



# **Strategy for the BNB Development**

## **2004–2009**

---

**ANNUAL REVIEW**

**October 2004 – October 2005**



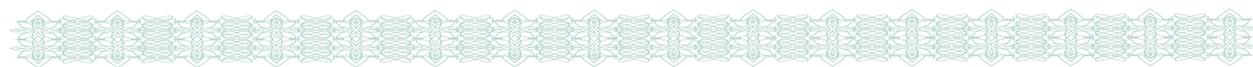
© Bulgarian National Bank, 2005

This Review is the first regular review of the Strategy.

It is aimed at reviewing the performance of the objectives and priorities under the Strategy, outlining the new challenges and risks, and proposing adequate corrective measures where such are necessary.

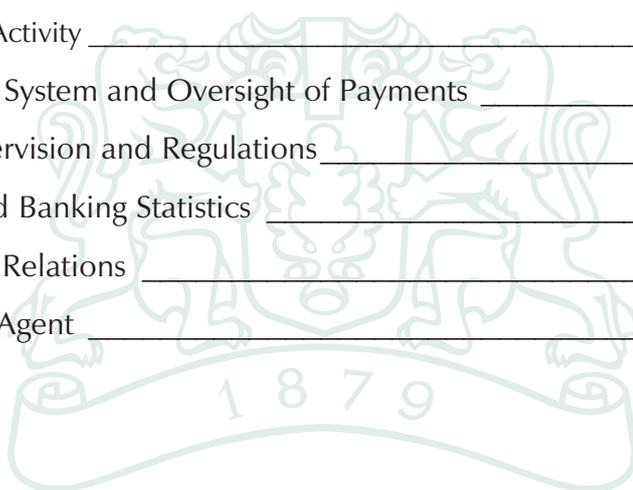
The contents may be quoted or reproduced without further permission. Due acknowledgment is requested.

Published by the Bulgarian National Bank  
1, Alexander Battenberg Square, 1000 Sofia, Bulgaria  
Telephone (+ 3592) 9145-1656, 1304  
Fax (+ 3592) 980 2425, 980 6493  
Website: [www.bnb.bg](http://www.bnb.bg)



## Contents

I. Achievement of Objectives _____	7
II. Fulfillment of Tasks _____	8
II.1. Monetary Policy under a Currency Board _____	8
II.2. International Reserves _____	9
II.3. Currency Circulation _____	11
II.3.1. Banknotes and Coin Production _____	11
II.3.2. Issuing Activity _____	12
II.4. The Payment System and Oversight of Payments _____	13
II.5. Banking Supervision and Regulations _____	15
II.6. Monetary and Banking Statistics _____	16
II.7. International Relations _____	18
II.8. Government Agent _____	20



## Abbreviations

AS ROAD	Automated System for Registration and Servicing of External Debt
EC	European Commission
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
EMU	Economic and Monetary Union
EMV-standard	Europay–MasterCard–Visa standard
ERM II	Exchange Rate Mechanism II
ESROT	Electronic System for Registration and Service of Trade in Government Securities
GSA	Automated System for Conducting Government Securities Auctions
IMF	International Monetary Fund
IOSCO	International Organization for Governmental Securities Commissions
MF	Ministry of Finance
NCBs	national central banks
RINGS	Real-time INterbank Gross Settlement System
SBS	State Budget Service
SDDS	Special Data Dissemination Standard
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer



A year has passed since the adoption of the Strategy for Bulgarian National Bank Development between 2004 and 2009. The Strategy was implemented in a dynamic external environment, which placed new challenges to the BNB – growing global imbalances accompanied by the abrupt increase in international oil prices, natural disasters with significant negative macroeconomic consequences both for the global economy, and on national scale, further opening of the Bulgarian economy and intensification of financial and banking intermediation and of the degree of the economy's monetization. Bulgaria's integration into the European Union (EU) continued, and the Treaty on the Accession of the Republic of Bulgaria of 1 January 2007 was signed in April 2005. The transposition of the European *acquis* into the national legal system is in its completion phase, and representatives of our country have already joined as observers the European structures.

In this setting, achieving the objectives and tasks under the Strategy required utmost mobilization and efficiency in the allocation of the Bank's resources, and often necessitated additional actions and solutions. The Strategy was implemented in the conditions of an ongoing dialogue with the general public and the banking community, and of the Central Bank's increasing transparency and efficiency.

The Governing Council's conclusion is that in the first year of its implementation the Strategy was and still is topical, and together with the Law on the BNB constitutes the most important instrument for the institution's management. In the period under review, the objectives and tasks of the Bank were achieved to the maximum extent, thus providing appropriate conditions for the implementation of the longer-term objectives and tasks under the Strategy. No amendments, nor any significant additions to the Strategy are required, and it remains in full operation.

The BNB's position is that irrespective of the changes in the global economy and the domestic social, political, and economic situation, Bulgaria should join ERM II immediately after its EU membership by making a unilateral commitment to maintain the currency board arrangement until joining the euro area, while preserving the current exchange rate of BGN 1.95583 to the euro. The BNB will adhere to the framework set by the European Commission and the ECB, which excludes the possibility of unilateral euroization by any acceding country. The Bank will pursue a policy ensuring the country's accession to the euro area in the second half of 2009 or from 1 January 2010.

