Bulgarian National Bank

REPORT • January – June 2006

BANQUE NATIONALE DE BULGARIE

Bulgarian National Bank

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

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

Under the provisions of Article 1, paragraph 2 and Article 50 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's Semiannual Report for the period ending 30 June 2006.

This Report was adopted by the BNB Governing Council on 26 October 2006 and published on the Bank's website (www.bnb.bg).

Ivan Iskrov
Governor
of the Bulgarian National Bank

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

By a Decree of the President of the Republic of Bulgaria of 13 June 2006 (Darjaven Vestnik, issue 32 of 2006), upon expiry of Garabed Minassian's term of office, Borislav Borisov was appointed member of the BNB Governing Council.

Governing Council

Ivan Iskrov
Governor

Emiliya Milanova
Deputy Governor
Banking Supervision Department

Tsvetan Manchev
Deputy Governor
Issue Department

Dimitar Kostov
Deputy Governor
Banking Department
and Fiscal Services Department

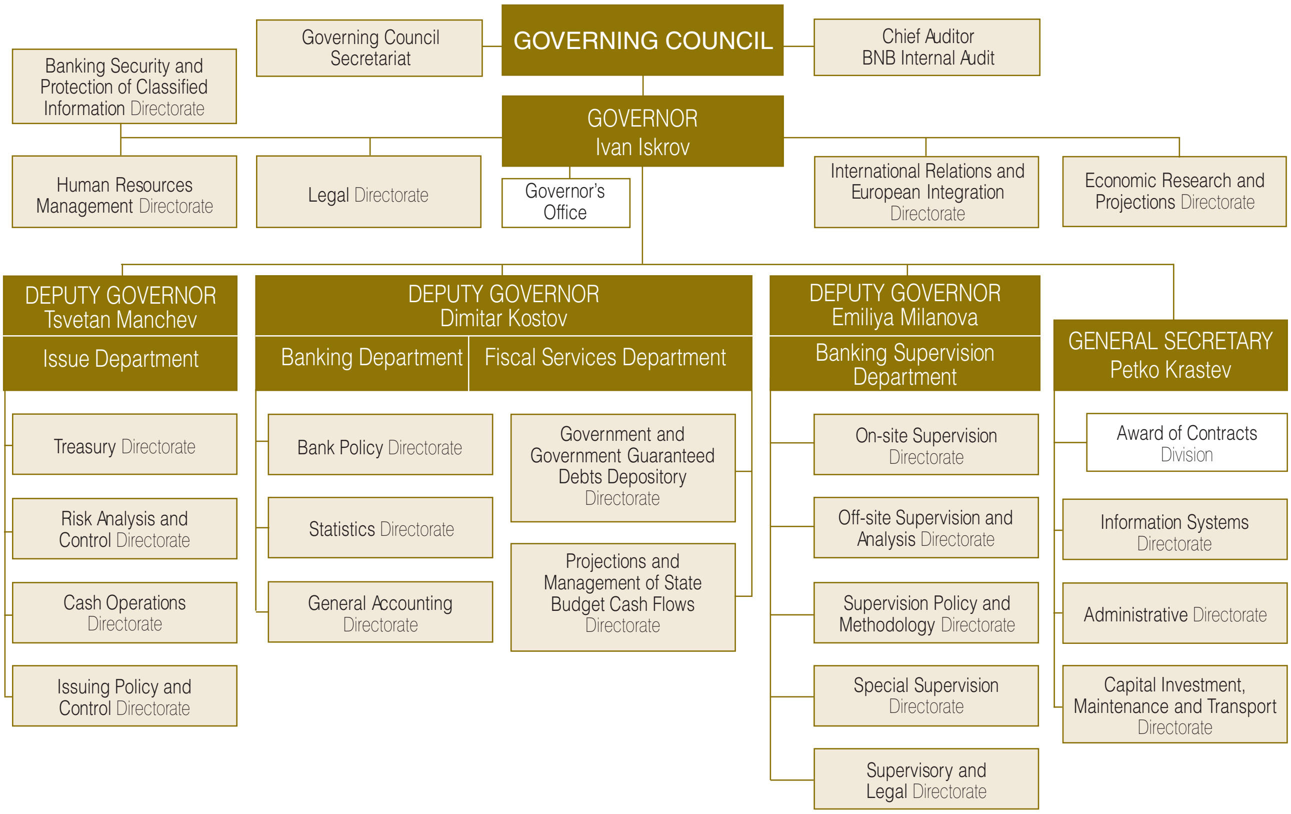
Nikolay Nenovsky

Statty Stattev

Borislav Borisov

Organizational Structure of the BNB

(as of January 2006)



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Abbreviations

ATM	Automated Tellers Machine
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
HISP	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
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
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

Bulgarian National Bank policy aims to accomplish the major objectives of maintaining price stability by ensuring national currency stability; managing international foreign currency reserves effectively; organizing and supervising payment systems, cash circulation and currency issue; and regulating and supervising Bulgarian banks to maintain banking system stability and protect depositors. BNB decisions on these major tasks rest on thorough analysis of trends in the world economy with especial attention to economic trends in the EU and their effect on the Bulgarian economy, and on evaluation of trends in Bulgaria's economy and financial system, taking account of risks associated with changes in the international situation. Bulgaria's economy enjoys high real GDP growth rates. To a great extent, these positive development trends reflect the consistent economic policy of prudent public finance management and the implementation of structural reform. The currency board plays an effective role as a major policy tool providing general macroeconomic stability and ensuring sustainable economic growth.

The external economic environment affects Bulgaria's economy significantly. It helped accelerate economic growth at relatively lower core inflation (excluding administered goods and services) than in the first half of 2005. Confidence in the economic policy being pursued, favourable prospects for Bulgarian accession to the EU in January 2007, and the higher relative return on investments in Bulgaria are the major factors determining the inflow of foreign capital: an important source of resources funding economic growth and investment in fixed assets. On the other hand, progressively rising prices of energy commodities and raw materials pushed imports up. Despite the faster growth of exports in the second quarter of 2006, the first half-year saw an increase in the balance of payment trade deficit, prompting a rise in the balance of payments current account deficit. The capital inflow on the balance of payments financial account funded the current account deficit and contributed to boosting gross international foreign currency reserves, whose market value reached EUR 7875 million by the end of June 2006.

Gross international reserves management is an important BNB duty performed within the requirements and constraints set out in the Law on the BNB and the opportunities provided by international financial markets. In early 2006 the international financial market expected rises in ECB interest rates, this leading to higher government bond yields in all maturity sectors in the first half of 2006, interest income being insufficient to offset capital losses incurred in fixed-yield instruments. To limit interest rate risk, the BNB decided to shorten the duration of euro-denominated assets to 0.5 years and raise the limit for a maximum exposure in deposits with prime-rate commercial banks from 30 to 40 per cent. International financial market developments over the second quarter proved the decision right. Net income from international reserves management over the reporting period totaled EUR 53.11 million: 0.81 per cent profitability in the first half of 2006.

In early 2005 the BNB enforced administrative constraints to curb lending growth to the non-government non-bank sector. Banks exceeding the administratively set growth rate had to deposit additional required reserves. In addition to these measures, 2005 saw a tightening of supervisory requirements. BNB measures yielded positive results, keeping credit growth in line with assets and borrowed funds growth, and stabilizing the capital adequacy ratio decline to a level matching banking system risk profile by the close of 2005.

In November 2005 the BNB amended Ordinance No. 21 after having assessed banks' adherence to credit constraints and with a view to ensuring compliance with the set credit growth rate. The amendments introduced a progressive scale of minimum required reserves, their maximum reaching 400 per cent of the excess of credit extended over the set limit. To eliminate opportunities for evading credit growth constraints, the amendments to Ordinance No. 21 extended the definition of credit to include bonds and other debt securities except ones issued or guaranteed by governments, central or local banks, or by entities with investment ratings assigned by leading rating agencies.

Additional measures were enforced also in respect of supervisory regulations. Amendments to Ordinance No. 8 on Capital Adequacy of Banks and Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were adopted in February 2006.

Amendments to Ordinance No. 8 concern claims on mortgage loans which now have to be reported as assets with a 50 per cent risk weight where a bank finances up to half the value of a mortgaged property instead of up to 70 per cent as formerly. Where banks finance more than half the property price, the risk weight is now 100 per cent. The amendment to Ordinance No. 9 unifies the definition of a bank guarantee when determining banks' capital adequacy ratios.

Based on June 2006 data, growth rates of claims on the non-government sector declined to 24 per cent from 42 per cent in June 2005. Given the favourable dynamics of credit aggregates and the falling efficacy of administrative measures, in June 2006 the BNB decided on a gradual lift of administrative constraints on lending growth to the non-government non-bank sector. As a first step, the progressive scale in calculating additional required reserves was removed and the initial rate of 200 per cent of the excess was restored. No changes to measures initiated to tighten supervisory regulations were foreseen. Moreover, in view of banks' transferring credit portfolios off balance sheets since early 2006, amendments were made to Ordinance No. 22 on the Central Credit Register. They introduced a requirement to provide information on loans due to third persons but serviced by local banks to the Register.

Overall banking system performance was good. Banks' deposit base posted sustainable growth, being the major source of lending expansion. During the January to June 2006 period no significant changes occurred in the banking system's risk profile; the quality of the credit portfolio stayed at a good level, with classified loans coming to 7.36 per cent at the end of June against 7.72 per cent in December 2005.

Implementing, operating and overseeing efficient payment systems is an important central bank duty. In early 2006 under the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems the BNB issued licenses to Bulgarian payment system operators Bankservice AD and BORICA AD. An important step to the faster integration of the Bulgarian financial market into international financial markets was the launch of international bank account numbers (IBAN) and Bulgaria's inclusion into the European Payments Council's Register.

IBAN launch entailed changing some 10 million bank account numbers in Bulgaria and affected domestic and international payments. Commercial banks, system operators, the Association of Commercial Banks, the Customs Agency, the Social Assistance Agency, the National Revenue Agency, and the National Insurance Institute took part in implementing this sizable project. The BNB initiated, planned, coordinated, and underpinned the project's statutory aspects. The project entailed significant changes in payment systems information technologies: the RINGS real-time interbank gross settlement system, the BISERA system for servicing customer payments initiated for execution at a designated time, the BORICA bank card payments organization, the System for Servicing Payments on Transactions in Book-Entry Government Securities, the Central Depository information system, and commercial banks' information systems.

BNB spent BGN 6,523,000 (24 per cent of operational expenditure) on servicing currency in circulation, including banknote printing and minting circulating and commemorative coins. Spending on currency circulation aimed to uphold the purity, security and efficiency of money in circulation. In addition, the BNB harmonized its cash operations with those of EU members. As a result, on 31 March 2006 the Bank adopted Ordinance No. 18 on the Control over Quality of Banknotes and Coins in Cash Circulation. The

Ordinance set terms and procedures for reproducing Bulgarian banknotes and coins; exchanging mutilated or damaged Bulgarian banknotes and coins; retaining, authenticating, and assessing suspect banknotes and coins; using banknote and coin sorting machines and customer-operated banknote and coin dispensing machines. Commercial banks and other service suppliers are mandated to ensure banknotes and coins are authenticated to BNB criteria before passing them on.

With regard to Bulgaria's European Union membership, the BNB adopted a programme to speed harmonizing banking and finance legislation and Bank experts participated actively in drafting the Law on Consumer Credit, the Law on Credit Institutions, the Law on Supplementary Supervision on Financial Conglomerates, and the Law on Financial Security Contracts. Adopting these statutes brings Bulgaria's banking and financial legislation into line with EU legislative requirements.

BNB responsibilities increased following the signing of the Treaty of Accession of Bulgaria and Romania to the European Union on 25 April 2005 and the Bank's acquiring observer status on ESCB committees and working groups. The Governor took part in the ECB General Council meetings in March and June. BNB officers participated in sessions of the 12 ESCB committees and in some committee working groups, as well as in the specialized working groups. BNB representatives took part in the sessions of other bodies to the EU Council and the European Commission. The BNB Governor took part in the informal EU Council of Ministers' meeting on financial and economic issues, held in April in Vienna, and BNB representatives participated in the sessions of the Economic and Financial Committee and its substructures (the Committee on Financial Services, the European Banking Committee, and the Committee of European Banking Supervisors and its Contact Group).

As participant in EU structures and institutions, the BNB aimed to improve its organization and boost efficiency. In the first half of 2006, as in 2005, the BNB's additional commitments in relation to EU membership were discharged without increasing staff. This remained at 931 persons against an establishment of 1007. The human resources system applied for a year encourages employees to boost their skills and efficiency. It is supplemented by a targeted training and proficiency improvement programme.

A number of projects to improve information infrastructure and software are underway. Spending on them accounted for approximately two-thirds of the BNB investment programme for the first half of 2006. The recommendations of regular internal audits were significant in improving BNB organization in the first half of 2006. Audits covered currency circulation, the BNB's role as government agent, information analysis and administrative aspects. With regard to BNB commitments for EU membership, projects are in progress to harmonize Bank statistical reporting with ECB requirements and develop analytical instruments and forecast models.

Internationally, an event which attracted attention in the first half of 2006 was the visit by ECB President Mr Trichet. Future cooperation between the ECB and the BNB in the process of preparing the Bank for ESCB participation was discussed during the visit. The BNB enjoyed the honour of producing and hosting the Financial Stability and Economic Integration: the 13th Meeting of Governors of La Francophonie Central Banks, between 11 and 13 May in Sofia. ECB President Jean-Claude Trichet and governors and deputy governors from 27 central banks worldwide took part in the meeting.

The Bulgarian National Bank continually extends its cooperation and exchanges of experience with other central banks. A new aspect of cooperation was the provision of technical assistance to Albania, Macedonia, and Kosovo, focusing primarily on EU integration, harmonization with EU *acquis communautaire,* international reserves management, payment systems and statistics.

I. Economic Development in the First Half of 2006

The business environment in the first half of 2006 featured accelerated global growth and greater inflationary expectations due to rising world market prices of energy and major raw materials. The external environment influenced Bulgaria's economy by boosting growth and exports, keeping imports at relatively high levels, and increasing the trade balance and current account deficits. The current account deficit was financed by net capital inflows attracted by sound economic policy and good prospects associated with pending EU membership, and by relatively high returns on investment alongside increasing international reserves.

As required by the currency board mechanism, part of international reserves growth was transformed into reserve money and monetary aggregates growth. Broad money marked an annual growth of 20.9 per cent by the end of June. As a result of BNB measures to moderate credit growth, non-governmental sector claims marked an annual growth of 24.2 per cent.

The considerable increase in tobacco prices after the new excise rise pushed inflation up. By mid-year it had started declining to reach 8.2 per cent in June.

Interbank money market liquidity remained high with the average monthly interest rate on deposits and repo operations fluctuating between 2.27 per cent in January and 2.71 per cent in June, affected mainly by the increase in ECB main refinancing operations interest rates.

On 1 March Moody's international rating agency upgraded Bulgaria's rating for long-term government bonds in foreign and local currency and raised the ceiling for foreign currency bank deposits to Baa3 and for local currency bank deposits to Baa1, consistent with its assessment of a stable economic environment and favourable economic trends.

1. The External Environment

In the first half of 2006 the world economy continued to develop at a robust pace. The leading Chinese economy grew strongly by 10.9 per cent in the first half with investment growth and positive net exports. A more favourable euro area and EU business climate led to accelerated second quarter growth. In the USA, GDP growth also accelerated, with lower private sector consumption and an investment slowdown counterbalanced by the increase in exports and government consumption.

Energy and major raw materials' prices continued rising and brought inflationary pressure to bear as a result of high demand and restricted production in the first half of 2006. Brent crude oil prices went above USD 75 a barrel at the end of June, the average increase for the period being 32.6 per cent compared to the first half of 2005. The growing threat of sanctions against Iran and the interruption of Nigerian exports resulting from subversion there were among the major factors pushing up crude oil prices.

Great demand in China, low supplies, and speculation by big hedge funds led to higher metal prices. Zinc, copper and aluminum increased by 115, 82, and 38 per cent respectively on the first half of 2005. Foods prices rose moderately by 8.3 per cent on average. Sugar saw the greatest increase of 90 per cent compared to the first half of 2005 due to increased demand for sugar cane used in ethanol making. Cereals went up by 12 per cent as a result of the expected low quality wheat crop in North America.

Major Macroeconomic Indicators (average annual change)

(%)

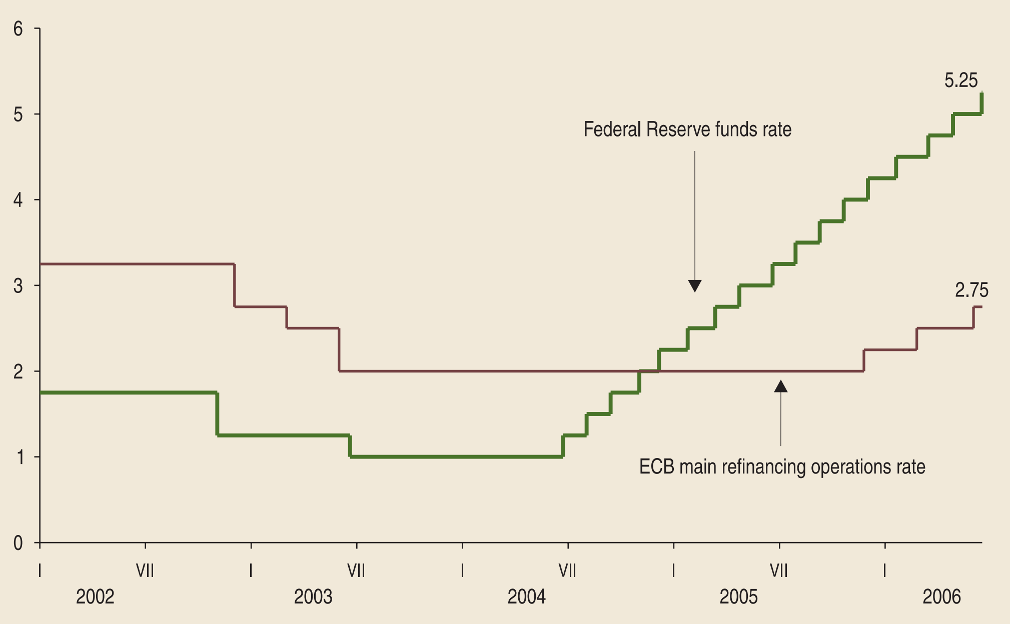
	Growth				Inflation				Unemployment			
	2004	2005	2006 I quarter	2006 II quarter	2004	2005	2006 I quarter	2006 II quarter	2004	2005	2006 I quarter	2006 II quarter
USA	3.9	3.2	3.7	3.5	2.7	3.4	3.6	4.0	5.5	5.1	4.7	4.7
EU-25	2.4	1.6	2.2	2.6	2.1	2.2	2.2	2.4	9.1	8.7	8.2	8.4
Euro area	2.1	1.3	2.0	2.4	2.1	2.2	2.3	2.5	8.9	8.6	8.1	7.9
Newly acceded countries	5.0	4.0	5.4	:	4.1	2.5	2.0	2.3	14.2	13.4	12.8	12.4
Japan	2.6	2.3	3.4	2.2	0.0	-0.4	0.4	0.7	4.7	4.4	4.4	4.2
China	10.1	9.9	10.3	11.3	4.0	1.8	1.2	1.4	4.2	4.2	:	:

Note: Inflation in newly acceded countries has been computed by weighing harmonized indices of individual countries' consumer prices based on EU-25 countries weights in HICP.

Source: Eurostat, Bureau of Labour Statistics, Bureau of Economic Analysis, Statistics Bureau of Japan, National Bureau of Statistics of China, BNB computations.

Key Federal Reserve System and ECB Interest Rates

(%)



Source: US Federal Reserve System, ECB.

The first half of 2005 saw an increase in global inflation. The average inflation in the USA accelerated to 3.8 per cent in the reporting period, and 2.4 per cent in the euro area.

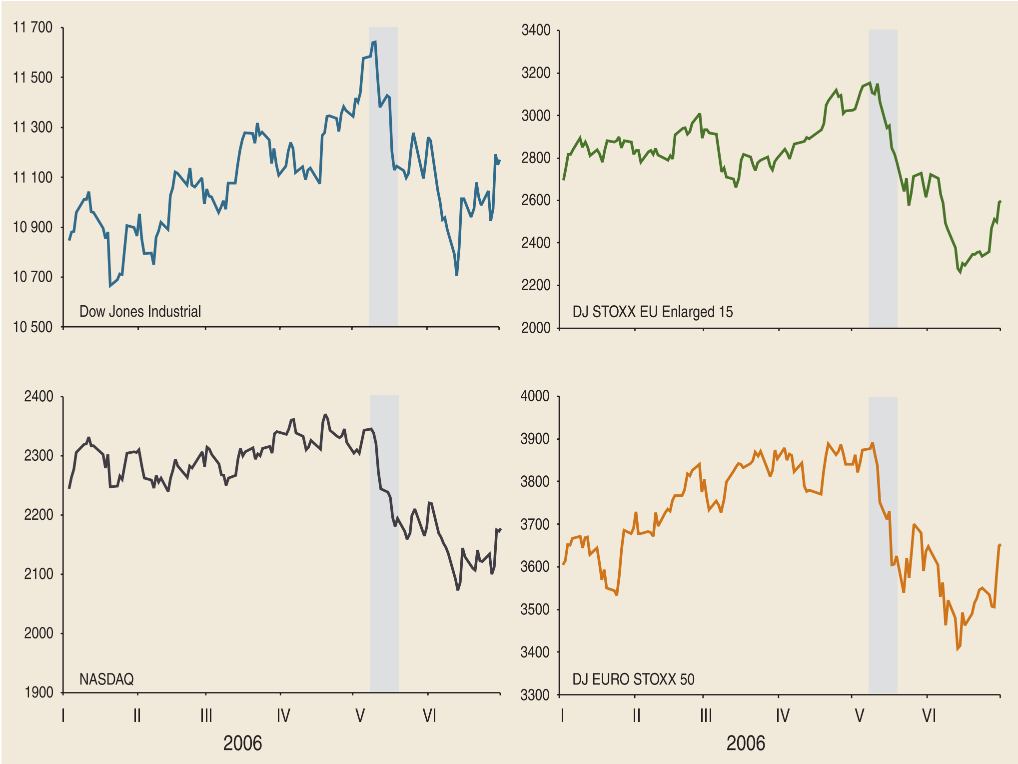
To counteract inflationary pressure, the US Federal Reserve System and the ECB continued raising interest rates. There was a fourfold increase in US federal funds interest rates by 25 basis points to 5.25 per cent. The ECB raised its main refinancing operations interest rates twice by 25 basis points reaching 2.75 per cent[1].

