relate to market risk and rules and procedures for items in trading portfolios. The Banking Supervision Department consulted the Association of Banks in Bulgaria on the new Ordinance.

New Ordinance No. 8 reporting forms embody the Committee of European Banking Supervisors' (CEBS) COREP (common reporting) standards. These aim at uniform market participants' reports and more effective interaction between EU supervisors.

Financial reports were also changed. Balance sheets and income statements in financial reports are now based on the CEBS' FINREP consolidated financial reporting framework. New forms were tested in November using 30 September 2006 data, with all commercial banks participating.

A strategy for launching the Extensible Business Reporting Language (XBRL) information platform was drawn up to facilitate reporting between commercial banks and the BNB after evaluating other countries' experience. The European Commission strongly encourages XBRL to facilitate communication between the market and EU supervisors.

In 2006 a new Ordinance No. 7 on Large Exposures of Banks was approved to incorporate Directive 2006/48/EC. Large exposure provisions are in line with the requirements of the Law on Credit Institutions and BNB Ordinance No. 8 on the Capital Adequacy of Credit Institutions. Ordinance No. 7 expands the scope of exposures which are excluded or reduced for the purposes of setting limits on concentration risk.

Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss also changed. The six-month retention of problem housing mortgage and consumer loans in the *watch*, *substandard* and *non-performing* groups after regular service had resumed was dropped. Another change equalized provisioning rates for consumer loans and mortgage loans with corporate loans. The list of high liquid collaterals used in forming provisions to cover impairment loss also changed, with the new wording reflecting the new Ordinance No. 8 on the Capital Adequacy of Credit Institutions.

To achieve compliance with the Law on Credit Institutions, changes were made in all supervisory ordinances.

With regard to developing international supervisory cooperation regulated by the new European directives in the area of transnational financial groups, Banking Supervision Department experts met Austrian, French, Greek, Hungarian, and Italian colleagues responsible for banking supervision over foreign banking groups represented in Bulgaria. Meetings examined the process and level of preparation to apply new capital requirements in relevant banking groups and different forms and degrees of international supervisory cooperation according to approaches applied for calculating risks and capital requirements. Department experts participated as observers in almost all EU committees on banking system developments and supervision: the Committee of European Banking Supervisors (CEBS) and its working groups, the European Banking Committee (EBC), the European Committee of Financial Conglomerates (ECFC), the Interim Working Committee on Financial Conglomerates (IWCFC) and the ECB Banking Supervision Committee (BSC) and its working groups.

Over the review period domestic banks joined the Bank for International Settlements' fifth Quantitative Impact Study (Basel QIS 5) to help the Basel Committee on Banking Supervision assess further changes to Basel II based on latest data.

Banking Supervision experts jointly with the Financial Supervision Commission helped draft the Bill on the Supplementary Supervision of Financial Conglomerates and rendered expert assistance in drafting the Law on Markets in Financial Instruments.

Supervisory Administration, Licenses, and Permits

Monitoring banks' regulatory adherence and dispensing supervisory measures and penalties are key Banking Supervision Department duties. The year saw 33 supervisory measures imposed on 22 banks and two foreign bank branches. Twelve measures were instructions, including one extending a term for remedying a violation and another lifting prior restrictions. Most measures resulted from on-site inspections. Often they were prompted by violations of Ordinance No. 9 risk exposure classifications or by breaches of Ordinance No. 8 capital adequacy.

A license transformed a local bank into a branch of BNP Paribas following the assumption of additional commitments.

Most of the 55 Law on Banks permits were under Articles 19 and 19b on acquiring 10 per cent or more of bank equity or on qualified participation in equity increases. The rest approved changes to banks' names, qualified participation in non-bank companies, increasing equity with non-cash contributions, and license scope extensions. Banks' board nominees obtained 51 banking qualifications and professional experience certificates, while one was refused. Also issued were 12 permits under the superseded Ordinance No. 8 for including subordinated term debt or debt/equity (hybrid) instruments into supplementary capital reserves or for transforming such funds into equity increases.

In 2006 three administrative Law on Banks penalty proceedings were initiated against banks and seven (five started in 2005) were completed, totaling BGN 120,000. Of these, one was appealed, with a Sofia City Court verdict pending. The rest were deposited into the Budget. Three penalties involved written warnings.

On-site Supervision

The annual on-site supervision programme entailed 23 full inspections at nine Group I banks, 11 Group II banks and two Group III banks. Under CAMELS criteria, 20 of the banks retained their ratings, two raised them, and one received its first rating. Component asset quality, capital assessment and management ratings changed often due to their high-risk nature, while liquidity ratings altered rarely. Inspections comprised primarily evaluations of risk management and information systems, and compliance with internal rules and procedures and banking law and supervisory rules. Major areas subject to supervisory inspection include asset quality, credit risk and its management, capital and its quality, solvency indicators, earnings and their quality and trends, market risk, management and internal control quality, off-balance-sheet commitments risks, and IT reliability.

Though risk management systems had remained reliable, control over the quality of loans and security had relaxed and loans had been made to equity holders and related persons. There was occasional lack of current financial data and due diligence on borrowers. To skirt credit concentration rules, some banks had lent to companies with opaque ownership, giving rise to concerns about undeclared relatedness between borrowers and potential illicit shareholder financing.

In expanding lending to individuals, some banks had relaxed borrower requirements and offered more attractive but riskier products generating higher income. At the same time, increasing consumer and mortgage lending was not supported by necessary IT updates, entailing considerable manual processing. In addition, trends in the quality of these products and reasons for this were not analyzed adequately. Alongside shortcomings in administering individual products, this impacted overall quality.

Inspectors found isolated cases where internal capital adequacy evaluation did not tally with set risk profiles and capital maintenance strategies. Individual banks had underestimated risks in their assets, relied on extra income which they could not use as a source of capital growth, had insufficient capital support capacity, and had poor planning and capital growth management, resulting in inadequate capital replenishment. Inspectors found that most banks were nonetheless prepared for new capital standards, though some had technological problems associated with limited capabilities of their information systems to monitor and control data inflows and outflows.

Operational risk had increased at some banks due to complex integration processes and inadequate management information scope and content. Some banks' IT products did not allow automatic generation of precise and timely information on varied operations, their managements relying on manual statements leading to attendant operational errors and inadequate decisions.

Overall, inspectors were impressed with the way banks were managed and found that executives could monitor, control, and manage bank risks. Internal rules and risk evaluation systems were consistent with banks' business profiles and with banking legislation and supervisory rules. Recommendations to managers addressed, *inter alia*, breaches of supervisory rules, management information improvement, failures to remedy prior supervisory recommendations, and breaches of separation between control bodies and line management.

Inspectors found 159 formal breaches of banking legislation and supervisory regulation, of which some 14 per cent did not relate to lending. More than half of the 254 supervisory measures related to lending. Major breaches involved underestimating credit risk and failing to disclose relatedness. Most recommendations addressed better risk management through appropriate administration and periodical measuring of risk exposures and improving internal bank mechanisms for relatedness monitoring.

Off-site Supervision

Off-site supervision aimed at early identification of increased risk zones, monitoring individual banks and the system continuously, and reporting on the effect of changed regulatory and accounting rules. Inspectors prepared 128 quarterly CAEL (capital, asset quality, earnings, and liquidity) rating system analyses alongside 36 monthly supervisory reviews of banks with ratings of 3 and below. They also issued 39 supervisory memoranda on individual banks, to be used as an alternative source of information on bank performance and relevant risks. Annual assessments of parent banks' finances and their capacity to support Bulgarian subsidiaries were finalized. Over the year 46 statements of opinion were prepared relating, *inter alia*, to capital increases and subsidiaries. Quarterly reports on banking system performance were issued alongside the *Commercial Banks in Bulgaria* quarterly and monthly press releases with updated banking statistics.

In 2006 supervisors analyzed lending and credit risk parameters and assessed bank operations' effect on financial stability. Significant efforts went on boosting experts' and analysts' capacity to react adequately and stay ahead of processes affecting bank risk profiles. The Uniform Bank Performance Report on monitoring commercial banks was improved. Some parameters for modeling developments in major risks *via* quarterly stress-tests (the Early Warning System) were further optimized.

Off-site supervision experts also sat on committees and working groups preparing for full Bulgarian membership in the EU. They drew up opinions and expert statements on banking development, macro analyses, banking supervision and financial stability and helped improve the quality of current analyses. Cooperation with international institutions (IMF, the World Bank) and rating agencies intensified. This called for further analyses, statements of opinion, and presentations showing banking processes adequately and cogently. International institutions and rating agencies base banking system performance assessments on information from off-site supervision specialists.

Off-site supervision also includes collecting, processing and generating current financial information on individual banks, target groups, and the whole system, as well as using random parameters to monitor events and trends. The year saw the launch of the Single Data Depository/Banking Supervision Reports project run jointly with IT experts. By the end of the year a portion of the gathered information was input into the system. Once all banks' data is input, opportunities for reliable, effective, and multifunctional database operations will increase. The project is of great importance to off-site supervisors in modeling various risks with a view to challenges associated with consolidated financial reporting framework (FINREP) and the Common Framework for Reporting on the Solvency Ratio (COREP).

Special Supervision

In 2006 the focus of special supervision was on banks' capital structure transparency and on preventing money laundering. Continuous monitoring aimed at strengthening bank financial stability and on improving the transparency of ownership structures. Business relatedness, financial standing, and funding sources were analyzed, alongside counter inspections at companies which hold commercial bank equity. Supervision attained greater clarity as to direct and indirect commercial bank equity owners, analyzed their finances in depth, tested the consistency between their financial status and equity participation, and conducted some precision assessments of individual equity holders' ability to support capital.

Functional specifications of ECB-required information obtained from the BNB's Single Data Depository and its Commercial Bank Equity Holder System were improved.

Consistent measures to determine money laundering and terrorist financing risks at commercial banks discharged duties under Basel Core Principles for Effective Banking Supervision and other recommendations. Banks were made aware of the key importance of clear rules, procedures, and principles in comprehensively checking new and existing customers to avoid operational, legal, reputation, and concentration risks which may prompt considerable financial losses. They were given methodological support in examining their security, bringing internal rules into line with requirements, and using the risk-based approach.

Findings were that banks maintained adequate controls, principles, and procedures in examining customers.

The technical assistance agreement between the BNB and USAID paid special attention to cooperation and supervision in preventing money laundering and terrorist financing.

Supervisory effort regarding the Currency Law and its statutory instruments addressed financial transparency requirements. Special attention focused on the requirement to disclose to the BNB instances of direct investment or financial loans and their scope.

Intensive cooperation with offices fighting financial fraud continued. Coordinated action under memoranda of understanding with the Chief Prosecutor, the Financial Investigation Agency, and the Financial Supervision Commission aimed to further financial sector stability.

Inspections at banks as custodians were conducted jointly with the Financial Supervision Commission. Trust organization and procedures were evaluated in accordance with BNB Ordinance No. 36. Breaches resulted in recommendations to managers mainly on the control functions of custodian banks and on statutory constraints in investing corporate assets. Conclusions proposed legislative changes for greater statutory efficiency and to clarify requirements to custodian banks.

The Prosecutor's Office, international regulators, and legal authorities prompted inspections at banks to test for breaches of the Law on Banks, the Currency Law, and the Law on Measures against Money Laundering. Several companies conducting banking operations without a license were also inspected. Detectives and prosecutors were advised of findings on cash operations, transactions, and the origin of funds.

In 2006 supervisors made 25 target inspections at banks, 24 target inspections at finance houses, and target counter inspections at seven other legal entities.

Over the year seven finance houses discontinued foreign currency trading under Ordinance No. 26 voluntary termination procedures.

Four new finance houses received licenses bringing the total to 86 at the end of 2006. Of them, 27 per cent have Financial Supervision Commission investment intermediary permits. Two companies' requests for permits to conduct foreign exchange transactions in the course of business were refused due to unacceptable risk.

The Banking Supervision Department keeps a register of entities which have advised the BNB of transactions under Article 1, paragraph 6 of the Law on Banks. By 31 December 2006 they numbered 116, 21 having started operating as non-bank financial institutions in 2006. In the past two years the number of companies conducting transactions under Article 1, paragraph 5 of the Law on Banks has grown steadily.

