



Bulgarian National Bank

ANNUAL REPORT • 2007



BANQUE NATIONALE DE BULGARIE



Bulgarian National Bank

ANNUAL REPORT • 2007

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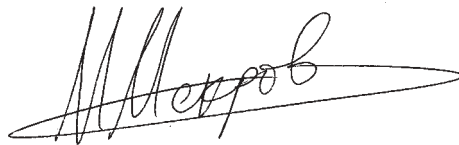
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The cover shows an engraving of the BNB building
from the 1938 banknote with a nominal value of 5000 leva.

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 2007 Annual Report.*

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

Ivan Iskrov
Governor
of the Bulgarian National Bank

BNB Governing Council



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

Governing Council

Ivan Iskrov

Governor

Tsvetan Manchev

Deputy Governor

Issue Department

Dimitar Kostov

Deputy Governor

Banking Department and

Fiscal Services Department

Rumen Simeonov*

Deputy Governor

Banking Supervision Department

Nikolay Nenovsky

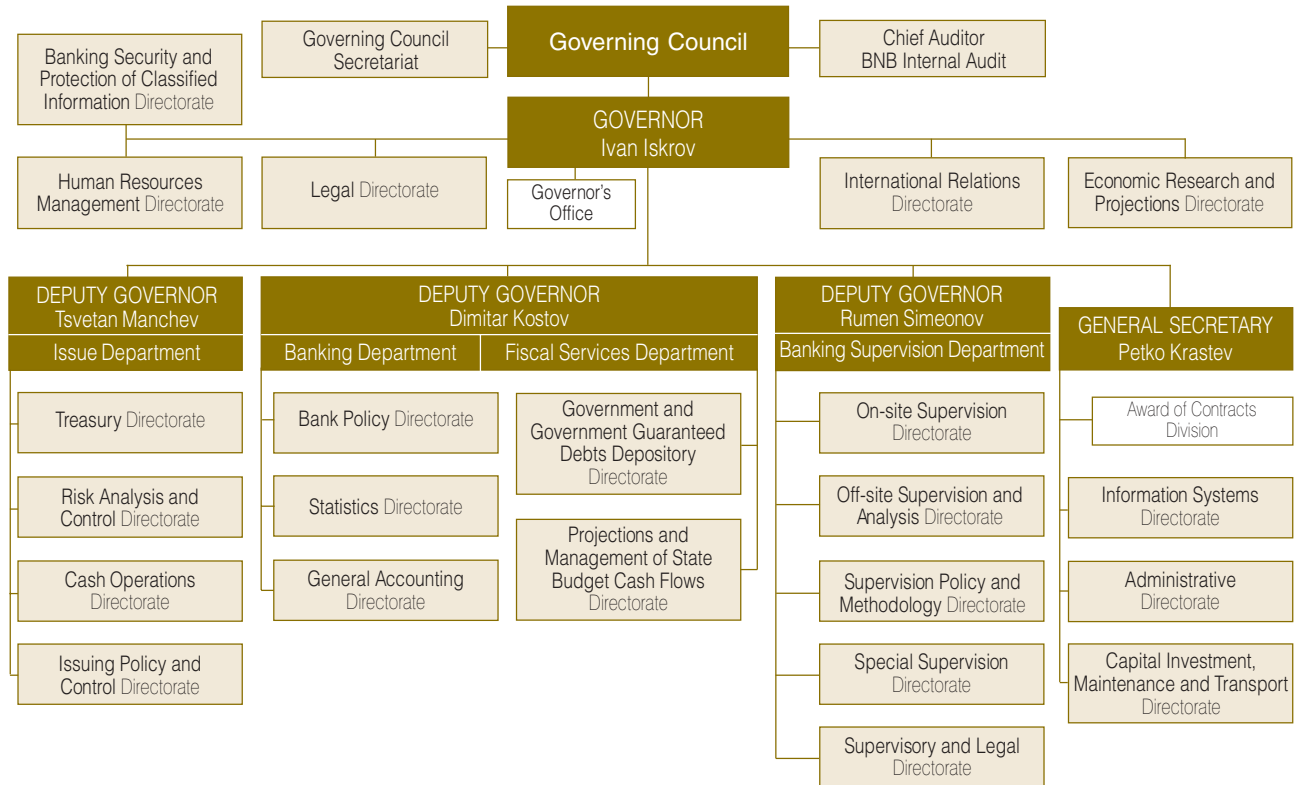
Statty Stattev

Oleg Nedyalkov

* Since 15 June 2007 Rumen Simeonov is a member of the BNB Governing Council and a Deputy Governor heading the Banking Supervision Department. Until 14 June 2007 Emiliya Milanova was a member of the BNB Governing Council and a Deputy Governor heading the Banking Supervision Department.

Organizational Structure of the BNB

(as of 1 January 2008)



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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

On 1 January 2007 Bulgaria became a member of the European Union, successfully completing ten years of negotiations during which significant legislative amendments and restructuring prepared the nation's economy to withstand competitive market pressures within the EU. The Bulgarian National Bank made an important contribution to the successful conclusion of membership negotiations. The Bank took an active part in drafting changes to the regulatory framework of banking which was completely overhauled in early 2007. The Bank's policy, directed at supporting confidence in the national economy and the currency, guaranteed macroeconomic stability: an essential condition for EU accession.

National currency stability is guaranteed by the currency board adopted under the Law on the BNB on 1 July 1997: the Bank's position (supported by government, parliament and public) is that Bulgaria should maintain the currency board until euro area membership, should preserve the current fixed exchange rate of BGN 1.95583 to EUR 1, and should pursue ERM II entry consistently, irrespective of changes in the global economic and political environment, dramatic fluctuations on world financial markets in the second half of 2007, and growing uncertainty about the global economic outlook in early 2008. The Bank will continue pursuing a consistent and predictable policy aimed at fulfilling Maastricht criteria and entering the euro area, while defending the rights to equal treatment in negotiations for ERM II entry and thereafter in assessing implementation of the criteria for euro area accession.

In 2007 the Bank continued to pursue its objectives of guaranteeing stability for the nation's currency and banking system successfully. The Law on the BNB calls for the Bank's monetary liabilities to be covered entirely by international foreign currency reserves at a fixed exchange rate. The Bank has a duty to sell and purchase reserve currency (euro) against leva at spot exchange rates which may not depart from the official rate by more than 0.5 per cent. (In 2004 the Bank abolished this fee on non-cash operations in reserve currency with banks.) This means that money may only be issued if it is covered by reserve currency (euro): a specific feature of the currency board regime which guarantees national currency stability in its entirety. In 2007 international foreign currency reserves reached EUR 11,936.6 million or 41 per cent of GDP. They covered reserve currency by 164 per cent and short-term debt by 202.1 per cent. International reserves were managed in compliance with the requirements and constraints of the Law on the BNB and international financial market dynamics.

The past year proved that Bulgaria's membership of the EU offers new guarantees for sustainable development of the national economy. One of the most important signs of success was the inflow of foreign direct investment, a significant source of finance for economic restructuring and modernization. In 2007 net foreign direct investment came to 20.5 per cent of GDP, covering over 100 per cent of the current and capital account deficits caused by sizable imports of capital goods (27.6 per cent of total imports). Dynamic economic development entailed increasing imports of major raw materials and energy (55.9 per cent of total imports), while growing disposable household incomes supported imports of consumer goods (16.4 per cent of total imports). The inflow of foreign direct investment remained high in the second half of 2007 when the US sub-prime mortgage crisis, which led to growing uncertainty and liquidity contraction on international financial markets, began to impact global economic activity.

Economic sustainability was also confirmed by real economic growth which retained its relatively high level of 6.2 per cent (6.3 per cent for 2006) despite the 29.8 per cent decline of agricultural value added resulting from poor weather. Though not directly slowing GDP growth, the crop output collapse coincided with world farm produce price rises (mainly for grains and oil-bearing crops) which led to domestic food prices rising by 21.1

per cent in 2007. The largest contribution to the 11.6 per cent inflation accumulated by the end of 2007 came from food price rises (5.1 percentage points) and public catering service prices (2 percentage points). Average annual inflation rose to 7.6 per cent in 2007.

Maintaining the stability of the banking system, a key component of macroeconomic stability, was achieved through BNB regulation. Data analysis shows that bank asset quality remained good. After lifting the administrative constraints on lending in early 2007, bank claims on the non-government sector began growing rapidly. By mid-year the increase in credit to the private sector was running at 47.7 per cent on an annual basis, compared to 24.6 per cent at the end of 2006. To limit credit risk, in July the BNB Governing Council decided to raise the minimum required reserve rate from 8 to 12 per cent of deposit base from 1 September. Thus, over the third quarter the Bank withdrew significant liquidity from the banking system (bank reserves with the BNB rose by BGN 2 billion only in September). Nevertheless, bank lending continued growing until the end of the year (by 62.5 per cent on an annual basis). This robust growth was most pronounced in loans to non-financial corporations, household credit growing relatively slowly.

By the end of 2007 total banking assets reached BGN 59.1 billion: up BGN 16.9 billion on 2006 or an annual growth of 40 per cent. Major financing sources for boosting asset growth came from borrowed funds (mainly deposits) and larger own funds. At the end of 2007 the return on assets (ROA) indicator stood at 2.37 per cent and core ROA at 2.26 per cent, while return on equity (ROE) was 23.89 per cent.

With Bulgaria's EU accession, the Bank became a member of the European System of Central Banks (ESCB). On 2 January 2007 the BNB paid its contribution due into ECB capital. The Governor of the BNB became a member of the General Council of the European Central Bank (ECB). BNB representatives now actively participate in discussions and decision making in the 12 ESCB committees and the 29 working groups to them. Co-operation between the BNB and other EU central banks expanded further with implementation of the twining project with the central banks of France, Italy and Netherlands and cooperation with the central bank of Germany on *monetary policy and operations, payment systems, cash operations, statistics, research and macroeconomic forecasting, banking supervision, risk management, internal audit, communications and communication strategies*. The experience accumulated during EU accession negotiations helped establish cooperation between the BNB and central banks in the Balkan region.

The BNB performed its functions and tasks, including the new responsibilities stemming from ESCB membership, through a policy of increasing efficiency and improving operational organization. The Bank provided the funds necessary to update its technological infrastructure and communications, bringing them into line with the requirements for protecting information flow security and optimizing Bank operations. Funds earmarked for training and boosting staff qualifications enabled the Bank to discharge its growing responsibilities with fewer employees.

I. Economic Development in 2007

1. The External Environment

Global economic development trends underwent a wholesale switch in 2007. While the first half of the year was marked by growing optimism, rapidly spreading pessimism set in over the second half of 2007. By the mid-year leading economies reported comparatively high rates of GDP growth. Global economic activity indicators were increasing at their levels of the first quarter of 2006. The business climate improved significantly both in industry and in services. The reversed trend in the middle of the year reflected the US sub-prime mortgage crisis in the summer of 2007.

Growing lack of confidence and uncertainty on world financial markets due to the US sub-prime crisis development began to impact global economic activity in the second half of 2007, especially in the fourth quarter when world trade growth slowed down to 5.1 per cent on an annual basis, from the average of 7.2 per cent between January and September, and global economic activity indicators worsened further.

Major Macroeconomic Indicators (average annual change)

(%)

	Growth			Inflation			Unemployment		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
EU (27)	1.9	3.0	2.9	2.3	2.3	2.4	8.9	8.1	7.1
Euro area (13)	1.6	2.8	2.6	2.2	2.2	2.1	8.8	8.2	7.4
Newly acceded countries (11)	4.8	6.4	6.1	3.4	3.2	4.3	12.0	10.0	7.7
USA	3.1	2.9	2.2	3.4	3.2	2.9	5.1	4.6	4.6
Japan	1.9	2.4	2.1	-0.4	0.3	0.1	4.4	4.1	3.8
China	10.4	11.1	11.4	1.8	1.5	4.8	4.2	4.1	4.0

Note: Inflation in newly acceded countries is measured by weighing individual Harmonized Index of Consumer Prices (HICP) by the EU-27 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.

In the fourth quarter euro area growth fell to 0.4 per cent on a quarterly basis, down from 0.8 per cent, reflecting both sluggish external demand and decreased investment and consumption, though moderation for the year was insignificant (from 3.0 per cent in 2006 to 2.9 per cent in 2007).

In 2007 US growth slowed down by 0.8 percentage points on 2006 to 2.2 per cent compared to the 3 per cent average annual GDP growth between 2003 and 2006. Major factors included continued declines in housing investment, weaker private consumption and the negative contribution of inventories. Consumer confidence fell due to the increasing level of unemployment and growing inflation. Alongside this, tightened lending conditions slowed investment demand.

The dynamics of international commodity prices in the first half of the year was quite different from that of the second half. In the first six months global inflation remained at levels close to those of the prior year. Reflecting poor weather in major producing countries, food prices started rising in the first half of the year (up 11 per cent on a year earlier). In the second half of 2007 this trend accelerated and cereal prices increased by 70 per cent on 2006, including wheat by 91 per cent and, most sharply, sunflower oil by 104 per cent (indices refer to US dollar prices). In the fourth quarter of 2007 the average monthly Brent price increased by 18.5 per cent on the previous quarter to reach USD 89 a barrel.

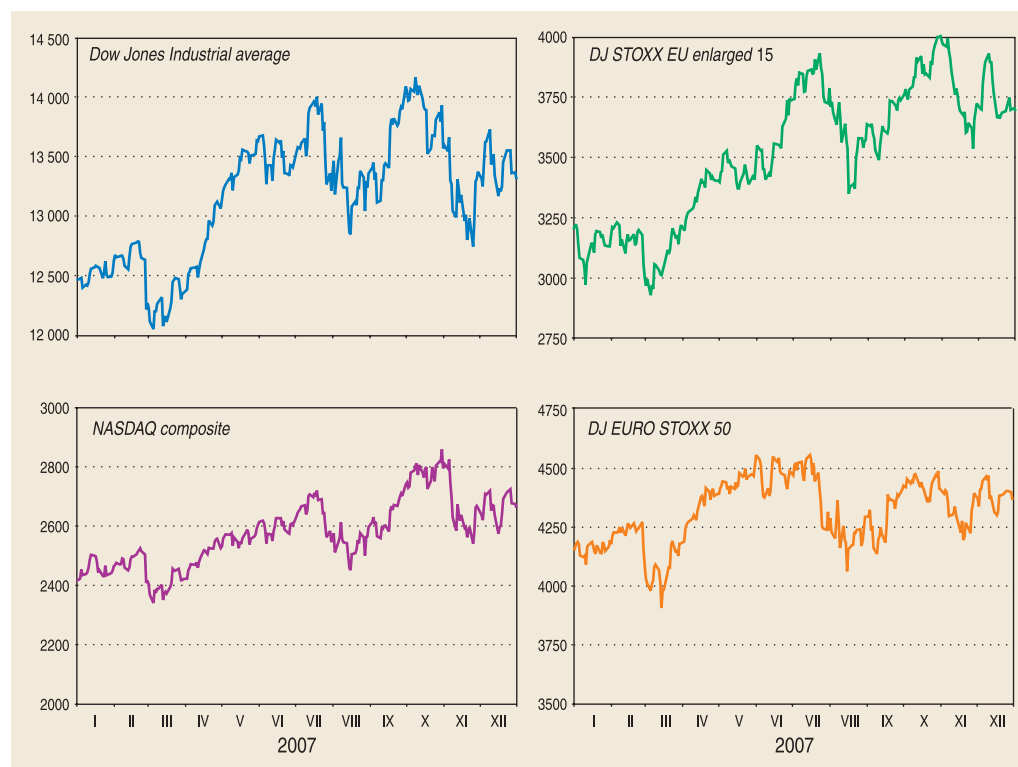
Reflecting the international prices of commodities and agricultural products, euro area HICP inflation accelerated to 3.1 per cent at the end of the year after stabilizing at

2 per cent in the first three quarters. In December 2007 US inflation as measured by the personal consumption expenditures price deflator rose to 3.5 per cent on an annual basis.

In early 2007 the ECB continued its policy of raising main interest rates. The main refinancing operations rate was raised by 25 basis points in two steps to 4.00 per cent in June. Changes in interest rates were driven by upside risks to euro area inflation in the medium term. The US Federal Reserve System did not change federal fund rates in the first half of the year in view of the relatively balanced inflation risks. Amid increasing inflationary pressure, worsening economic indicators, global financial instability, and liquidity contraction, in the second half of 2007 the Federal Reserve System took a line of cutting interest rates driven mainly by the expected downturn in economic growth. After cutting the reference interest rate by 50 basis points on 18 September, the Federal Open Market Committee cut the federal funds rate by 25 basis points in two consecutive steps in October and December to 4.25 per cent.¹ To compensate the negative effect of financial uncertainty on market liquidity, the ECB Governing Council decided in November and December to leave unchanged the interest rate on main refinancing operations at 4.0 per cent. In addition to regular weekly refinancing operations, the ECB launched additional liquidity-providing operations against security with a maturity of three months.²

In 2007 stock markets continued to be highly volatile. Significant turbulence was observed in February and March, July and August, and November, reflecting the US sub-prime mortgage crisis and global risk revaluation. In Europe, the *Dow Jones EURO STOXX 50* and *Dow Jones STOXX EU Enlarged 15* indices grew by 7.7 per cent and 19 per cent respectively, the US *NASDAQ Composite* and *Dow Jones Industrial* growing by 9.5 per cent and 8.4 per cent respectively.

Major Stock Indices



Sources: Dow Jones, STOXX, NASDAQ.

¹ In early 2008 the Federal Reserve System cut the federal funds rate in three steps to 2.25 per cent by the end of March from 4.25 per cent at the end of December 2007.

² For details on international financial market developments, see Section II, 2. *The Market Environment*.

Global risk aversion due to the US market turmoil resulted in an increase of risk premium on emerging markets' government debt. At the end of 2007 the spread on Bulgaria's government debt reached 69 basis points despite the conservative fiscal policy and the considerable consolidated state budget surplus. In addition to its effect on government debt spreads which reflect mainly market sentiment rather than fundamental economic factors, reduced investor appetite for riskier assets put an end to the increase in emerging markets' stock indices, this also affecting the Bulgarian Stock Exchange. No other effects of the world financial market turmoil on the Bulgarian economy were recorded until the end of 2007.

2. The Bulgarian Economy

Real GDP growth remained relatively high in 2007 at 6.2 per cent, despite a 29.8 per cent annual value added drop in agriculture. During the first half of the year the increase came to 6.5 per cent, mainly due to industry and services. Extremely adverse weather brought a third quarter real terms decline of 44.1 per cent in agriculture; this had a negative contribution to GDP growth over the quarter. High growth in industry and services did not offset completely the negative contribution of agriculture and in the third quarter real growth slowed to 4.9 per cent. During the second half of 2007 real GDP went up 5.9 per cent on the respective period of the previous year as a result of a large fourth quarter increase (6.9 per cent). Though improving on the third quarter, the contribution of agriculture remained negative, while industry and services retained their favourable dynamics.

Gross Value Added Real Growth

(%)

	2006		2007	
	growth	contribution	growth	contribution
Gross value added growth	6.6		6.3	
Agriculture and forestry	-1.0	-0.1	-29.7	-2.5
Industry	7.8	2.3	14.0	4.3
Services	7.1	4.4	7.5	4.5

Source: NSI.

With regard to demand, in 2007 gross fixed capital formation added most to growth (6.8 percentage points). A major factor behind the high investment level was Bulgaria's accession to the EU and local firms' efforts to meet common market standards and improve output quality, thus capturing competitive positions. Spending on tangible fixed assets went up by 42 per cent on 2006, while its structure stayed relatively unchanged. Manufacturing occupied the greatest share, followed by trade and transport. The year saw an increase in the share of property and business services, resulting both from continuing Bulgarian property demand and growing business services development over the last few years.

Real GDP Growth by Expenditure Component

(%)

	2006		2007	
	growth	contribution	growth	contribution
GDP	6.3		6.2	
Final consumption	7.3	6.4	4.9	4.2
Household consumption	9.5	6.7	5.3	3.7
Government consumer expenditure	0.1	0.0	2.7	0.2
Collective consumption	-2.5	-0.2	3.4	0.3
Gross fixed capital formation	14.7	3.6	21.7	5.6
Physical change in inventories	47.5	1.8	20.4	1.2
Balance (exports – imports)	33.7	-5.4	26.1	-4.9

Source: NSI.

Household consumption began slowing down in the second quarter of 2007 as shown by data on household budgets and consumer sentiment. Real growth in government consumption was close to zero during the first three quarters, pulling back final consumption growth. However, by the close of 2007 sizable extra revenue allowed the government to spend more; as a result, over the year total expenditure exceeded budget projections by BGN 1 billion. This boosted real GDP growth in the fourth quarter, government consumption contributing 2.2 percentage points to GDP growth.

Household consumption dynamics reflects growing incomes and inflation. The upward trend in employment and wages continued. On an annual basis, the number of employed people picked up by 2.9 per cent, while unemployment fell to 6.9 per cent (9 per cent in 2006). New job creation contributed to the improvement of labour market conditions, offering more opportunities and motivating those who would like to work but had stopped seeking employment – a significant resource for boosting employment – to join the workforce. During the fourth quarter of 2007 the economic activity ratio of people aged from 15 to 64 reached 67.1 per cent against 65.3 per cent in the respective period of 2006.

Following a couple of years of moderate growth, in early 2007 wages started rising faster, growing by 20.5 per cent (12 per cent in real terms) over the year compared with 2006 averages. Drivers for this were, first, growing productivity reflecting sizable fixed capital investment, and second, the dramatic unemployment drop and skills shortages in industries such as construction, mining, and transportation. Given the comparatively small share of unit labour costs in value added, rising productivity, and good financial performance, companies could afford to raise wages without affecting profits. During the year wages were also affected by regulatory changes (raising the minimum wage by 12.5 per cent) and the 6 percentage point drop in social insurance premiums in 2006.

Average annual inflation in 2007 was 7.6 per cent. By the close of 2007 accumulated inflation reached 11.6 per cent, with food and public catering contributing most (5.1 and 2 percentage points respectively). Food prices posted the highest average annual growth of 21.1 per cent. A poor market garden crop coincided with rises in international farm produce prices (chiefly cereals and cooking oil), stemming from bad harvests in major producing countries and strong global demand. Bulgaria's accession to the EU in 2007 prompted external demand for Bulgarian food by EU neighbours due to lower prices and the poor Romanian harvest. Annual growth in the prices of these commodities and services picked up dramatically in the second half of 2007, pushing down real household consumption growth³.