The expected rise in future short-term interest rates called for higher government bond profitability in all maturity sectors in the first half of 2006. Long-term interest rates rose somewhat more than short-term ones, influenced by growing long-term inflationary expectations due to petrol price growth and improved short-term global growth prospects.

As a result of the general increase in profitability of all maturity sectors reported over the first half of 2006, fixed-income instruments featured negative capital balances. These were not compensated by the positive coupon income earned in longer-term maturity sectors, prompting negative profitability for the period as a whole.

[1] On 3 August 2006 the ECB decided on a new interest rate rise by 25 basis points, the main refinancing operations interest rate reaching 3 per cent on 5 October.

Major Fund Indices



Source: Dow Jones, STOXX, NASDAQ.

As part of the trend since the first half of 2005, leading indices moved upwards in most months of the first half of 2006. The increase in public companies' profits, high growth in the developed countries, and a more favourable economic environment (especially in the euro area) added to the positive rise in fund indices. In the middle of the second quarter, however, the trend broke and most leading indices lost most of the year's gains within two weeks. The Dow Jones STOXX EU Enlarged 50 fell by 8.7 per cent in the euro area, the Dow Jones STOXX EU Enlarged 15 fell by 18.3 per cent, the NASDAQ Composite fell by 6.7 per cent, and the Dow Jones Industrial fell by 4.7 per cent in the USA. This adjustment came as a result of intentions by three central banks (the US Federal Reserve System, the European Central Bank and the Bank of Japan) to increase interest rates. Unwilling to assume additional risk, investors converted accumulated income from risky asset classes, including equity, redirecting it into government securities. By the half year's end these market adjustments were shown to be temporary, some leading indices managing to recoup their earlier positions.

2. The Bulgarian Economy

Economic Activity and Inflation

In the first half of 2006 Bulgarian economy was characterized by high growth rates of gross domestic product which rose by 6.1 per cent on the corresponding period of 2005.

Over the review period gross value added increased by 6 per cent annually, its growth encompassing all major industries, with the exception of agriculture and forestry, still recovering from summer floods of 2005. Construction, manufacturing, energy, mining and quarrying, trade and financial services developed at high rates of growth. Exports in manufacturing, the main driver of growth, rose by 14.2 per cent in real terms compared with the same period of 2005.

Gross Value Added Real Growth

(%)

	2005		2006
	January – June	July – December	January – June
Agriculture and forestry	-4.4	-10.5	-1.7
Industry	10.1	4.8	8.9
Services	6.5	6.7	5.3
Total (base prices)	**6.8**	**3.8**	**6.0**

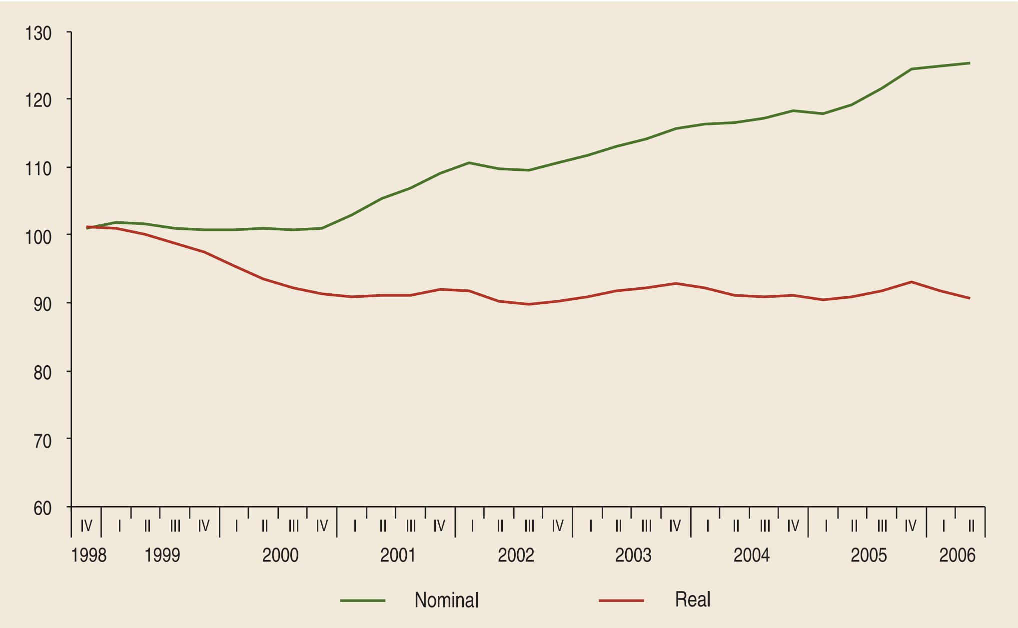
Source: NSI.

Investment in fixed capital played a key role in growth. In most industries, investment activity stayed high, with manufacturing, trade, transport and construction contributing most significantly to growth. Foreign investment inflows covered almost half of the firms' investment expenditure. In the last two years high real growth rates of investment in fixed assets boosted the technological level, productivity and efficiency of the economy. The improving production efficiency helped sustain the favourable trend in unit labour costs in manufacturing and total economy as an important indicator of economic competitiveness. This contributed to maintaining relatively high growth rates of exports.

Unit Labour Cost (Total Economy)

(four-quarter moving average)

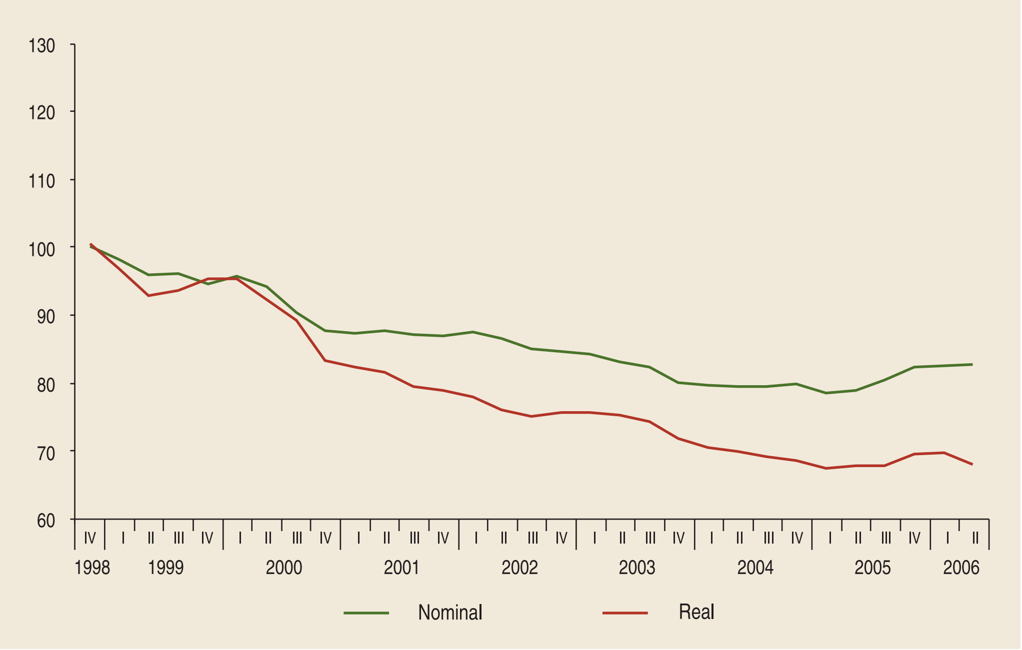
(1998 = 100)



Source: NSI, BNB.

Domestic demand continued to be a growth factor, equally due to consumption and to investment into fixed assets during the first half of 2006 despite the considerably higher share of consumption in GDP. Over the half-year the contribution of investment in fixed assets was approximately equal to that of household consumer expenditure. Although export growth accelerated, stronger imports pushed up the negative contribution of foreign trade balance to overall GDP growth.

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



Source: NSI, BNB.

GDP Growth by Final Use Constituents

(%)

	2005		2006
	January – June	July – December	January – June
GDP	6.2	5.0	6.1
Household consumption	6.5	8.7	6.6
Government consumer expenditure	7.5	4.3	4.5
Collective consumption	6.4	-1.0	0.7
Gross fixed capital formation	14.3	22.6	20.8
Exports	10.7	4.5	11.4
Imports	13.2	15.7	15.3

Source: NSI.

Increasing incomes are the major factor behind high consumer demand. Average income *per* household member picked up nominally by 14 per cent on an annual basis in the first six months of 2006 on the same period of the prior year, prompted by favourable employment dynamics; in real terms, the increase was 5.6 per cent.[2] The labour survey shows the average number of employed people in the first half-year up by 4 per cent on the prior year's corresponding period. Unemployment fell to 9.2 per cent by the end of June, down by 1.9 points on the respective period of 2005. Between January and June real salaries grew moderately by 1.5 per cent on an annual basis.[3] The household budgets survey shows entrepreneurship incomes growing most during the period. Based on these data, income grew faster than consumer expenditure, indicating that households could boost savings.[4]

While domestic demand has driven growth in recent years, the rise in administratively set prices and international fuel and commodity prices have underlain inflation. By June 2006 inflation accumulated since the year's start reached 2.9 per cent. Rises in to-

[2] According to the NSI monthly household budget survey.

[3] Deflated by the CPI.

[4] For further details on the dynamics of deposits and loans by institutional economic sectors, see Section VI, Maintaining Banking System Stability.

bacco product prices (by 75 per cent on December 2005) due to higher excise duty contributed most to this. The world crude oil price, up by over 30 per cent in the first six months, was an external inflationary factor. In June inflation rose to 8.2 per cent on an annual basis.

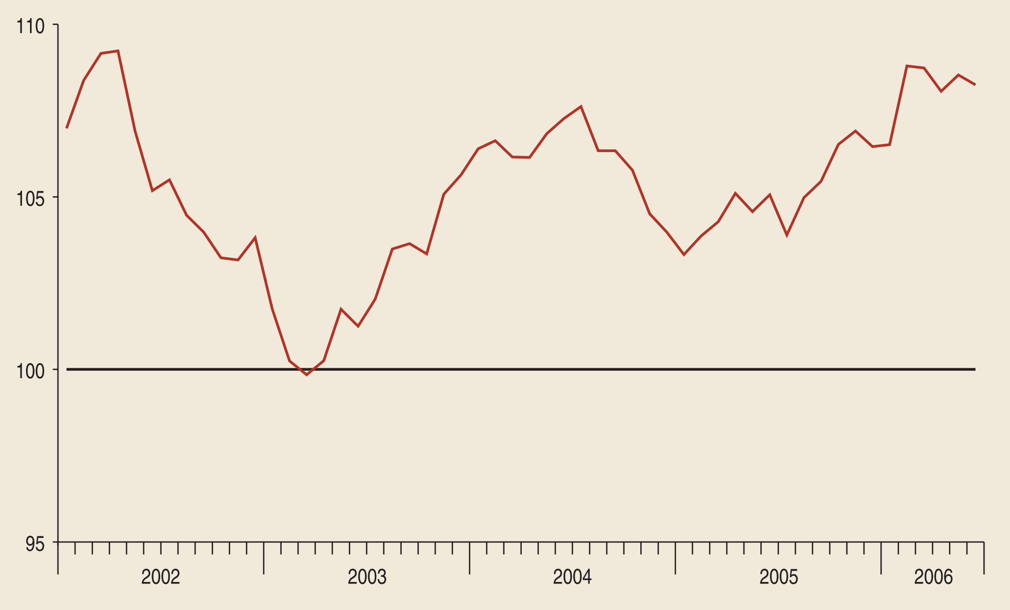
Inflation Accumulated since Year's Start

	January – June	
	2005	2006
Inflation, %	1.21	2.91
Contribution, p.p.		
Foods	-0.64	-0.47
Non-foods	0.86	2.93
Fuels	0.59	0.12
Public catering	0.16	0.15
Services	0.86	0.34
Goods and services with administratively set prices	0.52	2.78

Source: NSI.

Consumer Price Index (on an annual basis)

(%)



Source: NSI.

The rise in administratively set prices since early 2006 was considerably higher compared with the same time last year; it contributed 2.78 percentage points to overall inflation, 2.72 percentage points of which was down to tobacco prices. Higher urban transport fares and road tax contributed 0.03 and 0.02 percentage points respectively.

Core inflation for the first six months comprised 0.16 per cent; prices of transportation and household fuel and of services posted the highest growth (2.54 per cent and 1.33 per cent respectively).[5] Retail fuel prices on the home market reflected higher excise duty and world energy prices (Brent crude picked up by 8.4 per cent since early 2006). They were only partially offset by euro (lev) appreciation against the US dollar by 4.45 per cent

[5] Core inflation is calculated by excluding administratively set or approved prices of goods and services.

in the first half-year. Prices of non-foods (excluding services with administratively set prices and fuel) increased by 0.8 per cent since the beginning of 2006. Factors behind the rising prices of services (excluding those with administratively set prices) were increased rents and prices of services related to leisure.

The Balance of Payments

During the first half of 2006 capital inflows into Bulgaria rose dramatically compared with the same period of the previous year. The net surplus in the balance of payment financial account totaled EUR 1890.5 million over the period: an improvement of EUR 456.4 million on the respective period of 2005. The surplus stemmed from foreign direct investments (EUR 1411.8 million), net loans received from the non-financial sector (EUR 804 million) and loans received from commercial banks (EUR 239.5 million).

Capital inflows pushed up domestic demand strongly, and especially investment demand. In its turn, part of buoyant domestic demand was satisfied by imported goods, with commodities and fuel, as well as investment goods, occupying a relatively big share in imported goods. In addition to domestic demand, imports reflected the rising international prices of crude oil and major raw materials. Between January and June total goods imports picked up by 26.8 per cent on the same period of the prior year and energy commodities, raw materials and investment goods had the greatest contribution (11.1, 7.8 and 5 percentage points respectively). Imports of consumer goods also increased but had the smallest contribution to total imports (3.3 percentage points).

The nominal growth in energy commodity imports by 61.7 per cent compared with the corresponding period of 2005 stemmed both from the 39.2 per cent rise in the average euro price of imported crude oil and its 27.7 per cent volumetric increase. Concurrently, the average euro price of exported petroleum products went up by 35.2 per cent and their physical volumes by 80.3 per cent. Irrespective of the favourable trends in real exports of petroleum products, the foreign trade balance formed by imports of crude oil, petroleum products and natural gas, and exports of petroleum products, was negative and the deficit rose by EUR 192.8 million on the same period of 2005. This deficit accounted for 37.5 per cent of the total trade balance during the first six months of 2006.

The first half-year saw a 30 per cent growth in exports attributable mostly to raw materials (11.8 percentage points), energy commodities (11.1 percentage points) and investment goods (4.6 percentage points). Despite the second quarter trend of imports lagging behind exports, the half-year trade balance deficit increased by EUR 351.3 million. The negative trade balance to a great extent determined the balance of payments current account deficit. Over the January to June period this came to EUR 1819.5 million, up by EUR 745.3 million on the previous year's corresponding period. Foreign direct investment inflows covered 78 per cent of this deficit.

In addition to being sufficient to cover the current account deficit, financial flows on the balance of payments formed a surplus; as a result, in the first six months of 2006 BNB international reserves increased by EUR 462.9 million (valuation adjustments excluded).

In structural terms, some 60 per cent of financial flows into Bulgaria comprised borrowings, including changes in net obligations between companies with foreign interest and direct foreign investors on financial, bond and trade credits which form part of foreign direct investment. By the end of June gross domestic debt reached EUR 16,593.3 million, up by EUR 2928.1 million (21.4 per cent) compared with June 2005. Debt growth was entirely down to the private sector whose foreign obligations went up by EUR 4215.3 million (54.3 per cent) while public sector obligations fell by EUR 1287.1 million (21.8 per cent). In the structure of private external debt, obligations on intercompany lending occupied 38.2 per cent and trade credits almost 10 per cent.

Public Finances

Consolidated state budget revenue grew at high rates in nominal terms prompted by buoyant economic activity. The trend towards an increase in indirect tax revenue in the revenue structure was sustained: it picked up by 3.6 percentage points to 41.3 per cent of total revenue and grants compared with the first half of the prior year. Revenues from value added tax on imports and excise duties contributed mostly to the growth of indirect taxes. The intensive increase in this budget revenue reflected the dramatic rises both in the prices and the physical volume of imports, mainly of fuel and other raw materials.

Consolidated state budget expenditure went up nominally by 5.9 per cent, while as a share of GDP it fell by 3.2 percentage points to 38.4 per cent in the half-year mainly due to lower capital expenditure and operating expenses. By June capital expenditure on the republican budget comprised 37.4 per cent and operating expenses 25 per cent of those set out in the Law.

The surplus on the consolidated state budget in the first half of 2006 came to BGN 1405 million or 3 per cent of the GDP projections for the year.[6] The primary surplus totaled BGN 1812.2 million (up by 16.7 per cent on the same period of 2005), comprising 3.8 per cent of GDP. The fiscal reserve grew by BGN 616 million since the start of the year reaching BGN 5127.6 million by the end of June in spite of early repayments of obligations to the IMF and the World Bank to the value of EUR 343.1 million in January and February. The government and government guaranteed debt to GDP ratio fell by 5.5 percentage points to 26.4 per cent. External government debt accounted for 20 per cent of GDP with the share of obligations in euro comprising 61.7 per cent. The trend to issuing government securities with longer maturity in line with the domestic debt management policy underlying the government strategy was sustained. By June 2006 the average-weighted maturity was seven years. The average-weighted residual term to maturity of the external debt was nine years.

The Financial Sector

Monetary aggregates continued to rise at relatively high rates reflecting intensified economic activity and the positive net capital inflow. Broad money posted an annual growth of 20.9 per cent by the end of June. Over the January to June 2006 period the M1 monetary aggregate rose by BGN 1000.7 million (8 per cent) and by the end of June its annual growth rate came to 20.4 per cent. In the first half-year currency outside banks picked up by BGN 107.4 million (2 per cent) and by the close of June its growth totaled 13.5 per cent, while overnight deposits reported a rise of BGN 893.3 million (12.7 per cent) and an annual increase of 25.7 per cent.

Quasi-money continued picking up steadily in line with rising incomes and increasing confidence in the banking system. Over the January to June period quasi-money rose by BGN 1279.4 million (10 per cent) with deposits with agreed maturity of up to two years increasing by BGN 1170 million (11.2 per cent), and those redeemable at notice of up to three months by BGN 109.1 million (4.7 per cent). Households' and non-financial corporations' deposits, which grew by BGN 1019.2 million and BGN 1114.9 million respectively in the first half of the year, were the major financing resource for bank lending.

The dynamics of claims on the non-government sector was affected by the measures taken by the BNB to moderate lending. Between January and June claims on the non-government sector went up by BGN 1544.6 million (8.3 per cent) and their annual growth stood at 24.2 per cent by the end of the period. Within the six-month period claims on non-financial corporations increased by BGN 511 million (4.5 per cent) posting an annual growth of 15.8 per cent by end-June, while claims on households registered a rise of BGN 956.1 million (13.8 per cent) and an annual growth of 38.7 per cent by the close of June.[7]

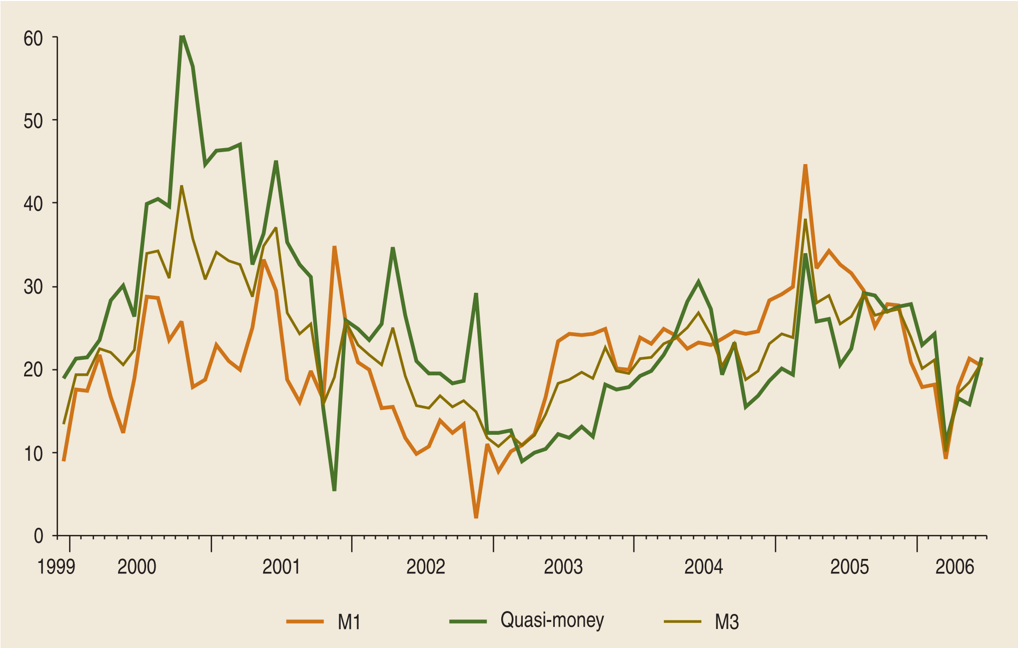
The real sector's need for long-term finance and banks' interest in extending longer-term loans continued changing the maturity structure of loans, with the share of loans with over a year's maturity increasing to 76.1 per cent by mid-year.