VII. The Central Credit Register

The Central Credit Register (the CCR) kept and developed by the BNB provides information on bank customer debt to the banking system.[22] Data covers all commercial bank claims irrespective of amount except debit card overdrafts of up to BGN 1000 (provided they are classified as *standard*), loans to the government, loans to the BNB and interbank loans. The system ensures reliable information submission and storage.[23] The fee *per* customer debt check is BGN 0.50.

Amendments to Ordinance No. 22 in August 2006 expanded the register's scope to include loans transferred to third parties but still serviced and administered by banks. The amendments were intended to keep records of these loans and their servicing. Further amendments in December regulated access by individuals and companies to CCR information about them. This had been possible before, but as part of the CCR's internal rules. A new procedure provides for individuals or companies to request corrections to wrong information by banks submitting it to the CCR.

Within the two-year twinning project on *Bulgarian National Bank Adjustment to Operate as a Full-fledged Member of the European System of Central Banks and the Eurosystem,*[24] experts from the Italian central bank consulted the CCR in December 2006. Italian experience in developing and improving the Italian credit register was studied. Having analyzed the CCR, the Banca d'Italia experts recommended measures for its improvement.

By the end of 2006 the CCR registered 2,009,006 loans (against 1,618,315 at the end of 2005) with a balance sheet exposure of BGN 22,603 million (against BGN 18,365 million at the end of 2005). Borrowers totaled 1,349,738, of whom 1,292,916 individuals, 55,337 resident legal entities and 1485 non-resident legal entities.

Over 2006 commercial banks conducted 2,979,620 CCR debt checks, almost double the 1,669,416 at the close of 2005. Of the total, 2,555,209 were on individuals and 424,411 on resident legal entities. The monthly average number of certificates was 248,000 or about 12,000 a business day. The growing number of CCR certificates indicates the reliability of information and its growing importance in managing commercial banks' credit portfolios.

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[22] The CCR is regulated by BNB *Ordinance No. 22 on the Central Credit Register of Banks*.

[23] Commercial banks have online CCR access. Authorized officer access is *via* digital certificates.

[24] The Bulgarian National Bank and Banque de France, De Nederlandsche Bank and the Banca d'Italia began implementing the two-year PHARE Programme-financed twinning project on *Bulgarian National Bank Adjustment to Operate as a Full-fledged Member of the European System of Central Banks and the Eurosystem* in October 2006.

VIII. The Fiscal Agent and State Depository Function

The Bulgarian National Bank is the state's official depository and the government's fiscal agent. Under contracts negotiated with the Ministry of Finance under market conditions and at market prices, the BNB collects and submits periodical information on budget entities' accounts with domestic banks to the Ministry and acts as government debt agent.

Under the agreement to define BNB long-term government agent duties, work continued on the electronic system for budget and fiscal reserve information servicing, the AS ROAD automated system for registering and servicing external debt, the GSA system for conducting government securities auctions and replacement subscriptions, the ESROT electronic system for registering and servicing government securities trading, the electronic system for settlement accounts of book-entry government securities system, and the Register of Pledges.

In 2006 the BNB collected BGN 1,208,700 in fees and commissions for its fiscal agency and government securities market services, including BGN 681,600 from agreements with the Ministry of Finance.

In September 2006 the fiscal agency offices moved to new premises on the 7 Pozitano Street. Relocation was gradual, to ensure process continuity and avoid affecting the timeliness and quality of services provided to the Ministry of Finance and other service users.

Information Service

Under Article 43 of the Law on the BNB and standing joint instructions by the Minister of Finance and the BNB Governor, information on budget, extra budgetary, accumulation, deposit, and letter-of-credit accounts of budget entities in levs and other currencies was regularly gathered from depository banks *via* the electronic system for budget and fiscal reserve information servicing. In the period under review the average monthly balances on accounts with the BNB were BGN 4415.1 million, with BGN 1296.7 million at the 24 depository commercial banks. Over the reporting year current and final information on the balances of accounts included in the fiscal reserve and serviced by the BNB and depository banks was collected and submitted to the MF daily. At the end of 2006 total balances on accounts serviced by the BNB and depository banks and included in the fiscal reserve came to BGN 5435 million.

Following the 5 June 2006 launch of a new statistical reporting form for payments into public claims administrators' accounts at the request of the Ministry of Finance, additional daily information on municipal account balances was collected daily in the second half of December 2006. The BNB submitted 387 report forms to the MF against 366 in 2005.

The AS ROAD system registered 30 Bulgarian government foreign financial obligations on which the BNB acted as agent for calculating and paying EUR 3106.5 million. Payments numbered 66 and came to EUR 502.7 million, comprising EUR 308.5 million principal and EUR 194.2 million interest.

Servicing Government Securities Trading

MF-scheduled auctions in 2006 for the sale of three-month, three-year, five-year and ten-year government securities nominally worth BGN 517.7 million were held *via* the GSA system for conducting government securities auctions and replacement subscriptions. Demand exceeded supply, with a 2.25 average bid-to-cover ratio. Of the 102 average bids *per* auction, 49 were approved. The reporting period saw a progressive upward trend in the volume of individual government securities issues aimed at increasing their liquidity and stimulating secondary market development.

December 2006 saw a new selection of government securities primary dealers, with 21 commercial banks and three investment intermediaries obtaining investment intermediary permits under Article 54 of the Law on Public Offering of Government Securities.

In the review period the ESROT electronic system for registering and servicing government securities trading registered payments of BGN 529.8 million at maturity date, of which BGN 380.8 million was principal and BGN 149 million interest; government securities bought back directly by individuals came to BGN 1.6 million. The total of newly registered government securities and payment registrations came to BGN 1049.1 million. Government securities transactions in the secondary market numbered 6355 at BGN 12,312.1 million nominal value. Blocking and unblocking of government securities had the largest share (37.6 per cent), followed by transactions with and on behalf of customers (26.6 per cent), outright purchases and sales (19.4 per cent), and repo agreements (16.4 per cent). Trading was most active on acquisition days and in the periods of most dynamic changes in budget entities' accounts with commercial banks which have to be backed by government securities.

The relatively large amount of government securities blocking and unblocking transactions reflected the high levels of budget funds with commercial banks. Under § 24 of the Transitional and Final Provisions of the Republic of Bulgaria 2006 State Budget Law and Minister of Finance and BNB Governor instructions, they have to secure the balances of budget entities' accounts by blocking domestic and external debt government securities held by themselves in favour of the MF. By the close of 2006 budget funds with commercial banks totaled BGN 1500.6 million (against BGN 1051.1 million at the end of 2005). Under its agreement with the MF, the BNB continued monitoring the daily balances of budget entities' accounts with commercial banks secured by government securities and the balances of budget entities' accounts reported by commercial banks. Average daily nominals of blocked domestic government securities were BGN 893.8 million, EUR 95.1 million, and USD 35.6 million, and foreign government securities (including the EIB Eurobond issue) were BGN 24.9 million, EUR 75.5 million, and USD 89.1 million.

In 2006 BGN 40 million worth of pledges and removal of pledges on government securities was listed in the *Central Register of Pledges* kept by the BNB under the Law on Registered Pledges.

By the end of 2006 accounts kept with the government securities settlement system came to 2404, including 83 for government securities of the issuer (the MF), 897 for participants' own government securities portfolios, 949 for government securities primary dealers' customers, and 475 for encumbered government securities. Government securities in these accounts totaled BGN 2955.8 million in nominal value.

System Development

System development followed the *Strategy for Bulgarian National Bank Development between 2004 and 2009* and the Ministry of Finance's *Debt Management Strategy for the 2006 to 2008 Period.* In June 2006 an update of the electronic system for budget and fiscal reserve information servicing was launched, offering online access to bank depositories of budget funds, uploading data, and monitoring processing results. This speeded data transfer and the preparation of statements for managing the balances of budget accounts to MF requirements and minimized system and other risks. After technical training and testing, as of the start of 2007 the BNB sends first level budget spending entities (45 ministries and agencies) aggregate data on their accounts as reported by banks in the form of an electronic document with a universal electronic signature.

The GSA system for conducting government securities auctions and replacement subscription was developed (mainly as regards subscriptions to switch issues) in line with a schedule for expanding functionality coordinated with the MF. Other changes ensured system function after the launch of the International Bank Account Number (IBAN). To improve and accelerate contact with participants in the government securities market, electronic correspondence with primary dealers was enabled by means of a universal electronic signature.

The new facilities of the modernized electronic system for registering and servicing government securities trading (ESROT) launched in May 2006 were reflected in annual surveys from specialized international institutions such as the Association of Global Custodians (AGC Questionnaire), Thomas Murray, the Committee on Payment and Settlement Systems (CPSS), and the International Organization of Securities Commissions (*IOSCO* –

Disclosure Framework). The overall opinion of government securities traders, expressed in analytical assessments, was that the new ESROT facilitated transactions significantly and boosted secondary market development and liquidity.

In June 2006 a project started to upgrade and expand the Register of Pledges. It will integrate the Register better into the complex set of systems servicing the BNB's Government Securities Depository, expand functionality through automating recording and preparing more and more detailed statements on registered pledges, and reduce system operational risk.

European initiatives for a safe integrated European securities market infrastructure were studied. They include the Subcommittee on EU Government Bonds and Bills Markets' resolutions, and measures for removing barriers to effective cross-border clearing and settlement in three *Giovannini Groups* (*Giovannini Reports/Giovannini Barriers*). Issues include technical/legal practices, taxation and legal certainty, the Single European Payments Area (SEPA) project, the ECB TARGET2 – Securities (T2S) project to centralize EU bond settlement in euro by 2013–2014, and the EC Code of Conduct for implementing clearing and settlement services objectives in the EU. By 2008 the Code aims at price transparency of services, operational compatibility of systems, free access to them, and detailed differentiation and accounting of major services offered mainly by government securities depositories.

In line with these documents and MF and BNB participation in EU working groups and committees, standpoints were prepared on the government debt market and its development, with the stress on studying all publications on the ECB's T2S project. The Bulgarian financial community was advised of the project before the close of the year.

In December 2006 the BNB and the MF began joint studies of EU experience in the practical aspects of Directive 2004/39/EC on Markets in Financial Instruments and its influence on the government debt market and government securities settlement. Alongside this, a twinning project started to develop an operational risk management system in line with ECB requirements. The GSA automated system for conducting government securities auctions and replacement subscriptions and the ESROT electronic system for registering and servicing government securities trading were included as pilot structures. Their operators helped develop BNB policy on operational risk management stating objectives, principles, scope, stages, and defining participants and their responsibilities.

IX. European Integration and International Relations

European Integration

In the run up to Bulgarian accession to the EU, the BNB focused efforts on completing harmonization between Bulgarian banking and financial law and *acquis communautaire*, preparing banking to implement new regulations, and creating public awareness about banking institutions and integration.[25] Deepening cooperation with the ECB and EU national central banks assisted Bank capacity building and preparations for ESCB membership.

At the end of 2005 the BNB Governing Council had decided to draft all banking Bills in the first half of 2006, allowing the National Assembly to debate and adopt them, and for banks to adjust to them, well ahead of accession in 2007.

During the year Bulgarian legislation transposed the following directives:

- Directive 2006/48/EC of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions (recast);
- Directive 2006/49/EC of the European Parliament and the Council on the capital adequacy of investment firms and credit institutions (recast);
- Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council;
- Council Directive 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents;
- Directive 2000/46/EC of the European Parliament and the Council on the taking up, pursuit of and prudential supervision of the business of electronic money institutions;
- Directive 2001/24/EC of the European Parliament and the Council on the reorganization and winding up of credit institutions;
- Directive 87/102/EEC for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit and amending Directives 90/88/EEC and 98/7/EC;
- Directive 2002/47/EC of the European Parliament and the Council on financial collateral arrangements;
- Directive 2002/65/EC of the European Parliament and the Council concerning the distance marketing of consumer financial services;
- Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions.

The requirements of these Directives were introduced into Bulgarian legislation through these laws and regulations:

- The Law on Credit Institutions, adopted by the National Assembly in July 2006;
- The Law on Consumer Credit, adopted by the National Assembly in June 2006; this provides effective consumer credit protection by defining creditor obligations and other means for protecting and guaranteeing consumer rights;
- The Law on Supplementary Supervision on Financial Conglomerates;
- The Law on Financial Provision Arrangements, adopted by the National Assembly in August 2006;
- The Law on Distance Financial Services, adopted by the National Assembly in December 2006;

[25] The BNB actively participated in harmonization and in working groups in areas such as provision of services, the free movement of capital, Economic and Monetary Union, statistics, consumer and health protection, financial controls, and the Lisbon strategy.