HICP Inflation Accumulated since Year's Start and Contribution (Eurostat Classification)

	January – December	
	2006	2007
Inflation (%)	6.1	11.6
Contribution (percentage points)		
Foods	1.38	5.06
Processed foods	1.27	4.11
Unprocessed foods	0.11	0.94
Services	1.41	3.36
Public catering	0.61	1.96
Energy products	-0.12	1.23
Transportation fuels	-0.18	1.17
Industrial goods	0.50	1.12
Goods with administratively set prices	0.66	1.06
Tobacco products	2.25	-0.26

Sources: NSI, BNB.

³ Inflation in 2007 was analyzed in detail in the BNB *Economic Review* quarterly.

In 2007 the contribution of foreign trade to GDP growth stayed negative; however, within the year an improvement from -10.3 per cent in the first quarter to -1.5 per cent in the fourth quarter was reported. Preliminary data shows that over the year goods exports grew 12.2 per cent in nominal terms on 2006, while imports (*FOB*) grew 18.5 per cent. Major export contributors included machines, vehicles, and equipment (4 percentage points), chemicals, plastics and rubber (2.5 percentage points), and base metals and their by-products (1.3 percentage points). Import dynamics was determined by raw materials (6.6 percentage points) and capital goods (6.5 percentage points).

The worsened trade deficit (EUR 7.4 billion in 2007, up by EUR 1.8 billion on 2006) was the main reason why the balance of payments' current and capital account deficit grew to EUR 5.9 billion. This deficit was completely offset, however, by foreign direct investment worth EUR 6.1 billion according to preliminary data. Foreign direct investment, the EUR 2.7 billion growth in the private non-banking sector's foreign obligations, and the EUR 2 billion increase in non-residents' deposits with local banks, formed a balance of payments' financial account surplus of EUR 10.1 billion. Thus, BNB gross international reserves went up by EUR 2.9 billion (valuation adjustments excluded).

Fluctuations and uncertainty on international financial markets impacted capital inflows into Bulgaria. The share of speculative external inflows into Bulgaria was small, portfolio investment comprising 5 per cent of Bulgaria's total international investment position liabilities in September 2007. Capital inflows were generally long-term, indicating foreign investor confidence in Bulgaria. Bulgarian firms and banks continued attracting sizable funds from abroad, prompting the growth of gross external debt to EUR 27 billion by end-2007, up by EUR 6.9 billion on December 2006. In 2007 public and publicly guaranteed debt fell by EUR 455.6 million to 15 per cent of total debt after repayments to the IMF and the World Bank. Over the review period, private non-guaranteed external debt increased by EUR 7.4 billion.

Growing investor confidence in the Bulgarian economy was strongly backed by the government's fiscal policy. In 2007 consolidated fiscal programme surplus came to BGN 2121.4 million (3.75 per cent of projected GDP). Last quarter expenditure (excluding the EU budget contribution) exceeded that of the previous year's period by 32 per cent, while its annual total exceeded projections by BGN 1 billion⁴. Most extra spending was on infrastructure projects; some BGN 174.5 million went on government fuel reserves. During the fourth quarter, government capital expenditure picked up by almost 60 per cent on the respective period of the previous year. This extra spending, approved by the National Assembly, became possible due to sizable extra revenue. Total consolidated state budget revenue increased by 20 per cent on 2006, direct tax revenue growing considerably. Despite a 5 percentage point corporate tax rate decrease, corporate profit tax revenue grew by some 39 per cent.

The high growth rates of monetary and credit aggregates during the year reflected the inflow of sizable external capital and brisk economic activity in Bulgaria. Following the removal of administrative restrictions to lending, since the year's start claims on the non-government sector picked up sharply⁵. By mid-2007, private sector lending rose by 47.7 per cent on an annual basis against 24.6 per cent by end of 2006. With a view to limiting credit risk stemming from the extremely rapid rise of debt, in July the BNB Governing Council adopted a resolution raising minimum required reserves from 8 per cent to 12 per cent of the deposit base from 1 September 2007. As a result, during the third quarter the Bank withdrew sizable liquidity from the banking system, bank reserves rising by almost BGN 2 billion in September. The dramatic growth of banks' BNB deposits determined the dynamics of reserve money which grew by 35 per cent by December compared with a year earlier. Broad money grew 31 per cent in 2007 against 27 per cent in 2006. Banks' claims on the non-government sector over the same period went up by 62.5 per cent. The lending increase was most clearly pronounced in the corporate sector, being relatively

⁴ In the Report on the 2007 State Budget Law total projected expenditure (EU budget contribution included) came to BGN 20,941 million.

⁵ Administrative curbs on bank lending growth involved banks depositing additional reserves at the BNB under certain conditions. For more details see *Section IV*.

weaker to households. Residential mortgage loans remained the fastest growing segment of claims on households, although by the end of the year their growth declined.

The fast expansion of lending was seen in the continuing growth of financial intermediation. The *claims on the non-government sector to GDP* ratio reached 67.5 per cent in December 2007: a 20.1 percentage point increase on the end of the previous year.

Buoyant lending meant banks needed to attract additional finance. Besides household and non-financial corporations' deposits, banks attracted funds from non-residents. Within the year household and non-financial corporations' deposits picked up by BGN 8 billion, while banks' net foreign assets dropped by BGN 5.9 billion, reflecting the considerable increase in foreign liabilities (by BGN 5.5 billion). Banks' need for additional funds and ECB monetary policy largely determined Bulgarian interest rate movements. In December the average time deposit rate in leva was 4.54 per cent against 4.17 per cent in January. Similar upward dynamics was registered by interest rates on time deposits in euro, their growth being even higher (80 basis points) over the same period.

Lev demand by individual banks during the last quarter of 2007 was a factor behind interbank rate rises. The LEONIA index went up from 4.24 per cent in September to 4.68 per cent in December, underpinned by a widening spread on euro area interbank market overnight deposits. Despite higher resource prices in 2007, loan rates did not change significantly. Household loans fluctuated somewhat, consumer loans recovered their early-year levels after a slight third quarter drop, while residential mortgage loans continued falling into the fourth quarter.

The increase in interbank rates was accompanied by growing trade volumes. Transactions rose by BGN 5.4 billion (8.1 per cent) overall on 2006. Deposits increased 5.2 per cent, while repos went up three-and-a-half fold.

In 2007 total foreign currency market turnover was EUR 256 billion: more than a three-fold increase on 2006. In banks' transactions with final customers, as in the previous year, the euro equivalent of purchased currencies exceeded that of sold currencies. In 2007 foreign currency trading between the BNB and commercial banks went up extremely sharply by over four times. On the interbank market the BNB was a net foreign currency buyer. On the other hand, there was a considerable decline on pure interbank foreign currency trading (without BNB participation), turnover falling by 39.9 per cent on 2006.

In 2007 the maturity structure of BGN-denominated Ministry of Finance issues included three-month discount treasury bills and three, five and ten-year treasury bonds with fixed interest rates. Placements of three-year government securities went up 17.5 per cent to BGN 150 million in nominal value, of five-year securities 16.1 per cent to BGN 180 million, and of ten-year securities 38.9 per cent to BGN 250 million. All terms registered average annual yield increases.

Outright transactions in domestic government securities between banks (including investment intermediaries approved as primary dealers) in the secondary government securities market totaled BGN 1.4 billion at market value. The 11.3 per cent decrease on 2006 stemmed from the trade in BGN-denominated bonds, while EUR-denominated bond turnover almost trebled. An upward trend in Bulgarian and euro area yield curves was observed; they moved in parallel, at close levels.

In March 2007 Moody's upgraded the Baa3 rating outlook for Bulgarian national and foreign currency long-term government securities from stable to positive.

Despite significant SOFIX and BG40 share index fourth quarter drops, as a whole they increased by 42.1 and 158.2 per cent respectively. The upward trend was clearest in the third quarter and the beginning of the fourth quarter, with SOFIX and BG40 hitting record highs of 1952.40 and 619.99 in October. As a result of general share appreciation and the new company listings, market capitalization almost doubled to BGN 28.987 billion or 51.8 per cent of expected 2007 GDP.

II. Gross International Reserves

Gross international reserves are managed in compliance with the requirements and constraints of the Law on the Bulgarian National Bank and international financial market opportunities.⁶ The Bank's gross international reserves comprise the assets on the Issue Department's balance sheet and their role is to provide complete cover for monetary liabilities under the fixed exchange rate of the lev to the euro⁷. The excess of gross international reserves over monetary liabilities forms the *Banking Department Deposit* item or the net value of the Issue Department's balance sheet.⁸

From early 2007 international reserves were managed on the basis of the new information system which went live at the end of 2006. Covering all units involved in international reserve management, the system boosts Bank efficiency while cutting manual processing considerably. It allows risk exposures to be monitored in real time and controls investment limits, increasing the security of international reserve operations.

1. The Amount and Structure of Gross International Reserves

By the end of 2007 the market value of gross international reserves was EUR 11,936.65 million: an increase of EUR 3010.22 million or 33.72 per cent on the end of 2006. The increase resulted from net monetary inflows of EUR 2545.48 million, earnings of EUR 368.62 million from investing international reserves, and foreign currency revaluation income of EUR 100.96 million.

Largest Cash Flows

(million EUR)

External flows	2006	2007
Total for the period	1 360	2 545
Purchases and sales of euro	1 720	2 410
At tills	-26	-60
Banks, incl.	1 746	2 458
purchases by banks	12 962	54 467
sales to banks	11 216	52 008
Flows on accounts of banks, the MF, etc.	-361	135
Minimum required reserves	524	827
Government and other depositors	-884	-691

Source: BNB.

⁶ The period under review saw no amendments to the Law on the BNB concerning the regulatory framework for gross international reserve management.

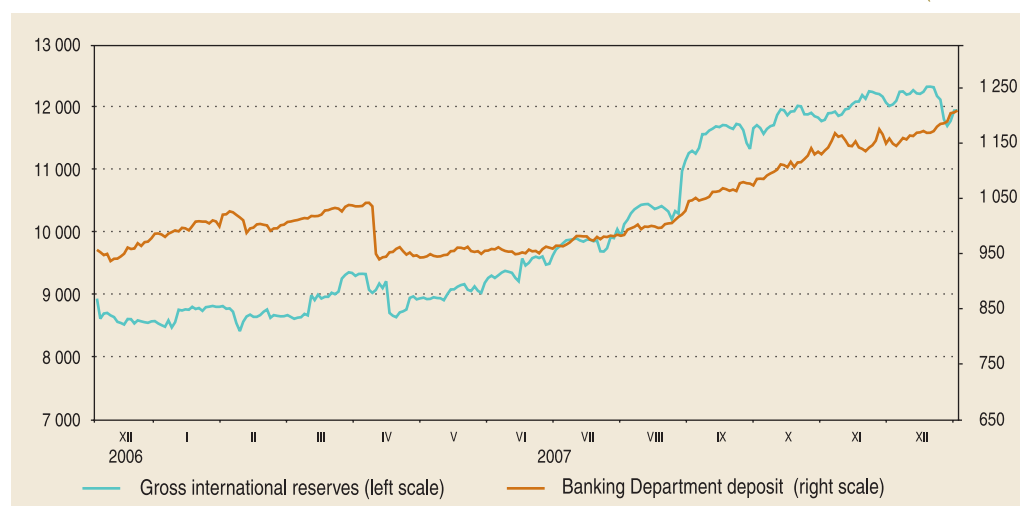
⁷ In accordance with Article 28, paragraph 2 of the Law on the BNB 'monetary liabilities of the Bulgarian National Bank shall consist of all banknotes and coins in circulation issued by the Bulgarian National Bank and any balances on accounts held by other parties with the BNB, with the exception of the accounts held by the IMF.'

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 with the exception of collateralized debt instruments; the balance on accounts receivable and payable on BNB forward or repo agreements with (or guaranteed by) foreign central banks, public international financial 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.

⁸ 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 on the basis of the fixed exchange rate.

Gross International Reserves and Banking Department Deposit

(million EUR)



Source: BNB.

The monetary inflow which contributed most to international reserves resulted from considerable demand for levs which, under the currency board rules, are covered by equivalent sales of euro. BNB net purchases of reserve currency from banks under this mechanism came to EUR 2410 million. Another factor behind the increase of BNB reserves was the increase in euro funds on banks' accounts with the BNB after the raising of minimum required reserves in early September 2007.

In the structure of BNB liabilities, monetary liabilities denominated in levs and euro exceeded 99.5 per cent on average over the year.

In the currency structure of international reserves, the share of euro-denominated assets grew at the expense of the shares of assets in other currencies. Despite the gold price rise in euro terms in 2007 on international markets, its share in reserves fell as a result of the increase in euro-denominated assets comprising the bulk of international reserves.

Currency Structure of International Reserves

(%)

Currency	Issue Department balance sheet assets	
	2006	2007
EUR	90.94	92.77
USD	0.54	0.27
Gold	7.96	6.56
SDR	0.53	0.39
CHF	0.02	0.01

Note: Average data for the period.

Source: BNB.

Changes occurred also in the structure of assets by financial instrument. The share of investment in securities grew to above 73 per cent on average, while investment into money market instruments, mainly short-term deposits with non-resident banks, fell over the review period. The change reflected reserve management policy and the reduced bank exposure limit from 40 to 30 per cent of international reserves since mid-2007. Following the impact of the US sub-prime crisis on world financial markets, BNB exposure to foreign counterparty banks was further reduced both in maturity and amount.

Structure of Gross International Reserves by Financial Instrument

(%)

Instruments	2006	2007
Vault cash*	16.07	11.18
Deposits**	14.60	12.87
Securities**	66.14	73.32
Gold in the vault	3.19	2.63

* 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.

The structure of international reserves by residual term to maturity changed compared to the 2006 average. The share of short-term investment (with maturity of up to a year) increased at the expense of all other maturity sectors. This was primarily due to the restriction on interest rate risk for maximum duration of assets in euro of up to six months, imposed early in the second quarter of 2006.

Structure of Gross International Reserves by Residual Term to Maturity

(%)

Maturity sectors	2006	2007
Up to 1 year	80.80	88.82
From 1 to 3 years	10.01	9.08
From 3 to 5 years	3.77	1.51
From 5 to 10 years	5.18	0.59
From 10 to 30 years	0.24	0.00

Note: Average data for the period.

Source: BNB.

2. Gross International Reserve Risk and Yield

The Market Environment⁹

The euro area benchmark government bond yield changed over 2007, with two divergent periods assessed. In the first half of 2007 bond yields increased robustly in all maturity sectors, reflecting buoyant euro area economic activities, promises of anti-inflationary action and the two-step increase in the ECB reference rate by 50 basis points.

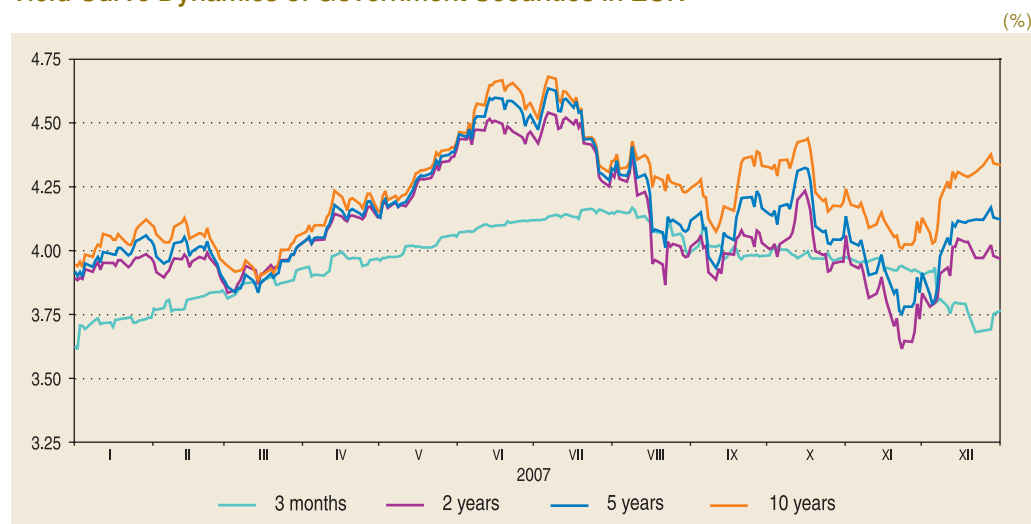
Over the second half of 2007 bond yields started to decline reflecting the significant impact of the US sub-prime market crisis on international financial markets and the increased interest in euro area benchmark bonds due to overall investor risk aversion. Another factor was the ECB's decision to stop raising short-term interest rates and the ensuing change in expectations of monetary policy in 2008.

Increased financial market uncertainty impacted other bond market segments. Over the second half of 2007 a significant rise was recorded in bond risk premiums in some euro area countries. Government bonds in Belgium, Italy, Ireland, and Spain appreciated less than German bonds since concerns prevailed that, given existing government debts and public finance performance, these economies would be more vulnerable to shocks.

Over the second half of the year credit risk premiums on bank claims expanded significantly due to market turmoil. This upward trend reflected growing uncertainty as to how exposed various financial institutions were to the US mortgage-related bond market and as to the impact of future market revaluations on profitability and solvency. Shaky confidence and doubts that systemically important bank groups in Europe may report considerable losses increased after unfavourable third quarter financial results in November. Global risk premium increases in this sector continued into the first quarter of 2008 after annual financial results.

⁹ See also Section I, item 1. *The External Environment*.

Yield Curve Dynamics of Government Securities in EUR



Source: BNB.

Gold and
the
Exchange
Rate

Gold prices increased throughout 2007, appreciating by 31 per cent in US dollar terms and 18.5 per cent in euro terms. Most of this increase occurred in the second half of the year when prices and their fluctuations increased markedly due to the negative financial market developments and flight-to-quality episodes. Other driving factors behind price rises were the continuing US dollar depreciation against the euro (9.5 per cent for 2007) and higher oil and commodity prices which pushed markets towards gold as an investment medium and a hedge against inflation.

Over the second half of 2007 the gold price was further affected by stock and credit markets which had divergent effects on demand reflecting changes in risk aversion. The traditionally high correlation between gold and oil prices declined dramatically. December saw a change in the EUR/USD rate in favour of the dollar, exerting a temporary downward pressure on gold prices.

At the end of November the ECB announced the sale of 42 tonnes of gold under the Central Bank Gold Agreement II. In the third year of the agreement covering the September 2006 to September 2007 period gold sales came to 475.75 tonnes which is within the annual 500 tonne sale limit. France, Spain, and Switzerland were the biggest gold sellers. In 2007 robust growth in investment demand continued, reaching 656 tonnes, of which 251 tonnes by exchange-traded funds (ETF) investing in gold.

US Dollar Price in Euro



Source: BNB.

One Troy Ounce Gold Price in US Dollars



Source: BNB.

One Troy Ounce Gold Price in Euro



Source: BNB.

Major Types of Risk

In early 2007 the BNB Governing Council confirmed international reserves risk tolerance on the basis of the greatest permissible risk to net asset value, $\text{VaR} = 0\%$ at 95 per cent confidence level¹⁰. The BNB did not exceed this tolerance over the review period.

Over the reporting period international reserve **interest rate risk** measured by reserves' average *modified duration* was 0.44: below the average 2006 level (0.78), mainly due to the interest rate risk restriction (maximum duration of assets in euro at six months) imposed early in the second quarter of 2006.¹¹

International reserve **currency risk** was constrained by the Law on the BNB stipulation that the sum of the absolute values of open foreign currency positions¹² 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. In 2007 minimal open currency positions were maintained in currencies other than the euro and immediate buying or selling against the reserve currency (the euro) followed any approach to the 2 per cent limit. Monetary gold continued posing the major currency risk to the Bank.

¹⁰ Net value risk measured by $\text{VaR} = -X\%$ ($X > 0$) at 95 per cent confidence level and allowing for normal yield allocation means that 95 per cent of the time maximum net value loss would not exceed X per cent.

¹¹ The average duration for 2006 was higher, being 1.78 only in the first quarter of 2006.

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

Over the second half of 2007 the BNB undertook several additional measures to curb **credit risk** in managing international reserves against the background of financial market volatility and global liquidity contraction. Restrictions were imposed on exposure to non-resident counterparty banks, the total limit of this asset class being reduced from 40 to 30 per cent of the reserve amount. The maximum term to maturity of short-term deposits with BNB counterparties was reduced and some individual bank limits tightened further. Thus, over the period exposure to non-resident counterparty banks fell to 23.9 per cent of total assets on average against 30.3 per cent in 2006. At the close of December exposure to non-resident counterparty banks came to around 18 per cent. Funds invested into assets with the highest credit rating (AAA) averaged 52 per cent, those in AA+ around 16 per cent, in AA 23 per cent, and in AA- 9 per cent. Under investment restrictions, financial instruments into which the Bank may invest, and counterparties where it may place short-term deposits, have to have at least an AA- rating by Standard & Poor's and Fitch Ratings or Aa3 by Moody's. All financial instruments or counterparties should have one of the above ratings assigned by at least two internationally recognized credit rating agencies.

Operational risk continued to be managed by strict monitoring and control under the business procedures for international reserve management. In early 2007 some of them were updated mainly due to launching the new information system and related functional and technical characteristics in processing transactions.

Yield and Efficiency

Amid global financial market instability and based on ongoing market analyses and forecasts for 2007, the BNB retained its 2006 international reserve interest rate risk restriction. Hence, the maximum duration of euro-denominated assets remained six months.

Over the review period BNB income from international reserve investment came to EUR 368.62 million: a 3.71 per cent annual yield. Total currency imbalance yielded¹³ EUR 100.96 million over the review period mainly due to the open position in gold and the fall in world gold prices in euro. Interest on Issue Department balance sheet liabilities was EUR 98.30 million. As a result of these three components, net earnings from BNB international reserve management came to EUR 371.28 million: 3.63 per cent net yield annually.

International Reserves Yield in 2007

(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	73.86	71.14	19.47	-16.75
II	28.37	71.07	-22.09	-20.62
III	131.60	112.38	48.86	-29.63
IV	137.45	114.03	54.72	-31.30
Earnings, total	371.28	368.62	100.96	-98.30
Yield, total, %	3.63	3.71	0.89	-0.97

Source: BNB.

The change in the net value corresponding to the *Banking Department Deposit in the Issue Department balance sheet* item resulted from two major factors: a net international reserve yield contribution of EUR 371.28 million (42.32 per cent annual yield), and a financial 2006 contribution to the state budget worth EUR 87.24 million, which led to a decrease in the net value.

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

¹³ Currency imbalance yield is the sum total of the effect of exchange rate movements on the open foreign currency positions of assets and liabilities.

Yield and Risk of Portfolios

Portfolio	Portfolio base currency	Yield		Risk (volatility)		Information ratio***
		Absolute (%)	Relative (basis points)*	Absolute (%)	Relative (basis points)**	
Investment 1	EUR	4.01	1	20	16	0.07
Investment 2	EUR	4.05	6	9	5	1.11
Liquidity	EUR	4.01	2	14	10	0.29
Gold	XAU	0.09	-6	1	1	-6.66
External manager A	EUR	3.80	-1	95	8	-0.10
External manager B	EUR	3.97	30	126	22	1.32

* The positive relative yield of an individual portfolio is the profit compared with benchmark yield. If the yield 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 ratio* indicator is the ratio between the expected relative yield of an individual portfolio and its relative risk.