[6] GDP projections for 2006: BGN 47,407 million.

[7] For further details on the structure and growth of bank loans, see Section VI. Maintaining Banking System Stability.

Monetary Aggregates (Annual Growth)

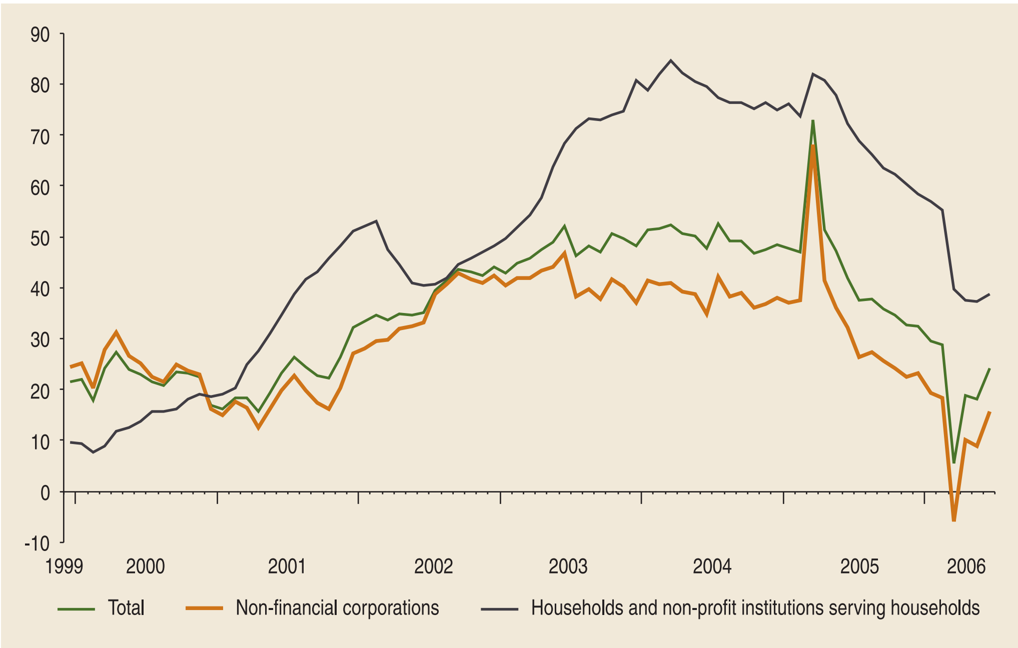
(%)



Source: BNB.

Claims on Non-government Sector (Annual Change)

(%)



Source: BNB.

On the interbank money market, the total volume of transactions increased by 16.9 per cent in the first half of 2006 on the same period of 2005. Deposits made up 95.9 per cent of turnover, followed by outright government securities transactions (2.4 per cent) and repo agreements (1.7 per cent). The average interest rate on term transactions came to 2.49 per cent and the monthly average of the average interest rate on interbank deposits and repo agreements varied from 2.27 per cent (in January) to 2.71 per cent (in June), the interest rate increasing in line with the ECB's decision to raise the interest rate on its main refinancing operations by 25 basis points in March and June 2006.

On the foreign exchange market, total turnover reached EUR 35,201.9 million in the first half of 2006:[8] up by 44.4 per cent compared with the same period of 2005. Turnover increases were reported both by interbank trading (by 59 per cent) and final customer trading (by 21.3 per cent).

Average Interest Rate on Interbank Money Market

(%)

Source: BNB.

The Ministry of Finance BGN-denominated issues included three-month discount treasury bills and three, five and ten-year fixed rate treasury bonds. Issues of three-month discount government securities became less frequent (two in the half year against four in the first six months of 2005), while the total nominal value of placements decreased to BGN 50 million. Placements of three and five-year government securities went up about 2.5 times in nominal value to BGN 107.7 million and BGN 135 million respectively, while those of ten-year government securities doubled to BGN 130 million. As a result, the total increase in placements of BGN-denominated government securities came to 87.9 per cent on the first half of 2005.

Outright transactions in domestic government securities between banks (including investment intermediaries approved as primary dealers) in the secondary government securities market totaled BGN 696.2 million (down by 38.1 per cent on the first half of 2005). BGN-denominated bond turnover fell by 34.6 per cent to BGN 638.3 million. EUR-denominated bonds dropped by 64.4 per cent to BGN 52.7 million, while the trade in USD-denominated bonds issued under ZUNK exhibited a dramatic rise to BGN 5.2 million.

EUR-denominated eurobonds maturing in 2007 closed the half-year at 102 per cent of nominal value. EUR-denominated global bonds maturing in 2013 were quoted at 117 per cent of nominal value and USD-denominated global bonds maturing in 2015 at 115 per cent.

Moody's 1 March 2006 upgrade in the rating of Bulgarian foreign and local currency long-term government securities to Baa3, and of the ceiling on local currency bank deposits to Baa1, was a factor supporting Bulgarian bonds' high prices.

[8] Turnover includes commercial bank transactions (including the BNB) in foreign currency against levs with a spot value date, same day value date, and next business day value date.

Corporate and municipal bonds were actively traded on the OTC market with subsequent registration on the stock exchange. The total volume of *bourse* trade in corporate and municipal bonds totaled BGN 160.6 million: up by 19.6 per cent compared with the same period of 2005.

The volume of the primary public offering market on the Bulgarian Stock Exchange, Sofia was formed by trading in rights on shares and came to BGN 3.7 million, while the turnover of shares on the secondary market reached BGN 1200.5 million (plus BGN 0.5 million payments to the Central Depositary on transactions on the OTC market). Transactions in rights on shares on the secondary market came to BGN 36.1 million: over 16 times more than the same period of 2005.

By the end of the half-year the shares' price indices rose closely to the technical limits of 160 points and 900 points for BG40 and SOFIX respectively. On 29 June BG40 reached a new record of 158.17 points. By June market capitalization of companies traded on the Bulgarian Stock Exchange, Sofia came to BGN 9914.4 million (22.2 per cent of 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 opportunities offered by world financial markets. BNB gross international reserves comprise the assets on the Issue Department's balance sheet which completely cover monetary liabilities under the fixed exchange rate.[9] The excess of gross international reserves over monetary liabilities forms the *Banking Department Deposit* item or the net value in the Issue Department's balance sheet.[10]

1. The Amount and Structure of Gross International Reserves

By 30 June 2006 the market value of gross international reserves came to EUR 7.875 billion, an increase of EUR 503 million or 6.8 per cent on the end of 2005. The change resulted from three major factors: net monetary inflows of EUR 434 million, earnings from investment of gross international reserves in financial assets to the amount of EUR 20.85 million, and net positive income from valuation adjustments in assets and liabilities of EUR 48.18 million.

Largest Cash Flows in the First Half of 2006

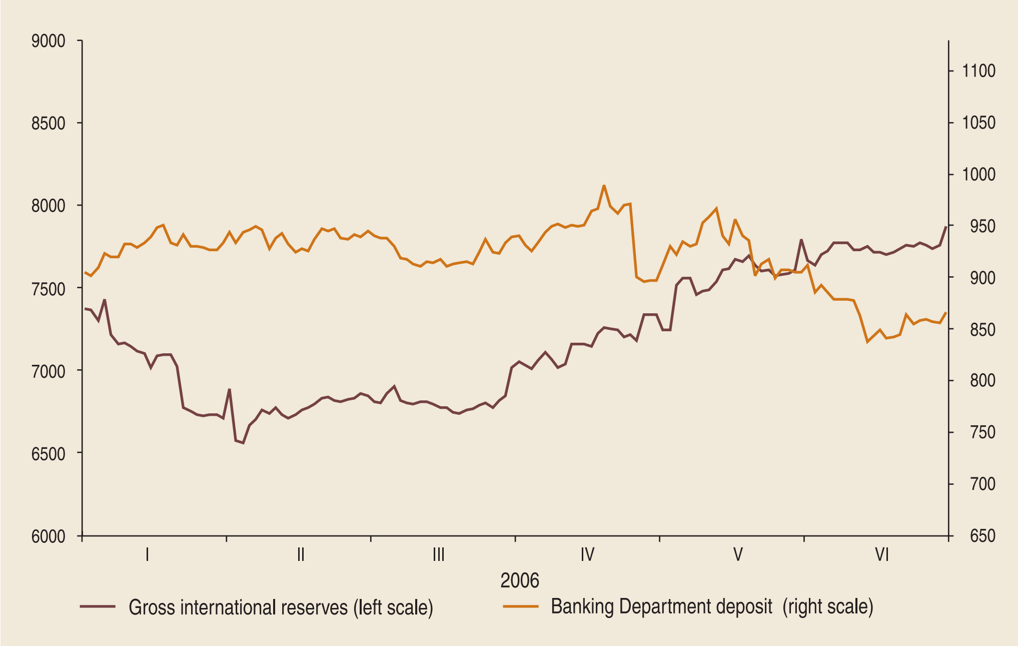
A)	**Euro purchases and sales**	**EUR**	**773 million**
	Net purchases from commercial banks, incl.:	EUR	785 million
	Euro purchases from commercial banks	EUR	5708 million
	Euro sales to commercial banks	EUR	4923 million
	Net euro sales at tills	EUR	12 million
B)	**Flows on commercial bank and government accounts**		
	(only larger external flows)	**EUR**	**-339 million**
	To increasing international reserves:		
	Revenue from servicing government and other BNB customer accounts	EUR	113 million
		USD	17 million
		SDR	10 million
	Net revenue from minimum required reserve accounts of commercial banks	EUR	603 million
	To decreasing international reserves:		
	Foreign currency payments on government and other BNB customer liabilities	EUR	929 million
		USD	141 million
		JPY	1.1 billion
		SDR	10 million

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

[10] 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,' and the lev equivalent shall be determined on the basis of the fixed exchange rate.

Gross International Reserves and Banking Department Deposit

(million EUR)



Source: BNB.

Payments on government debt service over the first half of 2006 included early repayment of EUR 147 million and USD 57 million of debt to the World Bank and EUR 151 million to the IMF.

The currency structure of gross international reserves changed in the review period, with euro and gold-denominated assets growing at the expense of others (primarily US dollars). The increase in euro-denominated assets reflected mainly net purchases of reserve currency from commercial banks to the amount of EUR 785 million. Another EUR 603 million was deposited with the BNB as additional minimum reserves maintained by commercial banks. The increase in the market value of gold assets reflected gold price rises on international markets. Decreases in USD-denominated assets were due to early external debt repayments by the Ministry of Finance and to insignificant receipts in US dollars over the reporting period.

Currency Structure of International Reserves

(%)

Currency	Issue Department balance sheet assets	
	2005	I – VI.2006
Euro	88.4	90.0
US dollar	3.5	0.8
Gold	6.6	8.6
Special Drawing Rights	0.6	0.6
Swiss franc	0.9	0.0

Note: Average data for the period.

Source: BNB.

In the structure of liabilities, monetary liabilities denominated in Bulgarian levs and euro exceeded 99 per cent on average.

Changes in the structure of assets by financial instrument reflected international financial market dynamics. The share of assets in cash and deposits with foreign banks increased at the expense of securities. Changes in gold stocks kept at BNB vaults were due to gold price rises on international markets. Over the review period over two-thirds of assets were invested in securities.

Structure of Gross International Reserves by Financial Instrument

(%)

Instruments	2005	I – VI.2006
Vault cash*	11.7	18.4
Deposits**	10.2	11.1
Securities**	75.5	67.1
Gold in the vault	2.6	3.4

* 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 assets by residual term to maturity underwent more significant changes. Due to constraints on interest risk (duration) adopted in the beginning of the second quarter of 2006, the share of assets with residual terms to maturity of up to a year increased to some 74 per cent. This rise resulted in decreased proportions of assets of all other maturity sectors.

Structure of Gross International Reserves by Residual Term to Maturity

(%)

Maturity sectors	2005	I – VI.2006
Up to 1 year	59.1	73.5
From 1 to 3 years	15.8	11.6
From 3 to 5 years	12.8	4.5
From 5 to 10 years	11.7	10.0
From 10 to 30 years	0.6	0.5

Note: Average data for the period.

Source: BNB.

2. Gross International Reserves Risk and Income

The Market Environment

European benchmark government bond yield rose steadily over the first half of 2006, reflecting relatively buoyant economic activity and high inflation, as well as growing expectations of changes in ECB monetary policy. Two-year benchmark bond yield reached 3.57 per cent (up 71 basis points for the review period), whereas ten-year bond yield picked up to 4.07 per cent (up 76 basis points). In the second quarter the two-year benchmark bond yield rose less rapidly than ten to thirty-year yields. Rises in long-term interest rates were mostly affected by enhanced long-term inflationary expectations due to high oil prices and improving short-term prospects for euro area economic growth.[11]

Indices of Realized Overall Yield on Government Securities Issued by Euro Area Countries (Quarterly)

(% for the period on an annual basis)

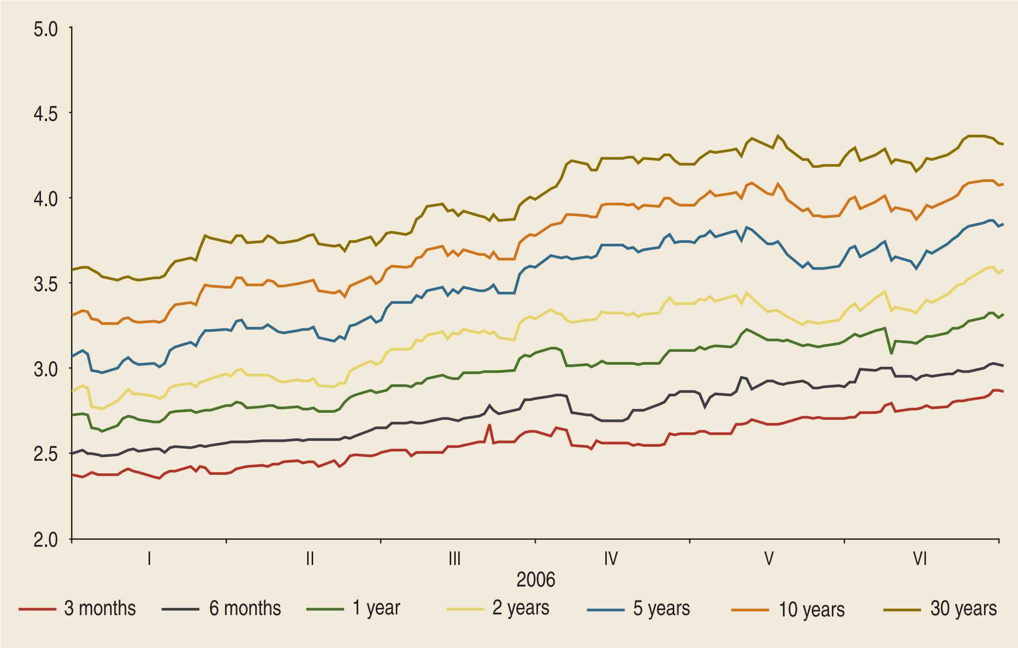
Maturity (years)	2006		2005				2004	
	II	I	IV	III	II	I	IV	III
1–3	0.44	0.04	-0.12	0.01	1.49	0.69	0.92	1.06
3–5	0.01	-0.89	-0.55	-0.16	2.69	0.85	1.72	2.01
5–7	-1.70	-0.37	-0.59	0.05	3.63	1.00	2.59	2.73
7–10	-0.93	-2.53	-0.35	0.47	4.61	1.22	3.52	3.35

Source: Merryll Lynch.

[11] For more details on international economic developments, see I.1. The External Environment.

Yield Curve Dynamics of Government Securities in EUR

(%)



Source: BNB.

EUR Government Securities Yield Curve Change

(b.p.)

Source: BNB.

The overall upward trend in market yields of fixed income instruments led to capital losses. In some maturity sectors, they failed to be offset by the coupon income achieved over the reporting period, particularly impacting long-term securities of over seven years' maturity.

Over the first and second quarters indices measuring realized overall yield of government securities issued by euro area countries showed negative values in the sectors of over three years. Depending on maturity, these values fluctuated between -2.53 and -0.37 per cent over the review period. Since government securities of higher duration are more sensitive to interest rate levels of the yield curve, the worst results were in the seven to ten-year sector.

Given these trends on international financial markets since early 2006 and in line with the low risk tolerance at the end of the first quarter, a decision was taken to limit interest rate risk assumed by the BNB by setting the maximum duration of assets in euro at 0.5 years. Reduced exposure to long and medium-term government securities set higher limits for maximum exposure in deposits with prime rate banks (up from 30 to 40 per cent of the market value of assets). This gives an opportunity for the bulk of international reserves to be placed in the form of short-term deposits, bearing practically minimum interest rate risk.

One Troy Ounce Gold Price in US Dollars

Source: BNB.

US Dollar Price in Euro

Source: BNB.

One Troy Ounce Gold Price in Euro

Source: BNB.

Gold is an important component of international reserves. The upward gold price trend continued over the review period in line with the increased risk of global price instability, gradually aggravating political tensions over Iran's nuclear programme, and significantly accumulated hedge fund speculative interests. In mid-May the gold price reached a 26 year high of USD 722.55 per troy ounce, followed by mass sales in the beginning of the third week of May as a result of market participants' reduced propensity to assume risk. Liquidation of long positions in gold futures cut the gold price to USD 565 in mid-June. After this period, more moderate growth was reported, with the price fluctuating between USD 600 and USD 660.

Major Types of Risk

Over the reporting period international reserve **interest rate risk** measured by reserves' average *modified duration* was 1.07. It decreased on 2005 (1.69) due mainly to interest rate risk limits introduced in the early second quarter of 2006.

The early 2005 requirement that absolute values of open foreign currency positions[12] in currencies other than euro, SDR, and monetary gold should not deviate by more than 2 per cent from the market value of monetary liabilities in these currencies set limits to international reserve **currency risk**. In the reporting period minimum open currency positions in currencies other than euro were maintained, with timely currency regulation intervention (buying and selling foreign currency for euro) whenever the 2 per cent limit was exceeded. The open gold position posed the major currency risk to the BNB.

Credit risk was managed by setting minimum credit ratings and maximum exposure to the respective asset classes. Funds invested in assets with the highest credit rating (AAA) averaged 60 per cent during the period under review. The Bank's exposure rose to 28.9 per cent on average of total assets (23.5 per cent in 2005).

Operational risk was managed in strict compliance with, and control over, relevant business procedures for international reserve management.

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

Profitability and Efficiency

In the reporting period net earnings from BNB international reserve management came to EUR 53.11 million: an asset profitability of 0.81 per cent for the first six months of 2006. Net earnings were formed by the following components: EUR 20.85 million income from investing international reserves in financial assets; EUR 48.18 million net positive income from foreign currency revaluation of assets and liabilities, primarily due to the open position in gold and the rising gold price in euro; EUR 15.91 million of interest paid on Issue Department balance sheet liabilities.

Profitability* of International Reserves, January – June 2006

(million EUR)

Quarters	Investment earnings (1)	Earnings from currency imbalance between assets and liabilities (2)	Expenditure (interest) on liabilities (3)	Earnings, net (1)+(2)+(3)
I	-14.08	61.70	-6.52	41.10
II	34.93	-13.52	-9.39	12.01
Total	**20.85**	**48.18**	**-15.91**	**53.11**
Profitability, share of assets,%	**0.24**	**0.78**	**-0.22**	**0.81**

* Six-month profitability.

The change in the net value corresponding to the *Banking Department Deposit* item in the Issue Department balance sheet resulted from two major factors: the net income from international reserves contributed to the net value rise by EUR 53.11 million, or a profitability of 5.62 per cent; the contribution to the state budget for 2005, worth EUR 77.21 million, led to a decrease in the net value.

Risk and Profitability of Portfolios

Portfolio	Profitability		Risk		Information coefficient***
	Absolute (%)	Relative (basis points)*	Absolute (%)	Relative (basis points)*	
Investment 1, EUR	0.21	1	0.39	4	0.34
Investment 2, EUR	0.20	-2	0.41	3	-0.90
Liquidity, EUR	1.26	-0	0.13	1	-0.11
Liquidity, USD	2.34	-3	0.17	2	-1.18
Gold, XAU	0.04	4	0.25	31	0.13
External manager A, EUR	0.41	-5	0.56	18	-0.27
External manager B, EUR	0.02	-2	0.86	12	-0.17

* The positive relative profitability of an individual portfolio is the profit compared with benchmark profitability. If the profitability were negative, it would be shown as a loss of profit in portfolio management. Relative profitability is rounded to 1 basis point. If it is between -0.5 and 0, it is shown as '-0' and if it is between 0 and 0.5 it is shown as '+0'.