- Ordinance No. 7 on the Large Exposures of Banks, adopted in December 2006;
- Ordinance No. 8 on Capital Adequacy of Credit Institutions, adopted in December 2006;
- Ministry of Finance Ordinance No. 21 on the Requirements for the Structure (Form) and Contents of Credit and Financial Institutions' Annual Accounts, adopted on 29 December 2006.

Negotiated commitments on harmonizing banking and financial sector law were fulfilled by the end of 2006 without the need for transitional periods or for excluding credit institutions from Directives' scope. Bulgaria is among the first countries to transpose Directives 2006/48/EC and 2006/49/EC into national legislation. BNB experts provided terminology consultations in the process of preparing Bulgarian versions of European legislation within the Bank's purview, with 90 per cent of translations completed by the end of 2006.

Promoting mutual awareness and cooperation, the BNB submitted information on EU law in its sphere to the National Assembly and public bodies. As part of the Bank's awareness drive, Bulgarian journalists were taken to the ECB and the EIB to learn of regulatory changes related to EU membership. Working with the Financial Supervision Commission and the Bulgarian Deposit Insurance Fund and with USAID finance, in December 2006 the Bank ran the Financial Sector Integrity and Development: Challenges and Expectations media seminar.

The BNB and the Association of Banks in Bulgaria produced a public brochure on the Settlement Dispute Conciliation Committee convened under Directive 97/5/EC on cross-border credit transfers and Recommendation 97/489/EC.

BNB preparation for ESCB membership followed the April 2005 Action Plan setting out Bank commitments related to ESCB membership. A November 2006 review showed that all milestones had been passed on schedule. The plan then broadened with new items and commitments in line with broadening BNB integration into the ESCB and obligations arising from new EU decisions.

To ensure success, BNB representatives at the ESCB and EU committees and working groups went on a training and qualification improvement programme. A new system for document flow between the BNB, the ECB/ESCB, and other EU bodies allowed the BNB to handle accession issues and participate actively in over 26 Committees and 44 working groups without extra staff.

Deeper and more intensive relations with the ECB helped BNB preparation for ESCB membership greatly. In 2006 ECB President Jean-Claude Trichet visited Bulgaria twice. A BNB delegation led by the Governor met the ECB President, Governing Council, Executive Board to discuss plans and challenges relating to Bulgaria's integration.

The BNB Governor attended ECB General Council sittings as an observer. BNB experts attended sittings at 12 ESCB Committees and the Human Resources Conference, as well as Committee working groups, to gain knowledge and experience relevant to ESCB and Eurosystem membership.

BNB representatives also attended meetings of other EU Council and Commission bodies. The BNB Governor took part in informal ECOFIN meetings of EU economic and financial ministers, while Bank executives attended meetings of the Economic and Financial Committee (EFC) and its substructures, the Committee of European Banking Supervisors (CEBS) and its working groups, the European Banking Committee (EBC), the European Financial Conglomerates Committee (EFCC), and the Interim Working Committee on Financial Conglomerates (IWCFC).

International Relations

The 13th Meeting of Governors of Francophonie Central Banks, Financial Stability and Economic Integration, took place in Sofia between 11 and 13 May 2006 at the invitation of the Bulgarian National Bank Governor. The forum was set up in 1994 at the initiative of the Banque de France. Bulgaria is the first country in Central and Eastern Europe to host the event. Representatives of 27 central banks of Francophonie countries attended the 13th Governors' meeting, the participation of the ECB President Mr Jean-Claude Trichet being a special honour to the BNB as host. Participants discussed topics such as systemic risk and banking system stability, global imbalances, and foreign direct investments in banking, bank supervision, Basel II challenges, financial conglomerates, and credit expansion. Institutional aspects of central banks' activities (autonomy, transparency, accountability) and issues related to regional integration (e.g. into the euro area or the Franc zone) were also discussed. The next meeting will be in Bern in 2007 at the invitation of the Swiss National Bank Governor.

The BNB Governor sits on the regular meetings of governors of central banks which own Bank for International Settlements equity as it is one of the major fora for cooperation between central banks. BNB experts actively participated in BIS seminars and attended the regular meeting of coordinators of technical assistance. At its Annual General Meeting, the BIS Board of Governors declared a dividend of SDR 245 *per* share for shareholding central banks. The BNB's dividend came to SDR 1.9 million.

The BNB organized the Internal and External Financial Resources Mobilization seminar with the EIB to which it invited all commercial banks as an occasion for deepening mutual cooperation.

In early August the BNB Governor took part in the 16th meeting of the Black Sea, Balkans and Central Asia Central Bank Governors' Club hosted by the Central Bank of the Russian Federation in Irkutsk.

After successful completion of two-year bilateral agreements with the French and Dutch central banks in 2005, a PHARE-supported two-year twinning project to adjust the BNB to ESCB membership and the Eurosystem, was contracted with the Banque de France, De Nederlandsche Bank, and the Banca d'Italia. It will comprise banking supervision, research and analysis, communication policy, payment systems, accounting and reporting, balance of payments statistics, risk management, cash operations, and financial markets. Work has started in line with the set timescale.

In 2006 the BNB Governor visited the Deutsche Bundesbank which will assist the BNB over coming two or three years with projects in payment systems, preparation for the euro, and management of international reserves.

An agreement with the Central Bank of the Russian Federation signed in September 2006 envisages information exchanges on major economic, legal, financial, and banking issues, and regular meetings.

The Financial Sector Integrity project financed by the US Agency for International Development (USAID) advanced significantly in the review period. Assistance focuses on fighting money laundering, improving financial regulation, and enhancing financial transparency. Training addressed measures against money laundering and terrorist financing, updates to on-site supervisory inspection procedures, risk matrix design, and report form development. The project and the National Justice Institute held two legal seminars with BNB, Financial Supervision Commission, and Bulgarian Deposit Insurance Fund participation. This enhanced coordination between regulators and the legal system by raising awareness of the new status of regulators and of changes in financial law.

Foreign consultants submitted advice on how the planned BNB cash centre would meet currency circulation management requirements, including ECB ones. An analysis of internal, external, and inter-institutional communication resulted in recommendations for its improvement. During the reporting period BNB staff attended in-house seminars on Efficient Management Skills and Efficient Presentation Skills, and an Office of the Superintendent of Financial Institutions in Canada (OSFI) Risk-Based Supervision Framework seminar.

In 2006 the BNB ran technical assistance seminars for the Bank of Albania, the National Bank of the Republic of Macedonia, and the Central Banking Authority of Kosovo. European integration, harmonizing legislations with *acquis communautaire*; payment systems, statistics, risk management, accounting, and financial planning formed the main spheres of cooperation.

The BNB supported government in its relations with the IMF, the World Bank, and the EBRD in setting out objectives and priorities in these institutions' strategies for Bulgaria and helping implement agreements with them. The BNB took part in the process of drawing up the 56th issue of the IMF Annual Report on Exchange Arrangements and Exchange Restrictions and the IMF Report on the Observance of Standards and Codes. The Bank took part in consultations between Bulgaria and the World Bank Group.

X. Statistics

The BNB gathers and distributes monetary and interest rate statistics, statistics on leasing, international reserves, the balance of payments, gross external debt, foreign direct investment, the international investment position, the international reserve and liquidity template, imports and exports, and the quarterly financial accounts of the *General Government* sector. Harmonizing statistics with ECB and Eurostat requirements are priorities in developing the statistics function.

The BNB now gathers more detailed monetary statistics on EU countries and receives quarterly data on the geographical structure of non-resident sector indicators. After research and methodological preparation in 2006, monetary statistics reporting units in 2007 in line with ECB Regulation 13 will include two new money market funds launched in 2006.

To complete the introduction of ECB requirements for deposit and loan interest rate statistics, *Methodological Instructions on Interest Rate Statistics* and a manual for their use under Regulation ECB/2001/18 were published along with an *Interest Rate Calculation Sample Book* and a booklet of questions and answers on using methodological documents on interest rate statistics. *Methodological Guidelines for Long-term Interest Rate Setting for Convergence Purposes* were drawn up to ECB requirements in consultation with the MF. An information system for computing daily and monthly long-term interest rate values was developed and the BNB has submitted its data to the ECB since December 2006.

Methodologies for collecting data from investment funds, insurance companies and pension funds are pending.

A new system for gathering and processing commercial banks' balance of payments information on a transaction-by-transaction basis went live in early 2006. Its launch and the development of a system to compile the balance of payments contributed to fulfilling the EU and Eurostat commitment to provide balance of payments statistics geographical structure. The introduction of a statistics field to payment orders when switching to IBAN made it easier for commercial banks and their customers to provide information on transactions between residents and non-residents.

A methodology developed by the BNB jointly with the NSI for assessing goods imports using FOB prices and freighting revenues and spending is in use since March 2006. A differentiated valuation approach applies, depending on importing nation, goods type, mode of transport, and carrier nationality. This has resulted in more accurate reporting of freight revenues and spending by vehicle type and geographical structure. A methodology for estimating remittances from casually employed Bulgarians abroad was also developed and introduced. Intermediaries and their customers and primary dealers of government securities received new quarterly reporting forms for portfolio investments. Work on establishing a security-by-security database continued. The reporting period saw the publication of Bulgaria's quarterly international investment position in line with international methodology and of quarterly data on direct investment into and away from Bulgaria.

The year saw the preparation of a random sample border survey of Bulgarians and foreigners, to start in 2007. It aims to improve the methodology for reporting data on the *Travel* and other balance of payments items.

In 2006 the BNB started work with the MF and NSI on coordinating methodologies and developing government finance statistics to ECB Guidelines 2005/5 and quarterly financial accounts of the *General Government* sector. For the latter the BNB designed a methodology to EC Regulation 501/2004.

In December 2006 a mission of the ECB Chief Statistical Directorate visited the BNB in connection with pending ESCB membership. The meeting discussed BNB statistical readiness.

XI. Research

Economic research, analyses of processes in the Bulgarian economy, and macroeconomic forecasts support the Bank's management in decision making and formulating economic policy positions. In 2006 research focused on developing macroeconomic models for analyzing and forecasting trends in the Bulgarian economy, nominal and real convergence programmes, and the history of central banks.

Specialized research under the Research Plan for the 2005 to 2006 Period supported BNB operations by assessing individual economic processes and sectors and developing instruments for forecasting and analyzing economic policy. The work on the Plan for the 2005 to 2006 period was successfully completed. The year under review saw research and modelling of nominal and real convergence, transmission mechanisms, foreign trade, and obtaining information on interest rates from derivative prices. BNB technical reports and seminars presented research results to experts from other institutions and from scientific and non-government organizations.

In June 2006 the IMF provided technical assistance for developing dynamic stochastic general equilibrium models to improve modelling and forecasting. This involved a general assessment of instruments for simulating various macroeconomic scenarios and forecasting, recommendations, and identifying areas for further development.

The two-year twinning covenant included a component related to research, development, and preparation of monetary policy operations to ECB good practice. An examination of macroeconomic modeling instruments developed by the BNB resulted in recommendations for expanding and improving them.

The first meeting of the Balkan Monetary and Finance History Study Network took place in April 2006. It was attended by representatives of Balkan central banks and those of Austria and France, and renowned economic historians from academic institutions in Bulgaria, Croatia, France, Greece, Serbia, Slovenia, Turkey, and the UK. The Network aims to deepen awareness of Balkan monetary and financial history and boost cooperation among Balkan central banks. The meeting resolved to compile a uniform database of major Balkan economic and monetary variables as part of a more comprehensive project on Balkan comparative monetary history. In October 2006 the special working group on compiling a historical database met for the first time. The meeting looked at results from the study of historical data on individual countries in the network and scheduled further stages and ways of presenting results.

A BNB Banking and Finance History Research and Publications Programme Council came together during the year and launched two series of publications. The Banking and Finance History/Heritage series started with *Marko Ryaskov: Memoirs and Documents* dedicated to a renowned early 20th Century Bulgarian banker and financier. A collection of papers by participants in the first General Meeting of the Balkan Monetary and Finance History Study Network formed the first of the Banking and Finance History/Research series.

The Guest Researcher Programme supports BNB research and helps establish fruitful cooperation with experts from Bulgaria and abroad on subjects of interest to the BNB. In 2006 five guest researchers worked on modelling credit in Bulgaria, developing a dynamic stochastic general equilibrium model, evaluating macroeconomic financial stability, transmitting foreign exchange fluctuations, and compiling a database of Bulgarian banking and financial statistics between 1878 and 1989.