Source: BNB.

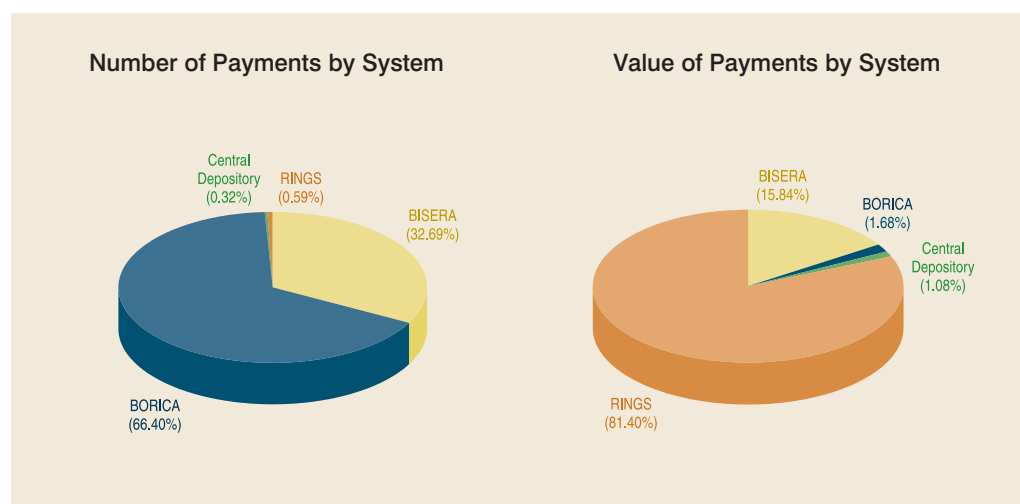
In 2007 a portion of international reserves again went under external management (5.63 per cent by the end of the review period). Beside additional diversification, using external managers helped exchange expertise in international market investment management. Liquid portfolios were formed to assist immediate payment needs. To diversify management styles and reduce operational risk, the bulk of euro-denominated assets continued to be split into two investment portfolios with identical benchmarks and investment limits, managed by different teams.

III. The National Payment System

The Law on the Bulgarian National Bank charges the Bank with organizing, supporting, developing, and overseeing efficient payment mechanisms. Reducing systemic risk and creating conditions for Bulgarian integration into the euro area payment infrastructure were among the Bank's major goals.

Participants in the national payment system were the RINGS real time interbank gross settlement system operated by the BNB, and two complementary systems: the BISERA system for servicing customer payments at a designated time operated by Bankservice AD, and the BORICA system for servicing card payments within Bulgaria operated by *MasterCard Europe* member service provider and *Visa International* processor company. Securities settlement systems in Bulgaria include the BNB System for Servicing Payments on Transactions in Book-Entry Government Securities and the Central Depository's System for Servicing Payments on Transactions in Book-Entry Securities.

Distribution of Payments in Bulgaria



Source: BNB.

In 2007 RINGS processed over 81 per cent of payments by value¹⁴. Progressively increasing RINGS' share of payments helped subdue payment risks significantly. RINGS processed 0.59 per cent of all non-cash payments. The slight drop in the payments processed by RINGS in 2007 resulted mostly from banking sector consolidation.

In 2007 payments processed by BORICA went up 13.52 per cent in number and 21.80 per cent in value. During the year consumers used bank cards more frequently to pay and draw money. ATM transactions grew by 38.87 per cent in number and 38.81 per cent in value on 2006.

Compared with 2006, transactions through BISERA rose by 12.18 per cent in value while their number declined by 1.39 per cent. The insignificant fall in the number of transactions was due to banking sector consolidation in 2007 and the removal of the requirement to use VAT accounts.

Transactions submitted to the Central Depository grew considerably by 85.76 per cent in number and 117.62 per cent in value on 2006; this reflects brisk developments in capital market trading.

¹⁴ This indicator's value of some 80 per cent is considered the optimum for RINGS functioning.

Payment system supervision played a major role in decreasing system risk and boosting national payment system reliability and efficiency by monitoring the 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. In October 2007 a supervisory inspection at the First Investment Bank addressed the use of the CaSys International authorization centre in Skopje for the purposes of that bank's card centre. The BNB issued recommendations on improving card centre functioning.

1. The RINGS Real Time Interbank Gross Settlement System

Processing most payment value through RINGS cuts payment risks: one of the Bank's major payment systems goals. In 2007 RINGS processed 917,537 payments totaling BGN 435,128 million. Compared with 2006, the daily average number of payments fell slightly by 6.69 per cent, while daily average value picked up by 89.18 per cent, reflecting dramatic average value rises of interbank and customer payments. Customer payments dropped by 7.72 per cent due to mergers at banks with large shares in the payment process and the increase of payments between their customers, now classified as intrabank transactions¹⁵.

In 2007, 37.45 per cent of payments were processed by noon and 70.32 per cent by 2:30 pm. A weak trend emerged to a rise in payment value in the later system day hours. As regards system traffic, 92.20 per cent of RINGS payments were effected by 2:30 pm, this indicator changing slightly on 2006.

Over the period no payments were rejected by the close of the RINGS' system day due to insufficient funds on participants' accounts, indicating good liquidity management by banks. In 2007 there was no recourse to the Reserve Collateral Pool established as an interbank insurance mechanism to guarantee settlement of system operators' orders.

During the year RINGS offered 99.93 per cent availability¹⁶, which rose on 2006. Operational problems were handled under RINGS contingency rules and procedures.

2. Payment System Developments

The Law on Credit Institutions which replaced the Law on Banks on 1 January 2007 established the new institutional category of electronic money companies subject to BNB licensing and supervision. Electronic money companies may provide financial and non-financial services involving electronic money, and electronic information storage. The Law on Distance Financial Services also came into force on 1 January 2007 to protect consumers.

On 16 November 2007 the BNB Governor licensed the SEP Bulgaria company to operate a mobile payment electronic payment instrument system pursuant to the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems. The license of the SEP Bulgaria company is for conducting activity on the territory of the Republic of Bulgaria as a system operator of a payment system for a remote access electronic payment instrument (mobile payment). Mobile payments between accounts in participating banks would be by mobile telephones used as payment terminals. Multilevel security is provided using PIN and CLIP codes and telephony encryption. The company will perform user identification and multilateral netting of obligations, and will submit settlement requests to RINGS. Mobile payments are a new way to make non-cash transfers in Bulgaria, supplementing traditional ones and allowing banks to broaden the range of customer payment options. Technological developments and mobile telephony enable new forms of paperless transfers and Bulgaria now ranks among countries with ongoing payment service improvement.

¹⁵ In 2007 the number of banks participating in RINGS fell to 29, following the formation of UniCredit Bulbank AD and Eurobank EFG Bulgaria AD.

¹⁶ The proportion of time during which the system was serviceable.

Payment system development in Bulgaria is related to BNB and banking community integration into European payment mechanisms and completion of the SEPA and TARGET2 projects. In line with this, in 2007 the National Council of Payment Systems met twice. At its first sitting it set up seven consultative groups to analyze key project components and facilitate transition to European payment mechanisms. These groups reported at the second Council sitting in December 2007 which set legal framework, payment instruments and payment systems priorities:

- ISO 20022 (UNIFI) XML and SEPA credit transfer, and later SEPA direct debit, are envisaged for BISERA petty levs payments. SEPA schemes would improve efficiency through automation, offer additional services and thus stimulate payment automation, update payment procedures, and create convenient payment mechanisms
- Card payment measures include implementing the EMV standard to payment infrastructure and bank cards. By late 2007 the total number of cards issued in Bulgaria was 7,007,363 of which 6,056,189 debit cards and 951,174 credit cards. EMV standard cards comprised 1.9 per cent of the total number of debit cards and 4.52 per cent of credit cards issued in Bulgaria. Slow EMV implementation increases card fraud risk. EMV implementation into the infrastructure is rather more advanced, with 93.13 per cent of the 3987 ATMs and 42.68 per cent of the 40,143 POS terminals using it by 31 December 2007. The Council recommended that banks and BORICA should speed up EMV adoption to counter rising card fraud.

A national payment system and infrastructure development plan for 2008 and 2009 will address the significant forthcoming challenges of the TARGET2, SEPA and EMV standard projects as the banking community integrates into the euro area payment system. The plan will be drawn up jointly by the Association of Banks in Bulgaria and the BNB in its capacity of the institution in charge of TARGET2 implementation, SEPA coordinator and legal regulator.

Close coordination and cooperation with national and world institutions engaged in the payment process is an important element of national payment system euro area integration and is effected by the BNB experts in the ESCB Committee on Payment and Settlement Systems and its working groups.

The BNB began drafting a bill transposing Directive 2007/64/EC on Payment Services in the Internal Market into Bulgarian legislation, with a view to full harmonization of payment services in the European Community.

IV. Commercial Bank Reserves at the BNB

In 2007 two important amendments were made to Ordinance No 21 on the Minimum Required Reserves Maintained by Banks at the Bulgarian National Bank.

The additional reserve requirement related to credit growth rates was removed on 1 January 2007. These reserves were introduced in the second quarter of 2005 as an administrative curb on the lending expansion. From the outset they were temporary and effective only over a short term. By the end of 2006 their effect was largely spent, having restricted lending and transferred credit risk outside banks' portfolios. Bulgaria's EU membership from 1 January 2007, and financial market integration into the Community, required banks to be regulated by the BNB to the same conditions as those elsewhere in the Community. The BNB removed administrative curbs on credit growth while preserving strict supervisory requirements and the increased deposit base¹⁷.

The Bank analyses carefully processes in the banking system, monitoring credit. By the middle of 2007 a clear trend to renewed high credit growth was evident, private sector indebtedness in Bulgaria having resumed its rapid growth at the end of the first quarter. In June 2007 bank credit growth rates reached 47.4 per cent against 24.6 per cent at the end of 2006. Private sector loans had picked up by BGN 6.5 billion by June 2007, of which only BGN 3.6 million were net loans returned to banks' balances (the balance between sold and repurchased loans). Private sector debt to the banking system grew from 47.4 per cent of GDP by the end of 2006 to 57.5 per cent by mid-2007.

When lifting the administrative constraints, the BNB stressed its right to intervene as necessary to guarantee moderate credit growth and system stability. Though 2007 credit growth was financed by a higher deposit base and own funds, and though the good quality of portfolios was retained, its fast growth increased credit risk accumulation in the system amid increasingly unstable international financial markets and climbing interest rates¹⁸. For these reasons, and to moderate credit in line with Bank policy for the past few years, on 1 September 2007 a new amendment to Ordinance No 21 raised the amount of minimum required reserves from 8 to 12 per cent. This rise prompted banks to retain more liquid assets and helped a gradual increase in interbank rates over the last quarter of 2007. The Bank will continue monitoring banking credit and will act as necessary in favor of moderate and balanced growth¹⁹.

In 2007 banks' liabilities which form the deposit base for setting minimum required reserves went up substantially by 33.91 per cent for attracted funds in levs and 31.61 per cent for the lev equivalent of foreign currencies. Greater deposit taking and the raising of required reserves with the BNB boosted the 2007 average amount of banks' BNB reserves by 34.55 per cent on 2006. The average annual amount of excess reserves dropped to 94.51 per cent of the prior year's amount (below 1 per cent of total reserves). Reserves in levs grew by 16.25 per cent, their absolute amount exceeding settlement needs twofold. Foreign currency reserves went up 47.78 per cent, their relative share fluctuating between 57.05 per cent and 72.55 per cent in individual months.

¹⁷ Between 3 February and 4 May 2007 seven banks which had exceeded lending growth restrictions in the fourth quarter of 2006 were obliged to deposit BGN 966 million of additional reserves.

¹⁸ See I.1. The External Environment and II. 2. The Market Environment.

¹⁹ See I.2. The Bulgarian Economy.

V. Cash in Circulation

The Bulgarian National Bank has a monopoly on banknote and coin issue in Bulgaria²⁰. The Bank's notes and coinage are legal tender mandatorily acceptable as payment at face value without restriction. The BNB prints banknotes, mints coins, and safeguards uncirculated and withdrawn banknotes and coins. Legal requirements regarding fit and unfit banknotes and coins, and identifying non-genuine and altered banknotes and coins, as well as constructive dialogue with the banking community, were the major factors behind improving the organization of cash circulation and the quality and cleanliness of cash in circulation.

Ordinance No 18 on Quality Control of Banknotes and Coins in Cash Circulation came into force in early 2007. It mandates banks to supply ATMs solely with banknotes classed as genuine and fit by sorting machines. The BNB has developed tests for sorting machines on request from manufacturers and publishes information on compliant machines on its website.

The year saw the launch of the Cash Services Company jointly with the three largest banks in Bulgaria. The company will develop a new market-oriented approach to banknote and coin processing to help optimize banking expenditure and maintain high quality standards for banknotes and coins.

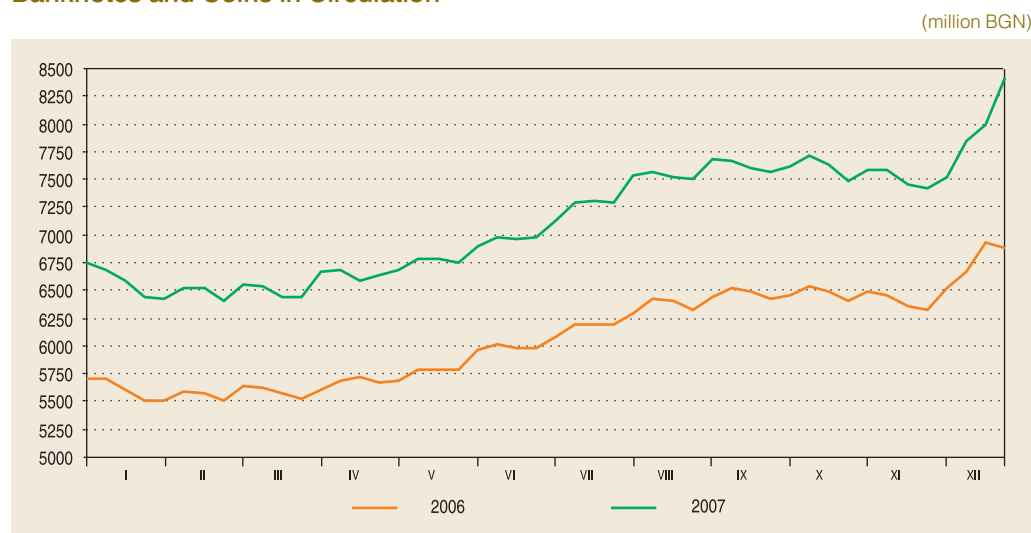
Completion of design for the new BNB cash centre in Sofia and selection of a chief contractor marked an important step to the implementation of another important project in 2007.

Banknotes and Coins in Circulation (Outside BNB Vaults)

By the end of 2007 cash in circulation²¹ came to BGN 8410.8 million in nominal value, up by BGN 1522.3 million or 22.10 per cent on the end of 2006.

By the close of 2007, 343.8 million banknotes worth BGN 8284.8 million were in circulation. Their number rose by 51.7 million or 17.71 per cent and their value by BGN 1503.3 million or 22.17 per cent on 2006. By 31 December 2007 the value of banknotes came to 98.50 per cent of the total value of banknotes and coins outside BNB

Banknotes and Coins in Circulation



Source: BNB.

²⁰The Law on the Bulgarian National Bank, Article 25.

²¹Banknotes and circulating or commemorative coins issued after 5 July 1999. Under BNB Governing Council Resolution No 110 of 6 October 2005, banknotes and circulating coins whose exchange term has not expired and which have not 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 years.

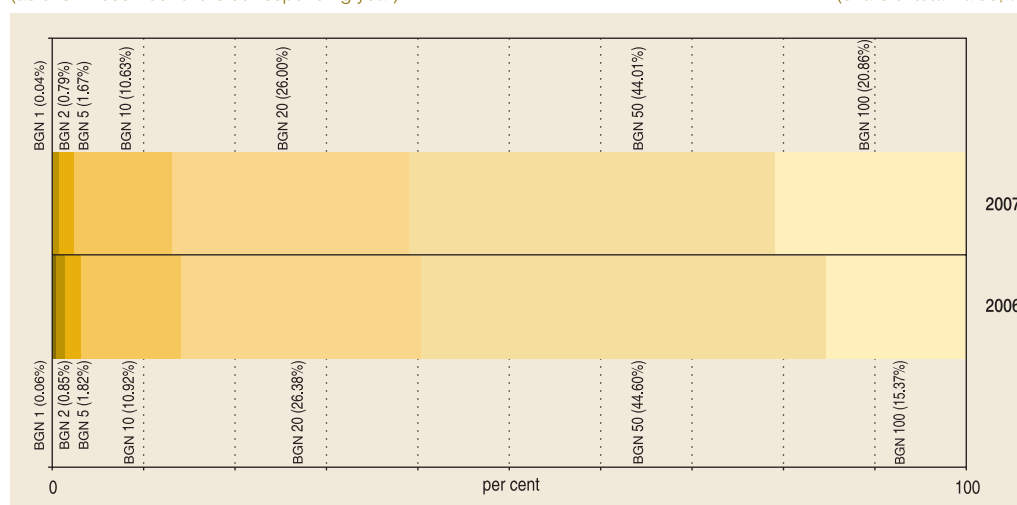
vaults. The average banknote in circulation by 31 December 2007 was worth BGN 24.10, up by BGN 0.88 or 3.79 per cent on 2006, reflecting the higher penetration of BGN 100 banknotes in circulation.

By the end of 2007 coins in circulation numbered 886.4 million, worth BGN 122.1 million. Compared with the end of 2006, their number grew by 125.6 million (16.51 per cent) and their value by BGN 18.4 million (17.71 per cent). The value of circulating coins accounted for 1.45 per cent of the total value of banknotes and coins outside BNB vaults by 31 December 2007. The relatively large rise in the number of coins resulted from the increased demand for coins of low nominal value during the year. The average coin in circulation over the review period matched its late 2006 level at BGN 0.14. Commemorative coins comprised 0.05 per cent of the total value of cash in circulation.

Denomination Composition of Circulating Banknotes

(as of 31 December of the corresponding year)

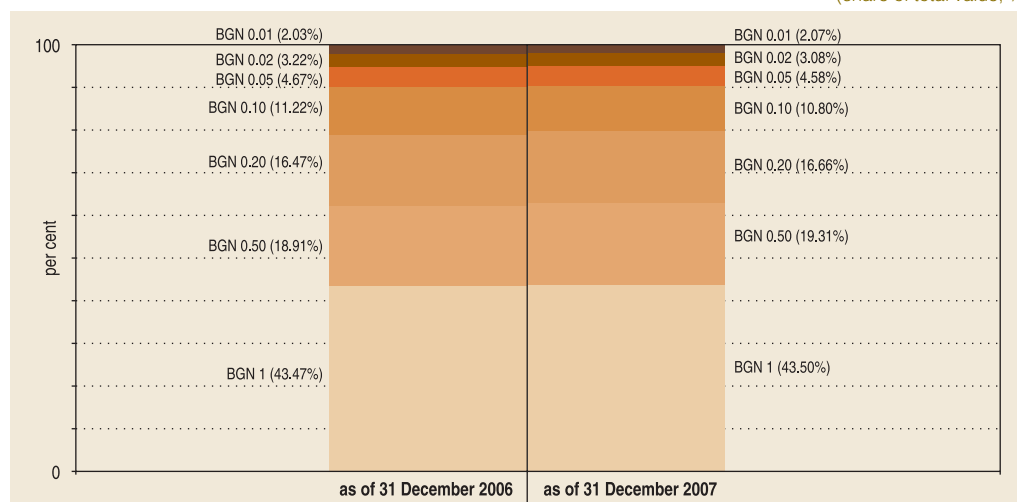
(share of total value, %)



Source: BNB.

Structure of Circulating Coins by Nominal Value

(share of total value, %)



Source: BNB.

Non-genuine Banknotes and Coins

The review period saw authenticity evaluations of 34,357 Bulgarian and foreign banknotes and 2151 coins suspected of being non-genuine or altered and referred by financial institutions, the Ministry of the Interior or the legal authorities to the BNB National Analysis Centre (NAC) under Article 27 of the Law on the Bulgarian National Bank. In 2007, 8118 Bulgarian non-genuine banknotes were registered with the BNB, 1542 of them seized prior to entering circulation and 6576 having entered into circulation. Compared with 2006, the number of non-genuine banknotes grew by 3542, or 77.40 per cent.

Banknotes of BGN 20 had 63.29 per cent of the total, followed by BGN 10 and BGN 50 banknotes at 32.16 and 3.92 per cent respectively. Reported non-genuine BGN 2, BGN 5 and BGN 100 banknotes numbered 51 (0.63 per cent). The NAC found 2118 non-genuine Bulgarian coins: 2105 BGN 0.50 and 13 BGN 1 coins.

By end-2007 the relative shares of non-genuine Bulgarian banknotes and coins in the total number of circulating banknotes and coins were 0.002361 per cent and 0.000239 per cent respectively, with the risk of financial losses being very low.

The BNB regularly send banks, exchange bureaus, and finance houses descriptions of non-genuine banknotes and advises them of methods for identifying them with a view to withdrawing them from circulation. As a follow-up of recent years' consistent measures for ensuring more efficient protection of Bulgarian banknotes against counterfeiting, during the fourth quarter the BNB circulated a BGN 20 banknote, issue 2007, with improved counterfeit protection features.

In performing its functions of maintaining close cooperation with the European Commission, the ECB, and other parties, in 2007 the BNB National Analysis Centre carried out expert assessments of 6835 euro banknotes, 5170 US dollar banknotes and 536 other foreign banknotes.

Cash Operations

BNB cash operations include receiving, storing and supplying valuable packages of banknotes and coins, keeping uncirculated fit and unfit banknotes and coins, sorting, counting and destroying banknotes, counting coins, and monitoring the authenticity and physical properties of submitted banknotes and coins. A BNB Governing Council resolution as of September 2007 closed down till operations with non-bank institutions and individuals at the Plovdiv, Varna, and Pleven Regional Cash Centers. Servicing retail customers and first level budget spending entities in leva and euro and selling commemorative coins is now concentrated at the Sofia Regional Cash Center.

In 2007, 143.05 million new banknotes and 100.3 million new coins worth BGN 2126 million were supplied under contracts with producers. The BNB launched the seven commemorative coins²² planned in its minting program.