The amendments to the Law on the BNB passed by the National Assembly early in 2005 had an extremely favourable effect on the implementation of the Strategy in the period under account. They mark the maximum possible progress in the harmonization of the central banking legislation with all European requirements in any necessary areas – in terms of ensuring the Bank's institutional autonomy, Governing Council members' personal independence, and the prohibition for the Bank to provide any direct financing to the public sector. This has been taken into consideration in the EC Comprehensive Monitoring Report on the Republic of Bulgaria for 2005.

The expanding cooperation with the national central banks and the ECB, as an element of the Strategy, provided opportunities for increasing expertise and speeding up BNB's preparations for joining the ESCB. The BNB invested substantially in the training and qualification improvement of its staff directly involved in the ESCB structures, as well as of all the Bank's personnel indirectly drawn in the process. In the period under review, adequate arrangements were made for the management of BNB's participation in the committees, subcommittees and working groups under the ECB, EC, and other European institutions.

The achievement of the objectives and tasks in the period was also made possible by the better internal coordination and consistency of actions, the exchange of information and the implementation of a teamwork approach in the performance of BNB's tasks. The new draft regulations are prepared by working groups of experts from all competent units in the Bank, the participation in the ESCB and EC structures is coordinated by a flexible internal structure known as the Coordination Group. This approach allows for enhancing the Bank's operational efficiency, the targeted use of resources and the economical budget spending.

The information flows intensified in relation to the Bank's accession to the ESCB, and obtaining an observer status in the ESCB and EC committees and working groups. Thus, for example, in the period 1 May – 27 October this year, 2560 documents of 22,235 pages have come to the attention of the respective committee and group members, 107 man-days of business trips for participation in the ESCB and 25 in the EC structures were made. Without increasing the existing resources, the BNB activities intensified as a whole both in terms of the BNB 65 employees directly involved and of the ones indirectly involved in the ESCB.

The Review is arranged along the following lines. First, it deals with the extent of achievement of the BNB's long-term objectives in the period October 2004 – October 2005. Second, it provides a general assessment of the extent of correspondence of each task included in the Strategy with the objectives thereof, and the degree of its accomplishment. It also reviews the main actions taken for the achievement of the tasks in the period under account, and makes recommendations for some steps to be taken in 2006. Where necessary, some further additions and developments of the Strategy tasks are provided.

## I. Achievement of Objectives

In the year past, the BNB achieved, within its powers and instruments at its disposal, its main objective of 'maintaining price stability'. The inflation in Bulgaria remains relatively low irrespective of the worldwide oil shock, the changes in some administered prices, and the effect of Bulgaria's integration into EU. This is largely owing to the stability of the national currency and the monetary policy pursued under the currency board arrangement in accordance with the Law on the Bulgarian National Bank.

Maintaining the stability of the banking system through improving prudential regulations and banking supervision which delineates in a timely manner adequate measures for limiting market and credit risks has also contributed significantly to the performance of this statutory objective. The strong fiscal policy in the period under review has also significantly accounted for the relatively low inflation rate.

For Bulgaria, regardless of the accomplishment of the BNB's objectives, meeting the Maastricht criterion of inflation within the timeframes set in the Strategy will require the timely implementation of structural reforms in the real economy and public finances, as provided for in the Agreement between the Council of Ministers of the Republic of Bulgaria and the Bulgarian National Bank on the introduction of the euro in the Republic of Bulgaria.

The main internal challenges faced by the BNB in the attainment of its objectives and the implementation of the Strategy in the time left are primarily related to the finalization of the harmonization of the legislation regulating its activities, building up adequate internal information systems, which would allow for more efficient management of available resources, and taking additional steps to speed up preparation particularly in areas like monetary and banking statistics, balance of payments statistics, and currency circulation management.

In line with the good practices, the BNB will speed up the preparations for the establishment of a reserve centre for international reserves management, and management and oversight of payments.

## II. Fulfillment of Tasks

### II.1. Monetary Policy under a Currency Board

**Assessment:** *This part of the Strategy corresponds to the objectives and is being implemented although the activities are in their early stage.*

In line with the Strategy, as early as November 2004, an Agreement was signed between the Council of Ministers and the Bulgarian National Bank on the changeover to the euro in the Republic of Bulgaria. It not only provides for a timeframe for meeting the requirements for abrogating derogation and for the full-fledged participation of the Republic of Bulgaria in the EMU and the adoption of the euro as the national currency, but also for the specific commitments of the parties thereto. The BNB's commitments under the Agreement are to abide by the rules of the currency board at the current exchange rate of the lev to the euro, developing its institutional capacities and compiling adequate information and analytical data for the legal, economic and institutional aspects of the process, as well as for the increased awareness of the decision-making bodies, the academia, businesses, and the general public on changeover issues.

The BNB Governing Council once again uses this opportunity to confirm its commitment to follow strictly the principles and rules of the currency board, as provided for in the Law on the BNB. In the period under account, the BNB has not caused with its activities any doubts, whatsoever, as regards the performance on this element of the Strategy and on the Agreement with the government. Thus, the Bank has contributed for the high credibility of the monetary regime among the public, as well as for establishing and maintaining macroeconomic stability and ensuring a predictable environment for sustainable long-term economic development.