In 2006 the BNB continued to publish its Discussion Papers series. An augmented editorial board updated paper selection and subject matter and accelerated papers' inclusion into international scientific exchange. Of 16 new papers reviewed during the year, five were published and six are being edited pending publication.

XII. Information Infrastructure

Developing and updating BNB information systems is a major policy priority. Among the number of projects on Bank and banking system information infrastructure in 2006, the IBAN launch in June 2006 entailed significant changes to payments systems (RINGS, BISERA, BORICA, the electronic system for settlement accounts of book-entry government securities, the Central Depository information system, and commercial banks' systems). Other applied systems were updated and upgraded.

In 2006 several projects emerged to improve BNB business and effectiveness. The new International Reserve Management System (*Trema FinanceKit*) was developed within the set timescale, going live in September. The updated ESROT electronic system for registering and servicing government securities trading features modern technologies and improved functions, logging and settling transactions in real time. A modernized version of the Register of Pledges was functionally connected to ESROT. Following development, testing, and staff training, data on the last quarter of 2006 were successfully processed into the single depository for Banking Supervision Department data. The third and final stage of the monetary statistics information system, concerning interest rate statistics, was completed.

The year saw new projects, of which most significant was the *SAP* core banking information system. *Blueprint*, the detailed functional and technical project brief, is complete.

The BNB IT Security Policy and Procedures project resulted in a uniform BNB IT Security Policy and a BNB IT Security Committee.

By the close of August the communication link to the ESCB was tested, with the first teleconference being on 30 November. Work on access for BNB users to ESCB systems started in December.

Updating and developing BNB technological architecture continued in 2006, with many servers upgraded and banking system software updated. Voice communication updating continued by replacing existing switchboards with VoIP technology.

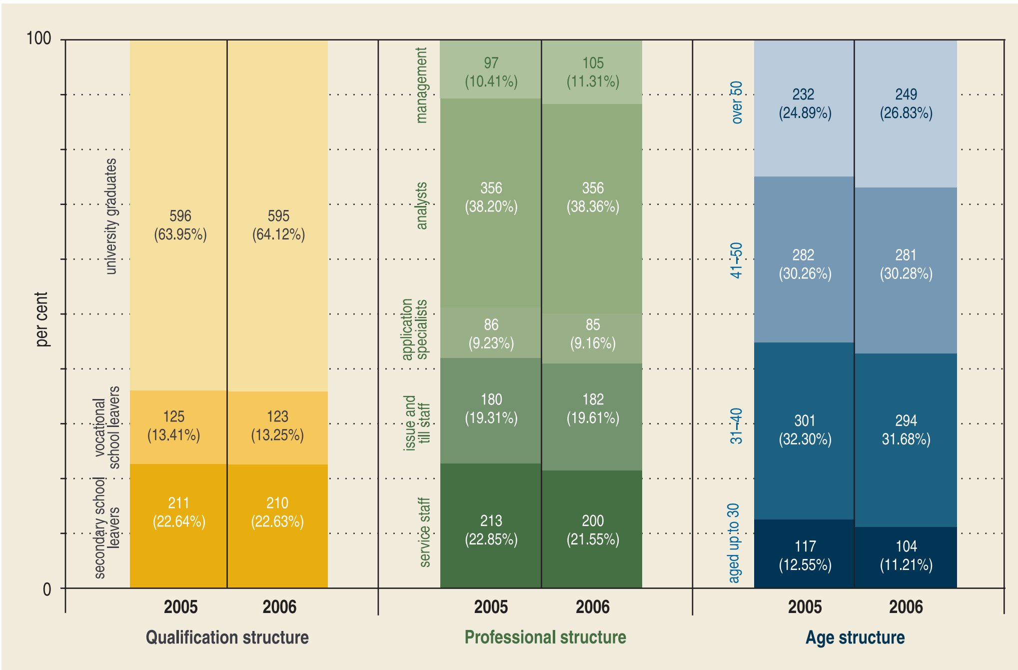
XIII. Human Resource Management

BNB observer status at the ESCB in 2006 and member status in 2007 meant important new tasks for staff. Additional commitments in 2006 associated with Bulgaria's EU accession in 2007 did not entail new recruitment. Staff numbered 928 (932 in 2005) against an establishment of 1007. Measures under the human resources management system adopted in 2005 encouraged employees to implement their tasks efficiently through better organization and attain higher qualifications.[26] Senior management attended business administration and European integration courses.

Staff training addressed macroeconomics, monetary policy, asset and risk management, banking supervision, monetary and banking statistics, accounting, banking and financial law, human resource management, and internal audit. Qualifications and skill improvement formed a targeted training programme of seminars, remote training sessions, and courses by international financial institutions.

Staff Structure

(as of 31 December of the corresponding year) (number, per cent)



Source: BNB.

Remote training in Bulgaria included 24 staff attending International Banking Institute events, five delegates at the Chartered Financial Analysts programme, three at the Chartered Internal Auditor programme, and 11 at the certification programme of the Sofia Technical University's CISCO Academy. Specialized short seminars and courses had 235 delegates, while 160 went on courses and seminars at foreign banks and financial institutions such as the IMF, the Joint Vienna Institute, the central banks of Austria, the Czech Republic, France, Germany, the Netherlands, Slovenia, Switzerland, and the UK, and the BIS, Basel. Organizers met most training expenses. ECB secondments for BNB employees contributed to qualification improvement.

[26] The BNB human resources strategy comprises Rules on Staff Assessment, Rules for Staff Recruitment, Internal Rules on Employee Remuneration, the BNB Staff Code of Ethics, Internal Rules on Traineeships at the BNB, Internal Rules for Raising Educational and Professional Qualifications.

In the 2005 to 2006 period 28 employees boosted their educational attainments without discontinuing work. Six employees were reading for doctors' degrees (one was awarded the degree), nine for masters' degrees (four awarded), nine for bachelors' degrees (four awarded) and four for specialist degrees (one awarded).

Language training bestows proficiency in English or other languages specified by job descriptions. In 2006, 67 per cent of BNB employees had the required foreign language proficiency, over 12 per cent had higher proficiencies, and 8 per cent were acquiring a second foreign language. Specialized courses addressed legal usage and general foreign language skills.

Recruitment aimed to improve staff educational attainment, qualifications, and age structure. Over the period 65 new recruits joined the Bank, and 69 staff left, including retirees. Short induction training was held for 48 new employees.

Every year the Bulgarian National Bank provides training to final year bachelor's and master's degree students. Under qualified specialist guidance, trainees gain insight of the Bank's functions and help with tasks appropriate to their knowledge. They work on BNB science and research projects or develop and present their own projects. In 2006 these trainees numbered 24.

Scholarships regulations changed, with the BNB offering two one-year scholarships to master's degree students and a one-year scholarship to a doctor's degree student from 2007.[27]

BNB experts help train future national economy staff by lecturing at universities and at the International Banking Institute.

[27] Information on scholarship disbursements and application terms is available on the BNB website.

XIV. Facilities Management

The BNB uses mainly wholly-owned premises and facilities, thus ensuring the requisite degrees of independence, security and protection expected from an institution of its standing. Long-term material asset management follows the BNB Premises Construction, Refurbishment, and Maintenance Strategy 2004 to 2009 and includes refurbishing and modernizing existing premises to meet new BNB needs and national and municipal regulations, and property acquisition and disposal as required by functional changes.

A major premises spending item in 2006 involved completing and commissioning the building at 7 Pozitano Street in Sofia where the BNB fiscal agency function moved in September. Facilities premises at both Sofia administrative buildings, at the 1 Alexander Battenberg Square and the 7 Moskovska Street, underwent planned refurbishment and building services and HVAC installations, as did the Plovdiv and Pleven regional cash offices. Both staff rest centres, at Varna and Primorsko, underwent planned refurbishment. The planned Sofia cash office at the Karo area on 117 Tsarigradsko Shose Blvd. saw various preparations, including removing lapsed building works, site clearing, boundary definition, and design.

To improve property maintenance in 2006, the BNB disposed of a property on Slaveykov Square in Sofia through open outcry auction.

During the year the BNB road fleet purchased six new vehicles as planned in the Road Transport Development Strategy 2004 to 2009. Selected budget organizations received ten used vehicles.

BNB 2006 property and facilities maintenance budget outturns for 2006 were:

- buildings maintenance, 111.2 per cent;
- new construction, refurbishment, and modernisation, 42 per cent;
- office furniture and equipment purchases, 95.4 per cent;
- new vehicle acquisition, 90.3 per cent;
- heating, 81.4 per cent;
- electricity, 85.5 per cent;
- contract maintenance, 101.8 per cent;
- buildings, facilities, and vehicle insurance, 93.7 per cent.

Underspending for new construction, refurbishment, and modernisation was due to delays to works on specialist BNB premises, the refurbishment Blocks G and D of 1 Alexander Battenberg Square BNB Building and to savings in removing lapsed building works at the future cash centre on 117 Tsarigradsko Shose Blvd.

XV. Internal Audit

Monetary policy, payment system maintenance, cash circulation, government agency, information and analysis, and administration were the more important of the 16 audits conducted in 2006 according to the Governing Council's annual audit programme.

Monetary policy underwent an operational audit alongside compliance audits on maintaining optimum cash balances and strategic and logistic reserves. Compliance with internal rules and cash accepting, storing, delivering and reporting were reviewed, and control reliability was assessed.

The RINGS audit established the new version's compliance with business requirements, investigated pending changes in relation to BNB inclusion in TARGET2, assessed ensuing risks and measures for protecting the network perimeter of RINGS, and followed up implementation of previous audits' recommendations.

Cash circulation audits included coin minting, plate decommissioning, banknote withdrawal and scrapping, counterfeit protection, and banknote trim waste scrapping.

Coin minting was audited operationally, alongside a compliance audit and assessments of minting, die scrapping, and manufacturing controls. The audits reviewed legal conformity, the implementation of past recommendations, and control efficiency in die scrapping.

The reporting period saw operational and compliance audits on withdrawing and scrapping unfit banknotes and coins. They followed up stocks and analyzed storage and scrapping methods.

The operational and compliance audits at the National Analysis Centre Division on counterfeit protection followed up suspect banknote and coin registration and expert assessment and looked at data exchange with external organizations.

The operational and compliance audits on banknote trim and paper scrapping at the BNB Printing Works AD examined storage, control and destruction of banknote trim and plates.

Audits on government securities auctions, the government securities register, the auction information system, agency contracts with the Ministry of Finance and international creditors, and government account balances on contracts with the World Bank examined the BNB's government agency function.

Operational, compliance and IT audits on conducting government securities auctions assessed risk control and management mechanisms adequacy, legal conformity, the reliability of information integrity and confidentiality protection, automated system utilization, and protection against business interruption.

Operational, financial, and compliance audits on Ministry of Finance and international creditor agency contracts followed up recommendations from previous reports and assessed the adequacy of risk control and management mechanisms, legal aspects, accounting record scope, timeliness, and reliability.

The 30 June 2006 BNB Consolidated Financial Statement audit evaluated the accuracy, scope, and reliability of BNB financial statements, their compliance with the Bank's accounting policy, and control systems' adequacy.

The operational and compliance audits on the BNB annual budget and its implementation between January and June 2006 inspected budget preparing, monitoring, implementing and reporting.

Operational and financial audits and an internal rules audit addressed procedures for selecting building designers and contractors and goods and service suppliers in conformity with the BNB budget and assessed internal rule efficiency and contract performance.

The BNB *Internal Audit* was assessed to International Standards for the Professional Practice of Internal Auditing and the ESCB Internal Audit Committee Manual.

In 2006 the Chief Auditor and Internal Audit experts concentrated on defining systems controls and designing important projects such as the Treasury TREMA subsystem, the SAP core banking information system, and monitoring the new BNB cash centre.

Concluded Audits in 2006

BNB functions	Audits
Monetary policy	Maintaining optimum cash balances
	Strategic, logistic, operational reserves
Maintenance of payment systems	RINGS audit. Interfaces
Maintenance of cash circulation	Coin minting
	Die scrapping
	Withdrawing and scrapping unfit banknotes
	Counterfeit protection
	Banknote trim and paper scrapping
Government agency	Government securities auctions. Government securities register
	Information system for conducting auctions
	Agency contracts with the Ministry of Finance and international creditors
	Government accounts on agreements with the World Bank
Information and Analytical	BNB financial statements as of 30 June 2006
	Bulgaria's position in the IMF
	Preparing and implementing the BNB budget
Administrative	Selection of suppliers
	Concluded and executed delivery contracts

Source: BNB.