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

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

International reserves are split into portfolios by currency, each portfolio with a specific investment goal and benchmark. To diversify management styles and reduce operational risk, the bulk of euro-denominated assets continued to be split in two investment portfolios for management by different teams. In the review period a portion of international reserves has again gone under external management (8.12 per cent by the end of the review period). Beside additional diversification, using external managers helped exchange expertise in investing on international markets.

III. The National Payment System

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

The 2005 Law on Funds Transfers, Electronic Payment Instruments and Payment Systems imposed a new requirement for payment system licensing. Accordingly, on 26 January 2006 the BNB granted licenses to Bankservice AD in Sofia and BORICA AD to trade as payment systems system operators within Bulgaria.

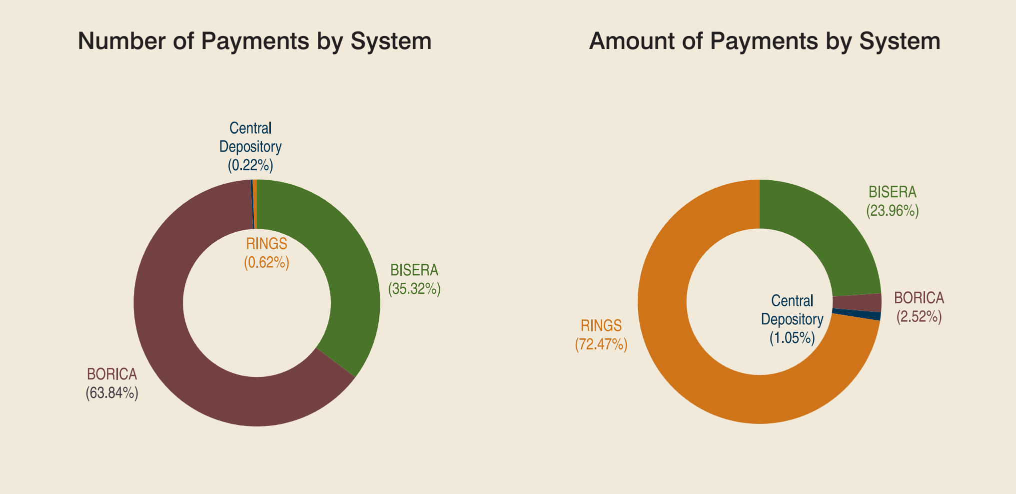
Bankservice operates a system for servicing customer transfers settled at a designated time (BISERA). This accepts and processes bank orders of up to BGN 100,000 with RINGS system day value date. It also sends RINGS a settlement request of results from the recalculated multilateral mutual obligations of system participants to a set schedule and confirms settlement outcomes to participants.

BORICA services bank card payments by collecting and classifying information on interbank payments initiated by cards issued by domestic Bulgarian banks. It processes information and sends RINGS a settlement request of the results of the recalculated multilateral mutual obligations of participants to a set schedule, acts as an intermediary between the issuer and the international card organization and advises banks on the settlement outcome of payments.

The BNB and all commercial banks, the Central Depository AD System for Servicing Payments on Transactions in Book-entry Government Securities, the BNB System for Servicing Payments on Government Securities Transactions, and the BNB's RINGS (Real-time Interbank Gross Settlement System) are also participants in the national payment system alongside licensed operators. In the reporting period the number of RINGS participant banks fell to 32 after the acquisition of the Piraeus Bank AD Sofia Branch by Piraeus Eurobank AD.

Given the progressively growing volume and value of non-cash payments, the inability of a large bank to fulfil its obligations is a potential source of financial instability for the entire banking system. To minimize risk, the BNB is continuously looking at ways of improving the infrastructure for processing large payments.

Distribution of Payments in Bulgaria, January – June 2006



Source: BNB.

In the first six months of 2006, 0.62 per cent of the total number of payments were processed by the BNB's RINGS, comprising 72 per cent by value. The trend towards increasing the RINGS share of processed payments in terms of value continued, helping subdue risk. Payments through the other two system operators also grew, BISERA picking up by 16.2 per cent in the first half of 2006 on the same period last year, with value up by 18.6 per cent. BORICA payments rose by 28.82 per cent on last year's respective period, with value up by 22.83 per cent. Combined with RINGS indicators, this indicated intensive growth in non-cash payments.

1. RINGS (Real-time Interbank Gross Settlement)

Between January and June 2006 RINGS payments numbered 433,534 totaling BGN 100,918 million. Compared with the first half of 2005 daily average payments increased by 23.6 per cent and their value by 30 per cent. Data reveal sustained growth in processed values and a decrease in their number, with average values payment increasing. The rise in the amounts traded on the interbank market was combined with smaller individual customer payments. Thus, growing numbers of people and companies use the system for transferring even small amounts, hastening turnover.

Over the first half of 2006, 45.2 per cent of payments were processed by noon and 73.9 per cent by 2:30pm. Compared with last year's corresponding period, a decrease in these indicators by 1 to 3 per cent was reported, showing a trend to processing payments later in the system day. This mainly reflects the increased amounts of budget payments clustered at the close of the RINGS system day. As regards the system traffic, 92.4 per cent of RINGS payments were effected by 2:30pm.

A new version of RINGS software with the improved functionality required by the BNB, banks and system operators went live on 25 January 2006. The product also reflects international bank account number (IBAN) introduction on 5 June 2006.

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

In the period under review RINGS offered 99.92 per cent availability[13]. This was slightly higher than in the first half of 2005 and in line with TARGET (the euro area large payments processing system). Incidents were handled under contingency rules and procedures.

2. Launching the International Bank Account Number (IBAN)

The IBAN project initiated in early 2005 following the adoption of Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes was completed on 5 June 2006 when the banking system implemented IBANs. The IBAN standard was prompted by pending Bulgarian membership in the European Union and the ensuing need to adapt the national payment infrastructure to the European one, as well as by genuine benefits for banks and end users. All EU countries apply this standard, and as of 6 June 2006 the European Payments Council listed Bulgaria in the register of IBAN countries. Application of general standards to the payment process is a major condition for establishing a common financial services market stemming from the continuing development of the unified European payment system. Launching IBAN in Bulgaria and using SWIFT to process small payments are thresholds in synchronizing the national banking system to the euro area. The national payment system operated smoothly and the pay-

[13] The ratio of time when TARGET is fully operational to TARGET operating time.

ments were not disrupted despite the significant change. Banks, system operators, the Association of Commercial Banks, the Customs Agency, the Social Assistance Agency, the National Revenue Agency and the National Insurance Institute took part in the project. The BNB was responsible for initiation, general planning, coordination and legal aspects.

Launching IBAN entailed changing some 10 million bank accounts and affected international and domestic payments. Conditions were created for higher payment automation and a considerable decrease in the risk of delayed or rejected payments. Confidence in transactions and their safety increased considerably reflecting better validation and identification mechanisms ensuring easier, faster and safer payments for customers.

The project was developed alongside other changes in the payment process to obtain positive results from modernizing the payment system. The SWIFT medium for transmitting BISERA messages was introduced, cutting spending on different interfaces to individual systems. Payments in the budget sphere were facilitated and bank service to end users was improved through increasing transfer efficiency, quality and speed and decreasing risk.

The project involved adapting participants' rules to the new legal framework, changing their internal systems, restructuring information on budget payments, staff retraining, coordinating changes among participants, and running a sizable media awareness campaign. Instructions under BNB Ordinance No. 3 on drawing up payment documents, operational rules, and access and data exchange through BISERA came into force on 5 June 2006. The instruction on domestic transfers through credit transfers and direct debits came into force on 8 March 2006. The BNB and MF instruction on bank services to budget-supported entities was updated. It addressed to the MF, the BNB, commercial banks, the SEBRA operator, budget-supported entities and organizations servicing payments of budget-supported entities through SEBRA (servicing organizations). Rules and procedures for operating the Real Time Gross Settlement System and drafting and exchanging payment messages were also adapted to changes in the legal framework on payment systems, payments and payment instruments.

3. Payment Systems Oversight

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

The half-year saw inspections under the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems at the System for Servicing Payments on Transactions in Book-Entry Government Securities operated by the Central Depository AD, Piraeus Bank Bulgaria AD, and Transkart AD.

The results from the inspection of the Central Depository AD showed that as a whole its system complied with the *Core Principles for Systemically Important Payments Systems* of the *Committee on Payment and Settlement Systems* and *Recommendations to Securities Settlement Systems of the Committee on Payment Systems and the International Organization of Securities Commissions (IOSCO).* With a view to improving system efficiency, reliability, safety, and stability, inspectors' recommendations focused on further developments of the legal framework and the system.

The inspection at Piraeus Bank Bulgaria AD looked at credit available for cards issued by Transkart AD. The BNB recommended bringing operations into compliance with the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems. The inspection of Transkart AD looked at credit card issue and ended with recommendations by the BNB on bringing the process into line with the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems.[14]

[14] Following the actions taken by the inspected entities in accordance with the BNB recommendations, all credit cards financed by Piraeus Bank Bulgaria AD are disabled as of 1 October 2006.

IV. Commercial Bank Reserves with the BNB

Over the first half of 2006 the average amount of required reserves maintained by banks with the BNB went up by 39.6 per cent on 2005, with lev deposits growing by 22.3 per cent and foreign currency deposits, by 19.6 per cent. Additional minimum reserves required from banks breaching credit growth constraints under Ordinance No. 21 increased progressively to BGN 997 million in May and June, and their average amount for the first six months was 2.5 times greater than in 2005. Excess banking system reserves rose by 23.3 per cent on average compared with the previous year.

Average banking system reserve assets in levs rose by 11.7 per cent on 2005, being twice what was required to ensure payments. Reserve assets in foreign currency grew even more, by up to 107 per cent in individual months, making up between 48.3 per cent and 65.9 per cent of minimum required reserves on foreign currency-denominated deposits. Foreign currency sales to the BNB and overnight interbank market transactions were the major source of banks' short-term liquidity. The volume of transactions rose by 10.8 per cent, while the cost of traded resources remained almost unchanged and matched or closely approximated euro area levels which have emerged as a result of ECB policy.

Between January and June four banks failed to fulfil their obligations to maintain reserves and one bank used more than 50 per cent of reserve assets on a single day. In accordance with the requirements of Ordinance No. 21 of the BNB, penalties worth BGN 12,179 were imposed on banks violating the statutory provisions.

Additional minimum reserves were regulated twice over the first half of 2006. Ten banks breached credit growth restrictions over the review period, with seven of them being in breach of both regulations. In the first base period sanctions were imposed on eight banks, with additional deposited reserves totaling BGN 684 million. Over the second base period sanctions were imposed on nine banks worth BGN 997 million. Higher additional reserves deposited in the second base period reflect the May 2006 scheme under which sanctions depend on the percentage excess of credit over admissible limits.

V. Cash in Circulation

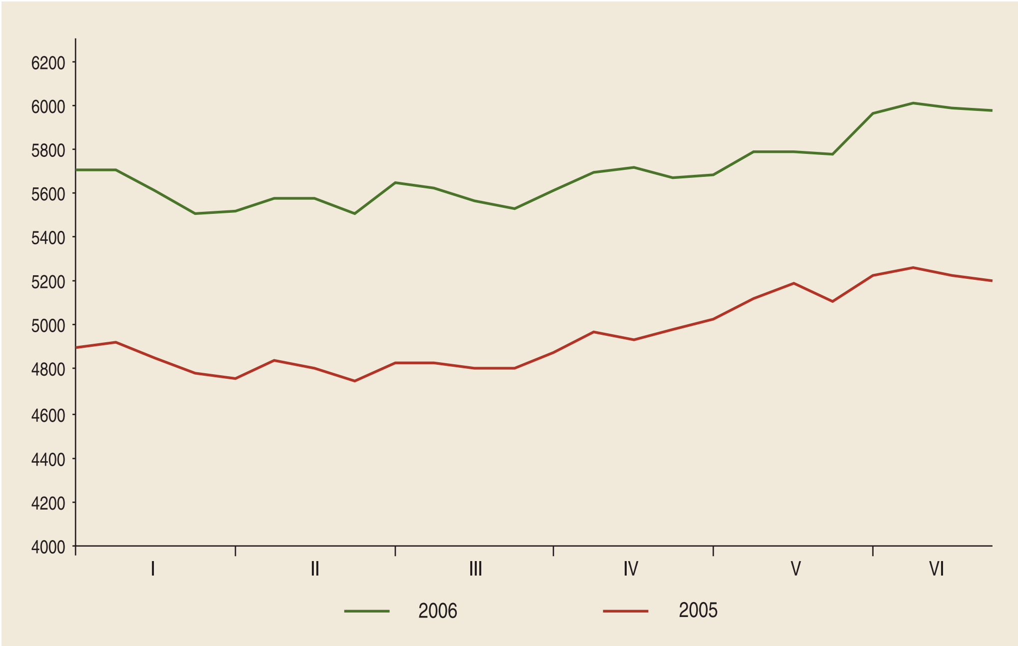
The Bulgarian National Bank has a monopoly on banknote and coin issue in Bulgaria.[15] Banknotes and coins issued by the Bank are legal tender and are mandatorily acceptable as payment at full face value without restriction. The BNB prints banknotes and mints coins, and safeguards uncirculated and withdrawn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

Banknotes and Coins in Circulation (Outside BNB Vaults)

By 30 June 2006 cash in circulation[16] came to BGN 5977 million nominal value, up by BGN 109.8 million or 1.9 per cent on the close of 2005. Cash in circulation posted an increase by BGN 773.4 million, or 14.9 per cent on an annual basis.

Banknotes and Coins in Circulation

(million BGN)



Source: BNB.

By the end of June 2006, 256.2 million banknotes were in circulation, amounting to BGN 5878.8 million. Their number rose by 29.9 million or 13.2 per cent and their value by BGN 759.7 million or 14.8 per cent on the corresponding period of 2005. Since early 2006 the number of banknotes in circulation grew by 2.3 million or 0.9 per cent and their value by BGN 104.8 million or 1.8 per cent.

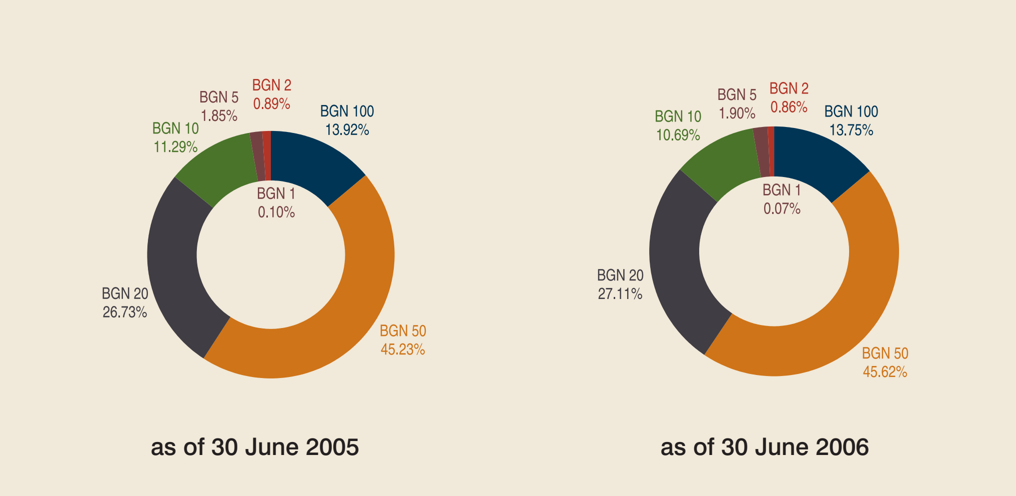
The share of banknotes comprised 98.4 per cent of the total value of banknotes and coins outside BNB vaults by end-June 2006. The average banknote in circulation by 30 June 2006 was worth BGN 22.95, up BGN 0.21 or 0.9 per cent. The recent years' upward trend in the average value of banknotes in circulation reflects a buoyant economy and an increasing share of higher denomination banknotes in the total number of banknotes. In particular, ATMs are mostly supplied with 10, 20 and 50 lev denominations.

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

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

Denomination Composition of Circulating Banknotes

(share of total value, %)

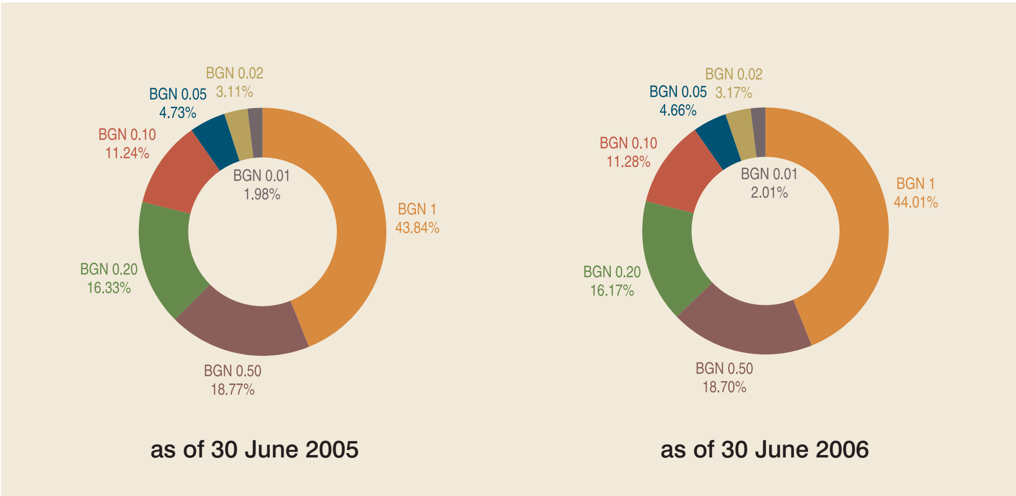


Source: BNB.

By the end of June 2006 coins in circulation numbered 692.2 million, worth BGN 95.1 million. Compared with the end of June 2005, their number grew by 99.7 million or 16.8 per cent and their value by BGN 13.2 million (16.2 per cent). As of early 2006 circulating coins outside BNB vaults rose by 41.1 million or 6.3 per cent and their value by BGN 4.8 million or 5.3 per cent. The value of circulating coins accounted for 1.59 per cent of the total value of banknotes and coins outside BNB vaults by the end of June 2006. Commemorative coins comprised 0.5 per cent of the total value of cash in circulation The average coin in circulation over the review period matched its 2004 level at BGN 0.14.

Denomination Composition of Circulating Coins

(share of total value, %)



Source: BNB.

Non-genuine Banknotes and Circulating Coins

Amendments to Article 27 of the Law on the BNB in 2005 laid down mechanisms whereby the central bank and financial institutions withdraw banknotes and coins retained as suspected of being non-genuine or altered. Over the review period the BNB National Analysis Centre performed authentication checks and evaluation of suspect Bulgarian and foreign banknotes and coins referred by financial institutions or the legal system.

Between January and June 2006 non-genuine Bulgarian banknotes registered with the BNB National Analysis Centre numbered 2540. Non-genuine banknotes seized prior to entering circulation numbered 162, with 2378 having entered circulation. Non-genuine banknotes of BGN 10 nominal value had the largest share (78.2 per cent) of the total number of registered and retained non-genuine banknotes followed by banknotes of BGN 20 nominal value (12.1 per cent) and BGN 50 nominal value (6.4 per cent). Reported non-genuine banknotes of BGN 2, 5 and 100 numbered 86, accounting for 3.4 per cent. Between January and June 2006 non-genuine Bulgarian circulating coins numbered 1221; of this, 1205 of 0.50 nominal value and 16 of BGN 1 nominal value.

As regards foreign banknotes and coins retained within Bulgaria, in the first half of 2006 the Bank's National Analysis Centre retained 3477 euro banknotes, 887 US dollar banknotes and 63 assorted foreign non-genuine banknotes.

BNB Cash Operations

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

Between January and June 2006, 41.7 million newly printed banknotes and 43.6 million newly minted coins worth BGN 3048.3 million were supplied under contracts with producers. Banknotes unfit for circulation numbering 36.6 million and worth BGN 388.8 million nominal value were destroyed. In compliance with its minting programme, the BNB put into circulation three commemorative coin issues.[17]

Over the first half of 2006 the BNB processed 183.3 million banknotes and 55.7 million circulating coins worth BGN 2671.9 million: a 15.7 million (9.4 per cent) increase in banknotes and an 8.3 million (17.5 per cent) increase in circulating coins on the corresponding period of 2006. Banknotes of BGN 10 and BGN 20 denominations and circulating coins of BGN 1, BGN 0.10 and BGN 0.20 denominations had the largest shares in the structure of banknotes and coins processed by the BNB. Over the review period banknotes of new issues retained in processing as unfit for circulation numbered 44 million, up 3.1 million or 7.5 per cent on the first half of 2005.