As regards institutional capacities, no focused preparation of the BNB staff has started for participation in the process of formulation and implementation of the monetary policy of the ECB. We believe that the very participation of BNB representatives in the ECB Monetary Policy Committee and the working groups under it will gradually build up capacities in this area. The forthcoming technical assistance project starting in the second half of next year, also includes the training of 15 experts, who will be the spearhead of future BNB activities in this area. As part of the project, a medium-term model and a plan for the BNB's organization in this area will be prepared with the assistance of European central banks, and if recommended by the ESCB – a Monetary Policy Committee will be established at the BNB.

In 2004–2005, considerable preparations were made for expanding BNB's potential for analysis and projection of processes and trends in the development of the national and European economies. Early in 2005, Internal Rules were adopted for the procedure and manner of development, adoption, implementation, and reporting of the research activities at the BNB, which would allow for the discussion of the two-year research plan within a broad circle of experts. Early in the same year, the Governing Council approved a Plan of Research Activities in 2005–2006, which covers topics and subtopics related to the development and improvement of analysis and forecast models, and also related to Bulgaria's membership in the EU, ERM II, and the euro area. To date, there is no delay in the timeframes for the performance on the subtopics in the research activities plan.

The BNB's macroeconomic forecast model is improved with the assistance of De Nederlandsche Bank, and the above-mentioned technical assistance project is envisaged to improve the activities in this area. In May 2005, the BNB organized the Third International Scientific Conference of Balkan Region Central Banks under the heading of Economic Modelling and Forecasting. Experts from scientific institutes and central banks from several EU member states participated with presentations in the Conference.

The development of simulation models is an important aspect of the activities related to analysis and forecasting of processes in the economy. With the assistance of an expert from the Bank of Canada, a simulation macroeconomic model was developed for the evaluation of the macroeconomic effects of changes in the fiscal and monetary policies. In line with the state-of-the-art trends in economic central bank modeling, resources have also been allocated in the BNB and preliminary investigations have started of the theory and practice of developing stochastic general equilibrium models.

With a view to promoting public awareness of the changeover to the euro, and the challenges facing Bulgaria in this regard, the BNB started publishing its first materials on these issues. The existing EU legal and institutional framework for the dialogue between individual countries and the EC and ECB on the issues of joining EMU, as well as the EU experience and assessment by BNB experts of the extent of Bulgaria's preparedness for participation, were presented. The BNB participated with presentations in the workshop on EMU issues traditionally held for mass media representatives.

The BNB organized a seminar on the Economic and Monetary Union one year after the ten new Central and Eastern Europe member states joined the EU. The lectures were delivered by ECB top level officials, representatives of the European academia and of eight national central banks. The BNB seminar provided an opportunity for members of the National Assembly, representatives of the government, non-government organizations, businesses and the mass media to participate in the discussion and to share in the knowledge of experts in the area.

#### **Recommendations:**

1. *To start in 2006 the activities for building up capacities for BNB participation in the process of formation and implementation of the ECB monetary policy.*
2. *To take steps in 2006 for further improvement of BNB activities in the area of short-term and medium-term macroeconomic forecasts, with the view of ensuring BNB's full-fledged participation in the preparation of ECB monetary policy-related documents.*

## II.2. International Reserves

**Assessment:** *This element of the Strategy corresponds to the objectives and is implemented within the scheduled timeframes.*

According to the Strategy, the expected outcome of the tasks performed in the area of international reserve management is 'guaranteeing security, liquidity and profitability in minimizing risks'. It is achieved through the ongoing improvement of strategic asset allocation methodology, in a way that would ensure its consistency with the modern trends in the international financial markets and the needs of ESCB member central banks. This is also the direction of streamlining the rules and procedures governing the BNB's international reserve operational management activities.

With a view to the above, the BNB Internal Rules on the Gross International Reserves Operations were adopted in May 2005. They provide in the maximum possible extent for the clear division of responsibilities at various levels of management in the international reserves strategic allocation decision-making process, and for the flexibility that would allow the Bank to respond to the quickly changing conditions at the international financial markets. There is full consistency of the adopted Rules with the Business Procedure Manual for International Reserves Management, which meticulously defines and details the operational activities at various levels in the chain of command. A draft was prepared, which would increase BNB's capacities to react to crisis situations at the international markets, and would be implemented jointly with the IMF and the World Bank in 2006.

A tender procedure was conducted for the selection of a new international reserves management information system. In October 2005, a contract was signed with the supplier of the selected TREMA system, used by most European central banks. It would become a reliable guarantee for BNB's successful integration in the ESCB and a basis for the management of the portion of international reserves which the ECB would assign for management by the BNB after the accession to the euro area, and for pursuing the ECB monetary policy. To guarantee the security in international reserve management, other countries' experience in establishing reserve management centres was studied.

In the period under account, the BNB invested significant resources to increase the transparency of international reserves management under the conditions of strict adherence to the legal provisions of observing professional, bank, and commercial secrecy. First, the quality of the information published on the BNB website, and in the BNB's public reports on the conditions and trends in the international financial markets, and on the results of international reserves management improved. Enhancing the integration of publications assessing macroeconomic stability and banking system stability with the ones discussing market environment in which the international reserves are managed increase the public awareness of market factors influencing the dynamics of international reserves. Second, work started on a special publication, which would deal with the theory, recommended international practices, and BNB practices in the process of international reserves management. The first part of this publication – presenting the theoretical basis and international practices of international reserves management and their role and macroeconomic significance – was successfully compiled and published in October 2005. Presently, preparations are underway for the second part of the publication, which will deal with the BNB's experience in the conditions of a currency board arrangement.