XVI. BNB Budget Implementation

The BNB Budget was adopted by the BNB Governing Council at its 8 December 2005 meeting and published in *Darjaven Vestnik,* issue 102 of 20 December 2005.

1. Operational Expenditure

BNB operational expenditure for 2006 totaled BGN 59,410,000 or 87.2 per cent of the annual budget.

Currency circulation cost BGN 18,885,000 or 85.8 per cent of the annual budget. Banknote and coin production cost BGN 17,983,000 or 88.3 per cent of budget, including BGN 13,985,000 or 86.1 per cent of budget on banknote printing and BGN 3,998,000 on coin minting, of which BGN 3,334,000 on circulation. Commemorative coin expenditure was in line with the Programme adopted by the BNB Governing Council. A coin marking Bulgaria's accession to the EU was minted. Funds were spent on designing new issues of banknotes and coins, banknote and coin scrapping, and consumables. Expenditure on machine spares for servicing currency in circulation came to BGN 101,000 or 44.3 per cent of budget. Renting premises at the BNB Printing Works cost BGN 513,000.

Material, external services, and depreciation spending totaled BGN 19,652,000 or 83.2 per cent of budget. Of this, materials comprised BGN 976,000. Major expenditure in this group comprised, *inter alia*, BGN 367,000 on inventories, BGN 229,000 on office materials, and BGN 226,000 on fuel and spares for the BNB transport fleet.

Expenditure on hired services was BGN 9,558,000 or 75.1 per cent of budget. More significant items concerned Bloomberg, Reuters, internet and other system provision at BGN 1,007,000. Software maintenance came to BGN 1,872,000. Equipment maintenance was BGN 741,000. Mail, telephone and telex spend came to BGN 518,000. Property and refuse collection levies were BGN 957,000, and electric bills were BGN 365,000. The Bank spent BGN 1,549,000 on its security contract with the Ministry of the Interior. Expenses on major building maintenance totaled BGN 646,000.

In 2006 BGN 358,000 (22 per cent of budget) went on consultation services for the TREMA and SAP projects (BGN 176,000 and BGN 124,000 respectively). Funds were spent on drafting the Bill on Credit Institutions, drawing up security specifications for the new BNB cash centre, drafting a methodology for the planned disaster recovery centre, property valuations, and compliance assessments of projected BNB Building works.

Depreciation expenses were BGN 9,118,000 or 94 per cent of budget. Salaries, social, and healthcare costs totaled BGN 16,846,000 or 99.7 per cent of budget. In accordance with the requirements of IAS 19, *Income of Hired Persons*, the Bank reported in its budget BGN 581,000 worth of current obligations to staff for retirement and unused paid leave.

Social expenditure amounted to BGN 1,816,000 or 98.1 per cent of budget.

Miscellaneous administrative expenditure for 2006 was BGN 1,476,000 or 60.8 per cent of the annual budget. Inland travel involved mainly supplying banknotes and coins to regional cash centres and conducting checks there. Foreign travel covered participation in seminars and staff training. Utilized funds came to BGN 379,000 or 66.4 per cent of budget. Staff training totaled BGN 652,000 and Bank representative and protocol expenses, BGN 272,000.

BNB staff training in 2006 followed the Educational and Professional Training Programme. Expenses were by the BNB (BGN 652,000) and the ECB and other international financial organizations (BGN 180,000).

Expenditure on BNB membership in the ESCB totaled BGN 735,000, of which BGN 18,000 on staff training. The cost of BNB representatives' participation at ESCB commission and committee sessions was BGN 156,000.

2. The Investment Programme

Budgeted investment funds were BGN 21,882,000, of which BGN 13,932,000 or 63.7 per cent was utilized. Most funds went on the Information and Communications Technology Development Strategy: BGN 10,217,000, of which BGN 3,200,000 for hardware. This included buying, installing and equipping servers, computers, laptops, monitors, printers, UPS protection, communications equipment, a scanner and a multimedia projector. Other money went on LAN cabling at the BNB Building and other sites.

Software spending came to BGN 7,017,000, of which BGN 2,303,000 on launching the Core Bank Information System, BGN 655,000 on SAP licenses, BGN 539,000 on a Trema (Europe) AB license, BGN 1,848,000 on FinanceKit launch services, and software upgrades.

Construction, refurbishment and remodeling of BNB properties came to BGN 1,845,000 or 42 per cent of budget. This covered removing works abandoned by an earlier site owner and completing the Fiscal Department building. All new build and remodeling expenditure was in line with the Governing Council's Buildings Construction, Refurbishment and Maintenance Strategy, 2004 to 2009.

Spending on security equipment totaled BGN 277,000 or 39.7 per cent of budgeted funds, including expanding and modernizing video surveillance.

Under the Governing Council's Road Transport Development Strategy 2004 to 2009 on gradual roll-over of the BNB vehicle fleet, the Bank purchased six new vehicles, including two minibuses.

The Bank spent BGN 677,000 on office furniture and equipment, including copying machines, a hot stamping machine for the BNB Printing Works, and air conditioners and fittings for new BNB offices.

Furnishing the BNB office in the ECB building cost BGN 79,000, including five UPS devices for BGN 56,000 and Groupwise licenses for BGN 23,000.

Implementation of the BNB Budget

Indicators	Report 30 Dec. 2006 (BGN'000)	Budget 2006 (BGN'000)	Implementation (%)
Section I. BNB operational expenditure	**59 410**	**68 092**	**87.2**
Currency circulation expenditure	18 885	22 018	85.8
Materials, services and depreciation expenditure	19 652	23 616	83.2
Salaries and social security expenditure	16 846	16 897	99.7
Social activity expenditure	1 816	1 852	98.1
Other administrative expenditure	1 476	2 427	60.8
BNB expenditure on membership in ESCB	735	1 282	57.3
Section II. Investment programme	**13 932**	**21 882**	**63.7**
Expenditure on construction, reconstruction and modernization	1 845	4 390	42.0
Expenditure on machine spares for servicing currency circulation	151	353	42.6
Expenditure on BNB security equipment	277	698	39.7
Expenditure on special automobiles	686	760	90.3
Expenditure on BNB computerization	10 217	13 673	74.7
Office furniture and equipment	677	710	95.4
BNB expenditure on membership in ESCB	79	298	26.5
Expenditure on restructuring currency circulation	0	1 000	0

XVII. Consolidated Financial Statements for the Year Ended 31 December 2006

KPMG

INDEPENDENT AUDITOR'S REPORT
TO THE MANAGING BOARD OF
THE BULGARIAN NATIONAL BANK

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of the Bulgarian National Bank and its subsidiaries, which comprise the consolidated balance sheet as at December 31, 2006, the consolidated income statement, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the 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 Commission. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

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 relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the 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 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 policies used and the reasonableness of accounting principles made by management, as well as evaluating the overall presentation of the 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 Bulgarian National Bank and its subsidiaries as at December 31, 2006, 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 Commission.

KPMG Bulgaria OOD

KPMG Bulgaria OOD

Sofia, 24 April 2007
37 Fridtjof Nansen Str.
1142 Sofia
Bulgaria

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

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

The financial statements of the Bulgarian National Bank approved by the Governing Council are prepared in accordance with 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 a general responsibility for taking such steps as are reasonably open to it to safeguard the assets of the Bulgarian National Bank and to prevent or detect fraud and other irregularities.

Ivan Iskrov
Governor of the BNB

Consolidated Income Statement for the Year Ended 31 December 2006

(BGN'000)

	Note	31 Dec. 2006	31 Dec. 2005
Interest and similar income	7	409,527	381,281
Interest expense and similar charges	7	(101,204)	(80,975)
Net interest income		308,323	300,306
Fee and commission income		6,930	5,745
Fee and commission expense		(2,952)	(3,312)
Net fee and commission income		3,978	2,433
Other net financial income/(expense)	8	(6,315)	213,348
Other operating income	9	32,685	40,366
Total income from banking operations		338,671	556,453
Administrative expenses	10	(74,361)	(69,196)
Profit from operations		264,310	487,257
Transfer (to)/from special reserves		55,509	(170,160)
Result after transfer (to)/from special reserves		319,819	317,097
Appropriations and transfer to reserves			
Proposed contribution to the budget of the Republic of Bulgaria		170,630	150,162
Transfer to other reserves and minority interest		149,189	166,935
		319,819	317,097

The accompanying notes on pages 69 to 86 form an integral part of the consolidated financial statements.

Consolidated Balance Sheet for the Year Ended 31 December 2006

(BGN'000)

	Note	31 Dec. 2006	31 Dec. 2005
ASSETS			
Cash and deposits in foreign currencies	11	4,206,480	3,430,616
Gold, instruments in gold and other precious metals	12	1,226,617	1,102,092
Investment in securities	13	11,968,687	9,823,829
Equity investments and quota in the IMF	15	1,465,753	1,551,185
Receivables from the Government of the Republic of Bulgaria	14	506,326	1,094,356
Property, plant and equipment and intangible assets	16	171,466	171,397
Other assets	17	35,688	28,732
Total assets		19,581,017	17,202,207
LIABILITIES			
Banknotes and coins in circulation	22	6,888,576	5,867,213
Due to banks and other financial institutions	18	3,593,746	2,485,207
Liabilities to government institutions and other borrowings	19	5,105,564	4,295,273
Borrowings against Republic of Bulgaria's IMF participation	20	1,356,364	1,438,739
Borrowings from general resources of the IMF	21	506,326	1,094,356
Accruals and other liabilities	23	19,108	22,573
Total liabilities		17,469,684	15,203,361
EQUITY			
Capital	24	20,000	20,000
Reserves	24	2,088,047	1,975,640
Minority interest	25	3,286	3,206
Total equity		2,111,333	1,998,846
Total liabilities and equity		19,581,017	17,202,207

The accompanying notes on pages 69 to 86 form an integral part of the consolidated financial statements.

Consolidated Statement of Cash Flows for the Year Ended 31 December 2006

(BGN'000)

	Note	31 Dec. 2006	31 Dec. 2005
Net cash flow from banking operations			
Net income from banking operations		264,310	487,257
Adjustments for non-cash and non-operating items:			
Dividend income		(4,489)	(4,451)
Depreciation	16	15,188	13,010
(Profit)/loss on disposal of property, plant, equipment and intangible assets		(147)	38
Revaluation of property, plant, equipment and intangible assets		-	(2,310)
Impairment of property, plant, equipment and intangible assets		-	1,061
Profit of associates		(2,494)	(5,242)
Other non-monetary movements		-	(6,223)
(Gains)/losses on working capital arising from market movements		41,241	(81,702)
Net cash flow from operating activities before changes in operating assets and liabilities		313,609	401,438
Change in operating assets			
(Increase)/decrease in gold and other precious metals		795	(225)
(Increase) in securities		(2,322,007)	(358,217)
Decrease in receivables from the Government		525,465	711,161
(Increase)/decrease in other assets		(954)	11,997
Change in operating liabilities			
Increase in due to banks and other financial institutions		1,109,031	445,554
(Decrease)/Increase in government deposits and current accounts		824,362	(709,944)
(Decrease) in borrowings from the IMF		(525,465)	(711,161)
Increase in currency in circulation		1,021,363	846,971
(Decrease)/increase in accruals and other liabilities		(3,308)	8,394
Net cash flow from operating activities		942,891	645,968
Cash flow from investing activities			
Purchase of property, plant, equipment and intangible assets, net		(15,352)	(10,753)
Dividends received		4,489	4,451
Proceeds from sale of BORIKA shares		-	6,223
Net cash flow from investing activities		(10,863)	(79)
Cash flow from financing activities			
Payments to the Government		(150,162)	(149,050)
Net cash flow from financing activities		(150,162)	(149,050)
Net increase in cash and cash equivalents		781,866	496,839
Cash and cash equivalents at beginning of period		3,448,332	2,951,493
Cash and cash equivalents at end of period	11, 17	4,230,198	3,448,332

The accompanying notes on pages 69 to 86 form an integral part of the consolidated financial statements.