Banknotes and circulating coins put into and withdrawn from circulation by commercial banks totaled BGN 5383.4 million in the first six months of 2006. Commercial banks deposited with the BNB 185 million Bulgarian banknotes and 14.9 million circulating coins worth BGN 2665.6 million, up by BGN 402.4 million or 17.8 per cent compared with the January to June 2005 period. Over the review period commercial banks withdrew from the BNB 183.6 million Bulgarian banknotes and 64 million circulating coins totaling BGN 2717.8 million, an increase of BGN 326.8 million or 13.67 per cent.

BNB purchases of reserve currency through its regional cash centres totaled EUR 0.84 million, including EUR 0.68 million from individuals and EUR 0.16 million from budget organizations. Reserve currency sales amounted to EUR 13.89 million, including EUR 5.71 million to individuals, EUR 4.45 million to commercial banks and EUR 3.73 million to budget organizations. BNB reserve currency purchases went down by EUR 0.71 million on the corresponding period of 2005, while BNB reserve currency sales posted an increase by EUR 5.6 million (67.98 per cent) .

The BNB continued to harmonize its organization and cash operations with those of EU member states by amending and supplementing the statutory framework in the first half of 2006 in line with Bank general and internal objectives.

On 31 March 2006 the BNB adopted Ordinance No. 18 on Control over the Quality of Banknotes and Coins in Cash Circulation. The Ordinance regulates reproducing Bulgarian banknotes and coins, exchanging mutilated or damaged banknotes and coins, retaining, checking and evaluating suspect banknotes and coins, and using sorting machines and customer-operated banknote and coin dispensers. The Ordinance establishes the general framework whereby financial houses, exchange bureaux and other businesses

[17] Information on commemorative coins is published on the BNB website.

which may come across non-genuine banknotes and coins, and for banknote recycling. Commercial banks and other service providers are required to conduct operations and payments with customer banknotes and coins only after these banknotes and coins has duly passed authentication and fitness check in accordance with BNB criteria.

For the practical implementation of these requirements, the BNB issued fitness standards for Bulgarian banknotes and coins. These standards set fitness criteria such as physical and chemical properties for Bulgarian legal tender and are expected to be employed in practice by banks and service providers.

On 1 May 2006 the BNB published *General Terms for supplying banknotes and coins at an announced value* and a *Tariff of Fees for banknote and coin supply*.

VI. Maintaining Banking System Stability

1. State of the Banking System

Between January and June 2006 banking assets rose by BGN 3,101,305,000 (9.4 per cent) on the end of the prior year to reach BGN 35,987,086,000. Assets of the ten largest Group I banks posted an increase of BGN 2,276,000 (9.4 per cent), while those of Group II banks grew by BGN 1,658,000 (24.1 per cent). The reduced number of foreign banks' branches meant an asset fall in Group III banks by BGN 833 million or 46.5 per cent.

BNB measures slowed gross credit growth to 7.8 per cent (BGN 1428 million) on the end of the prior year.[18] The ten largest Group I banks' credit portfolios grew by BGN 1554 million (11.3 per cent). Those of Group II banks grew by BGN 455 million (12.7 per cent), while foreign banks' branches posted a BGN 580 million decline, reflecting the consolidation of the Piraeus Bank branch. This data does not include loans by domestic banks to parent banks or their leasing companies. If the volume of loans sold over the reporting six months were excluded, gross credit growth between January and June 2006 would be 16.5 per cent: slower than the 20.1 per cent (BGN 2773 million) increase in the corresponding period of 2005.

Over the first half of 2006 bank loans to residents and non-residents increased seven-fold compared with the June to December 2005 period (BGN 251 million).

All types of loans grew in nominal terms. The share of housing and mortgage loans continued growing at the expense of commercial loans. By the end of June the shares of both these segments accounted for 36 per cent of total credit, against 34 per cent at the close of 2005. The phased removal of Ordinance No. 21 administrative constraints on credit growth, announced on 1 June 2006, was followed by higher growth in June (4 per cent or BGN 764 million). Compared with the end of 2005 net loans (total portfolio less allocated provisions) went up by BGN 1393 million (7.9 per cent) and their share in assets decreased slightly to 53.2 per cent from 53.9 per cent in December 2005. Seven banks' credit portfolios experienced a decline and net credit growth in half the banks was higher than the banking system average.

The banking system deposit base continued growing sustainably and remained the major source of funds. Non-financial customer deposits posted a growth of 14.8 per cent (BGN 3017 million) over that of assets, while financial institutions' resources fell by 13 per cent or BGN 656 million. Over the review period total deposits grew by BGN 2361 million, with the growth rate of 9.3 per cent matching that of assets. Own funds posted 10.1 per cent growth (BGN 351 million) outstripping asset and credit growth rates. The growth was attributable mostly to the **profit** of BGN 342 million generated over the first six months of 2006 and equity increases of BGN 128 million.

The January to June 2006 period saw no significant changes in banks' **risk profile** characteristics. The ten largest banks pursued a policy of strengthening their market positions through relatively good control over major risks, while small and medium banks continued facing risk-associated difficulties or the inability to ensure the sound growth necessary to retain market share. The leading foreign bank branches managed to sustain their market positions in the corporate segment, their risk control complying with the high standards of the banking groups. Banking system asset risk remained at an acceptable level. Credits transfers (mostly intended to stay within credit growth constraints) and investment into subsidiaries during the reporting period did not prompt a fall in standards

[18] The insignificant difference in credit growth rates shown here and in Section I is due to methodological differences in determining credit portfolio scopes for supervisory and statistical purposes.

and did not cause any threats of obscuring risk. Operation financing continued to be dominated by permanent sources (basically, the deposits of non-financial institutions), with the volume and stability of the sources indicating the degree of confidence of banks' customers.

Credit risk continued dominating the profiles of individual banks and the entire banking system. Despite lending cutbacks over the review period and on an annual basis (and taking into account the effect of the transfer of credit risk to other non-bank institutions), no significant changes occurred in the classification structure of credits. Though *classified banking system credits* fell to 7.36 per cent from 7.72 per cent in December 2005, problems with consumer loans in particular banks continued. The classified proportion of consumer credit came to BGN 406 million by the end of June against BGN 333 million by the end of 2005, accounting for 9.1 per cent of total consumer credits (8.01 per cent by 31 December 2005). Classified mortgage loan followed a similar pattern, picking up to BGN 199 million or 7.69 per cent against BGN 151 million and 7.43 per cent in December 2005. One of the reasons for the increase in classified household credit (mortgage and consumer loans) is that the solvent portion of the public has already taken up a variety of credit products. There are indications that growing household debt coupled with inadequate economic culture (in particular among consumer credit customers) renders consumer lending highly problematic. The fact that risk reclassification is possible only when an exposure consistently satisfies all the conditions of a lower-risk classification group for six months also contributed to this.

Amid comparatively stable **asset quality** indicators, comprehensive supervisory inspections found instances of non-compliance with Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss. Some inspected banks did not comply with the ordinance in respect of past due terms and financial performance, thus boosting asset quality artificially. In most instances, reclassification of the respective positions was required, worsening these indicators. Sufficient core operational earnings for ensuring the required provisions and maintaining the capital position were of essential importance for these banks.

Despite the good level of overall banking system **revenue**, significant efficiency fluctuations among banks have not been ironed out. The traditional major contribution of some Group I banks to the system's good financial results continued to obtain. Therefore, each broader movement due to one-off factors (e. g. additional non-interest spending to change or improve larger banks' business strategies) impacted system performance. There are good examples of stable profitability among smaller banks focused on core earnings. System revenue between January and June 2006 was affected strongly by: slower credit growth and correspondingly less interest income; ECB interest rate rises from late 2005 followed by hikes in the cost of resources; narrowing interest rate spreads due to fierce competition; and significant losses from trading portfolio securities (BGN 47 million). Despite the similar structures of financing funds for Group I and Group II banks, resource costs for small and medium banks were significantly higher, impacting earnings. Data by bank group reveal that under the same net interest income of 21 per cent, Group II reported higher non-interest income growth (by 43 per cent) than Group I (26 per cent) and more moderate non-interest expenditure growth (12 per cent) than at larger banks (30 per cent). This gave a higher profit growth rate to small and medium banks (61 per cent) compared with the ten largest Group I banks (21 per cent). Consequently, by the end of June 2006 the share of Group II profit in total system profit reached 17 per cent against 13 per cent a year earlier. However, Group II earnings indicators showed worse key ratio values, with the bulk of banks reporting lower returns on assets and on equity than in 2005. The *return on average assets* (ROA) indicator reached 2.01 per cent and *return on equity* (ROE) stood at 21.10 per cent.

Own funds, a leading indicator of banks' current financial performance and risk absorption capability, reflect several trends: integration of the 2005 accumulated financial result entirely or partially into equity, an increase in paid-up equity, and a preference for tier 2 capital instruments. The overall capital position improvement, however, could not conceal the higher risk sensitivity of some banks, indicating difficulties in ensuring limited capital growth adequate to asset and risk growth. Small and medium banks' capital position remained more sensitive, the pressure mostly resulting from problems related to asset quality, the inability to generate sound revenue, and depleted capital surplus.

Primary capital increases through retentions of 2005 profit and the sale of standard credit portfolios by some banks pushed banking system own funds faster (22 per cent) than risk-weighted assets (17 per cent). This helped attain higher capital indicator values compared with 2005: the *capital adequacy* ratio reached 16 per cent against 15.33 per cent for the basis period and *tier 1 capital* reached 13.33 per cent against 12.53 per cent. Between January and June 2006 banking system own funds went up by BGN 649 million, the bulk of this due to tier 1 capital growth of BGN 588 million. The total risk component rose by BGN 3121 million. Positions subject to credit risk measurement traditionally contributed most to this growth (BGN 2672 million), while the risk-weighted asset equivalent for market risk grew by mere BGN 116 million (16 per cent). The proportion of capital used to cover market risk stayed insignificant at 3.75 per cent against 3.78 per cent at the end of 2005. Risk structure did not change significantly: 79 per cent of the risk-weighted asset equivalent for market risk was formed by debt instruments, particularly Bulgarian government securities and those of issuers listed in Ordinance No. 8 Appendices 1 and 2. The foreign currency component of market risk posted a certain increase: from 9.5 per cent of the risk-weighted asset equivalent to 13.5 per cent by the end of June 2006. The interest rate component of market risk did not experience significant changes, providing adequate capital cover. *GAP position*, reflecting the total interest rate imbalance of assets and liabilities, stayed negative (-1.38 per cent against –1.16 per cent by end-December 2005).

Processes had certain group specifics. Over the first six months of the year large banks' own funds rose faster than the risk component, while the trends in Group II were divergent. For example, small and medium banks' contribution to own funds growth was 15 per cent, while their contribution to risk component growth reached a quarter. In addition, the tier 1 capital adequacy ratio of most small and medium banks significantly exceeded requirements, only a few of these banks having managed capital positions using financial instruments in preference to paid-up capital and reserves. Consequently, the tier 2 capital of large banks accounted for up to a quarter of the tier 1 capital of the group, against just 12 per cent for Group II.

In line with the basic ratios, *tier 1 capital leverage* also posted an increase on the end of 2005: 9.22 per cent against 8.4 per cent in December 2005. The *share of net classified assets in own funds* went down dramatically, by 5 percentage points to 24.46 per cent, reflecting the faster growth of own funds.

As usual, *the capital in excess of Ordinance No. 8 requirements* by the end of the half year was higher than reported at the close of the past year. Banking system excess reached BGN 909 million, with the increase of BGN 261 million on December 2005 primarily due to including the portion of retained profit in tier 1 capital, as discussed above. The capital buffers of the ten largest banks amounted to BGN 676 million, with BGN 212 million at small and medium banks.

The liquidity position remained a low risk source for banks. The review period is traditionally characterized by liquidity adequate to balance sheet structure and liability maturity and concentration. Changes in liability prices and the cost of some instruments into which banks deposited assets did not change the liquidity structure. In practice, there were no banks exposed to significant risk, even the smallest financial institutions having sufficient resources to meet current needs. Banking system liquidity indicators remained comparatively high. The significant volume of additional funds frozen at the BNB as part of credit curbs was another factor fostering good system liquidity. Confidence with regard to liquidity was backed by the findings of supervisory inspections on liquidity management and control systems. The stable growth in non-financial customer deposits over the past six months was due to the variety of deposit products on offer and to the increased attractiveness of deposits after the latest ECB rate rise.

There were no significant changes in key liquidity indicators at the system or individual bank levels with regard to the structure and tradability of assets and hence the structure and concentration of financing sources. *Tradable assets as a share of total banking system assets* continued rising to reach 29.46 per cent at the end of June against 28.65 per cent in the base period. Faster tradable asset growth compared with banking system asset growth (13 per cent against 9 per cent in gross assets) had a favourable effect on the indicator measuring the *degree of coverage of borrowed funds*. They reached 34.31 per cent against 33.12 per cent six months earlier. The values of these indicators ensured the sufficiency of individual banks' tradable assets to cover possible cash outflows.

Though lower by a percentage point than in December 2005, the *loans to deposits ratio* remains high at 71.27 per cent and justifies the required enhanced supervisory attention to credit quality. Moreover, the level of this indicator calls for a sufficiency of liquid assets as resources in case of possible liquidity pressures on the banking system or individual banks.

As regards system maturity structure, most banks sustained their January to June 2006 figures. Liquid assets entirely covered outflows on borrowed funds within the shortest time horizon of up to seven days. In the horizons of up to one month, three months, and six months, values stayed under 100 per cent. A mere eight out of the 28 banks failed to cover deposits by liquid assets over the shortest time horizon.

2. Compliance with Prudent Banking Requirements

Major supervisory requirements subject to monitoring in the first half of 2006 involved:

Capital adequacy: the capital positions of individual banks remained stable and adequate to their risk profiles. No dips below regulatory minima were reported, though some banks' total capital adequacy ratios and/or tier 1 capital ratios were close to 12 per cent and 6 per cent respectively.

Large exposures: Isolated deviations from maximum admissible limits for large exposures (25 per cent) were established and rapid corrective supervisory measures were initiated.

Internal loans: full supervisory inspections established cases of deliberate evasion of the statutory framework by particular banks and formations of hidden relatedness exposures. Concentrations around major shareholders were found. These banks' managements were required to tighten control over the legality of transactions and loan fund utilization, and warned against lenient lending to shareholders and related companies. It was also recommended to these banks to amplify their lending rules and procedures by clearer definitions of relatedness.

Investment into fixed assets: No deviations from statutory admissible levels were found, with fixed assets investment occupying an insignificant share of banking capital. Two banks reported values close to the regulatory limit of 50 per cent.

3. Banking Supervision between January and June 2006

Supervisory Policy, Ordinances, and Accounting Methodology

In the first half of 2006 bank supervisory action aimed to erect a legal framework reflecting the latest European directives which introduce international requirements for capital measurement and capital standards convergence under Basel II. This framework included the new Law on Credit Institutions and the Ordinance on Capital Adequacy.

The new Law on Credit Institutions[19] enters into force on 1 January 2007, alongside Bulgaria's accession to the European Union. It intends to achieve comprehensive compli-

[19] The Law on Credit Institutions was adopted by the National Assembly on 13 July 2006 and published in the *Darjaven Vestnik,* issue 59 of 21 July 2006.

ance between Bulgarian legislation and European directives on credit institutions. The Law introduces the concept of credit institutions, encompassing banks and electronic money institutions. The single license principle is defined to ensure mutual recognition of the right of credit institutions and their subsidiaries to trade within the European Union directly or through branches without additional permits from host country banking supervisors. Relations between different countries' supervisory bodies in regulating international financial groups are also treated. The Law revises and develops the legal framework of the current Law on Banks by removing some of its practical shortcomings and recognizing experience since 1997. At the same time, it is based on the provisions of the current Law and follows its regulatory principles, ensuring coherence and consistency in banking legislation.

Another important element of the regulatory framework is the draft Ordinance on Capital Adequacy[20] which sets new bank risk control requirements. New and improved credit risk management approaches are introduced. Risk-weighted exposures are assessed using external credit assessment which allows an objective and adequate distinction of risk within a particular class of exposures. A second approach allows banks disposing of free resources to calculate credit risk using internal rating models. Significant changes were made in supervisory recognition of credit risk mitigation (through, *inter alia*, guarantees, collaterals, and credit derivatives) and securitization schemes. Capital requirements for operational risk were also introduced. There were few amendments related to market risk and rules and procedures for items included in trading portfolios. In May the Banking Supervision Department sent the initial draft for consultation to the Association of Commercial Banks.

To apply the new Ordinance on Capital Adequacy, draft report forms will be prepared to the Committee of European Banking Supervisors (CEBS) standard FINREP (financial reporting) and COREP (common reporting) frameworks. These standards aim at uniform and harmonized market participants' reports and more effective interaction between EU supervisory bodies. In line with this, a strategy for launching the Extensible Business Reporting Language (XBRL) information platform is elaborated to facilitate reporting between commercial banks and the central bank. The European Commission strongly encourages XBRL introduction.

Banking Supervision Department representatives took part in international meetings promoting cooperation with authorities responsible for supervision on a consolidated basis in the context of the new Basel Capital Accord as part of international cooperation in regulating transnational financial groups to recent European Directives. Meetings were hosted by supervisory authorities from Greece, Italy, Austria, and Hungary. They featured presentations on progress towards the new capital requirements in relevant banking groups and on forms and degrees of international cooperation dependent on risk and capital requirement calculation. Department experts participated in workshops at various European committees on banking system developments and supervision within the EU.

Over the review period Bulgaria joined the fifth Quantitative Impact Study (Basel QIS 5) to help the Basel Committee on Banking Supervision assess putative further changes to the Basel II capital framework on the basis of most recent data.

In addition to helping draft the new Credit Institutions Bill, Banking Supervision experts took a leading part in drafting the Supplementary Supervision of Financial Conglomerates Bill. Following the European Commission's high assessment of compliance with European directives, the Bills were adopted into law by the National Assembly at their first and second readings and published in the *Darjaven Vestnik*. Ensuing adjustments to statutory instruments are in progress.

[20] This Ordinance was approved at its first reading by BNB Governing Council Decision of 13 September 2006.

Supervisory Administration, Licenses, and Permits

A key Banking Supervision Department duty is to control banks' adherence to regulatory requirements and dispense supervisory measures and penalties. The first half year saw 23 supervisory measures imposed on 17 banks, one suffering three measures and three banks two measures each. Eleven of the measures resulted from on-site inspections, while the rest were prompted by bank reports or off-site supervision findings. After improperly including profits into capital in close-of-year accounts, five banks were asked for urgent readjusted reports. Over the first six months of 2006 no serious supervisory measures, such as limiting bank operations or appointing conservators, were imposed.

In the first half of 2006 a foreign bank applied for license to open a branch in Bulgaria. The procedure of compiling required documents was almost finalized and contacts with the supervisory body of the country where the applicant bank is headquartered were established.

Thirty-five permits were issued under the Law on Banks. Fourteen of them were under Articles 19 and 19b on acquiring 10 per cent or more of bank equity or on qualified participation in equity increases, with the remainder on acquiring qualified participation in non-banking companies, extending the scope of issued licenses or changes to banks' names after significant changes to majority ownership. Also issued were six permits related to tier 2 capital instruments under BNB Ordinance No. 8 on banks' capital adequacy. Twenty-eight certificates of banking qualifications and professional experience were obtained by bank board nominees over the review period.

On-Site Supervisory Inspections

Implementing the annual on-site supervision programme entailed 11 full supervisory inspections of three Group I banks and eight Group II banks over the first half of 2006. CAMELS criteria allowed all inspected banks to retain their ratings. Inspectors found 114 formal violations to banking legislation and supervisory regulation, of which 70 in three banks. Recommendations for improving various bank operations numbered 139. Major violations were related to supervisory requirements for evaluating and classifying risk exposures (72), breaches of deadlines for reporting large loans (9), reporting lower than actual loan amounts (5), and failing to declare relatedness between borrowers with large exposures (5). Most recommendations addressed improving loan administration (especially of loans tending to worsen), specifying and expanding criteria in the early study of credit applicants (especially new and risk companies), and improving the systems for monitoring and controlling all manners of business relatedness with a view to timely disclosure and reporting to avoid credit concentrations.

In some banks, inspections found that credit risk increased due to non-compliance with supervisory requirements for evaluating and classifying risk exposures. Deviations from good banking practice in managing assets were mostly associated with ineffective credit risk monitoring and control systems which were inadequate to the risk profile and portfolio growth of credit institutions. Quite often units responsible for risk exposure evaluation in individual banks failed to discharge their duties, with superficial or insufficiently thorough decision making. Affected banks had lower risk exposure allocations and their reports did not reflect the genuine risks assumed. Their managements were offered a range of measures for attaining conformity with good banking practice.

As regards credit concentrations, it was found that undeclared concentrations exceeding statutory limits and formed by groups of companies existed in addition to business relatedness declared by banks. Though no proof of direct financial dependence existed, large money transfers between identical corporate borrowers were observed in a bank, alongside providing one company's assets as security on other companies' loans and similar practices. The risk of unidentified concentrations between borrower companies in regular trading relations with banks' majority shareholders gave rise to special concerns. Affected banks were obliged to strengthen control over disclosure and reporting of all types of relatedness and to mitigate concentrations. In addition to this, further requirements were introduced on equity and its increase to cover higher credit risk.

Loan agreements at some banks were repeatedly renegotiated in annexes. In most cases, credit files contained no explanations why deadlines had been stretched and no timely reviews of borrowers' financial status and their business prior to changes in loan terms and conditions. Some renegotiations resembled restructuring, though loans were not reclassified into more risky classification groups as required. At other banks, unreasonably long grace periods were negotiated for principal repayment, involving postponing the risk of non-payment. In both groups of cases, credit risk was put off for an indefinite time which may result in its uncontrolled increase.