Considerable progress was achieved in improving the qualification of the BNB reserve management analytical staff. Almost 25 per cent of the staff directly involved in the international reserves management have participated in an international certification programme for acquiring a Chartered Financial Analyst (CFA) certificate. The exchange of experts within the bilateral cooperation with the French and Dutch central banks continues, although so far no agreement has been reached on the exchange of portfolio managers. The Bank for International Settlements and the World Bank provide technical assistance and training. In 2005, after three years of participation, the BNB 'completed' successfully the Reserves Advisory Management Program (RAMP) of the World Bank for countries which need its consultancy services in the area of international reserves management. This is a convincing proof of the recognition by the international financial community of both the capability of

the BNB team to manage its international reserves in line with the recommended international practices in this area, and the existence of sufficiently effective and efficient reporting and control procedures in place. The BNB is among the supporters of the idea of launching the Post Graduate Reserves Advisory Management Program of the World Bank for monitoring and assessment of the future development of the international reserves management capacities of the central banks that have completed RAMP.

**Recommendations:**

1. To continue in 2006 the efforts for signing agreements on the exchange of portfolio managers with other banks in the euro area.
2. To publish in 2006 the BNB's practice of international reserves management under a currency board arrangement as part of the measures for increasing the central bank transparency.

## II.3. Currency Circulation

### II.3.1. Banknotes and Coin Production

**Assessment:** *This part of the Strategy meets the objectives but it must be made more concrete so as to allow a precise quantitative measurement of the progress. The BNB Printing Works AD is implementing the Strategy at a good pace, whereas the Mint EOOD should speed up the processes.*

One of the major priorities of the banknote and coin production, according to the Strategy, is the creation of competitive advantages for Bulgarian enterprises which will allow them to apply to the EC and the ECB for the euro production as soon as possible. As the information on the EC and ECB requirements is confidential, even after Bulgaria obtained an observer status, the BNB does not have such information. Therefore, in terms of the Strategy implementation, every attempt at an adequate overall evaluation of the progress made by the currency production enterprises looks very biased.

Consequently, the BNB will further develop the Strategy vision of enhancing the BNB enterprises' partnership with companies enjoying a good reputation in the European currency production market. This vision is harder to implement at the Mint EOOD because the euro coin production is the right and responsibility of the individual countries. The EC requirements and regulations regarding euro coins are fewer and far less strict than the ECB requirements and regulations regarding euro banknotes which presupposes enhanced flexibility and greater variety of decisions.

As a result of the efforts to improve the management of currency production enterprises, in the review period the BNB Printing Works AD applied for and was granted the international certificates for quality management under ISO 9001:2000 and information security management under the BS 7799-2 British standard. The first Moody's regular audit under ISO 9001:2000 was successfully completed. The BNB Printing Works AD already has a perfect system of rules for the production process organization, accounting and control, which were coordinated with and approved by the BNB, and this system is in compliance with the recommended international management practices of banknote production enterprises. Changes have been made in the control and the Rules for the Controllers' Activities in the Mint EOOD which will allow the Mint to speedily remove the established deviations from the recommended practices.

In 2005 the BNB demonstrated its abilities to design and issue new banknotes of high quality in short terms – banknotes having the most advanced security features. The BNB Printing Works AD produced the first Bulgarian commemorative banknote which was prepared in less than a year and has been in circulation since September 2005. This banknote was very well received and highly valued at the traditional annual conference of the currency production industry in Montreal (Canada) attended by more than 500 representatives of central banks, currency producers and the police authorities from over 70 countries.

**Recommendations:**

1. *To look for and specify the ways of enhancing the BNB enterprises' partnership with companies enjoying a good reputation in the European currency production market.*
2. *To use all possibilities to deepen the BNB knowledge of the ECB and EC requirements regarding currency production enterprises.*

### II.3.2. Issuing Activity

**Assessment:** *This part of the Strategy meets the objectives and sticks to the pre-defined time limits.*

The objective in this area is to ensure purity, security and efficiency of issuing activity in compliance with the ECB regulations and decisions and thus guarantee the changeover. The accomplishment of this objective has been going in several directions. First, the work on improving the legal framework was carried on. In January 2005 amendments were made to the Law on the BNB that aimed to establish the BNB's role in the mechanism for detecting non-genuine or counterfeited currency in the Bulgarian financial system. In accordance with Article 27 of the Law, in October 2005 the BNB prepared and adopted Ordinance No. 18 on the Control of the Quality of Banknotes and Coins in Circulation.

Second, in February 2005 the BNB and the ECB signed an agreement on the cooperation in the fight against euro counterfeiting, in compliance with the already approved amendments to the Law on the BNB. On the basis of this cooperation agreement the BNB and the ECB started to exchange information on the technical aspects of euro counterfeiting, and statistical data.

Third, in July 2005 the BNB Governing Council approved the BNB Strategy for the Cash Circulation in 2005–2009 which further specifies the tasks set out in the Strategy for Bulgarian National Bank development between 2004 and 2009 in the cash circulation area. The major points in this document are the preparation and adoption by end-2005 of the BNB basic regulations on the security and quality of cash in circulation; the construction of a modern BNB cash centre; reaching of an agreement with the banking community on a cash circulation organization scheme that would ensure a smooth changeover from the date of Bulgaria's membership in the euro area. The BNB developed, approved and proposed several versions of the scheme.