Consolidated Statement of Changes in Equity for the Year Ended 31 December 2006

(BGN'000)

	Capital	Minority interest	Revaluation reserves from: non-current assets	monetary assets	commemorative coins	Other reserves	Total
Balance as at 1 January 2005	**20,000**	**3,093**	**104,500**	**774,774**	**10,841**	**756,428**	**1,669,636**
Revaluation of equity investments	-	-	1,397	-	-	-	1,397
Transfer of unrealized gains on the revaluation of gold	-	-	-	295,067	-	-	295,067
Transfer of net foreign exchange gain	-	-	-	6,097	-	-	6,097
Transfer of net loss on the revaluation of financial instruments	-	-	-	(341)	-	-	(341)
Transfer of net loss on the revaluation of securities	-	-	-	(131,627)	-	-	(131,627)
Other transfers	-	43	(393)	-	(10,003)	923	(9,430)
Payment of the prior year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	(149,050)	(149,050)
Current year contribution to the Budget of the Republic of Bulgaria	-	-	-	-	-	150,162	150,162
Profit for the year after the contribution to the budget of the Republic of Bulgaria and minority interest	-	70	-	-	-	77,865	77,935
Other special reserves	-	-	-	-	-	89,000	89,000
Balance as at 31 December 2005	**20,000**	**3,206**	**105,504**	**943,970**	**838**	**925,328**	**1,998,846**
Revaluation of equity investments	-	-	(1,355)	-	-	-	(1,355)
Transfer of unrealized gains on the revaluation of gold	-	-	-	125,423	-	-	125,423
Transfer of net gain on the revaluation of financial instruments	-	-	-	252	-	-	252
Transfer of net foreign exchange losses	-	-	-	(4,763)	-	-	(4,763)
Transfer of net loss on the revaluation of securities	-	-	-	(177,401)	-	-	(177,401)
Other transfers	-	-	(202)	-	(103)	979	674
Payment of the prior year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	(150,162)	(150,162)
Current year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	170,630	170,630
Profit for the year after the contribution to the budget of the Republic of Bulgaria and minority interest	-	80	-	-	-	84,109	84,189
Other special reserves	-	-	-	-	-	65,000	65,000
Balance as at 31 December 2006	**20,000**	**3,286**	**103,947**	**887,481**	**735**	**1,095,884**	**2,111,333**

The accompanying notes on pages 69 to 86 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 Republic of Bulgaria.

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

Under this law, the principal activities of the Bank may be summarized as:

- Maintaining price stability through national currency stability;
- Exclusive right to issue banknotes and coins;
- Regulation and supervision of other banks' activities with a view to banking system stability maintenance;
- Facilitation of non-cash payments through establishment and operation of efficient payment systems.

Under this law, the principal operations of the Bank may be summarized as:

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

The Governing Council of the Bulgarian National Bank approved the consolidated financial statements set out on pages 61 to 86 on 12 April 2007.

2. Statement of compliance

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

The accounting policies have been consistently applied.

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

4. Basis of consolidation

Subsidiaries

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

Associates

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

5. Summary of significant accounting policies

(a) Income recognition

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

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

Other financial income/expense include gains and losses arising from disposals and changes in the fair value of financial assets and liabilities at fair value through profit and loss and available-for-sale assets.

Dividends on available-for-sale equity instruments are recognized in the income statement when the Bank receives the payment.

(b) Financial instruments

(i) Classification

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

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

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

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

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

(ii) Initial recognition

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

The Bank manages foreign reserves in line with the prudential investment principles and practices as per the requirements of the Law on the BNB. Investments in securities can only be in liquid debt instruments issued by institutions with high credit rating.

(iii) Subsequent measurement

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

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

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

(iv) Fair value measurement principles and disclosures

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

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

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

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

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

The fair value of cash and cash equivalents, deposits in foreign currency, other receivables and liabilities is approximately equal to the book value given, because of their short-term maturity. The Bank changes the contractual interest rate on the liabilities to the Government that carry the floating interest rate to reflect the movement in the market interest rates.

(v) Gains and losses on subsequent measurement

All gains and losses arising from a change in the fair value of financial instruments through profit and loss and those available- for-sale are recognized in the income statement.

Gains and losses arising from changes in the fair value of available-for-sale financial assets are recognized directly in equity, until the financial asset is derecognized or impaired at which time the cumulative gain or loss previously recognized in equity should be recognized in profit or loss.

(vi) Derecognition

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

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

(vii) Automatic securities lending agreements

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

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

(viii) Impairment of assets

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

(c) Gold and other precious metals

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

(d) Equity investments

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

Details of investments held are set out in note 15.

(e) Property, plant, equipment and intangible assets

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

(i) Subsequent expenditure

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

(ii) Depreciation

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

(%)

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

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

(iii) Calculation of recoverable amount

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

(iv) Reversals of impairment

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

(f) Foreign currencies

Income and expenditure arising in foreign currencies are translated to BGN at the official rates of exchange on the transaction date. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the official exchange rate ruling on that day. Foreign exchange gains and losses are recognized in the income statement. Foreign currency denominated non-monetary assets and liabilities are valued at the exchange rate on the date of acquisition or at latest determination of fair value.

Open forward foreign exchange contracts are marked to market. The gains and losses on revaluation of open forward contacts are recognized in the income statement.

The exchange rates of major foreign currencies as at 31 December 2006 and 31 December 2005 were:

Currency	31 December 2006	31 December 2005
US Dollar (USD)	1 : BGN 1.48506	1 : BGN 1.65790
Euro (EUR)	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rights (SDR)	1 : BGN 2.23412	1 : BGN 2.36959
Gold (XAU)	1 troy ounce : BGN 944.198	1 troy ounce : BGN 847.489

(g) Taxation

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

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

(h) Loans from the International Monetary Fund (IMF)

Borrowings from the IMF are denominated in Special Drawing Rights (SDR).

(i) Profit distribution policy of the Bank

The distribution policy of profit from banking operations of the Bank is defined in the Law on the BNB. Within the meaning of Article 36 of the Law on the BNB, the Bank allocates special reserves that comprise net gains and losses arising from revaluation of assets and liabilities denominated in foreign currency or gold. According to the requirements of Article 8, para. 2 of the Law on the BNB, the Bank sets aside 25 per cent of its result after the special reserve transfer into a Reserve Fund. According to Article 8, para. 3 of the Law on the BNB, after the allocation to the Reserve Fund the Bank allocates reserves to cover market risk losses and other reserves on decision of the Governing Council. Subsequent to the allocation of reserves as required by the Law on the BNB, the Bank stipulates the contribution to the State Budget.

(j) Cash in hand and deposits in foreign currency

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

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

IFRS 7 (effective from 1 January 2007) – Financial Instruments: Disclosure

The standard will require increased disclosure about the significance of financial instruments for an entity's financial position and performance, and qualitative and quantitative disclosures on the nature and extent of risks. The Bank considers that the significant additional disclosures required will relate to its financial risk management objectives, policies and processes.

Amendments to IAS 1 (effective from 1 January 2007) – Presentation of Financial Statements – Capital Disclosures

As a complimentary amendment arising from IFRS 7, the standard will require increased disclosure in respect of the Bank's capital.

IFRIC 9 Reassessment of Embedded Derivatives (effective for annual periods beginning on or after 1 June 2006)

The interpretation requires that a reassessment of whether an embedded derivative should be separated from the underlying host contract should be made only when there are changes in the terms of the contract that significantly modify the cash flows that otherwise would be required under the contract. IFRS 9 is not relevant to the Bank's operations, as the Bank has not changed the terms of the contracts, which contain embedded derivatives.

6. Risk management disclosures

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

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

The foreign currency reserve risks are managed by an independent risk management unit. It is directly responsible for the strategic asset allocation and the determination of the foreign exchange reserves benchmark, and prepares and submits for approval the investment management limits. On a quarterly basis, an overall review is made of the changes in the market conditions, the amount and structure of foreign currency reserves, and if required, the investment limits and benchmarks are updated. The observance of underlying limits, rules, and procedures is monitored on a daily basis. Reports are regularly prepared both for the needs of foreign currency reserves operating management, and for providing updated information to the Bank's management.

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

The foreign currency reserve management is governed by rules of behaviour and procedures regulating the performance of the functions and tasks of the main structural units responsible. The rules and procedures are included in the document *Manual of Business Procedures for Foreign Currency Reserve Management.*

(a) Credit risk

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

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

- Bonds issued by countries, state-guaranteed institutions, central banks and international financial organisations;
- Term deposits in foreign currency and gold placed with central banks, supranational financial institutions and banks;
- Commercial paper issued by countries, supranational, state-guaranteed institutions and banks;
- Secured Eurobonds (securities backed by high quality pool of assets) issued by first rate foreign banks in many countries in the euro area, of which bonds issued by German and French financial institutions of the type Jumbo Pfandbriefe and Obligations Foncieres and Irish Asset Covered Securities are currently eligible for investment;
- Bonds issued by first rate financial agencies, which are not guaranteed by the states;
- Futures (bond and interest rate) traded on the international regulated markets;
- Repurchase agreements;
- Securities lending agreement programmes performed by a bank agent and/or the custodian of the securities.

A minimum exposure limit is set for investments in debt issued by countries, central banks or state-guaranteed financial institutions. The limit defines the portion of foreign currency reserves to be invested in the most risk-free and highly liquid asset class. The rest of the above asset classes are subject to limits of maximum exposure. All limits take into account the level of credit risk of the relevant asset classes.

According to the BNB Policy for counterparties in foreign currency reserve management, foreign financial institutions acting as BNB counterparties are divided into two groups:

- Group One – financial institutions to which the BNB may have a credit exposure. These should have long-term credit rating higher or equal to AA- according to S&P and Fitch

Ratings, or Aa3 according to Moody's by at least two of the above indicated agencies.

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

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

(b) Liquidity risk

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

The Bank's customers are determined by the Law on the BNB. It attracts funds by means of a number of instruments – deposits/investment accounts, a structured indexed account (SIA), settlement accounts and other borrowed funds established by law. The Bank strives to maintain a balance between the maturity of borrowed funds and that of assets through investments in financial instruments with a range of maturities. Limits are set to ensure minimum liquidity by type of currency. The Bank is able to provide the required liquidity by investing in various types of instruments. This liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments. In addition, there are limits on the residual term to maturity for the financial instruments of those asset classes approved for investment. They guarantee adequate liquidity and limit the market risk.

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

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

(BGN'000)

As at 31 December 2006	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Undefined maturity	Total
Assets							
Cash and deposits in foreign currencies	3,814,409	392,071	-	-	-	-	4,206,480
Gold, instruments in gold and other precious metals	164,457	483,265	75,464	-	19,017	484,414	1,226,617
Investment in securities	3,316,539	3,488,840	3,506,981	1,598,821	57,506	11,968,687	
Equity investments and quota in the IMF	74,044	-	-	-	-	1,391,709	1,465,753
Receivable from the Republic of Bulgaria	-	38,948	136,319	331,059	-	-	506,326
Property, plant, equipment and intangible assets	-	-	-	-	-	171,466	171,466
Other assets	4,026	12,286	18,498	142	-	736	35,688
Total assets	7,373,475	4,415,410	3,737,262	1,930,022	76,523	2,048,325	19,581,017
Liabilities							
Banknotes and coins in circulation	-	-	-	-	-	6,888,576	6,888,576
Due to banks and other financial institutions	3,593,746	-	-	-	-	-	3,593,746
Liabilities to government institutions and other borrowings	4,280,887	802,695	21,982	-	-	-	5,105,564
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	-	1,356,364	1,356,364
Borrowings from general resources of the IMF	-	38,948	136,319	331,059	-	-	506,326
Accruals and other liabilities	6,155	4,122	6,299	-	2,532	19,108	-
Total liabilities	7,880,788	841,643	162,423	337,358	-	8,247,472	17,469,684
Asset-liability maturity mismatch	(507,313)	3,573,767	3,574,839	1,592,664	76,523	(6,199,147)	2,111,333

(BGN'000)

As at 31 December 2005	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Undefined maturity	Total
Assets							
Cash and deposits in foreign currencies	3,194,792	235,824	-	-	-	-	3,430,616
Gold, instruments in gold and other precious metals	582,145	-	-	67,745	17,404	434,798	1,102,092
Investment in securities	592,982	1,926,517	2,231,059	2,354,527	2,718,744	-	9,823,829
Equity investments and quota in the IMF	78,199	-	-	-	-	1,472,986	1,551,185
Receivable from the Republic of Bulgaria	23,104	358,835	175,389	537,028	-	-	1,094,356
Property, plant, equipment and intangible assets	-	-	-	-	-	171,397	171,397
Other assets	14,553	12,678	52	1,331	-	118	28,732
Total assets	4,485,775	2,533,854	2,406,500	2,960,631	2,736,148	2,079,299	17,202,207
Liabilities							
Banknotes and coins in circulation	-	-	-	-	-	5,867,213	5,867,213
Due to banks and other financial institutions	2,485,207	-	-	-	-	-	2,485,207
Liabilities to government institutions and other borrowings	4,273,419	21,854	-	-	-	-	4,295,273
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	-	1,438,739	1,438,739
Borrowings from general resources of the IMF	23,104	358,835	175,389	537,028	-	-	1,094,356
Accruals and other liabilities	17,862	-	2,322	-	-	2,389	22,573
Total liabilities	6,799,592	380,689	177,711	537,028	-	7,308,341	15,203,361
Asset-liability maturity mismatch	(2,313,817)	2,153,165	2,228,789	2,423,603	2,736,148	(5,229,042)	1,998,846

(c) Market risk

Market risk

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

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

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations which affect 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 of the market value of an asset (liability) in response to 1 per cent change of the interest rate levels. In addition, technical parameters of the portfolios such as convexity, spread duration, duration in a fixed point of the yield curve 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 allowable deviation of the modified duration of the portfolio from that of the respective benchmark.