Individual banks fragmented control over target credit utilization between a number of units and had insufficient information. On occasion, significant funds were handed over at tills, creating conditions for them to be diverted to purposes other than those set in loan agreements.

Several supervisory reports expressed serious reservations about individual bank managements' performance after substantial non-compliance with supervisory regulators, failures to fulfil multiple recommendations to comply with good banking practice, and easy loans to shareholders and related companies were found. Other banks' risk management was adversely impacted by, *inter alia*, underestimating bank information systems as development drivers, lack of key staff retention mechanisms, and failure to recruit quality employees.

Off-site Supervision

A key element of the supervisory cycle, off-site supervision continued monitoring the implementation of the supervisory strategies for individual banks and analyzing trends and dynamics in the development of major risks.

Monitoring in the first half of 2006 focused not only on adherence to supervisory regulators, but also on banks' financial performance, their business behaviour and its adequacy to the challenges Bulgaria's banking system faces. On the basis of weekly, monthly and quarterly financial statements, quarterly ratings were assigned to four CAMEL/CAEL system components: capital, asset quality, earnings, and liquidity. Trends in the risk profile development of individual banks were determined. Special attention was paid to credit risk dynamics, solvency, and economic and business relatedness between commercial banks' customers.

Efforts to develop products for analyzing banking system performance were stepped up. Together with the quarterly Uniform Bank Performance Report, other analyses and statements on banking components were prepared for the purposes of the BNB and other resident and non-resident consumers. The accumulated database allowed further honing of the Early Warning System. This provides for modelling of the dynamics of major banking risks (credit, market, and liquidity) by studying time series of several dozen indicators of commercial banks' operations. Over the review period stress-test scenarios were optimized, the major change aiming at determining the degree of bank and banking system sensitivity to credit risk. Longer statistical time series are available now on credit growth and internal migration in credit portfolio classification groups, and were instrumental in improving these scenarios.

Another aspect of off-site supervision relates to those commercial banks which require additional supervision. Argumentation and application of additional supervisory adjustments were needed alongside optimizing financial information methodology and analysis. Statements of opinion were drawn up in relation to equity acquisition and partnerships, mergers and consolidations, new business areas, and various capital support and bank financing instruments.

Special Supervision

Enhancing transparency through continuous monitoring of commercial banks' equity holders remained a major priority in the first half of 2006. Relevant supervisory efforts revealed the structure of direct or indirect equity holders in commercial banks. Their financial standing and ability to support, where necessary, capital at twelve banks, were analyzed and assessed.

Consistent measures were enforced against money laundering and terrorist financing. Supervisory action to determine risk levels at four commercial banks and seven financial houses concluded that risks were kept to a minimum and that the banks and financiers were not handling illegal funds. Given banks' key role in these processes, they were assisted by the BNB in establishing a special secure regime. Special attention was paid to whether adequate procedures to identify money laundering risks were in place at banks and financial houses. As regards established weaknesses, they were advised to apply more thorough customer identification procedures and adopt additional requirements for non-resident customers.

Significant effort went into harmonizing the Law on the Measures Against Money Laundering with international standards in this area, as recommended in European Commission assessment reports in October 2005 and February 2006.

In accordance with the technical assistance agreement between the BNB and USAID, special attention was paid to improving supervisory practice to prevent the banking system being used for money laundering and terrorist financing.

Cooperation with offices fighting financial fraud and money laundering enjoyed key expert assistance from the legal authorities.

A Bulgarian/US group for fighting financial fraud, including banking supervision experts, worked intensively.

Two inspections at banks in their capacity as custodians were conducted under BNB Ordinance No. 36 on Custodian Banks under the Social Security Code jointly with the Financial Supervision Commission to evaluate custody organization and procedures. Infringements found resulted in recommendations to managers mainly on the control functions of custodian banks and compliance with statutory constraints in investing corporate assets. Inspection conclusions included proposals for legislative changes for more effective implementation of statutory requirements and clarifying requirements from custodian banks.

As regards the Currency Law and its statutory instruments, supervisory effort addressed requirements for banking and financial transparency. Special attention was paid to compliance with the requirement to declare to the BNB instances of direct investment or financial loans and their scope.

The inspected four banks and seven financial houses have now taken the necessary steps to ensure compliance with currency legislation and BNB ordinances and instructions. The documentation of four companies filing for permits to conduct foreign exchange transactions under the Currency Law and Ordinance No. 26 on Foreign Exchange Transactions by Brokerage and Financial Houses was examined. Two were granted permits and the others were refused due to non-compliance with statutory provisions.

Between January and June 2006 four financial houses ceased trading and were deleted from the financial house register kept by the BNB.

Five new companies were entered in the register of entities who have notified the central bank of transactions under Article 1(6) of the Law on Banks.

VII. The Central Credit Register

The Central Credit Register (CCR) developed and maintained by the BNB provides information on bank customer debt to the banking system.[21] Data covers all commercial bank claims irrespective of amount except debit card overdrafts of up to BGN 1000 provided they are classified as standard, loans to the government, loans to the BNB, and interbank loans. The system ensures reliable information submission and storage.[22] The fee per customer debt check is BGN 0.50.

By the end of June 2006 the CCR registered 1,776,093 loans (against 1,427,755 at the end of June 2005) with a balance sheet exposure of BGN 20,208 million (against BGN 16,356 million in June 2005). Borrowers totaled 1,226,984, of whom 1,177,411 individuals, 48,368 resident legal entities and 1205 non-resident legal entities.

Over the half-year commercial banks conducted 1,337,420 CCR debt checks, double the 662,346 in the same period of 2005. Of the total, 1,178,535 were on individuals and 198,885 on resident legal entities. The monthly average number of certificates was 230,000 or about 10,000 a business day. The growing number of CCR certificates indicates the reliability of information and its growing importance in managing commercial banks' credit portfolios.

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

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

VIII. The Fiscal Agent and State Depository Function

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

Under the Agreement between the Council of Ministers and the Bulgarian National Bank on Introduction of the Euro in the Republic of Bulgaria, in early 2006 an agreement was signed between the Ministry of Finance and the Bulgarian National Bank to define the Bank's long-term government agent duties. The BNB undertook to develop its fiscal agent functions to European standards and in line with the Ministry of Finance's Government Debt Management Strategy for the 2006 to 2008 Period. To this end, the BNB has developed and consistently improves a number of systems: the electronic system for budget and fiscal reserve information servicing, the AS ROAD system for registering and servicing external debt, the GSA automated system for conducting government securities auctions and replacement subscriptions, the ESROT electronic system for registering and servicing government securities trading, the electronic system for settlement accounts of book-entry government securities, and the Register of Pledges.

Over the first half of 2006 the BNB collected BGN 674,300 in fees and commissions for its fiscal agency and government securities market services, including BGN 340,800 from agreements with the Ministry of Finance.

Budget and External Debt Information Service

Under Article 43 of the Law on the BNB and joint instructions by the Minister of Finance and the BNB Governor, information on the budget, extra budgetary, accumulation, deposit, and letter-of-credit accounts of budget entities in levs and other currencies was regularly gathered from 24 depository banks (including the BNB). Under paragraph 24 of the Transitional and Final Provisions of the Republic of Bulgaria 2006 State Budget Law and joint instructions by the Minister of Finance and the BNB Governor, balances on these accounts with commercial banks were secured by blocking domestic and external debt government securities held by the banks in favour of the Ministry of Finance. In the period under review the average monthly balances on accounts with the BNB were BGN 3688.2 million, with BGN 1164.6 million at depository commercial banks.

At the request of the Ministry of Finance due to the phasing out of BIN codes, from 5 June 2006 a new statistical reporting form was introduced for payments into public claims administrators' accounts. This is completed twice monthly and brings the number of budget reporting forms submitted to the MF by the BNB to 185. Over the review period current and final information on the fiscal reserve was collected and submitted to the MF daily. By the end of June 2006 total balances on accounts serviced by the BNB and depository banks and included in the fiscal reserve came to BGN 4649.8 million[23] against a BGN 2500 million minimum fiscal reserve projected in the Republic of Bulgaria 2006 State Budget Law.

In June 2006 a modernized version of the electronic system for budget and fiscal reserve information servicing was launched. The new version offers improved methods of obtaining primary data from commercial banks by speeding their processing and preparing various reports as required by the MF for managing the balances of budget accounts. System and other risks were minimized.

[23] Balances on foreign exchange accounts are recalculated in levs based on the official BNB exchange rate for 30 June 2006.

The AS ROAD external debt system registered 30 Bulgarian government foreign financial obligations under which the BNB acted as agent for calculating and paying EUR 3229.9 million.[24] Payments numbered 40 and came to EUR 381.5 million, comprising EUR 243.3 million principal and EUR 138.3 million interest.

Servicing Government Securities Trading

In accordance with the schedule announced by the MF, in the reporting period auctions for the sale of three-month, three-year, five-year and ten-year government securities nominally worth BGN 422.7 million were held *via* the GSA automated system for government securities sale and repurchase auctions. Of the 101 average bids *per* auction, 54 were approved. The reporting period saw a progressive upward trend in the volume of individual government securities issues aimed at increasing their liquidity and stimulating secondary market development. Demand for government securities exceeded supply, with a 1.92 average bid-to-cover ratio. An average of 20 primary dealers bid at the auctions.

June saw a new selection of government securities primary dealers, with 22 commercial banks and three investment intermediaries obtaining investment intermediary permits under Article 54 of the Law on Public Offering of Government Securities.[25]

In the review period the ESROT electronic system for registering and servicing government securities trading registered payments of BGN 305.3 million[26] at maturity date, of which BGN 225.5 million was principal and BGN 79.8 million interest; government securities bought back directly by individuals came to BGN 1 million. The total of newly-registered government securities plus payment registrations came to BGN 729 million.

Government securities transactions in the secondary market numbered 3405 at BGN 5983.6 million nominal value. Blocking and unblocking of government securities had the largest share (35.5 per cent), followed by transactions with and on behalf of customers (28.2 per cent), outright purchases and sales (18.7 per cent), and repo agreements (17.6 per cent). Trading was most active on days when newly issued government securities were acquired.

By June 2006 accounts kept with the government securities settlement system came to 2624, including 90 for government securities of the issuer (the MF), 948 for participants' own government securities portfolios, 1036 for government securities primary dealers' customers, and 472 for encumbered government securities. Government securities in these accounts totaled BGN 3023.6 million in nominal value.

In the first half of 2006 records of pledges and removal of pledges on government securities worth BGN 8.8 million were listed in the *Central Register of Pledges* created by the BNB under the Law on Registered Pledges: up by BGN 8 million on the corresponding period of 2005. Transactions in government securities for securing budget funds with commercial banks comprised BGN 2118 million or approximately equal to the previous year's respective period. The sustainable relatively high amount of transactions for blocking government securities for securing budget-supported entities' funds under Article 24, paragraph 2 of the Transitional and Final Provisions of the Republic of Bulgaria 2006 State Budget Law reflected the high level of budget funds with commercial banks and banks' interest in managing financial security by government securities in real time as required by the MF.

In line with the agreement with the MF, the BNB continued comparing daily data on balances of budget entities' accounts with commercial banks secured by government securities and information on the total balances of budget entities' accounts reported by commercial banks. The average daily nominal values of blocked domestic government securities came to BGN 799.1 million, EUR 87.1 million, and USD 31.7 million, and of foreign

[24] Total debt is recalculated in euro based on the official BNB exchange rate for 30 June 2006.

[25] In compliance with Ordinance No. 15 of the MF and BNB on control over transactions in book-entry government securities.

[26] The lev equivalence of government securities issues denominated in foreign currency is calculated on the basis of the BNB exchange rate valid for the day of payment.

government securities, including the EIB eurobond issue, to BGN 24 million, EUR 71.9 million, and USD 83.6 million.

Under the agreements with the Ministry of Finance, 2006 saw further improvement of the GSA automated system for conducting government securities auctions and replacement subscriptions, allowing subscriptions to replace government securities from one issue with those from another. The system will be further developed to enable primary dealers to participate in replacement auctions with competitive bids on account of their customers and limiting the amount of securities acquired by a single customer regardless of the number of dealers.

The modernized ESROT electronic system for registering and servicing government securities trading went live in May 2006 as laid down in the Ministry of Finance's *Debt Management Strategy for the 2006 to 2008 Period* and the *Strategy for Bulgarian National Bank Development between 2004 and 2009*. This brings straight-through end-to-end processing, moves from automated package processing of transactions to real-time processing of individual transactions and extends the system day for settling government securities transactions. System participants can now monitor their customers' transactions in real time. The system uses two uniform communication channels: SWIFT *per* ISO 15022 and a VPN-based web interface using universal electronic signatures. Government securities data in ESROT are automatically balanced with those in the registration systems maintained by the system's participants. It comprises a statistical module for providing data to the MF and other institutions; this also submits information on the government securities market and the development of the BNBGSSS system for government securities registering and settlement to the ECB. Risks associated with the system are limited and it complies with CPSS/IOSCO (the Committee on Payment and Settlement Systems/International Organization of Securities Commissions) and ESCB/CESR (the European System of Central Banks/Committee of European Securities Regulators) requirements and standards.

The BNB Governing Council amended MF and BNB *Ordinance No. 5* on the Terms and Procedure for Acquisition, Redemption and Trade in Government Securities and MF and BNB *Ordinance No. 15* on the Control over Transactions in Book-entry Government Securities (published in the *Darjaven Vestnik,* issue 38 of 2006) to reflect ESROT.

On completion of ESROT modernization, in June 2006 a project started to modernize the Register of Pledges. This will expand its functions and integrate it with other BNB information systems, and will meet MF requirements.

IX. European Integration and International Relations

European Integration

In the first half of 2006 the BNB focused effort on completing the harmonization of Bulgarian banking and financial legislation with EU requirements, on strengthening administrative capacity for its implementation, and on preparing itself to participate in the European System of Central Banks in view of approaching Bulgarian membership of the European Union from 1 January 2007.[27]

After the publication of the EC Monitoring Report in late 2005, the BNB Governing Council decided to draft all banking sector Bills in the first half of 2006 and submit them to the National Assembly for debating and voting at the beginning of the second half of 2006. This hastening aimed at having the main Bills adopted into law before the autumn of 2006, providing enough time for banks to prepare their implementation from the beginning of 2007.

Between January and June 2006 the Law on Consumer Credit was adopted and the Credit Institutions, Supplementary Supervision of Financial Conglomerates, and Financial Collateral Arrangements Bills, as well as a new Ordinance on Credit Institutions' Capital Adequacy, were drafted. These statutes contribute to full compliance between Bulgarian banking legislation and *acquis communautaire*. Bulgaria is among the first countries to transpose Directives 2006/48/EC and 2006/49/EC into law, through the Law on Credit Institutions and the new Ordinance on Credit Institutions' Capital Adequacy.

The Law on Consumer Credit adopted by the National Assembly in June 2006 completely introduces the requirements of *Directive 87/102/EEA on consumer credit* and the amending *Directives 90/88/EEA* and *98/7/EC*. The law provides effective consumer protection by laying down creditor obligations in consumer credit contracts, as well as other means for protecting and guaranteeing consumers, such as the right to early repayment and the availability of dispute resolution through legal, administrative or conciliation means.

In March and June the BNB Governor attended ECB General Council sittings as an observer. BNB experts attended sittings of the 12 ECB Committees, as well as those of working groups to these Committees, acquiring knowledge and experience of particular significance for BNB membership in the ESCB and the Eurosystem.

Alongside this, BNB experts attended meetings of other EU Council and European Commission bodies. In April the BNB Governor took part in the informal ECOFIN meeting in Vienna, while BNB experts attended the meetings of the Economic and Financial Committee and its substructures, the Regional Group of Banking Supervisors for Central and Eastern Europe (BSCEE), the Financial Services Committee (FSC), the European Banking Committee (EBC), and the Committee of European Banking Supervisors (CEBS) and its Contact Group (GdC).

The BNB continued establishing the required administrative capacity for successful participation of its experts in ESCB Committees and working groups and other EU bodies. BNB observers at ESCB and EU Committees and working groups and key personnel preparing related documentation received training to acquire more thorough knowledge of the functions and legislative and institutional frameworks of the ESCB and ECB, coordination mechanisms between the ECB and NCBs, the role, function and mandates of ESCB committees, and rules for handling ECB documents.

[27] The BNB actively participates in harmonizing legislation and takes part in the following working groups: Freedom to Provide Services, Free Movement of Capital, Economic and Monetary Union, Statistics, Protection of Consumers and Their Health, Financial Control, Lisbon Strategy.

International Relations

ECB President Jean-Claude Trichet visited Bulgaria in February 2006 at the request of the Deputy Prime Minister and Minister of Foreign Affairs and the BNB Governor. At a Bulgarian Diplomatic Institute presentation, Mr Trichet delivered a lecture entitled 'Looking at EU and Euro area Enlargement from a Central Banker's Perspective: the ECB's Views' to senior government officials, parliamentary deputies and businessmen. The ECB President and BNB Governor discussed future cooperation between the two institutions in preparing the Bank for ESCB participation.

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

The BNB Governor sits on the regular meetings of governors of central banks which own Bank for International Settlements equity.

After successfully finalizing bilateral agreements with the Dutch and French central banks in two years, a new twinning project on Bulgarian National Bank Adjustment to operate as a Full-Fledged Member of the European System of Central Banks and the Eurosystem was contracted under the PHARE Programme. The project will be implemented by a consortium of the Banque de France, De Nederlandsche Bank and the Banca d'Italia. Envisaged proceedings fall into nine subcomponents: banking supervision, research and analysis, communication policy, payment systems, accounting and reporting system, balance of payments statistics, risk management system, cash operations and financial markets.

The two-year Financial Sector Integrity project financed by the US Agency for International Development (USAID) advanced significantly in the review period. Assistance focuses on three areas: fighting money laundering, improving financial sector regulation, and enhancing financial sector transparency. Training addressed measures against money laundering and terrorist financing, updates of provisions for on-site supervisory examinations, risk matrix design, and improving report forms. Foreign consultants submitted advice on the new cash centre.

A discussion on financial supervision and cooperation between financial and judicial offices was held in June between law enforcers, the BNB, the Financial Supervision Commission, and the Bulgarian Deposit Insurance Fund. This enhanced coordination between regulators and the judicial system by raising awareness of the new status of regulators and legal developments.

During the reporting period BNB staff attended the Efficient Management Skills, Efficient Presentation Skills and Risk-Based Supervision Framework seminars by the Office of the Superintendent of Financial Institutions in Canada.

Providing technical assistance to lands such as Albania, Macedonia and Kosovo is a new aspect to expanding BNB cooperation and experience sharing with other central banks. European integration, harmonizing legislation with *acquis communautaire*, payment systems, and statistics are among the main spheres of cooperation with the Bank of Albania. Risk management, accounting, and financial planning are the spheres of cooperation with the National Bank of the Republic of Macedonia.

The BNB supported the government in its relations with the IMF, the World Bank and the EBRD in setting out objectives and priorities in these institutions' strategies for Bulgaria and helping, within its purview, to implement agreements with them.

The annual update to the IMF Annual Report on Exchange Arrangements and Exchange Restrictions was drawn up in March. The paper underwent consultations with the Ministry of the Economy and Energy and the Ministry of Finance and reflects the provisions of the Law on the BNB, the Currency Law, Ministry of Finance Ordinance No. 10, the Law on Foreign Investment, and BNB Ordinances No. 8, 27, and 28.

Working consultation meetings with the IMF on Article IV of its Statute were held in May. EBRD support for the financial sector will focus on developments of the non-banking sector and primary and secondary mortgage markets.

X. Statistics

BNB gathers and distributes information on monetary and interest rate statistics, lease activity statistics, international reserves, the balance of payments, gross external debt, foreign direct investment, the international investment position, the international reserve and liquidity template, and imports and exports. Harmonizing statistics with ECB and Eurostat requirements and implementing the Bank's Action Plan are priorities in developing the statistics function.

Monetary statistics methodology guidelines and reporting forms were further developed so as to provide more detailed sectoral and geographical information and include the non-resident sector. BNB started publishing information on commercial banks' deposits and loans broken down by business and quantitative categories in compliance with monetary statistics methodology.

Methodological instructions on interest rate statistics and a manual on their implementation under Regulation ECB/2001/18 were completed, as was a *Book of Samples* for calculating interest rates and a questions and answers booklet on implementing methodological documentation on interest rate statistics. *Methodological Guidelines* for long-term interest rate setting for convergence purposes were drawn up to ECB requirements and in consultation with the Ministry of Finance and the ECB. A new information system for computing the daily and monthly values of the long-term interest rate was developed.

Since bank loans with zero or low interest rates for initially fixed maturity period affect overall interest rate levels, in February 2006 the Statistics Directorate started gathering information on such products from commercial banks. Since May this year the process has been automated.

A new system for compiling and processing commercial banks' balance of payments information on a transaction-by-transaction basis was introduced in early 2006. The commitment to the EU and Eurostat under Chapter 12 *Statistics* for compiling balance of payments statistics with a geographical breakdown was fulfilled and the quality and scope of information from commercial banks was improved. The introduction of a statistics field to payment orders when switching to IBAN made it easier for the commercial banks and their customers to provide information on transactions between residents and non-residents.