Fourth, in line with the Strategy for the Cash Circulation, a decision was taken to build a modern BNB cash centre. Its construction site has been determined and the Bank came into possession of the site. In July 2005 an internal committee, chaired by the BNB Chief Cashier, was set up and it prepared and presented a report on the organization of the project. The BNB is going to build the cash centre with partial automation and the centre will start operations in the second half of 2008.

Fifth, in line with the Strategy for the Cash Circulation, the BNB opened a dialogue with the banking community about the development of a safe, flexible and efficient cash circulation system. An agreement on the chosen scheme is expected by the end of this year or early next year. Consequently, contingent expenses may arise for the BNB budget for 2006 which will finance the fulfilment of commitments made by the Bank during the negotiations, after the end of the budget period.

**Recommendations:**

1. *In the dialogue with the banking community to assert the position that from 2007 the cash distribution must be organized on a market principle.*
2. *To adopt a detailed plan for the activities of building the new cash centre and thus guarantee that all deadlines will be met.*

## II.4. The Payment System and Oversight of Payments

**Assessment:** *Considerable progress has been made in the area of payment systems. All the activities follow the Strategy. There is a delay in the introduction of the EMV standard.*

Great progress is made with regard to the main priority in this area: the systemic risk reduction and integration of the system into the euro area payment system.

In compliance with the Strategy, a stable, reliable, safe and efficient national payment system is maintained – 99.7 per cent efficiency of the RINGS system is ensured, there is no loss of information or any lost payments. The number of payments over the period rose by 24 per cent, with customers' payments being the most significant portion.

In line with the Strategy, much progress is made in the oversight of payment systems. The elaboration of the legal framework for this very important for the financial stability activity, through the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems adopted in 2005, created conditions for an efficient oversight. The systems included in the national payment system are under constant monitoring. The BNB units are evaluating to what extent the national payment system is in compliance with the principles and standards of the European Central Bank and the Bank for International Settlements. On this basis recommendations are made for improving the function of the national payment system. So far supervisory inspections have been carried out of: the system for the service of customers' payments initiated for execution at a designated time (BISERA); the system for the service of card initiated payments in the territory of Bulgaria (BORICA); the system for servicing payments on government securities transactions (Government Securities Depository); the system for the service of payments on book-entry securities transactions (Central Depository). The outcome from all these examinations indicates a high degree of compliance of the above systems with international standards and practices. Actions are planned to ensure full compliance, mostly by increasing the operators' technical capabilities and adapting to the requirements for participation in the Eurosystem.

The preparation of the national payment system for integration into the euro area payment system, another strategic priority, is in progress.

The close coordination and collaboration with the national and international institutions involved in the payment process is an important element of this preparation. For this purpose a new legal and regulatory framework was developed, which

until now did not exist, evaluations are made of the compliance with the BIS core principles for systemically important payment systems.

Over the past year there was a constant dialogue with the payment system participants, the ECB and the BIS.

As the Strategy requires, a National Council for Payment Systems<sup>1</sup> was set up which includes representatives of various institutions involved in the payment process, and the major goal of this Council is to prepare a strategy on the development of payment systems, and organize and coordinate Bulgaria's financial integration into the euro area payment systems and the implementation of the Single European Payment Area Project. Rules for the operation of this Council were adopted, and its two working groups function intensely.

We have prepared and are to adopt a National plan for the implementation of the Single European Payment Area in Bulgaria. Tests are underway for the introduction of the next RINGS version. Under Ordinance No. 13, a Plan for the Implementation of the IBAN Project was developed and it will solve some of the issues related to the general improvement in the payment process in Bulgaria. All these changes involve the application of the SWIFT international standard for the messages used by the BISERA system and the removal of the BIN numbers for budget payments. We have drafted the SEBRA specifications and are going to draw up a document on the MF policy for budget payments and the future development of SEBRA and revise the temporary guideline of the BNB and the MF 03-13003 Opening and Keeping Budget Accounts and Making Budget Payments.

The BNB supervises all participants in the national payment system although the Bank has operational control only over RINGS. All payment systems in Bulgaria have been included in the National Indicative Plan for the Development of Payment Systems. The BNB requires that these systems define clear rules and procedures, that they monitor each system's effect on risks and have precise procedures for managing credit and liquidity risks.

The Strategy makes commitments to changes in the legal framework and these commitments have been fulfilled. The Law on Funds Transfers, Electronic Payment Instruments and Payment Systems, Ordinance No. 13 on International Bank Account Numbers and Bank Identifier Codes, Ordinance No. 16 on Electronic Payment Instruments, Ordinance No. 3 on Funds Transfers and Payment Systems and guidelines to them were prepared and took effect.

In line with the Strategy, the sale procedure for BORICA is over. In May 2005 the BNB sold 63.76 per cent of its shares in BORICA to 25 commercial banks.

In accordance with the Strategy, which says that in 2005 card payments will ensure the application of the so-called EMV standard and thus security will be enhanced considerably, a National Committee was established for the implementation of this standard. As additional investments are needed for its application, commercial banks are slowing down the process. So the implementation will not take place in 2005 as was initially planned.

**Recommendation:** *The BNB, the MF and the Association of Commercial Banks to prepare jointly a policy for the development and expansion of non-cash payments.*

<sup>1</sup> The National Council for Payment Systems combines the interests of the participants in the payment process; coordinates the activities of the various institutions involved in the payment systems; makes proposals and develops terms of references for innovations in the payment system; defines the requirements for the integration of the national payment systems and will adapt the related regulatory framework.