Under Ordinance No 18 on Quality Control of Circulating Banknotes and Coins, in force since early 2007, banks and service suppliers may only dispense cash classed as genuine and fit to new criteria. This increased the volume of cash deposited at the BNB for processing, and hence recirculation of banknotes, particularly BGN 10 and BGN 20, through the BNB.

Banknotes and coins circulated and withdrawn by banks through regional cash centers totaled BGN 16,838.6 million in 2007. Banks deposited 521 million Bulgarian banknotes and 26.6 million coins worth BGN 7656.1 million with the BNB: up by BGN 2044.1 million or 36.42 per cent on 2006. Over the year banks withdrew 571.7 million Bulgarian banknotes and 168.1 million coins worth BGN 9182.5 million: up by BGN 2619.8 million or 39.92 per cent.

Sorting machines test the authenticity and fitness of Bulgarian banknotes deposited with the BNB to maintain their quality. In 2007 the BNB processed 529 million banknotes and 100.4 million coins worth BGN 7912.9 million: banknote numbers increased by 129.1 million (32.29 per cent), while coins fell by 11.1 million (9.95 per cent) on 2006. BGN 10 and BGN 20 banknotes and BGN 0.10 and BGN 0.20 coins were the most frequently processed ones.

The BNB retained 123.9 million banknotes (up by 24.3 million or 24.42 per cent on 2006) and 0.4 million coins (up 63.9 per cent). Banknotes of BGN 20 and coins of BGN 0.10 had the largest share of unfit cash.

In 2007, the BNB purchased EUR 1.9 million at regional cash center tills, including EUR 1.3 million from individuals and EUR 0.6 million from budget organizations. Sales amounted to EUR 62.6 million, including EUR 54.5 million to individuals and EUR 8.1 million to budget organizations.

²² Information on commemorative coins is published on the BNB website.

VI. Maintaining Banking System Stability

1. State of the Banking System

Credit institutions expanded their operations sustaining the stability of their financial base irrespective of unfavourable financial market developments over 2007. By the end of 2007 the *banking assets* totaled BGN 59.1 billion and exceeded by BGN 16.9 billion the 2006 level, posting an annual growth of 40 per cent, or approximately 12 percentage points higher than the average for the 2005–2006 period. Major sources of funds for financing asset growth were the increase in borrowed funds (mostly deposits of institutions and those of individuals and households) and the increased own funds.

Consolidation of banks in Bulgaria continued with the emergence of two new institutions: UniCredit Bulbank and Eurobank EFG Bulgaria. The concentration in the banking sector enhanced with the establishment of these banks: for a year the market share of the *big five* in the banking system assets rose by 6 percentage points to 56.6 per cent. These banks' development determines the processes in the banking system as a whole. With the increased number of banks' subsidiaries from the EU, their market share reached 75.3 per cent. Concurrently, the group of *resident credit institutions* went down to 8 banks with a share of 17.7 per cent. Foreign credit institutions' branches in 2007 increased their market share to 4.9 per cent of the banking system's balance sheet figure.

The share of *loans and receivables (including finance leases)* reached 76 per cent of the banking sector assets by the end of 2007. *Gross loans and advances* rose by BGN 14.2 billion (44.9 per cent), with the highest growth reported in the fourth quarter of 2007. Over 2007 all segments of this item exhibited growth with the exception of *receivables from credit institutions* (placements and repo agreements) which went down on 2006. By the end of 2007 *gross loans and advances* totaled BGN 45.9 billion; of this BGN 24.3 billion was extended to corporate customers and retail exposures amounted to BGN 13 billion. The dynamics of loans and advances was impacted by the BNB policy: in early 2007 administrative constraints on lending growth were lifted and as of 1 September 2007 the minimum required reserves to be deposited by the banks with the BNB were raised from 8 per cent to 12 per cent. Receivables from credit institutions (BGN 7.9 billion) ranked third as a share in the portfolio followed by non-credit institutions (BGN 0.5 billion) and central governments (BGN 0.2 billion). Over the period under review gross loans and advances and retail exposures posted the most substantial growth: by BGN 14.5 billion (63.7 per cent), with more than half of the growth attributable to the big five. Concurrently, net sales of loans in the amount of BGN 1048 million were reported on banks' balance sheets.²³

Unlike the previous year retail exposures in 2007 posted a slower growth rate (58.8 per cent) compared with corporate loans growth. Household loans indicated an increase by BGN 4.8 billion in banks' balance sheets, with the amount equally distributed between the two products: housing mortgage and consumer loans. Compared with consumer loans the annual growth rate of housing loans remained higher. Over the year the share of net loans to corporates and retail exposures in banking assets rose by 9 percentage points and by the end of December accounted for 61.4 per cent. By the close of the year almost two-thirds of disbursed corporate loans were denominated in euro, while retail exposures were dominated by the lev component (80 per cent). The currency composition of gross *loans and advances* pointed to an increase in the share of euro-denominated exposures (to 51.5 per cent) and a decrease in lev-denominated exposures (to 43.7 per cent) and in other currencies (to 4.8 per cent).

²³ Net sales of loans are the balance between sold and repurchased loans which between January and December 2007 amounted to BGN 2179 million in credit portfolio sales and BGN 1131 million in repurchased loans.

Within the foreign currency structure of funds borrowed by banks (*financial liabilities measured at amortised cost*) the share of those denominated in euro went up to 51.9 per cent by the end of 2007 and the shares in levs and other currencies declined to 41.2 per cent and 6.9 per cent respectively. For a year borrowed funds increased at a rate close to that of assets, rising by BGN 15 billion, mostly at the expense of additional resources provided by institutions and households. By year-end the contribution of funds borrowed from *institutions other than credit*, which accounted for 38.6 per cent, proved largest to total borrowed funds. The share of deposits of *individuals and households*, accounting for 36.4 per cent, ranked second. Credit institutions' resources comprised 22 per cent. The structure of total borrowed funds based on the residence principle indicates that bank businesses are mostly funded by domestic resources: the share of residents accounted for 76.5 per cent and that of non-residents 23.5 per cent.

The *total capital* balance sheet aggregate rose by BGN 1830 million (41.7 per cent) over the year. The 1.7 percentage point increase reflects banks' equity and reserve increases and higher profits. Stock exchange share issues by three credit institutions and the increase in their premium reserve by BGN 213 million also increased overall equity.

The new Common Reporting Framework (COREP) and the consolidated Financial Reporting Framework (FINREP) were introduced in early 2007. They introduced additional capital requirements which, given stiff competition, strongly exercise banks' capital planning and the management of major bank risks (credit, operational, position, commodity and foreign exchange).

The introduction of the new Basel II capital framework called for more precise calculation of capital required to cover bank risks. Credit institutions had to put up adequate extra capital to meet new credit, position, foreign exchange and commodity risk and to report a new item, operational risk. They handled these new requirements generally successfully and met the additional requirements. This boosted the banking system's own funds by 52 per cent (BGN 1981 million) over the year, mostly from increased tier one capital. Over the review period system capital as a whole, and that of most banks, provided the required regulatory cover. By late 2007 *overall system capital adequacy* was 13.86 per cent against 14.51 per cent a year earlier. Almost all institutions reported positive results, a handful of banks reporting levels close to statutory limits, mostly reflecting poor capital planning and management. The system capital surplus of BGN 775 million was unevenly distributed, a sizable portion concentrated at the big five.

Most banks continued to raise capital mainly from existing equity holders. Tier one capital grew by 46 per cent. Over the reporting year a few banks managed to cover growing operational risk using instruments recognised as tier two capital, showing its substantial remaining potential. Funds in the form of subordinated term debt or debt/equity (hybrid) instruments were attracted mostly by banks which lend intensively and have access to parent company resources.

Credit risk continued to dominate, with required capital cover of BGN 4486 million, or 89.5 per cent of the total capital required to cover all banking risks. In 2007 the share of credit risk increased at the expense of other risks (market and operational).

The method used for reporting *operational risk* (the method of basis indicator based on audited annual financial statements) explains the sustained amount of capital requirements of BGN 405 million in 2007, or 8 per cent of total capital requirements.

Banks exhibited low sensitivity to market (*commodity, position and foreign exchange*) risks due to their aversion to complex instruments, speculative positions and currencies other than the euro. A mere BGN 124 million or 2.5 per cent of total banking system capital requirements were allocated to cover market risk.

Indicator analysis points to *good asset quality* at most leading banks. Compared with December 2006 impaired loans increased at most banks, and particularly at the big five. Banking system classified exposures in 2007 went up by 18.5 per cent: a rate of growth slower than that of annual assets²⁴. At the same time non-performing loans grew by 53.3 per cent and provisions by 44.6 per cent. Classified corporate loans made up

²⁴ The calculations do not include foreign bank branches, which do not report classified exposures on individual basis as of the end of 2007.

62 per cent of total classified loans and advances, their share in line with banks' portfolio structures. The share of classified corporate loans accounted for 4.4 per cent of total loans to corporates. Compared with 2006 their share diminished, consistent with the faster growth of loans to corporate clients. Classified household loans increased significantly faster: a signal to banks of the need for more thorough analyses of potential clients' creditworthiness. Classified consumer loans comprised 5.8 per cent of all consumer loans at the end of 2007. As a result of rapidly growing mortgage lending, 2007 saw some signs, however weak, of deterioration in this segment. Despite a 3.7 per cent classified portion, residential mortgage loans recorded the highest classified exposures growth in 2007 at 54.6 per cent. The trends outlined in the three credit portfolio segments are similar for banks contributing most to lending growth and for smaller institutions.

Stiffer competition between credit institutions and increased bank indebtedness pushed up the number of borrowers with debts to more than one bank. Though large exposures were not a source of significant systemic risk (placement or counterparty quality), some banks with more problematic assets also reported higher concentrations. In addition there was relatedness risk in bank balance sheets which was not always properly reported and evaluated. Nevertheless, the banking system remained stable as evidenced by off-site supervision and the on-site inspections.

Stress testing putative shocks by recategorizing loans by risk exposure suggests the availability of absorption capacity without undue portfolio worsening. Though most banks' equities were adequate for major risks, there was a lag between risk identification and its reflection in balance sheets. In view of this, banks' managements ought to focus efforts on proactive credit risk management, particularly addressing increased volatility on world financial markets and circumscribed opportunities for obtaining extra liquidity or equity.

The year under review saw an increase in euro area interest rates and a rise in the cost of borrowing, more pronounced in the second half. Banking system interest rate margin gradually narrowed on a background of unchanging lending rates. Despite this, by the end of 2007 banks reported their largest profits for the last decade. Between 2006 and 2007 they grew by BGN 365 million or 46.4 per cent, exceeding asset growth by 6.4 percentage points. Banks' profitability corresponded to the banking system's balance sheet structure: interest-bearing assets and the share of net interest income occupied the largest shares. ***ROA and ROE indicators also showed a sustainable trend with values higher than the EU average.*** By the end of 2007 banking system ROA was at 2.37 per cent, core ROA at 2.6 per cent and ROE at 23.89 per cent. A bank-to-bank review suggests that subsidiaries of EU banks with much stronger market positions were more profitable than domestic banks. Income level and structure suggests that the positive trend will continue into 2008, preserving asset quality.

Balance sheet structures and relatively static pricing strategies (despite new product launches) helped retain the relative proportions of interest and non-interest income within operational revenues. Compared with 2006 interest expenditure grew faster (by 8 percentage points) compared with interest income. Over the same period non-interest expenditure also rose faster than non-interest income. Should the volume of interest income change, the banking system's ability to offset falling monetary inflows could be seriously limited.

The banking sector as a whole and most banks succeeded in spending more conservatively on operations. By the end of 2007 the efficiency ratio stood at 51.56 per cent: an improvement by 8.7 percentage points on 2006. Banks still have room for attaining optimum levels, taking into account that this indicator reports investment into branch networks and improving their operations.

In 2007 ***banking system liquidity remained good***, underpinned by stable deposit growth. The conservative policy pursued by the BNB also contributed to the higher liquidity values reported through the year. Supplementary reserve requirements for particular banks had the effect of restraining liquidity until being dropped in May 2007. After their release, they were transformed into earning assets, including deposits with credit institutions. With the September 2007 increase in reserves and the subsequent monetary expansion, banking system liquid assets posted a sizable new rise. Any resource shortfall was

offset by funds from parent banks abroad. Customer and investor confidence both in the banking system and in individual banks was sustained. Institutions reporting lower values of major indicators did not face difficulties in servicing customers. In 2007 the banking system *liquid assets indicator* moved steadily within the range of 28 to 33 per cent.

2. Compliance with Prudent Banking Requirements

Supervisory inspections and off-site supervision in 2007 found regulatory deviations. Action including warnings, diverse sanctions, and supervisory measures, was taken against offenders.

Capital adequacy: individual banks had temporary dips below the minimum admissible levels in BNB Ordinance No 8, due to inadequate capital planning and management and aggressive lending. Individual cases were carefully analyzed and relevant supervisory measures initiated.

Large exposures: over the reporting year banks generally adhered to BNB Ordinance No 7, with isolated violations of regulations on individual large exposures and lending to economically related parties. Relevant supervisory action, including shortening reporting intervals, was taken.

Internal loans: no widespread or substantial violations of the Law on Credit Institutions and Ordinance No 7 were found. Corrective action was taken against offenders.

Investment into fixed assets: all banks stayed within limits set by the Law on Credit Institutions and Ordinance No 17.

3. Banking Supervision

Supervisory Policy

The implementation of a legal framework comprising the latest European directives introducing Basel II requirements (the International Convergence of Capital Measurement and Capital Standards: a Revised Framework) continued in 2007. The Law on Credit Institutions came into force on 1 January 2007 as Bulgaria acceded to the European Union, introducing compliance between Bulgarian legislation and European directives on credit institutions.

A new Ordinance No 8 on Capital Adequacy of Credit Institutions was also adopted, setting more detailed requirements to banks' risk management systems. Since early 2007 intensive talks on Ordinance No 8 issues and reporting forms were held. Progress in a project on problem issues and possible solutions will be posted on the BNB website.

In early 2007 a new Ordinance No 7 on Large Exposures of Banks and a new Ordinance No 11 on Liquidity Management and Supervision of Banks were approved. Ordinance No 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Credit Risk and Ordinance No 17 on Establishing the Amount of Bank Investment under Article 47 of the Law on Credit Institutions were amended. By the close of the year a new Ordinance No 12 on the Supervision on a Consolidated Basis was also adopted. In late March new reporting forms, compliant with the common reporting standards (COREP) of the Committee of European Banking Supervisors (CEBS) were launched for Ordinance No 8 on Capital Adequacy of Credit Institutions. Analyses of form testing results were completed in February. Major computations and logic checks were automated. The standardized forms uniformize and harmonize market participant reporting and communication between EU supervisors. New balance *sheet and income statements* based on CEBS FINREP consolidated financial reports were introduced. Instructions and reporting forms for other amended ordinances were also updated.

In the context of mutual EU recognition for external credit rating agencies and Ordinance No 8 on Capital Adequacy of Credit Institutions Articles 27 and 49, the BNB recognized Standard & Poors', Moody's Investor Services', and Fitch Ratings' scales for determining bank exposure risk weights in standardized credit risk measurements.

In April a new section on the BNB website, Supervisory Disclosure, was launched. Under the Law on Credit institutions Article 102 the BNB publishes information on new leg-

isolation and regulations, the manner in which national rights to choice and discretion are exercised, and major statistical data under Directives 2006/48/EC and 2006/49/EC. The CEBS supervisory disclosure model is used and the BNB involved the Financial Supervision Commission into the project. Over the year the section was updated regularly with summaries and details of the Bulgarian versions of the FINREP and COREP packages.

Implementation of an electronic system for information exchange between banks and supervisory institutions based on the Extensible Business Reporting Language (XBRL) information platform is underway. It is intended to ensure compliance in communication between individual supervisors and EU financial institutions.

In the second half of 2007 work started on adapting Committee of European Banking Supervisors' instructions to the national regulatory framework. This addresses specific issues related to Directives 2006/48/EC and 2006/49/EC where no comprehensive requirements have been provided or further clarification is needed. These instructions refer to the Basel II Second Pillar on, *inter alia*, supervisory review and assessment, internal capital adequacy analysis, stress-tests, and bank portfolio interest rate risk management.

BNB banking supervision experts participated in EU banking development and supervision fora: the Committee of European Banking Supervisors (CEBS) and its working groups, the European Banking Committee (EBC), the Interim Working Committee of Financial Conglomerates (IWCFC), the ECB Banking Supervision Committee (BSC), and the regional Group of Banking Supervisors from Central and Eastern Europe (BSCEE).

Banking supervision experts rendered methodological assistance under the Deposit Insurance Fund's risk-weighted contributions project.

Supervisory Administration, Licenses, and Permits

Licensing and enforcing BNB administrative (supervisory) measures relate directly to banking stability. To this end, publication of *The Major Principles of BNB Licensing Policy* in July 2007 was of significant importance. The document lists the essential considerations of prudent and conservative licensing for new entrants into the banking market.

BNB policy on issuing individual permits was also conservative and prudent. Following thorough studies and analyses several banking consolidations were approved.

The local HVB Bank Biochim and Hebros Bank, separate subsidiaries of UniCredit Group directly controlled by Bank Austria Creditanstalt, were taken over by Bulbank to form UniCredit Bulbank AD, a subsidiary of the Italian UniCredit financial group. After the Greek EFG Ergasias acquired a majority in the DZI Bank, the BNB allowed the latter to be taken over by the Bulgarian Post Bank, establishing Eurobank EFG Bulgaria AD, an indirectly controlled subsidiary of the Greek bank group.

Large EU financial groups continued entering the Bulgarian banking market. In 2007 a permit was issued to the Belgian KBC financial conglomerate to acquire the Economic and Investment Bank AD. In the other direction, ambitions by well-performing domestic banks to expand across the Balkans resulted in acquisitions, permitted by the BNB, of majority packages by the Central Cooperative Bank AD in the Post Bank AD of Skopje and of the Sileks Banka AD of the same Macedonian city. The restructuring of the local BNP Paribas Bank (Bulgaria) AD into a branch of the French BNP Paribas financial group was completed. After transferring the subsidiary's operations to the previously licensed branch, a permit for liquidation of the local company was issued.

Effective risk management at systemically important credit institutions did not entail serious corrective supervisory measures. Any deviations from statutory requirements established in the course of supervision were duly removed, formal instructions to remove violations being imposed only on three banks. At the same time, new capital requirements and buoyant lending required rapid and flexible capital planning and management decisions by bank managements and shareholders. Individual delays resulting in minor and already remedied capital shortfalls prompted three warnings. One bank's significant exposure concentration to a monolithically managed group of companies resulted in constraints on the extent of new exposures and exposures to particular persons and to more detailed supervisory accountability.

On-site Supervision

Assessment of inspected institutions rested on thorough quantitative and qualitative analyses of their entire operations, risk profiles, financial performance, the adequacy of internal control and management mechanisms, and adherence to regulatory requirements. Internal systems and procedures to identify, measure, monitor, and control assumed risks were inspected and their day-to-day application was assessed. To optimize performance, supervisory staff was assigned to teams for two year periods, each team responsible for a set group of banks. This boosted on-site inspection continuity and consistency while taking better account of inspected institutions' risk profiles, management specifics, and development strategies.

The 2007 on-site supervision program increased the intensity of overall and spot inspections, the latter including monitoring of particular risks and implementation of measures and recommendations stemming from full inspections. There were operational risk management inspections at all banks. The supervisors' found that banks were highly aware of operational risk and managed it adequately.

After full inspections three banks improved their complex evaluation ratings, nine retained theirs, and one had it lowered. All banks were assigned operational risk basis component ratings based on sensitivity to operational risk and operational risk management adequacy and quality.

Inspections established 57 formal breaches of banking legislation and supervisory regulations. Most breaches involved evaluating and classifying risk exposures, large exposures to informally related borrowers, inadequate monitoring of loan spending, and insufficiently tight trade portfolio management.

Recommendations to inspected banks numbered 125. Most addressed credit risk management, loan accountability including exposure classification and provisioning, and credit concentration, particularly where there may be informal or indirect relatedness between borrowers and shareholders. Other recommendations involved improving and updating banks' internal rules, adopting long-term development strategies focused on improving risk evaluation and control, updating of rules and procedures and strict adherence to them, and common regulatory framework requirements.

Follow-up inspections mostly addressed implementation of earlier recommendations and evaluated the current status of particular risk areas.

Off-site Supervision

Off-site supervision focused on early identification of increased risk and monitoring banking system risk dynamics due to its critical importance for national financial stability. The dropping of lending restrictions increased the need for continued monitoring and analyzing of banking system credit risk and risk distribution among banks. Given adverse changes in international markets, special attention was paid to the financial stability of parent banks and foreign institutions' abilities to support local subsidiaries in good time where necessary.

An important accent in off-site supervision work was the updating and improvement of CAEL methodology for monitoring credit institutions' performance individually and as a whole (The Uniform Bank Performance Report). Analyzing bank risks prompted changes to the Early Warning System reflecting both the changed regulatory framework and new credit institution operations.

Aggregated, verified, and processed data by bank formed the basis for a number of Bulgarian banking sector analyses. Off-site supervision periodical publications included the *State of the Banking System* quarterly, the *Commercial Banks in Bulgaria* bulletin, and monthly press releases on banking performance.

Bulgaria's banking system was included in two ECB reports for the first time in 2007 through comparable indicators based on annual data for 2006. Intensive work on EU accession addressed exchanging information and participating in ECB Banking Supervision Committee analyses and research. Off-site supervision specialists helped prepare positions and expert opinions on issues at individual supervisory institutions or ECB working group projects involving bank crisis management, liquidity risk management within the European banking system, stress-test practice and policy, foreign exchange lending risk, household lending risk, and distribution channels. Cooperation and information exchange

with international institutions (IMF, EBRD), foreign organisations, 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. The research work and data exchange in turn helped improve the quality of current analyses.

The year saw the launch of the second part of the Single Data Depository/Banking Supervision Reports project. The project had two purposes: introducing new report forms from 1 January 2007 and defining data for them, and transferring input data into annual accounts for 1998. Off-site supervision experts participated actively in the Central Credit Register Improvement and Development project launched in 2007. This will improve the current credit portfolio provided by banks and supplement it with Central Credit Register data for banking supervision purposes.

Special Supervision

In 2007 the focus of special supervision was on obtaining transparency on bank shareholders and their finances. This involved ongoing monitoring of shareholders' contributions to banks' capital. Business relatedness, financial status, and funding sources were analyzed. Supervision attained greater clarity on direct and indirect equity holders, analyzed their finances in depth, and conducted some precision assessments of individual equity holders' ability to support capital.

Following the core principles for effective banking supervision, consistent measures were initiated to prevent the illegal use of banking. Supervisory effort was directed at evaluating the risks of money laundering and terrorist financing. Banks were made aware of the key importance of clear rules, procedures, and principles in comprehensively checking new and existing customers to avoid reputation, operational and legal risks. They were offered methodological support in examining security, bringing internal rules into line with legal requirements, and using the risk-based approach.