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

(BGN'000)

As at 31 December 2006	Effective rate	Total	Floating rate instruments	Fixed rate instruments		
				Less than 1 month	Between 1 month and 3 months	Between 3 months and 1 year
Assets						
Cash and deposits in foreign currencies	3.68	4,193,663	6,314	3,796,183	391,166	-
Gold, instruments in gold and other precious metals	0.15	707,551	-	148,874	483,259	75,418
Investment in securities	3.65	11,817,460	-	3,281,937	3,446,814	5,088,709
Equity investments and quota in the IMF		81,736	-	74,044	-	7,692
Receivable from the Republic of Bulgaria		506,326	506,326	-	-	-
Other interest-bearing assets		23,891	-	23,891	-	-
Non-interest bearing assets		2,250,390	-	-	-	-
Total		19,581,017	512,640	7,324,929	4,321,239	5,171,819
Liabilities						
Due to banks and other financial institutions		3,593,746	-	3,593,746	-	-
Liabilities to government institutions and other borrowings	3.33	4,771,575	146,687	3,803,374	800,000	21,514
Borrowings from general resources of the IMF		506,326	506,326	-	-	-
Non-interest bearing liabilities (including banknotes and coins in circulation)		8,598,037	-	-	-	-
Total		17,469,684	653,013	7,397,120	800,000	21,514
Asset/liability gap		2,111,333	(140,373)	(72,191)	3,521,239	5,150,305

(BGN'000)

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

(d) Currency risk

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

As a result of the currency board arrangement in Bulgaria, the Bulgarian currency is fixed to the euro. As the currency in which the Bank presents its financial statements is the Bulgarian lev, the Bank's financial statements are impacted by movements in the exchange rates between the currencies outside the euro area and the lev. The daily change in the price (rate) of the monetary gold against the euro has also a material impact on the Bank's balance sheet.

To minimize currency risk, a limit is set to mismatches between the currency structure of assets and that of liabilities. According to Article 31(3) of the Law on the BNB, the market value of assets in a currency other than the euro, SDR and monetary gold should not deviate by more than +/-2 per cent from the market value of liabilities denominated in the same currency.

The foreign currency exposures are as follows:

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Assets		
Bulgarian lev and euro area currencies	16,261,368	13,173,795
US dollar	128,776	285,148
Japanese yen	68	55
Pound sterling	307	494
SDR	1,960,923	2,636,920
Gold	1,223,516	1,099,117
Other	6,059	6,678
	19,581,017	17,202,207
Liabilities and equity		
Bulgarian lev and euro area currencies	17,592,803	14,385,697
US dollar	124,018	281,227
Japanese yen	-	-
Pound sterling	56	5
SDR	1,861,369	2,532,218
Gold	-	-
Other	2,771	3,060
	19,581,017	17,202,207
Net position		
Bulgarian lev and euro area currencies	(1,331,435)	(1,211,902)
US dollar	4,758	3,921
Japanese yen	68	55
Pound sterling	251	489
SDR	99,554	104,702
Gold	1,223,516	1,099,117
Other	3,288	3,618

7. Interest income and expense

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Interest income		
- on securities	290,941	325,856
- on deposits	117,146	55,425
- on other	1,440	-
	409,527	381,281
Interest expense		
- on deposits	93,192	74,065
- on other	8,012	6,910
	101,204	80,975

Interest expenses on deposits in BGN paid to the Government are BGN 76,862 thousand for 2006 (for 2005: BGN 32,025 thousand) and interest paid on deposits in foreign currency to the Government is BGN 14,564 thousand (for 2005: BGN 36,573 thousand). Interest expenses on deposits in BGN of other state organisations are BGN 1108 thousand for 2006 (2005: BGN 3773 thousand) and on deposits in foreign currency BGN 658 thousand (for 2005: BGN 1694 thousand).

8. Other net financial income/(expense)

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Net gains from operations in securities	49,530	43,062
Net gains from operations in foreign currency	644	1,090
Net revaluation gains/(losses) on futures	252	(341)
Net revaluation losses on securities	(177,401)	(131,627)
Net revaluation gains/(losses) on foreign currency assets and liabilities	(4,763)	6,097
Net gains from revaluation of gold and precious metals	125,423	295,067
	(6,315)	213,348

9. Other operating income

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Net income from disposal of non-current assets	80	3,069
Turnover of subsidiaries	18,586	17,213
Income from associated companies	2,494	5,242
Income from sales of coins	1,152	1,069
Dividend income	4,489	4,451
Other income, net	5,884	9,322
	32,685	40,366

Other income includes income from the derecognition of the old coins and banknotes issued before 5 July 1999 in the amount of BGN 4450 thousand (31 December 2005: BGN 8270 thousand).

10. Total administrative expenses

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Personnel costs	24,148	23,285
Administrative expenses	32,433	29,723
Depreciation	15,188	13,048
Other expenses	2,592	3,140
	74,361	69,196

Personnel costs include salaries, social and health security accrued under the provision of local legislation as at 31 December 2006 respectively: for BNB – 18,662 thousand, for the Printing Works – 3785 thousand, and for the State Mint – 1701 thousand. The number of employees of the Bank and its subsidiaries was 1284 as at 31 December 2006 (31 December 2005: 1257) including BNB staff of 928 as at 31 December 2006 (31 December 2005: 932).

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

Based on actuarial calculations, the Bank has accrued retirement compensation liabilities to the personnel in the amount of BGN 221 thousand and unused annual leave of BGN 360 thousand (31 December 2005: 764 thousand and 291 thousand). The retirement compensation and unused annual leave for the subsidiaries of the Bank as of 31 December 2006 are BGN 298 thousand and BGN 163 thousand (31 December 2005: BGN 265 thousand and BGN 143 thousand).

Administrative expenses include also the currency circulation expenses of the BNB amounting to BGN 18,885 thousand as of 31 December 2006 (31 December 2005: BGN 17,510 thousand).

11. Cash and deposits in foreign currencies

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Foreign currency cash	8,001	10,153
Current accounts with other banks	6,462	8,887
Deposits in foreign currency	4,192,017	3,411,576
	4,206,480	3,430,616

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

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Euro area residents		
In EUR	2,191,004	2,068,506
In other foreign currencies	70	261
	2,191,074	2,068,767
Non euro area residents		
In EUR	1,948,882	1,072,203
In other foreign currencies	66,524	289,646
	2,015,406	1,361,849
	4,206,480	3,430,616

12. Gold, instruments in gold and other precious metals

	31 Dec. 2006		31 Dec. 2005	
	Troy ounces'000	BGN'000	Troy ounces'000	BGN'000
Gold bullion in standard form	513	484,414	513	434,798
Gold deposits in standard form	686	647,722	686	582,145
Gold in other form	17	15,962	17	14,480
Other precious metals	-	3,055	-	2,924
Other instruments in gold	80	75,464	80	67,745
		1,226,617		1,102,092

Gold deposits in standard form include gold held with correspondents. This gold earns interest at rates between 0.01per cent and 0.02 per cent per annum.

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

Gold in other form includes gold commemorative coins of BGN 13,980 thousand. Other precious metals include silver commemorative coins of BGN 302 thousand and platinum commemorative coins of BGN 2753 thousand.

13. Investment in securities

(BGN'000)

Securities at fair value through profit and loss	31 Dec. 2006	31 Dec. 2005
Foreign treasury bills, notes and bonds	11,968,687	9,823,829
	11,968,687	9,823,829

Debt securities comprise both EUR and USD-denominated coupon and discount securities. The coupon interest on the EUR denominated securities reached 3.89 per cent.

As at 31 December 2006 the value of securities pledged as collateral on futures transactions amounts to BGN 19,800 thousand.

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

(BGN'000)

	Issuers' rating	31 Dec. 2006	31 Dec. 2005
Investment grade securities	AAA	8,776,027	7,114,166
	AA+	1,473,739	1,806,876
	AA	947,726	781,628
	AA-	771,195	121,159
		11,968,687	9,823,829

14. Receivables from the Government of the Republic of Bulgaria

The value of the receivables from the Government of the Republic of Bulgaria as at 31 December 2006 is SDR 226,633 thousand (31 December 2005: SDR 461,833 thousand).

The receivables from the Government have been matched to the Government's borrowings from the IMF which are repayable according to the repayment schedules of the agreements. At the beginning of 2006 the Bulgarian Government has repaid EUR 127,000 thousand ahead of the repayment schedule of the Extended Fund Facility of the IMF (refer note 21).

In accordance with the Strategy for the management of the state debt of the Government in the period 2006 – 2008, it is expected that the final repayment of the borrowings of the Republic of Bulgaria from the IMF would be done ahead of the repayment schedule.

The receivables are repayable as follows:

(BGN'000)

Year	31 Dec. 2006	31 Dec. 2005
2006	-	557,328
2007	175,267	185,894
2008	175,267	185,894
2009	116,844	123,930
2010	38,948	41,310
	506,326	1,094,356

15. Equity investments and quota in the IMF

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Republic of Bulgaria's quota in the IMF	1,430,540	1,517,110
Equity investments in international financial institutions	22,351	23,706
Equity investments in domestic companies	12,862	10,369
	1,465,753	1,551,185

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 74,045 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 3.77 per cent annual floating rate paid quarterly.

The equity investments in international financial institutions include the equity investment in the Bank for International Settlements (BIS), Basle. Twenty-five per cent of the equity investment in BIS Basle is paid up. The current value of these shares is SDR 10,000 thousand, which as at 31 December 2006 equals BGN 23,696,000 (31 December 2005: BGN 22,230,000 – ref. note 29 (i). The capital subscribed but not paid in has an option to be paid in within three months upon a decision of the BIS Board of Governors.

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

The Bank exercises substantial influence on the financial and operational policies of the following associated companies:

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

16. Property, plant, equipment and intangible assets

(BGN'000)

	Land and buildings	Equipment	Motor vehicles	Fixtures and fittings	Assets in progress	Other	Intangible assets	Total
Cost or valuation								
At 1 January 2006	120,928	80,846	3,995	3,979	7,333	304	10,525	227,910
Additions	828	1,034	88	41	13,942	-	9	15,942
Disposals	(421)	(772)	(257)	(36)	(224)	-	(16)	(1,726)
Transfers	1,433	3,517	656	556	(13,809)	-	7,647	-
At 31 December 2006	122,768	84,625	4,482	4,540	7,242	304	18,165	242,126
Depreciation								
At 1 January 2006	(9,393)	(38,155)	(2,528)	(1,935)	-	(130)	(4,372)	(56,513)
Charge for the period	(3,239)	(8,728)	(411)	(457)	-	(44)	(2,309)	(15,188)
On disposals	16	732	255	35	-	-	3	1,041
At 31 December 2006	(12,616)	(46,151)	(2,684)	(2,357)	-	(174)	(6,678)	(70,660)
Net book value at 31 December 2006	110,152	38,474	1,798	2,183	7,242	130	11,487	171,466
Net book value at 31 December 2005	111,535	42,691	1,467	2,044	7,333	174	6,153	171,397

The intangible assets of BGN 18,165 thousand include licenses to the amount of BGN 9058 thousand at 31 December 2006 (31 December 2005: BNG 2722 thousand), software to the amount of BGN 8478 thousand (31 December 2005: BNG 7177 thousand) and other intangible assets utilized by the Bank in its subsidiaries. Included in the net book value of the tangible fixed assets of BGN 159,979 thousand (2005: BGN 165,244 thousand) are the tangible fixed assets of the BNB amounting to BGN 108,896 thousand (2005: 109,486 thousand) and property and equipment of the State Mint of BGN 2860 thousand (2005: BGN 2447 thousand) and the property and equipment of the Printing Works of BGN 48,223 thousand (31 December 2005: BGN 53,311 thousand).