## II.5. Banking Supervision and Regulations

**Assessment:** *The activities in the banking supervision area follow the Strategy of the BNB. There is no delay in the various components.*

In line with the Strategy, over the past year one of the BNB's major priorities and tasks in the banking supervision area was the preparation and introduction of the European banking legislation. A significant work was done in this area.

The EU directives on capital adequacy were fully transposed – a new Ordinance No. 8 was adopted together with a new package of return reports and instructions therefor. A unit was set up for the use of internal models. All the other tasks relating to the staff training have also been fulfilled.

One of the BNB's medium-term tasks is the preparation for and the implementation of the European directive for the new Capital Accord of the Basel Committee. The preparations started in the past year. A working group, with five subgroups on individual topics, was established. We sent and are still going to send guidelines and instructions to commercial banks regarding various topics. The development of a new ordinance on capital adequacy is underway. The staff training is a permanent process and includes training courses and seminars at home and abroad.

Together with the Financial Supervision Commission we drafted a law for the implementation of Directive 2002/87 on the supplementary supervision of financial conglomerates.

We have set up a mechanism for drawing up legal provisions that would renovate the Law on Banks and would achieve, from the present high level of harmonization, full compliance with the European banking legislation.

Another priority of the Strategy is maintaining a high level of sustainability that will be adequate for the increasing banking intermediation and free competition with EU credit institutions.

The Department formed a new inspection team and recruited more examiners. It changed and perfected the analytical tools of the supervision and made a number of amendments to the regulations to ensure stricter credit risk assessment.

The lending of commercial banks is monitored on a monthly basis. The methodology and techniques of the Early Warning System have been improved. The BNB updated the rules of credit risk assessment – the off-site supervision manual.

As the Strategy prescribes, another continuous task is the maintenance of a high level of transparency of the shareholder capital: the BNB demands, collects and analyzes a large amount of information; carries out specialized inspections; and firmly stands up for its position not to admit any shareholders whose financial capabilities, the origin and adequacy of capital have not been indisputably proved, and not to allow them to exercise control over capital. The BNB requires that the banks having insufficiently transparent shareholders' structure must make serious efforts to improve the capital structure and qualities of shareholders.

The BNB is building its capacity to carry out on-site supervisory inspections in the local commercial banks' branches and subsidiaries abroad.

In keeping with the Strategy the supervisory cooperation was significantly intensified and expanded: further to the 12 memoranda already signed, the memoranda with Serbia and Russia are heading for finalization, and the agreement with Austria is scheduled to be signed in November this year.

The preceding year was marked by an active interaction with the local authorities on matters of financial stability. The information exchange and coordination with the Financial Supervision Commission, the Financial Intelligence Agency and the Bank Deposit Insurance Fund improved. The BNB is actively involved in the work of the Financial Stability Council.

**Recommendation:** *To speed up the preparation for implementation of the financial and capital reporting forms, which are common for the EU.*

## II.6. Monetary and Banking Statistics

**Assessment:** *A substantial progress is made with regard to monetary banking statistics.*

Statistics is one of the key elements of the preparation for joining the ESCB. This calls for additional measures in order to meet the challenges and make up for the relative delay in some of the areas.

In the field of statistics the Strategy envisages the realization of two important objectives. The first one aims at bringing the monetary and banking statistics, the balance of payments and the external debt statistics, and the other elements of the financial statistics (the statistics of the sectoral financial accounts, financial instruments, payment systems and financial markets), which are BNB's responsibility, in line with EU standards by 2006 year-end. The second objective of the statistics is to ensure and maintain the required database and metadata for Bulgaria's participation in the Special Data Dissemination Standard (SDDS).

The second objective has already been successfully accomplished, while the realization of the first one is well underway.

Although 'flow statistics' has not been implemented in its entirety so far, a methodology on flow statistics was developed and sent to commercial banks. Presently, a 'Flow statistics' module to the Monetary Statistics Information System is in preparation. The first information to be reported by commercial banks is expected in mid-November 2005 with data for October. The survey will continue for three months and the submittal of data for the ECB is expected to begin by the end of the first half of 2006.

The Monetary Survey is already supplemented with short operational analysis as provided for by the Strategy. Since June 2005 the monthly Monetary Survey is published with a supplement 'Selected Monetary Indicators in Their Dynamics'. The supplement is published in the weekly information since April 2004.

The Strategy envisages seasonal adjustments of some of the indicators from the monetary and banking statistics. These have not been made as yet; however, they are envisaged to be made not later than the euro area accession date.

The Strategy envisages full compliance of interest rate statistics with that of the ECB. A substantial progress has been achieved in this area. Methodological guidelines on interest rate statistics are developed in line with ECB Regulation 18 (ECB/2001/18), which will take effect in 2006. The work has begun for developing the terms of reference for a new information system on interest rate statistics, which is also scheduled to be developed in 2006.

In the preceding year steps were taken towards expanding interest rate statistics with data on interest rates on various financial instruments. Changes were made to the scope and type of the published information on interest rate statistics, part of the *Weekly Monetary and Interest Rate Statistics* publication as a further step in the process of harmonizing interest rate statistics. This change is in effect developing and estab-

lishing new indicators (repo transactions and savings deposits in euro and US dollars), expanding the maturity structure of time deposits, full correspondence with the European definition in terms of the scope of overnight and savings deposits indicators. The changes in the data are disclosed also in time series on the BNB website. Interest rate statistics will be further expanded with the introduction of the new methodological guidelines in 2006. Full harmonization of interest rate statistics on the basis of ECB currently effective methodological requirements is to be achieved not later than 2006 year-end, provided the project is adequately supported in terms of software development.