The methodology developed by the BNB jointly with the NSI for assessing the balance of payments using FOB prices and freighting revenues and spending was introduced in March 2006. A differentiated valuation approach is applied depending on importer and carrier nationality, goods category, and transport mode. This has resulted in more accurate reporting of freight revenues and spending by vehicle type and location. A methodology for estimating flows from casually employed Bulgarians abroad was also developed and introduced.

New quarterly reporting forms were introduced for portfolio investments by intermediaries and their customers, and for primary dealers of government securities, while work on establishing a security-by-security database continued.

The reporting period saw the publication of Bulgaria's quarterly international investment position in line with international methodology, and of quarterly data on direct investments into and out of Bulgaria.

XI. Research

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

Specialized research under the Research Plan for the 2005 to 2006 Period supported BNB operations by assessing individual economic processes and sectors and developing instruments for forecasting and analyzing economic policy. In line with the Plan, the first half of 2006 saw research and modelling of nominal and real convergence, transmission mechanisms, foreign trade, and obtaining information on interest rates from derivatives' prices. Research results were presented in technical reports and at BNB seminars attended by experts in the respective fields from other institutions and from scientific and non-government organizations.

In June 2006 technical assistance for developing dynamic stochastic general equilibrium models was provided by the IMF with a view to improving the modelling and forecasting system. A general assessment of instruments for simulating various macroeconomic scenarios and forecasting was conducted within the framework of this assistance, recommendations being made and areas for further development being identified.

The first meeting of the Balkans Monetary and Finance History Study Network took place in April 2006. It was attended by representatives of Balkan region central banks, the Austrian National Bank and the Banque de France, and renowned economic historians from academic institutions in Bulgaria, Croatia, France, Greece, Turkey, Serbia, Slovenia, and the UK. The Network aims to deepen awareness of Balkan monetary and financial history and to boost cooperation among Balkan central banks. After discussions the meeting resolved to compile a uniform database of major Balkan economic and monetary variables which would be incorporated into a more comprehensive Balkan Comparative Monetary History project.

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. Over the first half of 2006 a guest researcher worked on the modelling credit in Bulgaria.

XII. Information Infrastructure

The project on the IBAN international bank account standard was launched by the BNB together with all other financial institutions by the end of June 2006. Its implementation led to sizable changes in the information systems servicing payments (RINGS, BISERA, BORICA, the electronic system for settlement accounts of book-entry government securities, the Central Depository information system, and commercial banks' systems). A new register of banking addressable entity (BAE) codes was developed and introduced. Relevant changes were made to other applied systems including modernizations and technological upgrades.

A number of important projects were completed in the reporting period. The International Reserve Management System was developed within the set time frame. The implementation of the Policy and Procedures for the BNB IT Security project resulted in the drafting of a uniform Corporate Policy for BNB IT Security. The ESROT electronic system for registering and servicing government securities trading was completed and the new updated system was launched. Based on modern technologies and with improved functions, the system ensures real-time registration and settlement of transactions.

Work on building a single depository for Banking Supervision Department data continued; following its development and testing, staff training and project implementation began. The launch of a new core banking information system (SAP) started; its first stage of preparing detailed functional and technical specifications (Blueprint) was completed by the close of the review period.

BNB technology infrastructure continued updating and developing. Work addressed computer workstations, servers and a local network, telecommunications items, and basic and specialized programmes.

XIII. Human Resources

The BNB's observer status at the ESCB meant new staff responsibilities and tasks. The Bank assumed additional commitments associated with Bulgaria's EU membership without increasing the number of employees: between January and June 2006 BNB employees numbered 931 against an establishment of 1007. The year-old human resources management system encourages employees to improve qualifications and efficiency.[28]

Qualification improvement is an essential factor in boosting efficiency and performance. Training focuses mainly on macroeconomics, monetary policy, asset and risk management, banking supervision, monetary and banking statistics, accounting, banking and financial law, human resources management, internal audit and legal aspects. A programme to prepare BNB representatives for ESCB committees includes a seminar on the EU, ECB and ESCB statutory framework and specialist language training to bestow levels of proficiency in English or other languages specified by individual job descriptions. Between January and June 2006, 71 BNB employees attended courses in English, six in German, and two in French.

Senior management attended courses in business administration and European integration.

Five BNB employees took part in the CFA Institute's Chartered Internal Financial Analyst remote training programme, three attended preparatory courses for an Institute of Internal Auditors' Chartered Internal Auditor certificate, and eleven trained under the CISCO Academy Sofia Technical University certification programme.

To raise their qualifications, 63 BNB employees attended professional courses and seminars run by the Bank's traditional partners: the International Monetary Fund, JVI – Vienna, the central banks of France, Austria, the UK, Germany, Slovenia, the Netherlands, the Czech Republic and Switzerland, as well as by the Bank for International Settlements in Basle.

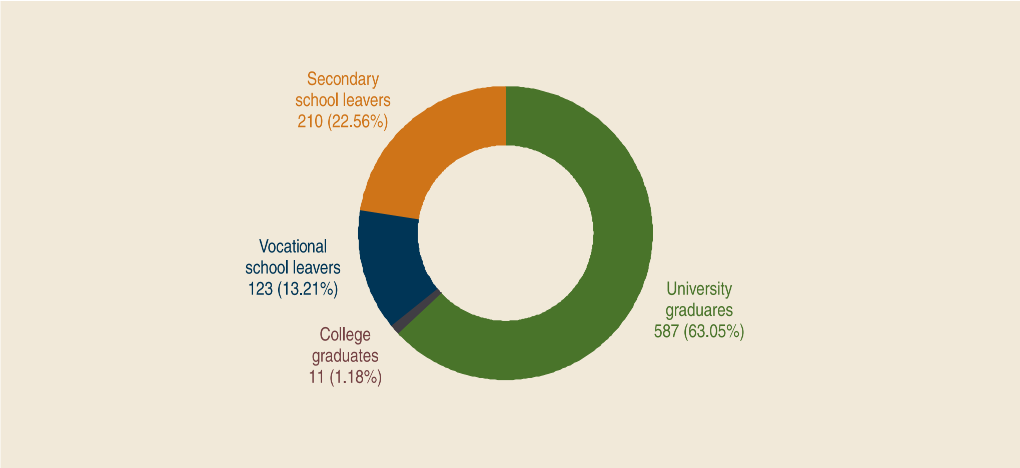
Some 48 employees attended short courses ran by the International Banking Institute and 14 bank employees attended short-term training programmes on specific banking issues. Short induction training was held for 32 new BNB employees.

Thirty-three employees boosted their educational attainments through university remote training programmes. Six employees are reading for doctors' degrees, 22 for masters' degrees (including five second masters' degrees) and a further five are reading for bachelors' degrees.

Staff recruitment strove to improve BNB employees' qualification and age structure.

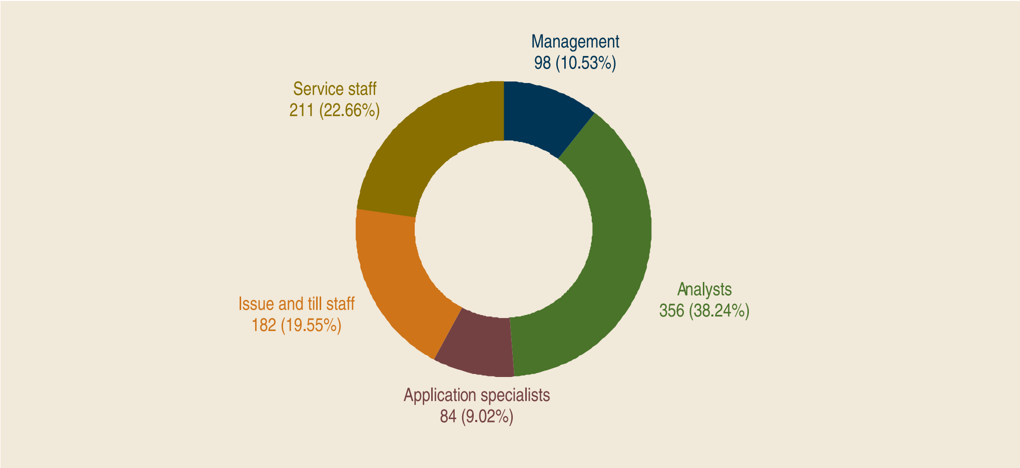
[28] BNB human resources strategy rests on *BNB Staff Assessment Rules, Recruitment Rules, Employee Remuneration Internal Rules, the BNB Staff Code of Ethics, Internal Training Rules, and the Internal Rules on BNB Staff Qualifications Upgrades.*

Staff Qualifications and Educational Structure as of 30 June 2006



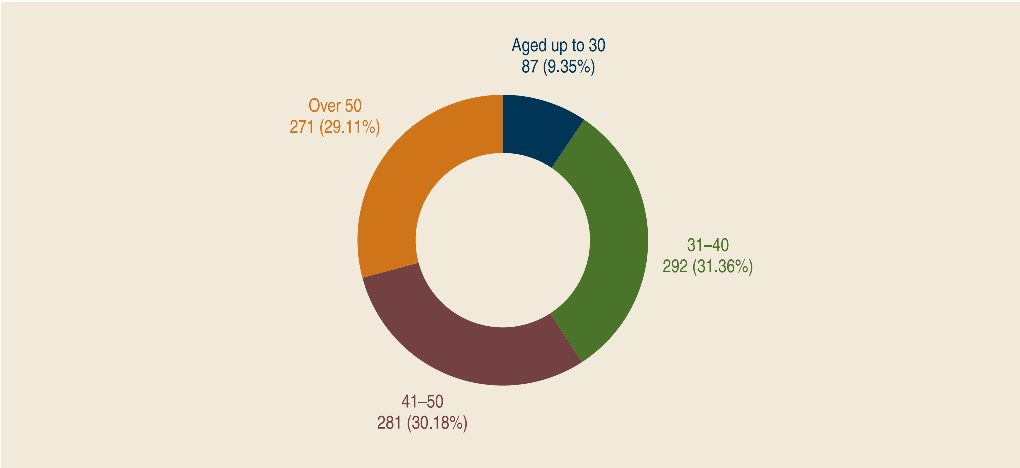
Source: BNB.

Staff Structure by Category as of 30 June 2006



Source: BNB.

Staff Age Structure as of 30 June 2006



Source: BNB.

XIV. Facilities Management

The BNB conducts its functions mainly within its own premises and property, thus ensuring the requisite degree of security and protection. The function of managing BNB long-term assets and estates comprises acquiring and disposing of estates, refurbishing and modernising existing assets, maintaining property and keeping it in line with legislation and local bylaws, and stores, deliveries, and fleet management.

Spending on estates and associated long-term assets is earmarked mainly for the following BNB properties:

1. the three office buildings in Sofia;
2. the cash centre in Sofia (at the design stage);
3. the Varna, Plovdiv, and Pleven regional cash centres;
4. the two staff holiday facilities in Varna and Primorsko.

Over the first half of the year, actual spending comprised the following proportions of budgeted allocations:

- estates refurbishment, 49 per cent;
- new build, refurbishment and modernisation, 24.8 per cent;
- office furniture and office equipment purchases, 28.6 per cent;
- heating and water spending, 45.44 per cent;
- contract maintenance, 18.21 per cent.

The low outturn under new build, refurbishment and modernisation was due to the circumstance that final payments for the erection of offices and car parking facilities at 7 Pozitano Street office building (where the Fiscal Services department moved) and for demolishing incomplete structures erected by an earlier owner at 117 Tsarigradsko Shose Blvd site in the Karo district (the future cash centre) were effected after June 2006.

No new properties were acquired over the first half year and no estate sales revenue accrued. As part of optimizing the vehicle fleet, the BNB disposed of five vehicles by passing them on to offices of state as gifts.

XV. Internal Audit

Under Article 22 of the Law on the Bulgarian National Bank, internal audit at the BNB is conducted by a Chief Auditor appointed by the BNB Governing Council upon approval by the President of the National Audit Office. Major BNB functions were audited in the first half of 2006: monetary policy, maintaining cash circulation, government agency, information and analytical, and administrative functions.

Cash circulation management was audited operationally, alongside compliance audits and assessments of coin minting and production control systems. Progress on recommendations made after previous examinations was followed up.

The BNB's government agency function was examined through an operational audit, a compliance audit, and an IT audit on government securities auctions. These aimed to ascertain the efficiency of control over the major areas and the management of related risks, legal conformity, the reliability of information integrity and confidentiality protection, automated system utilization, and protection against business interruption.

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

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

An operational and financial audits and an internal rules audit addressed procedures for selecting building designers and contractors and goods and service suppliers in conformity with the BNB budget and supply, works and services contracts and assessed internal rule efficiency and contract performance.

The Chief Auditor and Internal Audit experts concentrated on defining systems controls and design of important projects such as the Treasury–TREMA subsystem, the SAP core banking information system, and the new BNB cash centre.

Concluded Audits and Participation in BNB Projects

BNB functions	Audits and participation as of 30 June 2006
Monetary policy	Treasury – TREMA subsystem project
Maintenance of cash circulation	BNB cash centre project
	Coin minting
	Tool destruction
Government agency	Government securities auctions. Government securities register
	IT audit on government securities auctions
	Agency contracts with the Ministry of Finance and international creditors
	Government accounts on agreements with the World Bank
Information and Analytical	SAP core banking information system project
	BNB financial statements as of 30 June 2006
Administrative	Selection of suppliers
	Concluded and executed delivery contracts

XVI. BNB Budget Implementation

The BNB Governing Council adopted the BNB Budget for 2006 at its meeting of 8 December 2005.

1. Operating Expenditure

BNB operating expenditure for the first half of 2006 totaled BGN 27,303,000 or 77.6 per cent of six-month projections and 40.1 per cent of annual budgeted spend.

Currency circulation cost the BNB BGN 6,523,000 or 59.3 per cent of six-month projections and 29.6 per cent of annual budgeted expenditure. Banknote printing cost BGN 4,939,000, and coin minting BGN 1,167,000, including commemorative coins at BGN 155,000. This spending ensured currency purity and security, and effective cash circulation. Spending on consumables for banknote and coin processing was BGN 120,000.

Expenditure on machine spares for servicing currency in circulation came to BGN 32,000. Royalties for commemorative coin designs and for renting premises at the BNB Printing Works and the Mint for issuing purposes accounted for BGN 256,000.

Materials, external services and depreciation spending totaled BGN 9,905,000; of this, materials comprised BGN 317,000 or 56.9 per cent of six-month projections and 28.5 per cent of annual budgeted expenditure. Major expenditure in this group comprised, *inter alia*, BGN 116,000 on office materials, BGN 101,000 on fuel and spare parts for the BNB transport fleet, and BGN 64,000 on inventories.

Expenditure on hired services comprised BGN 5,423,000, or 76.3 per cent of six-month projections and 42.9 per cent of annual budgeted funds. More significant expenses covered Bloomberg, Reuters, SWIFT, Internet and other system provision at BGN 582,000. Software maintenance cost BGN 1,311,000.

Mail, telephone and fax expenses amounted to BGN 256,000, property and refuse collection levies to BGN 591,000, and the BNB security contract with the Ministry of Interior to BGN 1,092,000. Subscription charges to Bankservice AD totaled BGN 190,000, and electric bills came to BGN 179,000.

Depreciation expenses amounted to BGN 4,165,000, or 84.1 per cent of six-month projections or 42 per cent of annual projections.

The salary and social security bill totaled BGN 8,571,000 or 50.7 per cent of expenses budgeted for 2006, including staff provisions to IAS 19.

Social expenditure amounted to BGN 1,217,000, of which BGN 64,000 spent on maintaining BNB staff recreation homes.

Miscellaneous administrative expenditure for the first half of 2006 amounted to BGN 868,000 or 73.7 per cent of six-month projections and 36.5 per cent of the annual budget. The Bank spent money on inland (BGN 17,000) and foreign travel (BGN 150,000), and on staff training at the Bank and regional centres (BGN 410,000). Training under the BNB Staff Educational and Professional Training Programme for 2006 aimed to prepare staff for the BNB's joining the ESCB. Bank representative and protocol costs were also reported.

Expenditure on BNB employees' participation in fora related to BNB membership in the ESCB totaled BGN 219,000, of which BGN 143,000 on travel and BGN 4700 on training. Hiring telecommunications services with the ESCB involved BGN 41,000, and subscription and translation of economics publications amounted to BGN 2000.

2. Investment Programme

Investment expenditure for the reporting period totaled BGN 4,594,000 or 24.8 per cent of budgeted annual costs. Funds went mostly on computerization under the Information and Communications Technology Development Strategy. The total was BGN 3,094,000, of which hardware came to BGN 1,010,000, three new servers to BGN 445,000, one laptop and 50 computer workstations to BGN 445,000; widening the voice communication system to BGN 208,000, a tape drive to BGN 184,000, and miscellaneous items to some BGN 10,000. Software expenses amounted to BGN 2,084,000, including treasury software to BGN 1,688,000, *Sybase ase version* 12.5 license to BGN 126,000, RINGS functional upgrades to BGN 88,000, updates to the government securities settlement information technology system to BGN 55,000, monetary statistics software programme upgrades to BGN 36,000, Symantec upgrades and licenses to BGN 18,000; communication software to BGN 20,000; Check Point software to BGN 17,000; foreign currency accounting system upgrades to BGN 16,000, and government securities auctions software upgrades to BGN 10,000.

Construction, refurbishment and modernization of BNB properties came to BGN 1,089,000, in line with the Governing Council's Buildings Construction, Refurbishment and Maintenance Strategy for 2004 to 2009. Most expenses were on offices and garages in a new administrative building at 7 Pozitano Street and on remodelling premises at 117 Tsarigradsko Shose Blvd in the Karo area of Sofia, where the new cash centre will be.

Implementation of the BNB Budget

Indicators	Report 30.VI.2006 (BGN'000)	Budget 2006 (BGN'000)	Implementation (%)
Section I. BNB operational expenditure	**27 303**	**68 092**	**40.1**
1. Currency circulation expenditure	6 523	22 018	29.6
2. Materials, services and depreciation expenditure	9 905	23 666	41.8
3. Salaries and social security expenditure	8 571	16 897	50.7
4. Social activity expenditure	1 217	1 852	65.7
5. Other administrative expenditure	868	2 377	36.5
6. BNB expenditure on membership in ESCB	219	1 282	17.1
Section II. Investment programme	**4 594**	**21 882**	**21.0**
1. Expenditure on construction, reconstruction and modernization	1 089	4 390	24.8
2. Expenditure on machine spares for servicing currency circulation	20	353	5.7
3. Expenditure on BNB security equipment	188	698	26.9
4. Expenditure on special automobiles	0	760	0
5. Expenditure on BNB computerization	3 094	13 673	22.6
6. Office furniture and equipment	203	710	28.6
7. BNB expenditure on membership in ESCB	0	298	0
8. Expenditure on restructuring currency circulation	0	1 000	0

XVII. BNB Consolidated Financial Statements for the Six Months Ending 30 June 2006 (Unaudited)

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

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

The financial statements prepared by the Bulgarian National Bank are based on the accounting principles approved by the Governing Council in compliance with International Financial Reporting Standards.

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

Ivan Iskrov
Governor of the BNB

Consolidated Income Statement
for the period ended 30 June 2006 (unaudited)

(BGN'000)

	Note	30 June 2006	30 June 2005
Interest and similar income	6	176,956	185,890
Interest expense and similar charges	6	(34,935)	(40,244)
Net interest income		142,021	145,646
Fee and commission income		3,769	3,144
Fee and commission expense		(1,421)	(1,569)
Net fee and commission income		2,348	1,575
Other net financial income/ (expense)	7	(34,601)	169,421
Other operating income	8	13,551	22,087
Total income from banking operations		123,319	338,730
Administrative expenses	9	(35,882)	(29,771)
Net income from banking and subsidiaries' operations		87,437	308,959
Transfer (to)/from special reserves		(59,263)	152,245
Net income from banking and subsidiaries' operations after special reserve transfer		146,700	156,714

The notes set out on pages 69 to 84 form an integral part of the consolidated financial statements.

Consolidated Balance Sheet as at 30 June 2006 (unaudited)

(BGN'000)

	Note	30 June 2006	31 Dec. 2005
ASSETS			
Cash and deposits in foreign currencies	10	4,398,401	3,430,616
Gold, instruments in gold and other precious metals	11	1,200,561	1,102,092
Investment in securities	12	9,746,855	9,823,829
Equity investments and quota in IMF	14	1,491,339	1,551,185
Receivables from the Government of the Republic of Bulgaria	13	619,871	1,094,356
Property, plant and equipment and intangible assets	15	169,808	171,397
Other assets	16	37,273	28,732
Total assets		17,664,108	17,202,207
LIABILITIES			
Banknotes and coins in circulation	21	5,977,068	5,867,213
Due to banks and other financial institutions	17	3,369,788	2,485,207
Liabilities to government, government institutions and other borrowings	18	4,360,125	4,295,273
Borrowings against the Republic of Bulgaria's IMF participation	19	1,381,864	1,438,739
Borrowings from IMF general resources	20	619,871	1,094,356
Accruals and other liabilities	22	19,428	22,573
Total liabilities		15,728,144	15,203,361
EQUITY			
Capital	23	20,000	20,000
Reserves	23	1,912,758	1,975,640
Minority interest	24	3,206	3,206
Total equity		1,935,964	1,998,846
Total liabilities and equity		17,664,108	17,202,207

The notes set out on pages 69 to 84 form an integral part of the consolidated financial statements.