17. Other assets

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Balances of subsidiaries held with local banks	23,718	17,716
Precious metal commemorative coins for sale	736	802
Inventories (including spare parts)	7,506	6,328
Accounts receivable	1,089	1,044
Prepaid expenses	715	535
Other	1,924	2,307
	35,688	28,732

18. Due to banks and other financial institutions

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Demand deposits from banks and other financial institutions		
- in BGN	1,540,437	1,456,691
- in foreign currency	2,053,309	1,028,516
	3,593,746	2,485,207

The Bank does not pay interest on demand deposits from banks and other financial institutions. Included in demand deposits is BGN 3,293 million representing the required reserves, which all local banks are required to maintain with the Bank as part of their current accounts (31 December 2005: BGN 2235 thousand).

19. Liabilities to government institutions and other borrowings

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Current accounts:		
- in BGN	106,650	341,011
- in foreign currency	369,109	426,176
Time deposit accounts:		
- in BGN	3,684,025	2,679,579
- in foreign currency	945,780	848,507
	5,105,564	4,295,273

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 USD earn interest between 3.83 per cent and 4.85 per cent. Government deposit accounts in EUR earn interest between 2.02 per cent and 3.27 per cent and in BGN earn interest between 2.02 per cent and 3.34 per cent.

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

The borrowings against Bulgaria's participation in the IMF as at 31 December 2006 amount to BGN 1,356,495 thousand – SDR 607,057 thousand (at 31 December 2005: BGN 1,435,020 thousand – SDR 605,598 thousand).

Borrowings from the IMF are denominated in SDRs. Borrowings related to Bulgaria's IMF quota are non-interest bearing with no stated maturity. The borrowings against the Republic of Bulgaria's participation in the IMF include account No. 1 of the IMF for administrative expenses denominated in BGN amounting to BGN 3701 thousand at 31 December 2006.

21. Borrowings from general resources of the IMF

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Extended fund facility	506,326	1,094,356
	506,326	1,094,356

The borrowings from the general resources of the IMF bear interest at rates set by the IMF on a weekly basis, and as at 31 December 2006 the interest rate amounted to 5.48 per cent.

Borrowings from the IMF are guaranteed by promissory notes, which have been cosigned by the Government and the Bank. Borrowing from general resources of the IMF correspond to the receivables from the Government and are paid in accordance with the repayment schedule of the agreements with the IMF (refer note 14). The total promissory notes outstanding as at 31 December 2006 were BGN 2,076,555 thousand (31 December 2005: BGN 2,443,937 thousand) – refer to note 27*(i).*

22. Banknotes and coins in circulation

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Banknotes in circulation	6,781,539	5,774,024
Coins in circulation	107,037	93,189
Currency in circulation	6,888,576	5,867,213

23. Accruals and other liabilities

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Salaries and social security payable	1,883	1,704
Deferred income	6,299	10,316
Other liabilities	10,926	10,553
	19,108	22,573

Deferred income includes the amount of BGN 4573 which represents the deferred income from the old banknotes which are not in circulation and the term for their exchange has not expired and the income is recognised over the period of three years (2005 – 2007).

24. Capital and reserves

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

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

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

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

Upon a decision of the Governing Council, BGN 65,000 was allocated to the special reserves for covering market risk losses.

25. Minority interest

BNB Printing Works AD is a joint-stock company with two shareholders: the BNB and the Government represented by the Minister of Finance. The Bulgarian National Bank holds 95.6 per cent of the company's equity. In 2005 the State, as represented by the Minister of Finance, acquired 4.4 per cent of the company's capital – 3093 shares with par value BGN 1000.

26. Monetary liabilities and gross international foreign exchange reserves

(BGN'000)

	31 Dec. 2006	31 Dec. 2005
Gross international foreign exchange reserves		
Cash and deposits in foreign currencies	4,206,480	3,430,616
Monetary gold and other instruments in gold	1,207,600	1,084,688
Debt securities investments	11,968,687	9,823,829
Equity investments and quota in the IMF	74,045	78,198
	17,456,812	14,417,331
Monetary liabilities		
Banknotes and coins in circulation	6,888,576	5,867,213
Due to banks and other financial institutions	3,593,538	2,483,916
Liabilities to government institutions	4,981,971	4,120,515
Other borrowings	123,800	176,048
	15,587,885	12,647,692
Surplus of gross international foreign exchange reserves over monetary liabilities	1,868,927	1,769,639

The interest receivable and interest payable is included within the value of underlying financial assets and liabilities.

The monetary gold is marked to market based on the official London Bullion Market closing price at the BNB balance sheet date.

27. Related party transactions

(i) Bulgarian Government

International Monetary Fund

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

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

The IMF quota is secured by promissory notes jointly signed by the Bank and the Government (ref. notes 20 and 21).

Government bank accounts

Government budget organizations and other government organizations have current accounts and time deposits with the Bank (ref. note 19).

Fiduciary activities

In accordance with the Law on the BNB and under the terms agreed upon with the Ministry of Finance, the BNB acts as a public debt agent. With regard to this role, BNB performs agent and central depository services related to the administration and management of government securities issued by the Ministry of Finance. The Bank receives income for providing these services. These securities are not assets or liabilities of the BNB and are not recognized in the consolidated balance sheet. The Bank is not exposed to any credit risk relating to such placements, as it does not guarantee these investments. As at 31 December 2006 the par value of the total securities held in custody was BGN 2935 million (31 December 2005: BGN 2843 million).

28. Subsidiaries

(BGN'000)

Ownership interest	31 Dec. 2006	31 Dec. 2005
State Mint	100%	100%
BNB Printing Works (ref. note 25)	95.6%	95.6%

The net income from subsidiaries for the period comprises net profit of BGN 1327 thousand from the State Mint (31 December 2005: BGN 691 thousand) and BGN 1824 thousand from the BNB Printing Works (31 December 2005: BGN 1608 thousand).

29. 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 at 31 December 2006 is BGN 67,024 thousand (31 December 2005: BGN 71,088 thousand).

(ii) IMF quota and borrowings

The IMF quota and borrowings are supported by promissory notes jointly signed by the Bank and the Government of the Republic of Bulgaria amounting to BGN 2,076,555 thousand (2005: BGN 2,443,937 thousand).

(iii) Capital commitments

As at 31 December 2006 the Bank has committed to BGN 1910 thousand to purchase non-current assets (31 December 2005: BGN 6908 thousand).

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

30. Events subsequent to the balance sheet date

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

Major Resolutions of the BNB Governing Council

12 January	Methods of determining and updating the selling prices of banknotes and coins sold by the BNB at a price other than the nominal value were approved.
19 January	As of 14 February 2006 the BNB put in circulation a coloured silver commemorative coin 'Vine-growing and Wine Production' with a nominal value of BGN 5, issue 2006.
2 February	Amendments to BNB Ordinance No. 3 on Funds Transfers and Payment Systems were adopted.
	Amendments to BNB Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes were adopted.
17 February	Procedure for open tender requited disposal of ownership of a BNB estate, a part of a building located in 6A, Slaveikov Square, Sofia was approved.
24 February	Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were adopted.
	New format and content of commercial bank reports under Ordinance No. 21 and instructions for their completion were approved.
	Amendments to BNB Ordinance No. 8 on the Capital Adequacy of Banks were adopted.
	Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were adopted.
2 March	Amendments to BNB Ordinance No. 3 on Funds Transfers and Payment Systems were adopted.
23 March	The Report on the Implementation of the 2005 BNB Budget was approved.
	As of 19 April 2006 the BNB put in circulation a silver commemorative coin 'Bulgarian Black Sea Coast', National Parks and Reserves series, with a nominal value of BGN 10, issue 2006.
	List including the types of documents used by the BNB was approved.
6 April	Manual of BNB Internal Audit Work was approved.
	General Terms of the Bulgarian National Bank for Supplying Banknotes and Coins at an Announced Value were approved.
	Tariff of Fees Collected by the Bulgarian National Bank for Banknote and Coin Supply was approved.
	Corporate Policy for BNB IT Security was approved.
20 April	The BNB Annual Report for 2005 was approved.
4 May	Amendments to BNB Ordinance No. 5 on the Terms and Procedure for Acquisition, Redemption and Trade in Government Securities were approved.

	Amendments to BNB Ordinance No. 15 on the Control over Transactions in Book-entry Government Securities were approved.
	Tariff of Fees and Commissions for Processing of Government Securities Transactions was approved.
	Internal Rules for the Work of the Programme Council of Banking and Finance History Research and Publications were approved.
	As of 23 May 2006 the BNB put into circulation a partially gold-plated silver commemorative coin 'Treasures of Bulgaria – Letnitsa' with a nominal value of BGN 10, issue 2006.
18 May	The BNB Staff Code of Ethics was supplemented.
1 June	Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.
	Amendments to BNB Ordinance No. 22 on the Central Credit Register of Banks were approved.
13 June	As of 3 July 2006 the BNB put into circulation as legal tender a banknote of BGN 50 nominal value, issue 2006.
	Additional members were appointed onto the BNB Consultative Council.
29 June	Amendments to BNB Ordinance No. 36 on Custodian Banks under the Social Security Code were approved.
	Internal Rules on the Selection Procedures for Subcontractors of Public Awards were approved.
20 July	The commemorative coin and banknote production programme for the 2007–2009 period was adopted.
	The Tariff on BNB Fees on Non-cash Foreign Currency Operations was adopted.
28 September	The Rules for the Tasks and Responsibilities of the Structural Units and BNB Senior Officials' Competences were supplemented.
	Amendments to BNB Ordinance No. 22 on the Central Credit Register of Banks were approved, in force as of 1 December 2006.
	Report on BNB Budget Implementation as of 30 June 2006 was approved.
	Additional members were appointed onto the BNB Programme Council of Banking and Finance History Research and Publications.
12 October	Internal Rules for Selecting of and Working with BNB Scholarship Students were adopted.
	As of 11 December 2006 the BNB put into circulation a gold commemorative coin 'St. John the Baptist' of the 'Bulgarian Iconography' series.
26 October	The BNB Report for January – June 2006 was adopted.
	The Tariff on Fees Collected by the BNB for Operating the Central Credit Register was adopted.

9 November Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.

As of 1 January 2007 the Bulgarian National Bank put into circulation a coin with a nominal value of BGN 0.50 commemorating Bulgaria's accession to the EU.

As of 1 January 2007 the Bulgarian National Bank put into circulation a partially gold-plated silver commemorative coin 'Bulgaria in EU'.

30 November Amendments to BNB Ordinance No. 10 on the Internal Control in Banks were approved.

Amendments to BNB Ordinance No. 17 on Establishing the Amount of Bank Investment under Article 30 of the Law on Banks were approved.

Amendments to BNB Ordinance No. 20 on the Issuance of Certificates under Article 9, Paragraph 2 of the Law on Banks were approved.

The BNB budget for 2007 was adopted.

The Auction Plan (Road Map) for the accomplishment of BNB commitments in relation to its participation in the ESCB was supplemented.

8 December Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were approved.

14 December Ordinance No. 8 on the Capital Adequacy of Credit Institutions was adopted.

A BNB Research Plan for the 2007 to 2008 period was adopted.

22 December Ordinance No. 2 on the Licenses and Permits Granted by the Bulgarian National Bank under the Law on Credit Institutions was adopted.

Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were approved.

Ordinance No. 7 on the Large Exposures of Banks was adopted.

Ordinance No. 26 on Finance Houses was adopted.

As from the date of BNB's registration under the Value Added Tax Act, a 20 per cent VAT is to be accrued on fees for services subject to taxation in compliance with the tariffs set by the BNB Governing Council and concluded contracts.

Audit Programme Plan for 2007 and Audit Strategy on Major BNB Functions up to 2009 were adopted.

Amendments to BNB Ordinance No. 27 on the Balance of Payments Statistics were approved.

CD Contents

The methodology and scope of the respective indicators are comprehensively presented in 2006 BNB Monthly Bulletin issues.