The Strategy provides for expanding the scope of the currently compiled monetary statistics with the statistics on the other non-bank financial institutions, which are included under the institutional sector 'Financial corporations'. A proposal was made to the NSI for the inclusion of non-bank financial institutions statistical research data in the NPSS (National Programme of Statistical Surveys). The BNB works jointly with the Bulgarian Association of Leasing Business Development on the statistical forms for lease companies so that the first reports to the BNB contain data as at 30 September 2005.

In relation with the enhancement of the information exchange in the field of balance of payments statistics with the ECB and Eurostat, as provided for in the Strategy, internal controls were put in place for sending GESMES/TS format data.

As the Strategy provides for, harmonization with the Eurostat requirements in the area of balance of payments statistics is continuing. Instructions on collecting and processing balance of payments statistical data from the banks were prepared and disseminated with a view to satisfying the ECB and Eurostat requirements for providing a geographical structure of the balance of payments and the international investment position. The Information Systems Directorate is behind schedule in preparing the terms of reference and selecting a supplier of the system for processing data from commercial banks.

In compliance with the enhancement of the services reporting methodology, as provided for in the Strategy, new methodological guidance was introduced for reporting data from commercial banks to balance of payments statistics. Work has commenced for developing a methodology for collecting data from the insurance companies. The major challenge in this respect is non-compliance by some of the banks with the BNB requirements as was established following on-site examinations of the reliability of reported data in seven banks. The Strategy tasks for improving the services reporting methodology were further specified and comprehensively laid down in the Action Plan for the implementation of BNB commitments in relation to the participation in the ESCB, and the deadlines for their realization updated. The timeframe for improving the methodology for reporting the *Transportation* item is the third quarter of 2006, and the *Travel* item – the fourth quarter of 2006.

Reporting of direct investments is improved by means of streamlining the statistical forms of reporting direct investments. Work is going on with regard to tasks of various time horizons as specified in a joint publication by the ECB and Eurostat. This activity requires coordination with the NSI. New forms of reporting enterprises from the real sector and insurance companies are to be developed.

Reporting on portfolio investments has improved. New methodological guidelines for commercial banks were introduced with new forms for portfolio investments, assets, and the reports on portfolio investments, liabilities, from the Central Depository were improved. A major problem in this regard is the lack of information on the income accrued on portfolio investments, liabilities with the Central Depository.

One key commitment in the field of statistics is the development and implementation of quarterly financial accounts in line with the requirements of Regulation (EC) 501/2004 and the ECB. Better resource support was provided. Methodological work has commenced with regard to the compilation of the quarterly financial accounts so that the first pilot data are ready in 2006.

**Recommendations:**

1. *To catch up with the schedule on part of the Information System Directorate in developing terms of reference and selecting a supplier of the system for processing commercial banks' data.*
2. *To submit a draft amendment to Ordinance No. 27 on the Balance of Payments Statistics.*

## II.7. International Relations

**Assessment:** *The activity in this area is fully compliant with the Strategy.*

In the area of international relations the Strategy includes a package of measures aimed at BNB's successful integration into the ESCB. In this regard, all immediate objectives have been met:

- In February 2005 the Governing Council adopted a Plan for the accomplishment of the commitments undertaken in the process of negotiation in the field of legislation within the BNB competence for the 1 January 2005 – 31 December 2006 period, which is strictly followed.
- By Decision No. 32 of the Governing Council as of 7 April 2005 an Action Plan was adopted (Road Map) for the accomplishment of BNB commitments in relation to its participation in the ESCB. The Plan is being strictly followed. The overall internal regulatory framework of the process was adopted: Internal Rules for coordination of the preparation and the participation of BNB representatives in the meetings of the ECB General Council, the ESCB committees and working groups and in EU structures and bodies; Internal Rules for the exchange of confidential information between the BNB and ECB/ESCB. All employees involved in the process signed additional confidentiality declarations.
- In compliance with the Strategy, consistent and coordinated relations are maintained with the ECB for the purpose of implementing the European integration plan. Consultations with competent ECB experts are made on a continuous basis in relation to drafts of regulatory acts in the field of banking. Based on the contacts established three missions and meetings between ECB and BNB representatives were held to discuss the BNB preparation for ESCB membership.
- The employees who participate in the sessions of the Committees and the working groups, as well as those who are engaged in assisting the process, were trained on European integration issues, negotiation skills, ESCB issues, and English. Lecturers of the highest qualification were provided from the ECB, EC, the Council of Ministers, the Ministry of Foreign Affairs, *etc.* Each participant was given a specialized training of 100 man hours.<sup>2</sup>

<sup>2</sup> A seminar on *EU history, institutions, decision-making* was held on 28 and 29 April with lecturers from the Ministry of the Exterior and the Council of Ministers; a seminar on *ECB documents: processing and confidentiality* held on 11 May 2005; a seminar on *Legal, institutional framework and operation of ECB and ESCB* held on 12 May 2005; a seminar on *Structure, role and functions of ECB, ESCB and the Eurosystem* with the participation of Isabela Lindner from the National Bank of Austria; a training on the subject of International negotiations was held on 17 and 18 May 2005 led by Robert Weibel from the Centre for European Negotiations and Decision Making.