Banks maintained adequate controls, principles, and procedures in examining customers.

Intensive cooperation with institutions responsible for preventing illegality in the financial sector continued. Coordinated action under memoranda of understanding with the Chief Prosecutor, the Financial Investigation Agency, and the Financial Supervision Commission aimed at financial sector crime prevention.

Under established good practice for assistance between institutions fighting financial fraud and money laundering expert help was provided to law enforcement bodies.

The joint Bulgarian and US group on measures against financial fraud which included representatives from the Special Supervision Department and the permanent working group for assessment and enforcement of measures against money laundering in the financial sector worked intensively over 2007.

Inspections at banks as custodians were conducted jointly with the Financial Supervision Commission. Trust organization and procedures to BNB Ordinance No 36 were evaluated. Statutory breaches resulted in recommendations to bank managements on the control functions of custodian banks and statutory constraints on investing corporate assets. Changes to legislation were recommended based on inspection findings.

The Prosecution Office, international regulators, and legal authorities prompted inspections at banks to test for breaches of the Law on Credit Institutions, the Currency Law, and the Law on the Measures against Money Laundering. Several companies conducting unlicensed banking operations were also inspected. Detectives and prosecutors were advised of findings on cash operations, transactions, and the origin of funds.

VII. The Central Credit Register

The Central Credit Register (CCR) developed and maintained by the BNB advises banks on customers' debt to the banking system. CCR activity is regulated by BNB *Ordinance No. 22 on the Central Credit Register of Banks*. The Register covers all bank claims irrespective of amount, except debit card overdrafts of up to BGN 1000 (provided they are classified as standard), loans to government, and loans to the BNB. Interbank lending is not covered. The system ensures reliable information submission and storage. Financial institutions participating in the CCR exchange data with the Register online. Authorized officer access is *via* digital certificates, and the fee *per* customer debt check is BGN 0.50.

Amendments to Ordinance No 22 in 2007 expanded the Register's scope under Article 56 of the Law on Credit Institutions to include loans by financial institutions' subsidiaries, which may now access Register data in evaluating credit risk through parent banks. Ordinance No 22 also extends the duty of care in submitting information, checking and amending data to subsidiaries. The extended CCR coverage creates better conditions for managing and controlling credit risk in the banking system and financial sector.

By the end of December 2007 the CCR listed 2,698,093 loans (against 2,009,006 at the end of 2006), with balance sheet exposure increasing to BGN 37,434 million (BGN 22,603 million as of 31 December 2006). Borrowers numbered 1,622,797, of whom 1,540,666 individuals, 79,438 resident legal entities and 2693 non-resident legal entities.

In 2007 banks conducted 3937.5 thousand CCR debt checks, up by around a million on 2006 (2979.6 thousand). The monthly average number of certificates in 2007 was 328,000 or over 16,000 a business day. Of the total checks, 3,176,652 were on individuals and 760,810 on resident legal entities. Growing CCR usage indicated its increasing importance in managing bank credit portfolios.

VIII. The Fiscal Agent and State Depository Function

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

In line with commitments under the Agreement²⁵ between the MF and the central bank which defines the BNB's long-term government agent duties, the Bank continually develops and improves its systems: the IOBFR electronic system for budget and fiscal reserve information servicing, the AS ROAD automated system for registering and servicing external debt, the GSAS system for conducting auctions and replacement subscriptions of government securities, the ESROT electronic system for registering and servicing government securities trading, the SDTK system for government securities settlement, and the Register of Pledges. System development follows MF requirements for expanding functionality and is in line with standards applied on international financial markets pursuing a secure infrastructure integrated into the European market of government securities.

In 2007 fees and commissions for the BNB's fiscal agency and depository functions totaled BGN 1338.0 thousand (up BGN 129.3 thousand on 2006), including BGN 759.0 thousand from the Ministry of Finance (up BGN 77.4 thousand on 2006), with the balance from government securities market participants (up BGN 51.9 thousand on 2006).

Information Service

Under Article 43 of the Law on the BNB and standing joint instructions by the Minister of Finance and the BNB Governor, daily and other regular information on operations and balances on budget entities' budget, extra budgetary, deposit, suspense, and letter-of-credit accounts in levs and other currencies was regularly gathered, processed and submitted to the MF *via* the electronic system for budget and fiscal reserve information servicing. At the end of 2007 total report forms numbered 429 or an increase of 42 on 2006. This change was due to the increased frequency of collecting statistical information on payments into public claims administrators' accounts from biweekly to weekly. Additional information was also gathered periodically on municipal account balances at MF request to manage and control consolidated fiscal programme receipts and payments.

Total balances on budget entities' and municipalities' bank accounts increased from BGN 6430.6 million at the end of 2006 to BGN 8762.8 million at the end of 2007 (up 36 per cent). Balances on accounts with the BNB rose from BGN 4930 million in December 2006 to BGN 6414.4 million in December 2007. Similar trends obtained in balances on cash accounts included in the fiscal reserve scope: at the end of 2007 their amount was BGN 7150.3 million²⁶ (BGN 5435.0 million at the end of 2006), of which BGN 6136.5 million on accounts with the BNB (BGN 4671.8 million at the end of 2006).

The AS ROAD system registered the Bulgarian government's foreign financial obligations, on which the BNB acted as calculating and paying agent, and which came to EUR 2733.0 million.²⁷ Payments numbered 49 and came to EUR 577.6 million, comprising EUR 382.7 million principal and EUR 194.9 million interest.

Servicing Government Securities Trading

MF-scheduled auctions in 2007 for sale of three-month, three-year, five-year and ten-year government securities nominally worth BGN 640 million, BGN 122.3 million more than in 2006, were held *via* the GSAS system. Government securities demand significantly exceeded supply, with a 2.77 average bid-to-cover ratio against 2.25 a year earlier. Of the

²⁵ The Agreement between the Council of Ministers and the BNB on introducing the euro into the Republic of Bulgaria and objectives and tasks in the Strategy for BNB Development between 2004 and 2009.

²⁶ Balances on foreign currency accounts are recalculated in levs at the official BNB exchange rate for 31 December 2007.

²⁷ The total debt amount was recalculated in euro at the official BNB exchange rate for 31 December 2007.

99 average primary dealers' bids *per* auction, 40 were approved.

In 2007 the ESROT electronic system for registering and servicing government securities trading recorded principal and interest payments of BGN 523.6 million²⁸ at maturity date. The total of initial acquisition operations in government securities, principal and interest repayment on maturing securities and reverse repurchases directly from individuals came to BGN 1163.8 million or 10.9 per cent higher than in 2006. The increase pertains mainly to larger volumes of newly issued securities. Government securities transactions in the secondary market numbered 6919 (up 8.9 per cent on 2006) at BGN 19,825.6 million nominal value²⁹ (growth by 61.0 per cent). Blocking and unblocking of government securities had the largest share (50.5 per cent), followed by repo agreements (30.4 per cent), transactions with and on behalf of customers (10.2 per cent), and outright purchases and sales (8.9 per cent).

The relatively large amount of government securities blocking and unblocking transactions reflected the high levels of budget funds with banks. Under Section 25 of the Transitional and Final Provisions of the Republic of Bulgaria 2007 State Budget Law and the Minister of Finance and BNB Governor's instructions, these funds 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 the review period budget funds with banks totaled BGN 2348.4 million (against BGN 1500.6 million at the end of 2006: a 56 per cent growth). Under its agreement with the MF, the BNB continued monitoring the daily balances of budget entities' accounts with banks along with data on collateralized government securities. In 2007 the average daily amount of these balances was BGN 1831.2 million (BGN 1322.7 million in 2006), while average daily nominals of blocked domestic government securities were BGN 1119.4 million, EUR 135.0 million, and USD 48.3 million, and foreign government securities (including EIB Eurobond issues) were BGN 178.9 million, EUR 119.0 million, and USD 126.2 million.

Over 2007 BGN 94.9 million³⁰ (up 137.2 per cent on 2006) worth of pledges and redeemed pledges on government securities were listed in the Central Register of Pledges kept by the BNB under the Law on the Registered Pledges.

At the end of 2007 accounts kept with the government securities settlement system came to 1886, including 52 for government securities of the issuer (the MF), 746 for participants' own government securities portfolios, 656 for government securities market participants' customers, and 432 for encumbered government securities. Government securities on these accounts totaled BGN 3199.9 million in nominal value, up 8.3 per cent on the end of 2006.

System Development

System development in 2007 complied with European initiatives related to updating financial market infrastructure: CPSS-IOSCO/ESCB-CESR recommendations and standards on securities settlement systems and their use in Eurosystem credit operations (1998; 2001); Giovannini barriers to cross-border clearing and settlement (Giovannini barriers: 2001); European Code of Conduct for Clearing and Settlement (Code of Conduct: 2006); and the ECB's TARGET2-Securities project (2006). Systems also developed in line with the Strategy for BNB Development between 2004 and 2009 and the Ministry of Finance Debt Management Strategy for the 2006 to 2008 period.

The adoption of the Law on Markets in Financial Instruments, which transposed Directive 2004/39/EC on Markets in Financial Instruments (MiFID) – one of the most important in the area – into Bulgarian legislation, was an important step to developing the capital market and integrating it into European financial markets. The Law prompted amendments to the Law on the Government Debt and the Law on the BNB and changes to statutory instruments regulating the government securities market. To this end, the BNB issued

²⁸ The lev equivalent of government securities issues denominated in foreign currency was calculated at the official BNB exchange rates valid for the date of payment.

²⁹ The lev equivalent of government securities transactions denominated in foreign currency was calculated at official exchange rates for relevant currencies on transaction dates.

³⁰ The lev equivalent of foreign currency denominated securities recorded in the Central Register of Pledges was calculated at official exchange rates for relevant currencies valid for the date of transaction.

new Ordinance No 5 of the MF and the BNB on the Terms and Procedure for Acquisition, Registration, Redemption and Trade in Government Securities, new Ordinance No 15 of the MF and the BNB on the Control over Transactions in Government Securities, new Ordinance No 31 of the BNB on Government Securities Settlement and a new Tariff of Fees and Commissions Charged on Processing Government Securities Transactions, in force from 1 November 2007 alongside the Law on Markets in Financial Instruments.

The above legislation transposed the single passport concept into the area of government securities investment intermediation. The scope of participants in the Government Securities Depository was extended to include banks, investment intermediaries, and central securities depositories from EU Member States. The anticipated listing by the European Commission of Bulgarian systems under Directive 98/26/EC of the European Parliament and of the Council on Settlement Finality in Payment and Securities Settlement Systems Article 10 will offer EU Member States immediate notification of insolvency on the part of any system participant.

Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments focuses on protecting customers' assets through guaranteeing their title. Therefore, new legislation requires stringent control over government securities subdepositories: a new category of market participants which do not necessarily act as primary dealers. Only banks whose licenses cover business listed in Article 2, paragraph 2, item 4 of the Law on Credit Institutions may act as subdepositories.

In compliance with practice in most EU Member States, primary dealers are likely to be selected by a commission appointed by the Minister of Finance on the basis of criteria approved by himself. To this end, the Bank undertook to provide daily information through the GSAS and ESROT systems to the issuer on reporting criteria related to participation in the primary and secondary government securities markets. Since access to these systems is based on specific organizational, operational, and technological requirements assuring safe and unimpeded settlement of cash and government securities on participants' accounts, relevant updates to GSAS and ESROT were launched.

Statutory and system changes were promptly noted in annually updated questionnaires by specialized international institutions such as the Association of Global Custodians, Thomas Murray, the Committee on Payment and Settlement Systems, and the CPSS-IOSCO – Disclosure Framework.

During the year consultative groups to the National Council on Payment Systems (including representatives of the IOBFR and ESROT operators) completed their work. The Consultative Group on Bulgarian securities settlement systems participation in similar European structures prepared a detailed analysis of the effect of business requirements and European standards on Bulgarian securities settlement systems' technological and operational parameters for the National Council on Payment Systems. To this end, and given the key significance of the TARGET2 Securities project, the Council set up two working groups on corporate and government securities to participate in ECB public consultations and monitor the project to ultimate launch in 2013. As in most EU Member States which have established national groups of consumers under the project, these groups will work in close cooperation and coordination with market participants, supervisory bodies, the Ministry of Finance and ECB representatives for Bulgaria.

Recommendations by the Consultative Group on Budget Payments in its report to the National Council on Payment Systems led to a thorough analysis of IOBFR functionality in the context of information provision options for the eventual application of SEPA schemes and of standards for new budget payment instruments. To define guidelines for developing and bringing IOBFR into line with EU practice, in 2007 the Bank and the MF explored the experience of the central bank of Italy which, under an agreement with the Italian Ministry of the Economy and Finance, collects daily information on cash budget flows from servicing banks in support of liquidity management decisions.

IX. International Relations and Participation in the ESCB

Participation in the European System of Central Banks

On 1 January 2007 the BNB became a full-fledged member of the European System of Central Banks. Thanks to good organization over past years, experience as an observer in the ESCB committees and working groups since 2005, and good internal organization supporting participation in meetings, the Bank performs these new functions successfully.

BNB representatives took part in inter-institutional working groups formulating Bulgarian positions on Economic and Monetary Union, financial and banking services, statistics, consumer protection in financial services, and EU enlargement. The Bank participates in consultations shaping national policy on financial issues deliberated in EU institutions and other bodies.

The European System of Central Banks comprises the ECB and the national central banks of the EU Member States. Under Article 28 of the ESCB and ECB Statute, national central banks are sole subscribers to and holders of ECB capital. Under Decision ECB/2004/10 laying down the measures necessary for the paying-up of European Central Bank capital by non-participating national central banks, on 2 January 2007 the BNB remitted EUR 3,561,868.99 (BGN 6,966,410.22), or 7 per cent of its subscription, into ECB capital. The remaining 93 per cent is to be remitted upon Bulgaria's accession to the euro area. The total BNB subscription to ECB capital is EUR 50,883,842.67 or 0.8833 per cent of ECB capital.

The BNB Governor is a member of the ECB General Council, along with central bank governors from all EU Member States and the President and Vice-President of the ECB. The General Council approves economic convergence reports of non-euro area EU Member States, discusses issues on participation in Exchange Rate Mechanism II, financial and economic developments and public finance, compliance with Articles 101 and 102 of the EC Treaty, and ECB statistical functions. The General Council also issues statements of opinion under the ECB's consultative function (European legal and national bodies have to consult the ECB on legislative bills within its competence). In 2007 the BNB Governor took part in four regular and one extraordinary meetings of the ECB General Council at which an extraordinary convergence report on Cyprus and Malta was reviewed to assess euro area accession criteria.

BNB representatives took part in 12 ESCB committees, 29 working groups, and the Human Resource Conference. Through representatives in ESCB committees and working groups, the Bank contributed to drafting ECB legal instruments and participated in shaping and developing standards on monetary and banking infrastructure, payment and settlement systems, and statistical reporting. In the period under review over 12,000 documents on committee and working group performance were discussed, with the Bank expressing opinions on all essential issues.

On 1 August 2007 the BNB joined the memorandum of understanding on cooperation between payment systems overseers and banking supervisors in Stage Three of the Economic and Monetary Union (in force from 1 January 2001) and the memorandum of understanding on cooperation between banking supervisors and EU central banks in crisis management (in force from 1 March 2003).

The first consultation between the BNB and the ECB on draft Law on Money Transfers, Electronic Payment Instruments and Payment Systems began on 25 October 2007, under Decision 98/415/EC of the Council of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions. The consultation on the Bulgarian draft Law ran smoothly and the ECB's opinion of 12 December 2007 was positive.

During the December meeting of the ECB Governing Council, the Governor of the BNB signed an Agreement amending the Agreement of 16 March 2006 between the European Central Bank and national central banks of Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union, as well as a Cooperation Agreement on transporting euro banknotes in Member States.

During the review period BNB representatives took part in preparing and coordinating the ECB Annual Report and the extraordinary Convergence Report for the first time. The BNB participated actively in translating these publications into Bulgarian and editing the translation. Quarterly issues of the ECB *Monthly Bulletin* are translated into Bulgarian and published on the Bank's website.

The BNB continued to improve its internal rules to increase the effectiveness of its representatives in the ESCB and other EU bodies and improve coordination within the Bank. In February 2007 the BNB Governor approved *Internal Rules for preparing opinions on written procedures carried out within the ECB General Council, ESCB committees and working groups, and other EU bodies*. The Rules set out individual Bank directorates' and officers' duties in preparing opinions on written procedures. Two meetings discussed BNB participation in the ESCB, improving information exchange between participants in various committees and working groups in 2007, and establishing common positions.

Participation in ECOFIN Meetings, Council and Commission Committees and Working Groups

The BNB Governor participates twice annually in ECOFIN informal meetings on assessing risks to financial stability, improving the supervisory framework and the quality of public finance, tax policy and quotas, and IMF representation.

Bank representatives sat on regular Economic and Finance Committee meetings tackling a broad range of EU economic issues and financial market developments, and participated in ECOFIN Council annual assessments of Member State stability and convergence programmes. Bulgaria's Convergence Programme for the 2006 to 2009 period was reviewed in early 2007.

BNB representatives also participated in EU Council and Commission bodies like the Financial Services Committee, the Committee of European Banking Supervisors (CEBS) and its working groups, the European Banking Committee, the European Financial Conglomerates Committee, the Committee on the Prevention of Money Laundering and Terrorist Financing, and EC committees and working groups on statistics. Meetings with EC experts are held twice annually to discuss Bulgaria's economy and BNB and EC forecasts. Participating in working groups at the Council of the European Union allowed the Bank to take active part in preparing a draft directive on payment services in the internal market and a directive amending several directives as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increases of shareholdings in the financial sector.

International Relations

Relations between the Bank and international financial institutions entered a new phase as Bulgaria acceded to the EU. With regard to the IMF, this was marked by a seminar, *Bulgaria's EU Accession: Building on a Decade of Success*, in May. Government officials, academics, European Commission representatives, and National Assembly deputies looked at financial challenges and policies after Bulgaria's accession to the EU.

The BNB Governor attended the bimonthly meetings of BIS central bank Governors: a major forum for cooperation between member central banks and discussion on world economic development and prospects, financial markets, and challenges to central banking from globalized financial systems. BNB representatives took part in the annual meetings of technical assistance coordinators to review the extended assistance and specify the need for technical assistance to Member States.

Work continued under the October 2006 twinning project for adjusting the BNB to ESCB and Eurosystem membership with the Banque de France, De Nederlandsche Bank, and the Banca d'Italia. In the area of banking supervision, De Nederlandsche Bank supported the BNB in applying the common reporting framework of capital adequacy (COREP) and using XBRL. A seminar on economic modeling and model calibration was

also held. Lecturers from the Banque de France, Deutsche Bundesbank, the Banca d'Italia, and 120 representatives of banks, payment system operators, the Ministry of Finance and diverse agencies took part in the seminar on challenges to Bulgaria in the process of integration into the single European payment infrastructures and standards (SEPA and TARGET2).

Banque de France twinning partners assessed the legal framework and internal accounting rules and procedures to help prepare financial statements to ECB requirements and held a one-day training course in Sofia on ESCB accounting rules. A *Risk Management Policy* was elaborated in cooperation with Banque de France experts and approved by the BNB Governing Council. Experts from the central banks of the Netherlands, Belgium, and Finland assessed current cash operations monitoring and control systems and held a seminar at the BNB. A proposal to improve the system was made and was approved by the BNB Government Council.

In June 2007 the Financial Sector Integrity project financed by the US Agency for International Development (USAID) ended after ten years of active support for banking sector reforms. Assistance focused on fighting money laundering, improving financial sector regulation, and enhancing financial system transparency.

The BNB has continuously broadened cooperation with ESCB central banks. Cooperation with the Deutsche Bundesbank addressed monetary policy, cash operations management, euro introduction, international reserve management, accounting, statistics, economic analyses and forecasts. Experience was exchanged in analyzing non-genuine banknotes and fighting money counterfeiting. The BNB hosted several expert meetings in the area of control and budgeting.

Increased BNB capacity attracted interest from central banks from EU candidate countries and beyond. In the first half of 2007 technical assistance was provided to the central bank of Albania in recruiting and administering personnel, references, training and qualification. Experience in economic and financial affairs gained in the process of Bulgarian accession to the EU and future cooperation with the central bank of Albania were discussed during a May visit by the BNB Governor to Albania. BNB technical assistance also supported the central bank of Macedonia in various areas. June saw a three-day training seminar for experts from the central bank of Azerbaijan on using the automated audit management system. In November following European Commission recommendation, a delegation of the central bank of China led by a senior Bank official visited the BNB to study effective legislation and practice in financial institution insolvency.

X. Statistics

In 2007 the BNB gathered the data required by the Law on the BNB and Article 5 of the ESCB and ECB Statute to ECB and Eurostat methodology, and worked on diverse projects to improve statistics gathering.

In monetary statistics, Regulation ECB/2001/13 was implemented and since February 2007 the scope of reporting units was expanded to include money market funds. Simultaneously, *euro area* and *non-euro area* data on the *EU* sector and net actual transactions began to be published. Complete sets of monthly data on monetary statistics, balances, and cash flows were provided to the ECB from July 2007, with quarterly data sets from November (including geographical and currency breakdown).

In interest rate statistics, Regulation ECB/2001/18 concerning statistics on interest rates applied by monetary financial institutions to deposits and loans *vis-à-vis* households and non-financial corporations was introduced, with relevant information sent to the ECB for the first time. In 2007 the *Interest Rate Statistics* subsystem to the *Information System for Monetary Statistics* was launched, ensuring automatic data submission to the ECB. In the second half of 2007 the BNB started to send daily data on long-term interest rates for convergence purposes.

In 2007 the BNB continued work on statistical cover of the non-bank financial sector whose information is used for the economic and monetary analyses, financial stability analyses, compiling other statistics, and fulfilling BNB duties as member of the ESCB.

Under Guideline ECB/2003/2 concerning certain statistical reporting requirements of the European Central Bank and the procedures for reporting by the national central banks of statistical information in the field of money and banking statistics, a methodology and report forms were designed for non-bank financial institutions which extend loans and for special investment purpose companies which securitize claims. The Bank started collecting this information in the second half of 2007 for publishing in 2008. From the fourth quarter of 2007 statistics from lease companies include data on loans to the non-resident sector.

An investment company and contract fund statistical methodology was introduced under Regulation ECB/2007/8 concerning statistics on the assets and liabilities of investment funds. Work on a methodology for pension fund and insurance company statistics and its phased introduction was completed in the second half of 2007. Work continued on developing a statistical methodology for special investment purpose companies specializing in estate securitization.

The first half-year saw the selection of a contractor to conduct random sample border surveys of Bulgarian and foreign nationals. Surveying started in the second half of 2007 and is intended to improve the methodology for reporting data on the *Travel* and other balance of payments items.

The BNB continued developing a methodology for comprehensive direct reporting by economic agents for balance of payments and international investment position purposes.

In late June the BNB and the European Commission (Eurostat) contracted to finance a pilot survey among resident direct investors in non-EU countries to get data for European Parliament and Council Regulation (EC) 716/2007 on Community statistics on the structure and activity of foreign affiliates.

In cooperation with the ECB, the BNB continued active support for the Centralized Securities Database project, with data exchange starting during the review period. The Banca d'Italia helped Bank specialists develop a methodology for the overall portfolio investment reporting model needed for a *security-by-security* database. Experts of the Statistics Directorate developed a prototype system for compiling, processing, and maintaining a securities database. Under commitments to the ECB, work started on producing a

database of Bulgarian securities. The portfolio investment reporting model expanded the circle of accounting units which report portfolio investment assets on a security-by-security basis directly. In 2007 investment companies and contract funds, supplementary pension funds and pension insurers, insurers, reinsurers and health insurers were incorporated into the scope of accounting units. At the end of 2007 a methodology and reporting forms were introduced to allow collection of information on the portfolio investment assets (on a *security-by-security* basis) of lease companies and non-bank financial companies extending loans.

Over the review period information on stock exchange statistics was prepared and sent for the first time to the ECB.

In 2007 the BNB started sending the ECB regular data on quarterly financial accounts of the *General Government* sector under European Parliament and Council Regulation 501/2004, as well as regular data on government finance statistics prepared jointly by the BNB, the Ministry of Finance, and the NSI under Guidelines ECB/2005/5.

Time series data were regularly submitted to the BIS and used in various BIS and ECB publications. In cooperation with the NSI, the Bank provided the ECB regular information on the publishing schedule of macroeconomic indicators and supplementary methodological data on HICP. Under the methodological requirements and according to the schedule, information was also sent to the IMF. Work continued on data updates and metadata certification under the Special Data Dissemination Standard.

Work on preparing technical terms of reference of the integrated statistical system project began in the review period. The system will automate receipt, control, processing, and dissemination of statistical information, cutting the reporting burden and boosting data reliability.

Adhering to the accessibility and clarity principle of the European Statistics Code of Practice, the BNB submitted scheduled information on monetary and interest rate statistics, the external sector, and non-bank financial institutions to consumers. In 2007 the Bank continued improving information access to website users. The *Interest Rate Statistics* publication was updated to include new indicators on capital and money markets. New time series were constructed to expand the online database. The BNB began publishing daily data on long-term interest rates for convergence purposes. The *Balance of Payments* monthly was updated to include supplementary tables with longer time series in Excel format. Creating records of all publications and statistical press releases in Bulgarian and in English began in the period under review.

XI. Research

Economic research, analyses of Bulgarian economic processes, and macroeconomic forecasts prepared at the BNB support the Bank's management in making decisions and formulating economic policy positions. In 2007 research reflected the BNB priorities of successful participation in the ESCB. Work focused on developing macroeconomic models used for forecasting economic developments in Bulgaria, preparing alternative scenarios and analyzing economic policy, and improving assessments of nominal and real convergence. The BNB continued researching the history of central banks through the Balkans Monetary and Finance History Study Network.

Specialized research under the Research Plan for the 2007 to 2008 period supported BNB operations by analyzing individual economic processes and issues and by improving forecasting and modeling tools. The period saw profound assessments of Bulgaria's readiness for euro area membership, the development of forecasting tools to ECB requirements, and the establishment of a methodological framework of economic policy analyses based on dynamic stochastic general equilibrium modeling. Assessments of nominal and real convergence included analyzing price dynamics, financial integration and transmission mechanisms, the long-term sustainability of public finance and long-term interest rates, competitiveness, and external position sustainability. Research results were published in technical reports and presented at seminars organized by the Bank for banking experts and academics.

To improve macroeconomic projections prepared at the BNB, a new basic macroeconomic forecasting model was elaborated. An initial version of the model was tested, with results and potential guidelines for improvement being discussed and coordinated with De Nederlandsche Bank experts.

In June 2007 the BNB hosted a seminar by specialists from the Bank of England's Centre for Central Banking Studies. Focusing on general equilibrium models and their application, this was attended by representatives of the central banks of Albania, Armenia, Croatia, Greece, Macedonia, Montenegro, Romania, Russia, Serbia, Turkey, and the Ukraine.

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 2007 five guest researchers worked on: developing a basic dynamic stochastic general equilibrium model for the Bulgarian economy, taking into account the specifics of the currency board; studying 1930s exchange control in Bulgaria and Italy; financial market integration and monetary policy transmission mechanisms; the factors behind real exchange rate dynamics in new EU Member States; and links between financial interests and choice of exchange rate regime in Eastern European transition economies between 1990 and 2004.

Through its Discussion Papers research series, the BNB continued to encourage the research potential of Bulgarian economic science and practice in the area of macroeconomics, finance, and economic history. The Discussion Papers Editorial Board reviewed 14 submissions in 2007. Six were published, one is being published, and three are being edited by authors according to the Board's recommendations.

The Programme Council for Banking and Finance History Research and Publishing, established by a decision of the BNB Governing Council in 2006, continued working actively. The fifth volume of *The Bulgarian National Bank: A Documentary Collection*, covering the 1947 to 1990 period, is a fruit of the Council's work, being published jointly with the Council of Ministers State Archives Agency. The Programme Council also launched a banking and finance history series, in whose heritage division the book *Marko Riaskow:*

Erinnerungen und Dokumente (in German) was prepared for publication. Work continued on publishing a collection of Asen Hristoforov's papers in 2009. In the research division, a historiography of Bulgaria's external debt between 1878 and 1989 was prepared for publication. With a view to marking the 130th anniversary of the BNB in 2009, preparations began for the fourth revised and amplified edition of the catalogues of Bulgarian banknotes and coins.

BNB representatives took part in the second annual conference of the Balkans Monetary and Finance History Study Network in Vienna and a Rome meeting on *International Monetary Cooperation on Both Sides of the Atlantic* organized by the European Association for Banking and Financial History (whose member the BNB has been since 2002). The Programme Council also organized visits and lectures by outstanding economists such as, *inter alia*, Prof Peter Bernholz from the University of Basel Centre of Economics and Business (WWZ) on *Long-term Law-like Regularities in the History of Money and Monetary Regimes*, Prof Stefan Max-Schulze from the London School of Economics on *The Economic Lag of Central and Eastern Europe Revisited: Regional Product and Market Potential in the Habsburg Empire, 1870–1910*.

XII. Information Infrastructure

Developing and updating BNB information systems is a key Bank policy priority which pursues technological modernity, optimized performance through fewer auxiliary and supplementary tasks, up-to-date organizational methods, and integration into relevant ESCB systems.

Working modes changed from administrative and hierarchical to project and team-focused, with business units playing a leading role in defining specific goals and tasks. A multifunctional project management system is being launched to introduce uniform standard project management methods in line with international standards and practice. Setting up an ongoing system of personnel training and qualification improvement in information technologies was another important task directly involving successful introduction of new technologies and infrastructure updates.

Ensuring a high degree of information security and protection in compliance with international standards and ECB recommendations was a BNB priority. Work continued on developing and applying policies, procedures, methodologies, instructions, and guidelines for ensuring information security. To this end, custom communication lines bypassing public grids were sought to minimize the risks of interruption in information provision and ensure continuity of in-house processes and operations. Improving and expanding BNB intranet functionality will optimize user access to corporate network resources and improve overall security and efficiency.

Phased work to allow BNB users access to ESCB information systems started in early 2007. In March and April electronic mail between EU central banks was routed *via* ESCBNet under the IERA project to protect electronic correspondence. Voice communication updating continued by replacing switchboards with VOIP technology. Building up an integrated information system to connect the BNB and ESCB involves processing and registering operational data and providing analytical, regulatory and managerial information.

The reporting year saw the first stage of a single banking supervision data depository intended to manage information flows effectively and pave the way to a single Bank data depository. Based on new regulations, these modern management methods help unify information flows and standards at the Bank. This project is consistent with contemporary requirements for integrity and efficiency over the entire period of data existence and will provide qualitative analyses for timely and flexible decision making.

The Statistics analytical application to provide statistical and analytical information was being developed to process incoming data and set defined statistical and analytical indicators, provide means for analyses and forecasts, and create sets of reports and statements.

A RINGS update was implemented, improving the system's functionality, ushering security controls at the application and technology levels, providing new administrative instruments, and enhancing its interface. A RINGS single data depository went live and will eventually form part of the single BNB data depository. All updates aim at minimizing RINGS operational risk, managing the system in line with BIS Principle VII for systemically important payment systems and modern information security requirements, and also with a view to eventual integration into the European payment system.

Developing a single enterprise resource planning system for SAP data processing will provide accounting and analytical information on BNB cash processes, service daily operations, monitor implementation of the BNB budget, and provide management information on assets and operational spending.

Other projects launched during the reporting year involve updates and functional upgrades to the GSAS and ESROT government securities systems and launching TREMA FinanceKit for Treasury operations.

As regards the technical means for servicing the BNB information infrastructure, fixed cabling was upgraded to operate faster, offer failsafe and secure performance, and allow easier expansion. Bank servers, workstations, system software and communication equipment were updated in line with the requirements of the Strategy for BNB Information and Communication Technology Development.

XIII. Human Resource Management

Human resource management rests on boosting staff effectiveness and optimizing personnel structure through bringing remuneration into line with results and encouraging employees to attain higher qualifications by increasing training and mobility.

The policy of restricting wage rises and emphasizing bonuses continued to be pursued in 2007, linking overall remuneration to results and the contribution of each employee to the attainment of BNB goals and tasks.

Qualification and skill improvement is a priority in BNB human resource management. Training focuses mainly on macroeconomics, monetary policy, international reserves and risk management, banking supervision, monetary and banking statistics, accounting, banking and financial law, human resources management, and internal audit.

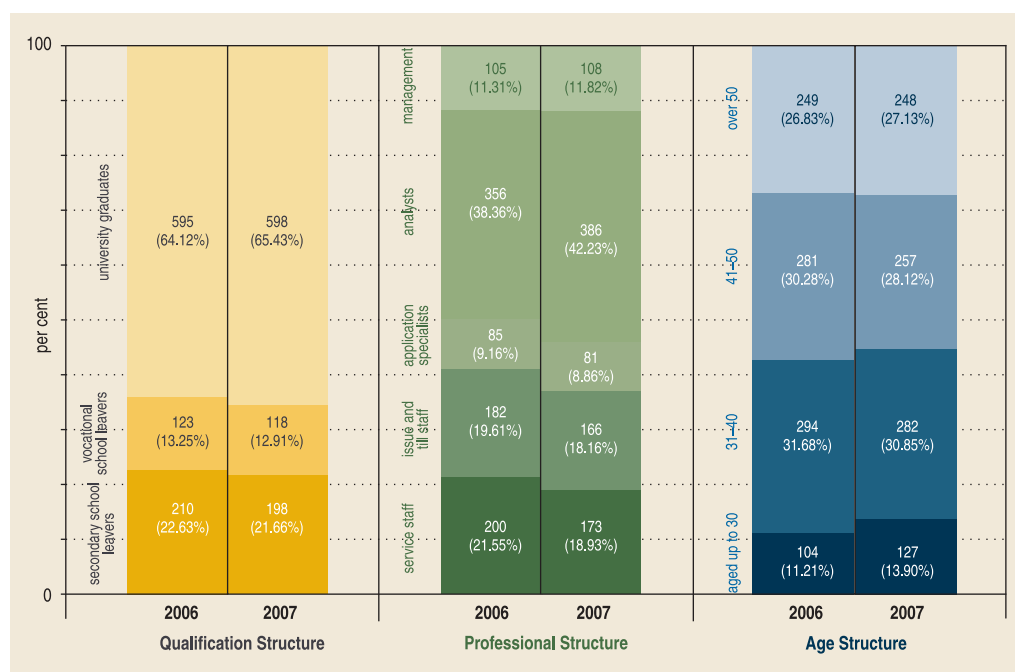
In the 2006 to 2007 period 32 employees boosted their educational attainments without discontinuing work by reading for doctors', masters', bachelors' and specialist degrees, against 28 a year earlier. Twenty nine employees went on distance learning courses, with 12 on the International Banking Institute ones, five on the CFA Institute's Certified Financial Analysts program, the two on the Institute of Internal Auditors' Certified Internal Auditors program, and ten on the CISCO Academy's Sofia Technical University certification program. In 2007 short-term courses and seminars on specific current problems were attended by 183 persons.

Specialized short-term training on amended internal cash operation rules had 30 delegates and that on the new version of the cash flow control and management system had 75 delegates. Attendance at information system training was very high, with a number of courses ran on internal infrastructure, system maintenance and upgrading, and new applications.

Staff Structure

(as of 31 December of the corresponding year)

(number, per cent)



Source: BNB.

In 2007, 128 BNB employees took part in seminars and courses ran by foreign banks and financial institutions, among them the International Monetary Fund, the Joint Vienna Institute, the Bank for International Settlements, and the central banks of Austria, the Czech Republic, France, Germany, the Netherlands, Slovenia, Switzerland, and the United Kingdom.

Preparing for the new functions and duties arising from ESCB membership involved a special program of seminars and specialized courses for Bank representatives on ESCB committees and working groups. In 2007, 16 employees attended 14 seminars, a specialized training course, and a conference organized by the ESCB.

Language training bestows proficiency in languages specified by job descriptions. In addition to courses for improving skills in English, employees attended courses for acquiring German, French, Spanish, and Italian as second foreign languages. Proficiency in more than one European language helps international cooperation and information access. In 2007, 73 per cent of employees reached their target levels.

Internal and external staff mobility was enhanced, with external reappointments of employees and their moving between units becoming more common. External mobility has also been successful, with two BNB employees taking on short-term appointments at the ECB.

Human resource management helped the BNB cope with the challenges of EU and ESCB membership with 914 staff in 2007 against 928 in 2006 (against an establishment of 1007 for the past three years). In 2007, there were 80 new recruits and 99 staff left. Yet more employees left due to structural unit operational changes and retirement (10 persons). Recruitment sought employees qualified to tight job descriptions.

Two-thirds of staff were university graduates, while analysts held the largest share by occupation. In 2007 BNB staff age profile changed, with under-30s becoming more numerous.

Over the year the Bank held induction training for 56 new employees, against 48 in 2006. They learned the Bank's history and traditions, their rights and duties in labour law and internal rules, and the tasks and duties of ESCB membership.

The Bulgarian National Bank supported young people from Bulgarian and foreign universities. Scholarships are disbursed annually to students reading for Master's and Doctor's Degrees, with three being awarded in 2007. Traineeships are also available, with 42 awarded in 2007, nine trainees going on to be appointed by the Bank.

XIV. Facilities Management

The BNB mainly trades from wholly owned premises, ensuring the level of independence, security and protection expected of a central bank. Property spending was mainly on implementing the investment programme in line with the BNB annual budget and included construction, refurbishment and modernization, deliveries and equipment, repairs, vehicles, supplying property, intangible assets and cash issuing and processing consumables, storing and using consumables and office materials at structural units, and optimizing electric power, heating, and water use at BNB buildings in Sofia. The implementation of 2007 budgeted spend on building repairs was 100 per cent, and that on equipment was 88 per cent. Construction, refurbishment, and modernization spend was only on design, coordination and construction of the new BNB Cash Center and came to 21.5 per cent of forecasts.

No properties were acquired or disposed in 2007. Energy efficiency was audited at the BNB buildings at 1, Knyaz Alexander I Square and 7, Moskovska Street in Sofia, a Category B Energy Characteristics Certificate being awarded. Based on this, no property tax will be imposed on the two buildings for the coming five years. During the year the BNB gave three vehicles *gratis* to budget organizations and purchased two new vehicles as planned in the fleet development strategy.

XV. Internal Audit

The more important audits in 2007 addressed monetary policy, cash circulation maintenance, government agency functions, information and analysis, and administration.

Monetary policy was audited both operationally and as regards international reserves compliance. The audits aimed at evaluating the fitness of portfolio management control and risk management procedures and at assessing the degree of reasonable assurance on attaining strategic goals. Assessing financial and operational information reliability and integrity, and ensuring compliance with effective legal acts are important BNB tasks. The changes following the new *TREMA* information system launch were reviewed in relation to their impact on internal control systems' adequacy, quality, and operation.

Alongside cash circulation maintenance, cash centres were audited, as was the ability of control systems and structural divisions to implement Internal Rules on Cash Operations in force from 1 July 2007. In line with restructuring cash operations to the Strategy for Bulgarian National Bank Development between 2004 and 2009, the chief auditor and BNB Internal Audit experts monitored implementation of the Cash Services Company and BNB Cash Center projects.

An audit addressed the electronic system for registering and servicing government securities trading with regard to the BNB's government agency function. Objective attainment with the system's modern version was assessed, including productivity and quality, control mechanisms, accuracy, security, reliability and processing punctuality, legal compliance and fidelity to internal rules, interface control, and IT security.

The 2007 audit of major financial statement positions aimed to evaluate their accuracy, scope, reliability, and compliance with changes in Bank accounting policy.

The operational and compliance audits on the Central Credit Register of Banks reviewed and evaluated information system implementation and register organization and development.

As regards Bank administration, compliance with the Internal Rules on Selection Procedures for Public Tender Subcontractors under the Public Tender Law was assessed, together with contract and service performance.

In line with the ESCB Internal Auditor Committee annual programme and ensuing commitments, BNB internal auditors took part in the preliminary stage of the ESCB Extranet and ESCB Document Dissemination Projects' IT audit. This addressed risks in documents exchange between ESCB central banks using extranet and new automation.

Internal auditors continued working on the BNB Operational Risk Management Policy, introducing rules on identifying, evaluating, and reducing risks attending central banks. Within the twinning project of the BNB and the Banque de France, a risk assessment methodology and a common matrix for it were elaborated.

In 2007 internal auditors prepared opinions, advice, and recommendations on a number of subjects within their competence.

Concluded Audits in 2007

BNB functions	Audits
Monetary policy	Managing international foreign currency asset portfolio
	Liquidity management
Maintaining cash circulation	Maintaining cash circulation
	Cash reception, consigning and safekeeping
Government agency	The ESROT electronic system
Information and Analytical	The BNB 30 June 2007 financial statements
	Central Credit Register
	Weekly and monthly balance sheets
Administrative	Supplier selection
	Concluded and executed delivery contracts

Source: BNB.

XVI. BNB Budget Implementation

The BNB Budget was adopted by the BNB Governing Council at its 30 November 2006 meeting under Resolution No 153 and published in the *Darjaven Vestnik*, issue No 101 of 15 December 2006. The Report on the Bank's budget comprises two sections: operational expenditure and the investment programme, pursuant to the BNB Governing Council's Internal Rules on Setting, Implementing, and Reporting the BNB Budget.

1. Operational Expenditure

The BNB spent BGN 63,972,000 or 87.8 per cent of its budgeted figure on 2007 operations.

Currency circulation cost BGN 20,522,000 or 89.3 per cent of budget. Banknote and coin production cost BGN 19,557,000 or 90.8 per cent of budget, including BGN 14,949,000 or 91 per cent of budget on banknote printing and BGN 4,608,000 on coin minting, of which BGN 3,724,000 on circulation. Commemorative coin spend was in line with a BNB Governing Council programme and came to BGN 884,000. Funds were spent on designing new banknotes and coins, scrapping old cash, and consumables for cash processing. Spending on machines for servicing circulating cash came to BGN 141,000 or 55.3 per cent of budget. Premise rentals for the BNB Printing Works and at the State Mint cost BGN 513,000.

Materials, external services, and depreciation spending totaled BGN 21,483,000 or 82.3 per cent of budget. Of this, materials comprised BGN 768,000. Major expenditure in this group comprised, *inter alia*, BGN 287,000 on office consumables and BGN 277,000 on fuel and spares for the transport fleet.

Expenditure on hired services was BGN 10,979,000 or 78.9 per cent of budget. More significant items concerned Bloomberg, Reuters, internet and other system provision at BGN 1,255,000. Software maintenance came to BGN 2,564,000. Equipment maintenance was BGN 749,000. Mail, telephone and telex came to BGN 467,000. Property and refuse levies were BGN 1,132,000, and electric bills were BGN 409,000. The Bank spent BGN 1,807,000 on its security contract with the Ministry of the Interior. Expenses on major building maintenance totaled BGN 648,000. In 2007 BGN 148,000 were spent on consultations related to, *inter alia*, the Value Added Tax Law, legal and actuarial services.

Depreciation came to BGN 9,736,000 or 88 per cent of budget.

Based on internal rules on remuneration compliant with labour and insurance legislation, the Law on the Bulgarian National Bank, and resolutions of the BNB Governing Council, salaries, social, and healthcare costs totaled BGN 17,938,000 or 99.6 per cent of budget. In accordance with IAS 19, *Income of Hired Persons*, the Bank reported BGN 192,000 of current retirement obligations and BGN 418,000 for unused paid leave. Social expenditure amounted to BGN 1,848,000 or 99.8 per cent of budgeted funds.

Miscellaneous administrative expenditure for 2007 was BGN 1,162,000 or 50 per cent of budget. Inland travel, mainly for supplying banknotes and coins to regional cash centres and conducting checks there, cost BGN 44,000. Foreign travel for participation in seminars and staff training came to BGN 459,000 or 74.9 of projections.

The Educational and Professional Training Programme in 2007 focused on ESCB and euro area issues. Expenses totaled BGN 429,000, including BGN 210,000 for training in European banking practice, BGN 175,000 for short-term training on changes in Bulgarian legislation, and BGN 44,000 for foreign language tuition. Bank representative and protocol expenses totaled BGN 209,000.

During 2007 expenses related to joining the ESCB came to BGN 1,019,000. The cost of BNB representatives' participation in ESCB committees was BGN 454,000. Spending

on telecommunications and equipment for the ESCB membership totaled BGN 529,000, while related training expenditure was BGN 36,000.

2. The Investment Programme

Budgeted investment totaled BGN 26,479,000, of which BGN 15,525,000 or 58.6 per cent was spent.

Construction, refurbishment and modernization came to BGN 962,000, of which BGN 594,000 for BNB Cash Centre survey, design, and consultancy services.

During 2007, BGN 1,652,000 was spent on machines and equipment, vehicles, and sundry equipment, of which BGN 309,000 on machine spares for cash circulation, BGN 202,000 on security equipment (including BGN 13,000 on video surveillance), BGN 89,000 on colour cameras and recording devices, BGN 9000 on drain pumps, BGN 36,000 on video cameras, and BGN 18,000 on monitors and other security equipment. The Bank purchased two vehicles.