- In keeping with the Strategy in terms of entering into and implementing bilateral agreements with national central banks for the purpose of implementation of the European integration plan, bilateral agreements with the central banks of France and the Netherlands were concluded. The cooperation with other euro area central banks, such as the Central Bank of Austria, is expanding.
- The Strategy aims to ensure consistency in the structure and functions across BNB units with those of the committees operating in the ECB and the euro area. The accession process is carried out within the framework of the current organizational structure.
- Instead of setting up and training of a coordination unit for BNB's preparation for participation in the ESCB committees, a Coordination Group was set up with the overall activity being administered by the International Relations and European Integration Directorate. A decentralized approach was adopted for managing the overall process of participation in the committees and the working groups, which entails responsibility for the BNB representatives in the relevant committees as regards the efficiency of participation. A Committee on the issues related to the BNB participation in ECB/ESCB and the EU institutions was created, which includes all BNB participants in the committees and the working groups at the ESCB, as well as the staff directly involved in the preparation for participation in the meetings. The Committee consists of 65 employees from the BNB.
- The planning of and reporting on the budget for preparation and participation in the committees and the working groups at the ESCB and the EC structures is centralized. The funds spent in the period from the end of April to the end of September amounted to BGN 107,637.

The Strategy includes one key objective for the BNB in relation to the accession to ESCB, *i. e.* to ensure an efficient internal exchange of information in the course of preparation and participation in the ECB committees, to adhere to the consistency of positions in keeping with the Eurosystem rules. Within this context CebaMail was implemented. The IT Directorate created a virtual office, which provides user access to the information of every committee and working group. A system was developed for registration of the documents received. This medium, however, is far from sufficient to ensure coordination of the process, efficient use of resources and to guarantee economy of time as well as confidentiality of the huge document flow. In this relation, a key issue in 2006 for coordination and monitoring of the BNB participation in the ESCB is to establish an overall internal information system. The system will allow for expediency, confidentiality, as well as monitoring and control of the compliance with the internal (within the BNB) and external (set by the ECB) time limits for the fulfilment of individual tasks. Forthcoming is the implementation by ECB of ESCB-Net and Core-Net and purchase of teleconference equipment.

The information flow in 2006 is expected to increase by around 45 per cent, and after the accession by another 30 per cent. This requires more in terms of competence from both the staff directly involved in the meetings, as well as from those involved in the preparation of materials for these meetings.

A substantial progress has been made in the strengthening of the administrative capacity by means of providing the necessary technical assistance to the BNB staff. A two-year USAID-financed project *Financial Sector Integrity* is in a process of implementation. The project covers the area of money laundering, improving financial sector regulations and transparency – public disclosure and consumer protec-

tion. The activities under the agreements with the central banks of France and the Netherlands in the area of statistics, accounting, balance of payments, *etc.* are being successfully performed.

**Recommendations:**

1. *To expand cooperation with other euro area central banks.*
2. *To develop and launch within the shortest timeframe of the overall Information system for management and coordination of BNB activities with regard to the participation in ESCB and EC structures.*
3. *To exercise more efficient monitoring of the participation of BNB representatives in the committees and working groups and the degree of impact of this participation on the BNB preparation for joining the ESCB.*

## II.8. Government Agent

**Assessment:** *The BNB Strategy in this area is being pursued.*

The objectives laid down in the Strategy in relation to the BNB agency function are successfully accomplished and within schedule. The results from the activities carried out in fulfilment of the Strategy objectives are as follows:

- Communication with participants in the government securities market was improved in line with the international procedures and standards by means of introducing SWIFT and VPN (Virtual Private Network) as an alternative. This commitment has been met in both the auction system and as regards the processing of trades in government securities on the secondary market;
- In November 2004 a new independent system for government securities auctions (GSA) was launched. It allows for fully automated processing of the auction bids from entry to exit;
- A project for modernization of the electronic system for registration and servicing of book-entry government securities (ESROT), is under implementation and it is envisaged to be completed by 2005 year-end;
- A high degree of compliance is maintained with regard to the BNB operated system for registration and settlement of government securities in line with the CPSS/IOSCO and EXCB/CESR standards, which is also evidenced by the periodic assessments of the Association of Global Custodians, Thomas Murray, Disclosure Framework of BIS, *etc.*
- The changes in the servicing of the government debt infrastructure have moved ahead through a stage-by-stage redistribution of the tasks agreed between the Ministry of Finance and the BNB, which brought about a 15.5 per cent reduction in the BNB staff involved in the fiscal agency activities.

Work on the transposition of EU Directives on settlement finality and the financial collateral agreements in the Bulgarian legislation is in progress. The issue of settlement finality in government securities transactions is currently governed by BNB Ordinance No. 31 on Government Securities Settlement. In the light of ECB recommendations for this particular issue to be regulated in a law, a proposal is made to the Ministry of Finance to include it in the Law on the Government Debt, which governs the issuance of government securities.

**Recommendation:** *To prepare the systems operated by Fiscal Services Department (GSA, ESROT, AS ROAD and SBS) to ensure the necessary information for the BNB structural units whose responsibility is to analyze the banking system liquidity and credit operations in the euro area for the purpose of a better coordination between the monetary and fiscal policies.*