Photocopiers, air-conditioners, furniture, and fans for special premises, and diverse office equipment cost BGN 812,000.

Investment was mostly directed at implementing the BNB information and communication technology development strategy. Computerization cost BGN 4,674,000, of which BGN 2,259,000 for hardware and BGN 2,415,000 for software. Software costs included, *inter alia*, BGN 708,000 on the SAP core banking information system, BGN 234,000 on the Project Portfolio Management System, BGN 160,000 on changes to ESROT, BGN 36,000 on expanding the Central Credit Register, BGN 149,000 on Microsoft licenses, BGN 287,000 on Oracle licenses and BGN 403,000 on upgrading cash operations.

Parallel to Bulgaria's accession to the EU on 1 January 2007, the BNB became a member in the ESCB. Bulgaria's contribution to ESCB capital came to EUR 3,561,868.99 (BGN 6,966,000 or 94.9 per cent of budget).

In compliance with a Governing Council resolution, the BNB holds shares in the newly founded Cash Services Company which has an equity of BGN 1,271,000.

Implementation of the BNB Budget as of 31 December 2007

Indicators	Report 30 Dec. 2007 (BGN'000)	Budget 2007 (BGN'000)	Implemen- tation (%)
Section I. BNB operational expenditure	63 972	72 865	87.8
Currency circulation expenditure	20 522	22 984	89.3
Materials, services and depreciation expenditure	21 483	26 115	82.3
Salaries and social security expenditure	17 938	18 008	99.6
Social activity expenditure	1 848	1 852	99.8
Other administrative expenditure	1 162	2 323	50.0
BNB expenditure on membership in ESCB	1 019	1 583	64.4
Section II. Investment programme	15 525	26 479	58.6
Expenditure on construction, reconstruction and modernization	962	4 483	21.5
Expenditure on machines, equipment, vehicles and sundry equipment	1 652	2 796	59.1
Expenditure on BNB computerization	4 674	10 360	45.1
Investment related to BNB participation in ESCB	6 966	7 340	94.9
Other investment	1 271	1 500	84.7

XVII. Bulgarian National Bank Consolidated Financial Statements for the Year Ended 31 December 2007

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INDEPENDENT AUDITOR'S REPORT TO THE GOVERNING COUNCIL OF THE BULGARIAN NATIONAL BANK

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the Bulgarian National Bank (the Bank) and its subsidiaries, which comprise the consolidated balance sheet as at 31 December 2007, 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

The Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with the International Financial Reporting Standards applicable within the European Union. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free of 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 the 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 misstatements.

The audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank'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. The audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the 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 31 December 2007, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as applied within the European Union.

Report as per Other Legal and Supervisory Requirements

Bank's Annual Report as per the requirements of Article 33 of the Accountancy Law.

In keeping with the Accountancy Law requirements we furthermore state that the historical financial information prepared by the Management and presented in the Bank's Annual Report, as per Article 33 of the Accountancy Law, complies in all material aspects of the financial information contained in the Bank's annual consolidated financial statements as at and for the year ended 31 December 2007. The Bank's Management is responsible for the preparation of the Annual Report approved by the Bank's Governing Council on 23 April 2008.



Sofia, 23 April 2008
KPMG Bulgaria OOD
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 Bank's financial position and performance for the period.

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

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

A handwritten signature in black ink, appearing to read 'Ivan Iskrov', with a large, sweeping horizontal stroke underneath.

Ivan Iskrov
Governor of the BNB

Consolidated Income Statement for the Year Ended 31 December 2007.

(BGN'000)

	Note	31 Dec. 2007	31 Dec. 2006
Interest income	7	688,104	409,527
Interest expense	7	(210,312)	(101,204)
Net interest income		477,792	308,323
Fee and commission income		8,332	6,930
Fee and commission expense		(4,530)	(2,952)
Net fee and commission income		3,802	3,978
Net gains / (losses) from financial assets and liabilities at fair value through profit and loss	8	257,408	(6,315)
Other operating income	9	36,445	32,685
Other operating income		775,447	338,671
Administrative expenses	10	(81,567)	(74,361)
Profit for the period		693,880	264,310

Profit distribution as of 31 December 2007:

(BGN'000)

	Note	31 Dec. 2007	31 Dec. 2006
Profit for the period		693,880	264,310
Transfer (to)/from special reserves	25	(239,016)	55,509
Result after transfer (to)/from special reserves		454,864	319,819
Transfer to other reserves and minority interest	25	204,230	149,189
Planned contribution to the budget of the Republic of Bulgaria		250,634	170,630
		454,864	319,819

The accompanying notes on pages 67 to 87 form an integral part of the consolidated financial statements.

Consolidated Balance Sheet for the Year Ended 31 December 2007

(BGN'000)

	Note	31 Dec. 2007	31 Dec. 2006
ASSETS			
Cash and deposits in foreign currencies	11	3,507,981	4,206,480
Gold, instruments in gold and other precious metals	12	1,432,666	1,226,617
Financial assets at fair value through profit or loss	13	18,356,669	11,968,687
Financial assets available for sale	14	1,391,586	1,465,753
Receivables from the Government of the Republic of Bulgaria	15	-	506,326
Tangible assets	16	151,430	156,328
Intangible assets	17	14,935	15,138
Other assets	18	46,359	35,688
Total assets		24,901,626	19 581,017
LIABILITIES			
Banknotes and coins in circulation	19	8,410,867	6,888,576
Due to banks and other financial institutions	20	5,783,538	3,593,746
Liabilities to government institutions and other liabilities	21	6,753,822	5,105,564
Borrowings from international financial institutions	22	-	506,326
Liabilities against participations in international financial institutions	23	1 275 420	1,356,364
Other liabilities	24	45 750	19,108
Total liabilities		22,269,397	17,469,684
EQUITY			
Capital	25	20 000	20 000
Reserves	25	2 608 836	2 088 047
Minority interest	26	3 393	3 286
Total equity and reserves		2 632 229	2 111 333
Total liabilities, equity and reserves		24 901 626	19 581 017

The accompanying notes on pages 67 to 87 form an integral part of the consolidated financial statements.

Consolidated Statement of Cash Flows for the Year Ended 31 December 2007

(BGN'000)

	Note	31 Dec. 2007	31 Dec. 2006
Operating activities			
Net profit		693,880	264,310
Adjustments for matching with the net cash flow from operating activities:			
Dividend income		(4,486)	(4,489)
Depreciation	16, 17	15,548	15,188
Profit on disposal of tangible assets		21	(147)
Gains on financial assets and liabilities arising from market movements		(243,784)	41,241
Profit of associates		(1,164)	(2,494)
Other adjustments		(35)	-
Net cash flow from operating activities before changes in operating assets and liabilities		459,980	313,609
Change in operating assets			
(Increase)/decrease in gold, instruments in gold and other precious metals		(485)	795
(Increase) in financial assets recognized at fair value through profit or loss		(6,350,866)	(2,322,007)
(Increase)/decrease in financial assets available for sale			
(Increase)/decrease in receivables from the Government		498,024	525,465
(Increase) in other assets		(5,901)	(954)
Change in operating liabilities			
Increase in currency in circulation		1,522,291	1,021,363
Increase in due to banks and other financial institutions		2,189,924	1,109,031
Increase in due to government institutions and other liabilities		1,653,165	824,362
(Decrease) in borrowings from international financial institutions		(498,024)	(525,465)
Increase/(decrease) in other liabilities		26,450	(3,308)
Net cash flow from operating activities		(505,442)	942 891
Investing activities			
Purchase of tangible and intangible assets		(11,269)	(15,352)
Dividends received		4,486	4,489
Increase in BNB's equity investments		(10,874)	-
Net cash flow from investing activities		(17,657)	(10,863)
Financing activities			
Payments to the Government		(170,630)	(150,162)
Net cash flow from financing activities		(170,630)	(150,162)
Net (decrease)/increase in cash and cash equivalents		(693,729)	781,866
Cash and cash equivalents at beginning of period		4,230,198	3,448,332
Cash and cash equivalents at end of period	11, 18	3,536,469	4,230,198

The accompanying notes on pages 67 to 87 form an integral part of the consolidated financial statements.

Consolidated Statement of Changes in Equity for the Year Ended 31 December 2007

(BGN'000)

Source of changes in equity	Capital	Minority interest	Revaluation reserves from non-monetary assets	monetary assets	commemorative coins	Other reserves	Total
Balance as at 1 January 2006	20,000	3,206	105,504	943,970	838	925,328	1,998,846
Gains on revaluation of gold	-	-	-	125,423	-	-	125,423
Loss on revaluation of foreign currency (net)	-	-	-	(4,763)	-	-	(4,763)
Loss on revaluation of financial assets at fair value through profit or loss (net)	-	-	-	(177,149)	-	-	(177,149)
Revaluation of financial assets available for sale	-	-	(1,355)	-	-	-	(1,355)
Payment of the prior year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	(150,162)	(150,162)
Planned 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
Other transfers	-	-	(202)	-	(103)	979	674
Balance as at 31 December 2006	20,000	3,286	103,947	887,481	735	1,095,884	2,111,333
Unrealised gain on gold revaluation	-	-	-	205,564	-	-	205,564
Unrealised loss on revaluation of foreign currency (net)	-	-	-	(3,734)	-	-	(3,734)
Unrealised gain on revaluation of financial assets at fair value through profit or loss (net)	-	-	-	37,116	-	-	37,116
Revaluation of financial assets available for sale	-	-	(1,328)	-	-	-	(1,328)
Payment of the prior year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	(170,630)	(170,630)
Planned current year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	250,634	250,634
Profit for the year after the contribution to the budget of the Republic of Bulgaria and minority interest	-	142	-	-	-	117,088	117,230
Other special reserves	-	-	-	-	-	87,000	87,000
Other transfers	-	(35)	(801)	-	(134)	14	(956)
Balance as at 31 December 2007	20,000	3,393	101,818	1,126,427	601	1,379,990	2,632,229

The accompanying notes on pages 67 to 87 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 (LBNB), which has been effective from 10 June 1997.

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

- Maintaining price stability through ensuring national currency stability;
- Exclusive right to issue banknotes and coins;
- Regulation and supervision of other banks' activities in the country with a view to banking system stability maintenance;
- Establishment and operation of efficient payment systems and their oversight;
- The Bank 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 banks except in the case of liquidity risk threatening to affect the stability of the banking system;
- The Bank may not deal in Bulgarian government securities;
- The Bank may not issue Bulgarian levs in excess of the Bulgarian lev equivalent of the gross international foreign currency reserves;
- Under terms agreed with the Minister of Finance, the Bank acts as agent for public debts or for debts guaranteed by the State;
- The Bank acts as a central depository of government securities.

The Governing Council of the BNB approved the consolidated financial statements set out on pages 67 to 87 on 23 April 2008.

2. Applicable standards

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 rounded to the nearest thousand (BGN'000). 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 Bank consistently applies its accounting policy from the previous year.

When preparing the financial statements in conformity with IFRSs, the Bank makes judgement, estimates and assumption that affect the reported amounts of assets and liabilities for the following financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstance.

4. Basis of consolidation

Subsidiaries

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

Associates

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

5. Principal accounting policy elements

(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 include 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 in the income statement when the corresponding service is provided.

Other financial income/expense includes 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 from capital investments.

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

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

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

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

(ii) Initial recognition

The Bank recognizes financial assets at fair value through profit or 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 instruments issued by institutions with high credit ratings.

(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 amortised cost less impairment losses. Amortised cost is calculated based 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 amortised based on the effective interest rate of the instrument.

(iv) Fair value measurement and disclosure principles

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 7, 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 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 through income statement 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 when it occurs and is reported as 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 Bullion Market closing 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 by the Bank are set out in note 14.

(e) Property, plant, equipment and intangible assets

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

(i) Subsequent expenditure

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

(ii) Depreciation

Depreciation is charged to the income statement on a straight-line basis as per established norms with a view to carrying as an expenditure the value or measurement of property, plant, equipment and intangible assets over their estimated useful lives. Land is not depreciated. The depreciation rates used are as follows:

(%)

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

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

(iii) Calculation of recoverable amount of assets

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

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 of the Bank on that day. Foreign exchange gains and losses resulting from the revaluation of monetary assets and liabilities 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.

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

The exchange rates of the major foreign currencies as at 31 December 2007 and 31 December 2006 are as follows:

Currency	31 December 2007	31 December 2006
US dollar (<i>USD</i>)	1 : BGN 1.33122	1 : BGN 1.48506
Euro (<i>EUR</i>)	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rights (<i>SDR</i>)	1 : BGN 2.10130	1 : BGN 2.23412
Gold (<i>XAU</i>)	1 troy ounce : BGN 1102.460	1 troy ounce : BGN 944.198

(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. 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 derived 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.

(i) Profit distribution policy of the Bank

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

(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) Implementation of relevant international financial reporting standards published but not yet effective as of the balance sheet date

IFRS 8 – Operating Segments (effective from 1 January 2009). The standard requires the disclosure of segments based on the Bank's components, which the management monitors for operating decision-making purposes. The Bank's operating segments are components of the Bank, for which discrete financial information is available, that is regularly reviewed by a chief operating decision maker to make decisions on resource allocation and to assess the performance of operating segments. The management is of the view that IFRS 8 is not relevant to the Bank's activities.

Revised IAS 23 – Borrowing Costs eliminates the option of recognizing all borrowing costs as expenses immediately upon their occurrence and requires entities to capitalize borrowing costs directly related to acquisition, construction, or production of a qualifying asset as part of the cost of that asset. The revised IAS 23 is mandatory to apply in the 2009 financial statements and is not relevant to the Bank's activities.

IFRIC 11 IFRS 2 – Group and Treasury Share Transactions (effective for the annual periods starting on or after 1 March 2007). The Interpretation requires that share-based payment arrangements, under which an entity receives goods or services as a compensation for its own equity instruments, should be recognized as share-based payment transactions, settled in shares, irrespective of how the necessary capital instruments were received. The Bank finds that IFRIC 11 will have no impact on the Bank's operations, as it has concluded no share-based payment arrangements in 2007.

IFRIC 12 – Service Concession Agreements (effective from 1 January 2008). The Interpretation provides guidance to private sector entities on certain aspects of disclosure and valuation issues arising from the accounting of public-private concession agreements. The

Bank finds that IFRIC 12 will not have any impact on its operations, as the Bank has no concession agreement concluded.

IFRIC 13 – Customer Loyalty Programmes addresses accounting by entities operating or participating in customer loyalty programmes. This Interpretation deals with customer loyalty programmes under which customers may exchange the loyalty credits collected by them for awards such as free or discounted goods or services. IFRIC 13 is in effect from 1 July 2008 and is not relevant to the activities pursued by the Bank.

IFRIC 14 – IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction (effective from 1 January 2008) clarifies when refunds or reductions in future contributions on defined benefit assets should be regarded as 'available', and provides information on the minimum funding requirements for these assets. IFRIC 14 clarifies in what cases minimum funding requirements for the assets under a plan may give rise to a liability. This Interpretation comes into effect for the 2008 financial statements, but it is not relevant to the activities of the Bank.

6. Financial risk management policy disclosure

(a) Introduction and overview

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

- Credit risk
- Liquidity risk
- Market risk
- Operational risk

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

General provisions of risk management

The process of the BNB management of the gross international reserves looks to the 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*.

(b) Credit risk

The BNB is exposed to credit risk through its trading operations and investment activities and in cases where it acts as an intermediary on behalf of the Government or other public institutions. The Bank assumes credit risk also in operations of 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 the bankruptcy or insolvency of a debt issuer, in whose debt instruments 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, central banks, supranational financial organisations and state-guaranteed institutions;
- Term deposits in foreign currency and gold placed with central banks, supranational financial institutions and banks;
- Commercial paper issued by countries, supranational, state-guaranteed and non-guaranteed agencies, banks and issuers of secured Eurobonds;
- 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 Foncières 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 and reverse 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.

(c) 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. This liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments. In addition, there are limits on the residual term to maturity for the financial instruments of those asset classes approved for investment.

The Bank continually assesses liquidity risk by identifying and monitoring changes in funding required for meeting its goals and targets set in terms of the overall Bank strategy. As

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

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

(BGN'000)

As at 31 December 2007	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
Financial assets							
Cash and deposits in foreign currencies	3,507,981	-	-	-	-	-	3,507,981
Gold, instruments in gold, and other precious metals	88,248	756,624	-	-	-	587,794	1,432,666
Financial assets at fair value through profit and loss	3,112,942	4,182,918	8,048,728	2,749,597	262,484	-	18,356,669
Financial assets available for sale	70,023	-	-	-	-	1,321,563	1,391,586
Total financial assets	6,779,194	4,939,542	8,048,728	2,749,597	262,484	1,909,357	24,688,902
Financial liabilities							
Banknotes and coin in circulation	-	-	-	-	-	8,410,867	8,410,867
Liabilities to banks and other financial institutions	5,783,538	-	-	-	-	-	5,783,538
Liabilities to government institutions and other borrowings	6,140,774	601,727	11,321	-	-	-	6,753,822
Liabilities for participations in international financial institutions	-	-	-	-	-	1,275,420	1,275,420
Total financial liabilities	11,924,312	601,727	11,321	-	-	9,686,287	22,223,647
Asset-liability maturity mismatch	(5,145,118)	4,337,815	8,037,407	2,749,597	262,484	(7,776,930)	2,465,255

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
Financial 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
Financial assets at fair value through profit and loss	3,316,539	3,488,840	3,506,981	1,598,821	57,506	-	11,968,687
Financial assets available for sale	74,044	-	-	-	-	1,391,709	1,465,753
Claims on the Government of the Republic of Bulgaria	-	38,948	136,319	331,059	-	-	506,326
Total financial assets	7,369,449	4,403,124	3,718,764	1,929,880	76,523	1,876,123	19,373,863
Financial liabilities							
Banknotes and coin in circulation	-	-	-	-	-	6,888,576	6,888,576
Liabilities 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 from international financial institutions	-	38,948	136,319	331,059	-	-	506,326
Liabilities for participations in international financial institutions	-	-	-	-	-	1,356,364	1,356,364
Total financial liabilities	7,874,633	841,643	158,301	331,059	-	8,244,940	17,450,576
Asset-liability maturity mismatch	(505,184)	3,561,481	3,560,463	1,598,821	76,523	(6,368,817)	1,923,287

The outstanding contractual maturities of the Bank's financial liabilities are as follows:
(BGN'000)

	Book value	Gross nominal outgoing cash flow	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	Over 5 years
As at 31 December 2007							
Banknotes and coins in circulation	8,410,867	8,410,867	-	-	-	-	8,410,867
Due to banks and other financial institutions	5,783,538	5,783,538	5,783,538	-	-	-	-
Liabilities to government institutions and other borrowings	6,753,822	6,758,799	6,130,862	605,605	22,332	-	-
Liabilities against participations in international financial institutions	1,275,420	1,275,420	-	-	-	-	1,275,420
	22,223,647	22,228,624	11,914,400	605,605	22,332	-	9,686,287
As at 31 December 2006							
Banknotes and coins in circulation	6,888,576	6,888,576	-	-	-	-	6,888,576
Due to banks and other financial institutions	3,593,746	3,593,746	3,593,746	-	-	-	-
Liabilities to government institutions and other borrowings	5,105,564	5,110,294	4,281,609	806,567	22,118	-	-
Borrowings from international financial institutions	506,326	506,326	-	38,948	136,319	331,059	-
Liabilities against participations in international financial institutions	1,356,364	1,356,364	-	-	-	-	1,356,364
	17,450,576	17,455,306	7,875,355	845,515	158,437	331,059	8,244,940

(d) Market risk

Market risk

All trading instruments are subject to market risk, i.e. the risk of impairment as a result of changes in the market conditions. The instruments are evaluated on a daily basis at fair value which best reflects current market conditions for the respective type of financial instrument. The Bank manages its portfolios in response to changing market conditions. Exposure to market risk is managed in accordance with the risk limits formally set in the Investment Limits to the Management of the Gross International Foreign Currency Reserves. The table below presents one important measure of market risk, i.e. Value at Risk (VaR). VaR is an indicator of the maximum loss over a certain period of time (holding period) and with a certain probability (reliability level). The VaR used in this report is based on a 95 per cent confidence level and a 1-day holding period.

Although VaR is an important tool in measuring market risk, the assumptions on which the model is based have some limitations:

- the 1-day holding period presupposes that it is possible to hedge or release positions in that period. This is considered to be a realistic assumption almost in all cases, except in the situations where market liquidity is low over a long period of time;
- the 95 per cent confidence level does not cover losses that may arise beyond that interval. Even within this model, there is a 5 per cent probability that losses may exceed the VaR;
- VaR is calculated at the end of each day and does not take account of the exposure to risks which may arise in the actual trade during the day;
- the use of historical data as the basis of determining the probable exits does not always cover all possible scenarios, especially those of unusual nature;
- VaR depends on the Bank's positions and the volatility of market prices. VaR of a position of an unchanged volume decreases when the market prices volatility diminishes, and *vice versa*.

The Bank uses VaR to measure the overall market, currency and interest rate risk, and also the risk of the fluctuating prices of debt instruments, and other price risks. Below you will find a brief description of the Bank's VaR positions.

(BGN'000)

	As at 31 December	Average	Maximum	Minimum
2007				
Currency risk	(22,814)	(14,074)	(24,701)	(4,399)
Interest rate risk	(591)	(1,104)	(4,682)	846
Correlation	0.26	-0.05	0.49	-0.32
Total:	(22,438)	(12,493)	(24,867)	(4,041)
2006				
Currency risk	(11,572)	(26,226)	(50,939)	(9,285)
Interest rate risk	(9)	(3,332)	(13,873)	91
Correlation	-0.02	0.04	0.41	-0.54
Total:	(11,344)	(26,644)	(48,515)	(7,424)

The VaR of currency risk consists of two components: gold and gold instruments, and another component of open positions in currencies other than the euro. The VaR component in gold and gold instruments is 99.61 per cent of the total VaR of currency risk as at 31 December 2007 (31 December 2006: 97.17 per cent).

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 in the market value of an asset (liability) in response to 1 percentage point change in the interest rate levels. In addition, portfolios' technical parameters 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 2007	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
Interest-earning assets						
Cash and deposits in foreign currencies	4.15	3,416,197	4,810	3,411,387	-	-
Gold, instruments in gold and other precious metals	0.16	844,752	-	88,245	756,507	-
Financial assets at fair value in the profit or loss	4.11	18,241,492	98,029	3,091,809	4,172,759	10,878,895
Financial assets available for sale		70,023	-	70,023	-	-
Other interest-earning assets		28,488	-	28,488	-	-
Total		22,600,952	102,839	6,689,952	4,929,266	10,878,895
Interest-bearing liabilities						
Due to banks and other financial institutions		5,783,538	-	5,783,538	-	-
Liabilities to government institutions and other borrowings	3.44	5,011,875	146,687	4,254,188	600,000	11,000
Total		10,795,413	146,687	10,037,726	600,000	11,000
Interest-bearing asset/liability gap		11,805,539	(43,848)	(3,347,774)	4,329,266	10,867,895

(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
Interest-earning 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
Financial assets at fair value in the profit or loss	3.65	11,817,460	-	3,281,937	3,446,814	5,088,709
Financial assets available for sale		81,736	-	74,044	-	7,692
Receivable from the Republic of Bulgaria		506,326	506,326	-	-	-
Other interest-earning assets		23,891	-	23,891	-	-
Total		17,330,627	512,640	7,324,929	4,321,239	5,171,819
Interest-bearing 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 international financial institutions		506,326	506,326	-	-	-
Total		8,871,647	653,013	7,397,120	800,000	21,514
Interest-bearing asset/liability gap		8,458,980	(140,373)	(72,191)	3,521,239	5,150,305

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

The standard scenarios include 100 basic points instant and parallel increase and decrease in all yield curves globally and 50 basic points increase and decrease in the yield curves for a period of over 12 months. The second two scenarios assume that the change in yields takes place at the beginning of the period and the next year the yield curve remains unchanged.

The analysis of the Bank's sensitivity to changes in interest rates, assuming a constant balance sheet position and excluding asymmetrical movement of yield curves, is as follows:

(BGN'000)

	100 b.p. parallel increase	100 b.p. parallel decrease	50 b.p. parallel increase in 1 year	100 b.p. parallel decrease in 1 year
2007				
As at 31 December	(102,790)	102,790	451,069	443,321
2006				
As at 31 December	(65,977)	65,977	290,837	277,095

Currency risk

Currency risk exists where there is a difference between the currency structure of assets and that of liabilities. From an accounting point of view, the Bank is exposed to currency risk when conducting transactions in financial instruments denominated in currencies other than the Bank's base currency (euro).

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

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

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Assets		
Bulgarian lev and euro area currencies	22,063,825	16,261,368
US dollar	34,353	128,776
Japanese yen	68	68
Pound sterling	230	307
SDR	1,368,157	1,960,923
Gold	1,429,006	1,223,516
Other	5,987	6,059
	<u>24,901,626</u>	<u>19,581,017</u>
Liabilities		
Bulgarian lev and euro area currencies	23,591,210	17,592,803
US dollar	34,148	124,018
Japanese yen	-	-
Pound sterling	-	56
SDR	1,274,243	1,861,369
Gold	-	-
Other	2,025	2,771
	<u>24,901,626</u>	<u>19,581,017</u>
Net position		
Bulgarian lev and euro area currencies	(1,527,385)	(1,331,435)
US dollar	205	4,758
Japanese yen	68	68
Pound sterling	230	251
SDR	93,914	99,554
Gold	1,429,006	1,223,516
Other	3,962	3,288

7. Interest income and expense

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Interest income		
- on securities	525,689	290,941
- on deposits	162,388	117,146
- other	27	1,440
	<u>688,104</u>	<u>409,527</u>
Interest expense		
- on deposits	204,329	93,192
- other	5,983	8,012
	<u>210,312</u>	<u>101,204</u>

Interest expenses paid on government deposits in levs as at 31 December 2007 are BGN 147,859 thousand, and BGN 31,622 thousand in foreign currency. Interest expenses paid on deposits in BGN of other government organisations as at 31 December 2007 are BGN 2883 thousand, and BGN 5942 thousand in foreign currency.

8. Net gains/(losses) from financial assets and liabilities entered at fair value in the profit and loss

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Net gains from operations in securities	18,346	49,530
Net gains from operations in foreign currency	116	644
Net revaluation gains on futures	9,387	252
Net revaluation gains/(losses) on securities	27,729	(177,401)
Net revaluation (losses) on foreign currency assets and liabilities	(3,734)	(4,763)
Net revaluation gains on gold and precious metals	205,564	125,423
	<u>257,408</u>	<u>(6,315)</u>

9. Other operating income

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Net income from disposal of non-current assets	300	80
Turnover of subsidiaries	21,044	18,586
Income from associated companies	1,164	2,494
Income from sale of coins	1,580	1,152
Dividend income	4,486	4,489
Other income, net	7,871	5,884
	<u>36,445</u>	<u>32,685</u>

Other net income includes income from derecognised old banknotes and coins issued before 5 July 1999 in the amount of BGN 4484 thousand (BGN 4450 thousand as at 31 December 2006).

10. Total administrative expenses

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Personnel costs	26,255	24,148
Administrative expenses	35,784	32,433
Depreciation	15,566	15,188
Other expenses	3,962	2,592
	<u>81,567</u>	<u>74,361</u>

Personnel costs include salaries, social and health insurance costs charged under the local legislation provisions as at 31 December 2007, respectively for the BNB – BGN 19,786 thousand, for the Printing Works AD – BGN 4458 thousand, and for the State Mint EOOD – BGN 2011 thousand. The number of employees of the Bank and its subsidiaries is 1253 as at 31 December 2007 (2006: 1264), including the BNB staff of 914 in 2007 (2006: 928).

According to the Labour Code requirements, on termination of the employment contract of an employee who has become entitled to retirement, the Bank is obliged to pay him/her compensation amounting to twice his/her gross monthly salary. If the employee has been employed by the Bank in the last ten years, the amount of this compensation is six times his/her gross monthly salary at the time of his/her retirement.

Based on actuarial calculations, the Bank has accrued its retirement compensation liabilities to the personnel in the amount of BGN 192 thousand and unused annual leave of BGN 418 thousand (31 December 2006: BGN 221 thousand and BGN 360 thousand). The retirement compensation and unused annual leave for the Bank's subsidiaries as at 31 December 2007 are BGN 258 thousand and BGN 162 thousand respectively (31 December 2006: BGN 298 thousand and BGN 163 thousand).

Administrative expenses include also the BNB's currency circulation expenses of BGN 20,522 thousand as at 31 December 2007 (31 December 2006: BGN 18,885 thousand).

11. Cash and deposits in foreign currencies

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Foreign currency cash	87,944	8,001
Current accounts in other banks	4,917	6,462
Deposits in foreign currency	<u>3,415,120</u>	<u>4,192,017</u>
	<u>3,507,981</u>	<u>4,206,480</u>

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

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Euro area residents		
in EUR	1,204,545	2,191,004
In other foreign currencies	<u>144</u>	<u>70</u>
	1,204,689	2,191,074
Non-euro area residents		
In EUR	2,264,465	1,948,882
In other currencies	<u>38,827</u>	<u>66,524</u>
	<u>2,303,292</u>	<u>2,015,406</u>
	<u>3,507,981</u>	<u>4,206,480</u>

12. Gold, instruments in gold and other precious metals

	31 Dec. 2007		31 Dec. 2006	
	'000 troy ounces	BGN'000	'000 troy ounces	BGN'000
Gold bullion in standard form	513	565,609	513	484,414
Gold deposits in standard form	766	844,872	686	647,722
Gold in other form	17	18,526	17	15,962
Other precious metals	-	3,659	-	3,055
Other instruments in gold		<u>-</u>	80	<u>75,464</u>
		<u>1,432,666</u>		<u>1,226,617</u>

Gold deposits in standard form include gold held with correspondents. This gold earns interest at rates between 0.005 per cent and 0.30 per cent per annum. Gold in other form includes gold commemorative coins of BGN 16,218 thousand. Other precious metals include silver commemorative coins of BGN 308 thousand and platinum commemorative coins of BGN 3351 thousand.

13. Financial assets at fair value through profit and loss

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Securities at fair value through profit and loss		
Foreign treasury bills, notes and bonds	<u>18,356,669</u>	<u>11,968,687</u>
	<u>18,356,669</u>	<u>11,968,687</u>

Securities comprise of both coupon and discount securities denominated in EUR. The coupon interest of the EUR-denominated securities reached 3.9 per cent in 2007 (31 December 2006: 3.89 per cent).

The value of securities pledged as collateral on futures transactions amounts to BGN 19,606 thousand as at 31 December 2007 (31 December 2006: 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)

	Issuer's credit rating	31 Dec. 2007	31 Dec. 2006
Investment graded securities	AAA	11,213,991	8,776,027
	AA+	4,860,584	1,473,739
	AA	1,545,181	947,726
	AA-	348,812	771,195
	A+	388,101	-
		<u>18,356,669</u>	<u>11,968,687</u>

14. Financial assets available for sale

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Republic of Bulgaria's quota in the IMF	1,345,663	1,430,540
Equity investments in international financial institutions	27,989	22,351
Equity investments in associates	<u>17,934</u>	<u>12,862</u>
	<u>1,391,586</u>	<u>1,465,753</u>

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 70,023 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 3.78 per cent annual floating rate.

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 2007 equals BGN 22,341 thousand (as at 31 December 2006: BGN 23,696 thousand – ref. note 30 (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.

Equity investments in international financial institutions do not exceed 10 per cent of the issued share capital of those institutions.

When the Republic of Bulgaria joined the European Union on 1 January 2007, the BNB has become a member of the ESCB. In accordance with the current regulatory framework the national banks of countries, which have not adopted the euro, pay effectively 7 per cent of the subscribed equity investment. The BNB's capital contribution in the ESCB is EUR 3,561,868.99 or BGN 6966 thousand.

Pursuant to a decision of the BNB Governing Council, the Bank has an interest in the capital of the new Cash Services Company made of both cash and non-cash contributions, and subscribes 2500 shares of its capital with a par value of BGN 1000 each.

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

Name of institution	Share holding per cent	Principal activity
Associated companies		
Bankservice AD	35.85	Interbank clearing
BORICA AD	36.24	Servicing bank card payments
International Bank Institute OOD	42.31	Financial training and research
Central Depository AD	20.00	Agent for corporate securities
Cash Services Company AD	25.00	Handling of sealed parcels of Bulgarian coins and banknotes coming from the BNB and commercial banks.

15. Receivables from the Government of the Republic of Bulgaria

The receivables from the Government of the Republic of Bulgaria, which match the Government's borrowings from the IMF have been repaid ahead of the repayment schedule on 24 April 2007, in accordance with the Strategy for the management of the state debt of the Government in the period 2006 – 2008.

(BGN'000)

Year	31 Dec. 2007	31 Dec. 2006
2007	-	175,267
2008	-	175,267
2009	-	116,844
2010	-	38,948
	-	506,326

16. Tangible assets

(BGN'000)

	Land and buildings	Equipment	IT equipment	Office equipment	Other equipment (incl. motor vehicles)	Tangible assets in progress	Total
As at 1 January 2007	122,761	66,925	17,789	4,442	4,795	3,599	220,311
Additions	94	2,795	83	206	-	5,232	8,410
Disposals	(392)	(2,189)	(3,736)	(86)	(65)	(18)	(6,486)
Transfers	-	924	3,090	315	321	(4,650)	-
As at 31 December 2007	122,463	68,455	17,226	4,877	5,051	4,163	222,235
Depreciation and impairment loss							
As at 1 January 2007	(12,616)	(34,152)	(12,058)	(2,299)	(2,858)	-	(63,983)
Charge for the period	(3,272)	(5,849)	(2,711)	(432)	(545)	-	(12,809)
On disposals	-	2,112	3,731	79	65	-	5,987
As at 31 December 2007	(15,888)	(37,889)	(11,038)	(2,652)	(3,338)	-	(70,805)
Net book value as at 31 December 2007	106,575	30,566	6,188	2,225	1,713	4,163	151,430
Net book value as at 31 December 2006	110,145	32,773	5,731	2,143	1,937	3,599	156,328

17. Intangible assets

(BGN'000)

	Software	Other intangible assets	Intangible assets in progress	Total
As at 1 January 2007	18,118	47	3,650	21,815
Additions	5	4	2,529	2,538
Disposals	(195)	(7)	-	(202)
Transfers	1,926	-	(1,926)	-
As at 31 December 2007	19,854	44	4,253	24,151
Depreciation and impairment loss				
As at 1 January 2007	(6,640)	(37)	-	(6,677)
Charge for the period	(2,734)	(5)	-	(2,739)
On disposals	193	7	-	200
As at 31 December 2007	(9,181)	(35)	-	(9,216)
Net book value as at 31 December 2007	10,673	9	4,253	14,935
Net book value as at 31 December 2006	11,478	10	3,650	15,138

Software includes, as at 31 December 2007, all licenses purchased by the BNB to the total amount of BGN 9923 thousand (31 December 2006: BGN 9173 thousand), and software products to the amount of BGN 9353 thousand (31 December 2006: BGN 8487 thousand).

18. Other assets

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Balances of subsidiaries held with local banks	28,488	23,718
Precious metal commemorative coins for sale	467	736
Inventories	8,543	7,506
Accounts receivable	3,699	1,089
Prepaid expenses	1,244	715
Other receivables	3,918	1,924
	<u>46,359</u>	<u>35,688</u>

19. Banknotes and coins in circulation

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Banknotes in circulation	8,284,832	6,781,539
Coins in circulation	<u>126,035</u>	<u>107,037</u>
	<u>8,410,867</u>	<u>6,888,576</u>

20. Liabilities to banks and other financial institutions

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Demand deposits from banks and other financial institutions		
- in BGN	2,117,513	1,540,437
- in foreign currency	<u>3,666,025</u>	<u>2,053,309</u>
	<u>5,783,538</u>	<u>3,593,746</u>

The Bank does not pay interest on demand deposits from banks and other financial institutions. Demand deposits include BGN 5295 million representing the required reserves, which all local banks are required to maintain with the Bank as part of their current accounts (31 December 2006: BGN 3293 million).

21. Liabilities to government institutions and other borrowings

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Current accounts:		
- in BGN	1,038,243	106,650
- in foreign currency	<u>846,282</u>	<u>369,109</u>
Time deposit accounts:		
- in BGN	3,520,929	3,684,025
- in foreign currency	<u>1,348,368</u>	<u>945,780</u>
	<u>6,753,822</u>	<u>5,105,564</u>

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in USD earn interest between 3.60 per cent and 4.98 per cent. Government deposit accounts in EUR earn interest between 3.22 per cent and 3.78 per cent and in BGN earn interest between 3.14 per cent and 3.85 per cent.

22. Borrowings from international financial institutions

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Extended IMF facility	-	506,326
	<u>-</u>	<u>506,326</u>

Borrowings from the general resources of the IMF have been repaid ahead of the repayment schedule on 24 April 2007. Borrowings from the IMF correspond to the receivables from the Government in the same amount and are paid in accordance with the repayment schedule of the agreements with the IMF (ref. note 15).

23. Liabilities against participations in international financial institutions

The liabilities against Bulgaria's participation in the IMF as at 31 December 2007 amount to BGN 1,271,866 thousand or SDR 605,276 thousand (as at 31 December 2006: BGN 1,352,663 thousand or SDR 605,457 thousand).

Liabilities to the IMF are denominated in SDRs. Liabilities related to Bulgaria's IMF quota are non-interest bearing with no stated maturity. This note includes account No. 1 of the IMF for administrative expenses denominated in BGN amounting to BGN 3554 thousand (as at 31 December 2006: BGN 3701 thousand).

24. Other liabilities

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
European Commission funds	32,914	-
Salaries and social security payable	1,720	1,883
Deferred income	1,765	6,299
Other liabilities	9,351	10,926
	<u>45,750</u>	<u>19,108</u>

As from 1 January 2007 the Republic of Bulgaria, in its capacity as EU Member State, participates in the funding of EU budget. Pursuant to Article 9 of the Council Regulation No 1150/2000 of 22 May 2000, the BNB has opened and services accounts in EUR and in BGN for the European Commission funds. The payment instructions for transactions on these accounts are given by authorized persons of the European Commission.

25. 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/ loss 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.

Pursuant to Article 8, paragraph 3 of the Law on the Bulgarian National Bank, as at 31 December 2007 upon a decision of the Governing Council, BGN 87 million was allocated to the Supplementary Reserves for Impairment Loss special fund. The 2007 profit distribution in accordance with the profit distribution policy disclosed in note 5(i) is as follows:

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Profit for the period	693,880	264,310
Distribution (to)/from the special reserve		
Unrealised (gains) on gold revaluation	(205,564)	(125,423)
Unrealised (gains)/loss on revaluation of financial assets at fair value through profit or loss	(37,116)	177,149
Unrealised loss on foreign exchange revaluation	3,734	4,763
Other unrealised (gains)	(70)	(980)
Result after distribution (to)/from the special reserve, incl.	454,864	319,819
<i>Distribution to other reserves and minority interest</i>	<i>117,230</i>	<i>84,189</i>
<i>Distribution to the special-purpose fund</i>	<i>87,000</i>	<i>65,000</i>
<i>Planned contribution to the state budget</i>	<i>250,634</i>	<i>170,630</i>

26. 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 Government, as represented by the Minister of Finance, acquired 4.4 per cent of the company's capital (3093 shares with par value of BGN 1000).

27. Monetary liabilities and gross international foreign exchange reserves

(BGN'000)

	31 Dec. 2007	31 Dec. 2006
Gross international foreign exchange reserves		
Cash and deposits in foreign currencies	3,507,981	4,206,480
Monetary gold and other instruments in gold	1,410,480	1,207,600
Debt securities investments	18,356,669	11,968,687
Equity investments and quota in the IMF	70,023	74,045
	<u>23,345,153</u>	<u>17,456,812</u>
Monetary liabilities		
Banknotes and coins in circulation	8,410,867	6,888,576
Due to banks and other financial institutions	5,783,339	3,593,538
Liabilities to government institutions	6,446,827	4,981,971
Other borrowings	340,108	123,800
	<u>20,981,141</u>	<u>15,587,885</u>
Surplus of gross international foreign exchange reserves over monetary liabilities	<u>2,364,012</u>	<u>1,868,927</u>

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

The monetary gold and other instruments in gold are revaluated on a daily basis based on the official London Bullion Market closing price.

28. Related party transactions

1) *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 also 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. note 22).

Government bank accounts

Government budget organizations and other government organizations have current accounts and time deposits with the Bank (ref. note 21).

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 2007 the par value of the total securities held in custody was BGN 3190 million (31 December 2006: BGN 2935 million).

29. Subsidiaries

(%)

Ownership interest	31 Dec. 2007	31 Dec. 2006
State Mint EOOD	100	100
BNB Printing Works AD (ref. note 26)	95.6	95.6

The net income from subsidiaries for the period comprises net profit of BGN 1000 thousand from the State Mint EOOD (31 December 2006: BGN 1327 thousand) and BGN 3252 thousand from the BNB Printing Works AD (31 December 2006: BGN 1824 thousand).

30. 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 2007 is BGN 63,039 thousand (31 December 2006: BGN 67,024 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 1,045,648 thousand.

(iii) *Capital commitments*

As at 31 December 2007 the Bank has committed to BGN 27,924 thousand to purchase non-current assets (31 December 2006: BGN 1910 thousand).

(iv) *Other commitments and liabilities*

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

31. 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

18 January	Ordinance on Amendment of BNB Ordinance No 3 on Funds Transfers and Payment Systems was approved.
1 February	Ordinance on Amendment of BNB Ordinance No 18 on the Control over Quality of Banknotes and Coins in Cash Circulation was approved. <i>Internal Rules on BNB Cash Operations</i> were approved.
15 February	BNB regional cash centres in Rousse and Bourgas were closed. As of 28 February 2007 the Bulgarian National Bank put into circulation a silver commemorative three-component coin 'Boris Hristov' of the 'Great Bulgarian Voices' series. Ordinance on Amendment of BNB Ordinance No 26 on Foreign Exchange Transactions of Brokerage Financial Houses was approved. New selling prices of banknotes and coins sold by the BNB at prices other than their nominal value were approved.
1 March	A new Ordinance No. 11 on Liquidity Management and Supervision of Banks was adopted. Ordinance on Amendment of BNB Ordinance No. 22 on the Central Credit Register of Banks was approved.
15 March	The report on BNB budget implementation as of 31 December 2006 was approved. As of 12 April 2007 the Bulgarian National Bank put into circulation a silver commemorative coin 'The Bulgarian Mountains' of the 'National Parks and Reserves' series with a nominal value of BGN 10, issue 2007.
27 March	As of 3 May 2007 the Bulgarian National Bank put into circulation a gold commemorative coin 'St George the Victorious' of the 'Bulgarian Iconography' series with a nominal value of BGN 20, issue 2007. As of 3 May 2007 the Bulgarian National Bank put into circulation a gold commemorative coin 'St George the Victorious' of the 'Bulgarian Iconography' series with a nominal value of BGN 100, issue 2007.
12 April	The BNB gave its consent for incorporation of the Cash Services Company. Its Articles of Association were approved.
24 April	The BNB Annual Report for 2006 was approved.
19 June	Pursuant to the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems, the <i>System for Electronic Payments</i> (SEP Bulgaria) AD, Sofia, was granted a license by the BNB for carrying out activities on the territory of the Republic of Bulgaria as a system operator of a payment system upon fulfilling the conditions under Article 61, paragraph 2 of Ordinance No. 3 on Funds Transfers and Payment Systems. The licence was granted on 15 November 2007.
19 July	Ordinance on Amendment of BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks was approved.

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

Main Principles of the BNB Licensing Policy were approved.

7 August

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

Ordinance on Amendment of BNB Ordinance No. 24 on the Exchange of Old Banknotes and Coins for New Banknotes and Coins in Connection with the Redenomination of the Bulgarian Lev was approved.

13 September

As of 23 October 2007 the Bulgarian National Bank put into circulation a coloured silver commemorative coin 'Carpet Making', Bulgarian Handicrafts series, with a nominal value of BGN 5, issue 2007.

The report on BNB budget implementation as of 30 June 2007 was adopted.

4 October

Ordinance No. 5 on the Terms and Procedure for Acquisition, Registration, Redemption and Trade in Government Securities was adopted.

Ordinance No. 15 on the Control over Transactions in Government Securities was adopted.

Ordinance No. 31 on Government Securities Settlement was adopted.

15 October

As of 12 November 2007 the BNB put into circulation as legal tender a banknote of BGN 20 nominal value, issue 2007.

8 November

The BNB Budget for 2008 was approved.

The BNB Report for January – June 2007 was approved.

As of 19 December 2007 the BNB put into circulation a partially gold-plated silver commemorative coin 'Pegasus from Vazovo', *The Treasures of Bulgaria* series, with a nominal value of BGN 10, issue 2007.

29 November

Ordinance on Amendment of Ordinance No. 36 on Custodian Banks under the Social Security Code was approved.

The Bulgarian National Bank stops buying Maltese Liras and Cypriot Pounds at its tills due to euro introduction in Malta and Cyprus.

7 December

BNB Ordinance No. 12 on the Supervision on a Consolidated Basis was approved.

21 December

The Maltese lira and the Cypriot pound were included in the currency exchange rate list published by the BNB.