Consolidated Statement of Cash Flows
as at 30 June 2006 (unaudited)

(BGN'000)

	Note	30 June 2006	30 June 2005
Net cash flow from operating activities			
Net income from banking operations		87,437	308,959
Adjustment for non-cash and non operating items:			
Dividend income		-	(5,478)
Depreciation	9, 15	7,098	6,388
(Profit)/loss on disposal of property, plant, equipment and intangible assets		65	(2,147)
(Profit) from sale of BORICA AD shares		-	(4,629)
(Profit) from revaluation of equity investments		-	(2,631)
Profit of associates		-	-
Other non-monetary movements		(83)	411
Gains/(losses) on working capital arising from market movements		47,693	(237,027)
Net cash flow from operating activities before changes in operating assets and liabilities		142,210	63,846
Change in operating assets			
(Increase)/decrease in gold and other precious metals holdings		488	(527)
(Increase)/decrease in securities holdings		(78,680)	(656,350)
(Increase)/decrease in receivables from government		431,234	170,084
(Increase)/decrease in other assets		(4,698)	(185)
Change in operating liabilities			
Increase/(decrease) in due to banks and other financial institutions		884,921	25,720
Increase/(decrease) in deposits and current accounts of the government and other government institutions		76,560	895,111
Increase/(decrease) in borrowings from IMF		(431,234)	(170,084)
Increase in currency in circulation		109,855	200,907
Increase/(decrease) in accruals and other liabilities		(3,224)	(4,010)
Net cash flow from operating activities		**1,127,432**	**524,512**
Cash flow from investing activities			
(Purchase) of non current assets, net		(5,648)	(2,254)
Dividends received		-	5,478
Proceeds from sale of BORICA AD shares		-	(3,777)
Minority interest		-	-
Net cash flow from investing activities		(5,648)	(553)
Cash flow from financial activities			
Payments to government		(150,162)	(149,050)
Net cash flow from financial activities		(150,162)	(149,050)
Net increase in cash and cash equivalents		971,622	374,909
Cash and cash equivalents at beginning of period		3,448,332	2,951,493
Cash and cash equivalents at end of period	10, 16	4,419,954	3,326,402

The notes set out on pages 69 to 84 form an integral part of the consolidated financial statements.

Consolidated Statement of Changes in Equity as at 30 June 2006 (unaudited)

(BGN'000)

	Capital		Revaluation reserves from: non-current assets	Revaluation reserves from: monetary assets	Revaluation reserves from: commemorative coins	Other reserves	Total
Balance as at 30 June 2005	20,000	3,093	105,024	924,091	10,527	752,674	1,815,409
Revaluation of equity investments	-	-	(1,234)	-	-	-	(1,234)
Transfer of unrealized gold revaluation loss	-	-	-	191,887	-	-	191,887
Transfer of net loss on futures	-	-	-	(341)	-	-	(341)
Transfer of net foreign exchange losses	-	-	-	294	-	-	294
Transfer of net revaluation losses of securities	-	-	-	(171,762)	-	-	(171,762)
Revaluation of non-monetary assets	-	-	-	-	-	-	-
Other transfers	-	-	1,714	(199)	(9,689)	428	(7,746)
Payment of the current year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	32,627	32,627
Profit for the year after the contribution to the Budget of Republic of Bulgaria	-	-	-	-	-	50,599	50,599
Other special reserve	-	-	-	-	-	89,000	89,000
Minority interest	-	113	-	-	-	-	113
Balance at 31 December 2005	20,000	3,206	105,504	943,970	838	925,328	1,998,846
Revaluation of equity investments	-	-	-	-	-	-	-
Transfer of unrealized gains on the revaluation of gold	-	-	-	98,957	-	-	98,957
Transfer of net loss on futures	-	-	-	1,944	-	-	1,944
Transfer of net foreign exchange gain	-	-	-	(3,052)	-	-	(3,052)
Transfer of net loss on the revaluation of securities	-	-	-	(157,598)	-	-	(157,598)
Other transfers	-	-	(74)	-	(82)	485	329
Payment of the prior year contribution to the budget of the Republic of Bulgaria	-	-	-	-	-	(150,162)	(150,162)
Net income after special reserve transfer	-	-	-	-	-	146,700	146,700
Balance at 30 June 2006	20,000	3,206	105,430	884,221	756	922,351	1,935,964

The notes set out on pages 69 to 84 form an integral part of the consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Statute and principal activities

The Bulgarian National Bank (the 'Bank') is 100 per cent owned by the Republic of Bulgaria.

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

Under this law, the primary objectives of the Bank may be summarized as:

- Maintaining price stability by ensuring the stability of the national currency;
- Exclusive right to issue banknotes and coins;
- Regulation and supervision of other domestic banks' activities with a view to maintaining the banking system stability, and
- Facilitation of the establishment and operation of efficient and effective payment systems and supervision over them.

The principal operations as a result of this law may be summarized as:

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

The Governing Council of the Bulgarian National Bank approved the consolidated financial statements set out on pages 65 to 86 on 26 October 2006.

2. Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards and interpretations issued by the International Accounting Standards Board (IASB).

3. Basis of preparation

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

The accounting policies of the prior year have been consistently applied.

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

4. Basis of consolidation

Subsidiaries

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

Associates

Associates are those entities in which the Bank has significant influence, but which are neither subsidiaries nor joint ventures. Investments in associates are reported in the Bank's consolidated financial statements according to the equity method as the value corresponding to the Bank's share in the equity of an associate as of the end of the reporting period. The Bank's share of associates' net results subsequent to acquisition is disclosed as investment income/expense in the income statement and is added to/deducted from the carrying value of the investment.

5. Summary of significant accounting policies

(a) Income recognition

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

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

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

(b) Financial instruments

(i) Classification

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

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

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

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

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

(ii) Initial recognition

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

The Bank manages foreign reserves in line with the prudential investment principles and practices as per the requirements of the BNB Law. Investments in securities can only be in liquid debt instruments issued by institutions with high credit rating. On 1 January 2005 the Bank's management changed the classification of its portfolio of available-for-sale securities to securities at fair value through profit and loss. The change in securities portfolio classification is in compliance with the requirements of the revised IAS 39 – Financial Instruments: Recognition and Measurement in effect as of 1 January 2005 which allows the reclassification from available from sale to financial instruments at fair value through profit and loss as a one off transfer.

(iii) Subsequent reporting

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 financial liabilities, except financial liabilities held for trading, originated loans and receivables and held to maturity financial assets are measured at amortized 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 amortized based on the effective interest rate of the instrument.

(iv) Fair value measurement principles and disclosures

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

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

The fair value of derivatives that are not market-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.

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

In accordance with IAS 32, the Bank discloses fair value information on assets or liabilities for which published market information is readily available.

The fair value of cash, deposits, other receivables and liabilities is approximately equal to the book value given, because of their short-term maturity.

(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 and then transferred to a special reserve account as required by the Law on BNB.

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. However, interest calculated using the effective interest method is recognized in the income statement. Dividends on available-for-sale equity instruments are recognized in the income statement where the Bank receives payments on the equity investments.

(vi) Derecognition

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

Available-for-sale financial assets and financial assets at fair value though profit and loss are derecognized on the trade 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 recognized in the balance sheet and are valued according to the accounting policy applicable to assets through profit and loss, or assets available for sale, respectively. Investments lent under automatic securities lending agreements are not derecognized from the Bank's assets. Incomes arising from automatic securities lending transactions are recognized at trade date as interest income.

(viii) Impairment of assets

Financial assets are reviewed at each balance sheet date to determine whether there is 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 marked to market at the London Bullion Market Gold Fix in euro on the balance sheet date.

(d) Equity investments in other entities

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

Details of investments held are set out in note 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 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 through profit and loss as an expense as incurred.

(ii) Depreciation

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

(%)

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

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

(iii) Calculation of recoverable amount

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

(iv) Reversals of impairment

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

(f) Foreign currencies

Income and expenditure arising in foreign currencies is translated into 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 Bank's official exchange rate on the last date of the reporting period. Foreign exchange gains and losses are recognized in the income statement, and are then transferred to or from a special reserve as permitted by the Law on the Bulgarian National Bank, refer note 5 (i) below. Foreign currency denominated non-monetary assets and liabilities are valued at the exchange rate on the date of acquisition or at latest determination of fair value.

Open forward foreign exchange contracts are marked to market.

The exchange rates of major foreign currencies at 30 June 2006 and 31 December 2005 were:

Currency	30 June 2006	31 December 2005
US Dollar (USD)	1 : BGN 1.53845	1 : BGN 1.65790
Euro (EUR)	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rights (SDR)	1 : BGN 2.27594	1 : BGN 2.36959
Gold (XAU)	1 troy ounce : BGN 923.467	1 troy ounce : BGN 847.489

(g) Taxation

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

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

The borrowings from the IMF are denominated in Special Drawing Rights (SDR). Any unrealized exchange gains or losses are accounted for in accordance with note 5(i).

(i) Capital and reserves

The capital represents the non-distributable capital of the Bank.

In accordance with the Law on the Bulgarian National Bank, the Bank is required to transfer to reserves 25 per cent of the annual excess of revenue over expenditure. Special reserves are established as follows: the net gains and losses arising from the revaluation of assets and liabilities denominated in foreign currencies or gold; or upon a decision of the Governing Council.

After transfers to reserves, the excess of the revenue over expenditure is credited to the account of the state budget. In accordance with IAS 10 'Events after the Balance Sheet Date', this contribution is treated as a dividend payment to the state and is held in a reserve account until paid.

(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 published International Financial Reporting Standards that are not yet effective and are relevant to the Bank's activities

IFRS 7 Financial Instruments: Disclosures (effective from 1 January 2007). The Standard will require increased disclosure in respect of the Bank's financial instruments. It supersedes IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions and is applicable to all entities that prepare financial statements in accordance with IFRS. The Bank considers that the significant additional disclosures required will relate to its financial risk management objectives, policies and processes.

Amended IAS 1 Presentation of Financial Statements – Capital Disclosures (effective from 1 January 2007). The Standard has been additionally amended in relation to the requirements of IFRS 7, and will require increased disclosure in respect of the structure of the Bank's capital.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option. The amendment restricts the designation of financial instruments as 'at fair value through profit or loss'. The Bank believes that this amendment should not have a significant impact on the classification of financial instruments, as the Bank should be able to comply with the amended criteria for the designation of financial instruments at fair value through profit or loss.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts (effective from 1 January 2006). The amendment requires guarantees that are not insurance contracts to be measured at fair value upon initial recognition. The Bank does not anticipate any impact of the amendment to IAS 39 on the financial statements.

6. Interest income and expense

(BGN'000)

	30 June 2006	30 June 2005
Interest income		
– on securities	131,855	161,905
– on deposits	44,877	23, 974
– on other	224	11
	176,956	185, 890
Interest expense		
– on deposits	31,333	35,427
– on other	3,602	4,817
	34,935	40 244

Interest expense on deposits paid to the government is BGN 30,409 thousand for 2006 (June 2005: BGN 32,510 thousand). Interest expense on deposits of other state organizations is BGN 912 thousand for 2006.

7. Other net financial incomes/(expenses)

(BGN'000)

	30 June 2006	30 June 2005
Net gains from operations in securities	25,043	17,014
Net gains from operations in foreign currency	105	658
Net revaluation gains on futures	1,944	-
Net revaluation gains/(losses) on securities	(157,598)	40,135
Net revaluation gains/(losses) on foreign currency assets and liabilities	(3,052)	5,803
Net gains/(losses) from revaluation of gold and precious metals	98,957	103,180
Net gains/(losses) from revaluation of equity investments	-	2,631
	(34,601)	169,421

8. Other operating income

(BGN'000)

	30 June 2006	30 June 2005
Net income from disposal of non-current assets	80	2,190
Turnover of subsidiaries	9,900	7,976
Income from associated companies	-	526
Income from sales of coins	363	538
Dividend income	-	5,478
Other income, net	3,208	750
Income from sale of BORICA AD shares	-	4,629
	13,551	22,087

Other income includes income from the derecognition of the old coins and notes still subject to exchange in the amount of BGN 2,213 thousand.

9. Total administrative expenses

(BGN'000)

	30 June 2006	30 June 2005
Personnel costs	12,297	10,594
Administrative expenses	15,272	12,104
Depreciation	7,101	6,399
Other expenses	1,212	675
	35,882	29,771

Personnel costs include salaries, social and health security under the provision of local legislation at 30 June 2006. The number of employees of the Bank and its subsidiaries was 1,257 for 2006 (June 2005: 1,269) including BNB staff of 931 for 2006.

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

Based on actuarial calculations, the Bank has accrued retirement compensation liabilities to the personnel in the amount of BGN 193 thousand and unused annual leave of BGN 1102 thousand. For the BNB Printing Works, actuarial obligations amount to BGN 8 thousand, and for The Bulgarian Mint – to BGN 9 thousand.

10. Cash and deposits in foreign currencies

(BGN'000)

	30 June 2006	31 Dec. 2005
Foreign currency cash	10,755	10,153
Current accounts with other banks	6,884	8,887
Deposits in foreign currency	4,380,762	3,411,576
	4,398,401	3,430,616

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

(BGN'000)

	30 June 2006	31 Dec. 2005
Euro area residents		
In EUR	2,687,796	2,068,506
In other foreign currencies	152	261
	2,687,948	2,068,767
Non euro area residents		
In EUR	1,537,791	1,072,203
In other foreign currencies	172,662	289,646
	1,710,453	1,361,849
	4,398,401	3,430,616

11. Gold, instruments in gold and other precious metals

	30 June 2006		31 December 2005	
	Troy ounces'000	BGN'000	Troy ounces'000	BGN'000
Gold bullion in standard form	513	473,778	513	434,798
Gold deposits in standard form	686	633,632	687	582,145
Gold in other form	17	15,699	17	14,480
Other precious metals	-	3,384	-	2,924
Other instruments in gold	80	74,068	80	67,745
		1,200,561		1,102,092

Gold deposits in standard form include gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 0.02 per cent per annum. The other instruments denominated in gold are held to maturity and earn interest between 1.00 per cent and 1.30 per cent per annum. Gold in other form includes part of the gold commemorative coins, which were transferred from other assets as trading balances in gold upon a decision of the Governing Council of the Bank.

12. Investment in securities

(BGN'000)

Securities at fair value through profit and loss	30 June 2006	31 Dec. 2005
Foreign treasury bills, notes and bonds	9,746,855	9,823,829
	9,746,855	9,823,829

The securities comprise EUR-denominated coupon and discount securities. The coupon interest on the EUR-denominated securities for June is 3.73 per cent in average.

As at 30 June 2006 the value of securities pledged as collateral on futures transactions amounts to BGN 20,050 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 rating	30 June 2006	31 Dec. 2005
Securities according to issuer's credit rating	AAA	6,180,950	7,114,166
	AA+	2,013,182	1,806,876
	AA	1,320,018	781,628
	AA-	232,705	121,159
		9,746,855	9,823,829

13. Receivables from the government of the Republic of Bulgaria

The value of the receivables from the Government of the Republic of Bulgaria as at 30 June 2006 is SDR 272,358 thousand (31 December 2005: SDR 461,833 thousand).

The receivables from the government have been matched to the government's borrowings from the IMF which are repayable according to the repayment schedules of the individual government loans. In February 2006 the Bulgarian Government repaid SDR 127 million ahead of the repayment schedule of the two-year Stand-by Facility of the IMF.

The receivables are repayable as follows:

(BGN'000)

Year	30 June 2006	31 Dec. 2005
2006	104,067	557,328
2007	178,547	185,894
2008	178,548	185,894
2009	119,032	123,930
2010	39,677	41.310
	619,871	1,094,356

14. Equity investments and quota in IMF

(BGN'000)

	30 June 2006	31 Dec. 2005
Republic of Bulgaria's quota in the IMF	1,457,264	1,517,110
Equity investments in international financial institutions	23,706	23,706
Equity investments in domestic companies	10,369	10,369
	1,491,339	1,551,185

The Republic of Bulgaria's quota in IMF is SDR 640,200 thousand. BGN 75,257 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 of 2.86–3.45 per cent semi-annually.

The equity investments in international financial institutions include the equity investment in the Bank for International Settlements (BIS), Basle. Twenty-five per cent of the equity investment in BIS Basle is paid up. The current value of these shares is SDR 10,000 thousand (ref. note 29 (i)).

The capital subscribed but not paid in, has an option to be paid in within three months upon a decision of the BIS' Board of Governors.

None of the equity investments in international financial institutions exceeds 10 per cent of the subscribed share capital of those entities. In 2005 the Bank sold 63.76 per cent of the equity of BORICA AD to commercial banks. As a result of the sale, the Bank holds 36.24 per cent of the equity of BORICA AD and has significant influence on the financial and operational policy of the associated enterprise. The significant equity investments in Bulgarian institutions may be analyzed as follows:

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

15. Property, plant, equipment and intangible assets

(BGN'000)

	Land and buildings	Equipment	Motor vehicles	Fixtures and fittings	Assets in progress	Other	Intangible assets	Total
Cost or valuation								
At 1 January 2006	120,921	80,846	3,995	3,979	7,339	304	10,525	227,909
Additions	776	160	88	25	4597	-	2	5,648
Disposals	-	(172)	(84)	(15)	(132)	-	(16)	(419)
Transfers	-	1,254	-	172	(2,606)	-	1,180	-
At 30 June 2006	121,697	82,088	3,999	4,161	9,198	304	11,691	233,138
Depreciation								
At 1 January 2006	(9,393)	(38,155)	(2,528)	(1,935)	-	(130)	(4,372)	(56,513)
Charge for the period	(1,604)	(4,210)	(188)	(221)	-	(23)	(852)	(7,098)
On disposals	-	171	83	14	-	-	13	281
At 30 June 2006	(10,997)	(42,194)	(2,633)	(2,142)	-	(153)	(5,211)	(63,330)
Net book value at 30 June 2006	110,700	39,894	1,366	2,019	9,198	151	6,480	169,808
Net book value at 31 December 2005	111,535	42,691	1,467	2,044	7,333	174	6,153	171,397

Intangible assets include software, licenses and other intangible assets utilized by the Bank in its operations.

16. Other assets

(BGN'000)

	30 June 2006	31 Dec. 2005
Balances of subsidiaries held with local banks	21,553	17,716
Precious metal commemorative coins for sale (ref. note 11)	756	802
Inventories	6,915	6,328
Accounts receivable	7,397	1,044
Prepaid expenses	7	535
Other	645	2,307
	37,273	28,732

17. Due to banks and other financial institutions

(BGN'000)

	30 June 2006	31 Dec. 2005
Demand deposits from banks and other financial institutions		
- in BGN	1,161,328	1,456,691
- in foreign currency	2,208,460	1,028,516
	3,369,788	2,485,207

The Bank does not pay interest on demand deposits from banks and other financial institutions. Included in demand deposits is BGN 3,128 million representing the required reserves, which all local banks are required to maintain with the Bank as part of their current accounts (31 December 2005: BGN 2,239 million).

18. Liabilities to government, government institutions and other borrowings

(BGN'000)

	30 June 2006	31 Dec. 2005
Current accounts:		
- in BGN	567,329	341,011
- in foreign currency	299,466	426,176
Time deposit accounts:		
- in BGN	2,951,589	2,679,579
- in foreign currency	541,741	848,507
	4,360,125	4,295,273

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in USD earn interest between 3.87 per cent and 4.08 per cent. Government deposit accounts in EUR earn interest between 2.12 per cent and 2.52 per cent and in BGN earn interest between 2.02 per cent and 2.54 per cent.

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

The borrowings against Bulgaria's participation in the IMF as at 30 June 2006 amount to BGN 1,393,329 thousand – SDR 607,134 thousand (at 31 December 2005: BGN 1,435,020 thousand – SDR 605,598 thousand).

Borrowings from the IMF are denominated in SDRs. Borrowings related to Bulgaria's IMF quota are non-interest bearing with no stated maturity.

20. Borrowings from general resources of the IMF

(BGN'000)

	30 June 2006	31 Dec. 2005
Extended fund facility	619,871	1,094,356
	619,871	1,094,356

The borrowings from the general resources of the IMF bear interest at rates set by the IMF on a weekly basis, and as at 30 June 2006, the interest rate amounted to 4.79 per cent. The borrowings from the IMF correspond to the Bank's receivables from the government in the same amount and are payable according to the repayment schedules under the individual agreements – refer to note 13.

Borrowings from the IMF are guaranteed by promissory notes, which have been co-signed by the Government and the Bank. The total promissory notes outstanding as at 30 June 2006 were BGN 2,014,698 thousand (31 December 2005: BGN 2,443,937 thousand) – refer to note 26(i).

21. Banknotes and coins in circulation

(BGN'000)

	30 June 2006	31 Dec. 2005
Banknotes in circulation	5,878,704	5,774,024
Coins in circulation	98 364	93,189
Currency in circulation	5,977,068	5,867,213

In 2005 the BNB Governing Council decided the liability related to the old coins to be written off and taken to the income statement and the liability in respect to the old banknotes to be taken to deferred income and recognized in the income statement over a period of three years.

22. Accruals and other liabilities

(BGN'000)

	30 June 2006	31 Dec. 2005
Salaries and social security payable	2,733	1,704
Deferred income	7,822	10,316
Other liabilities	8,873	10,553
	19,428	22,573

Deferred income include the amount of BGN 6,860 thousand which represent the deferred income from the old banknotes which are written off and not in circulation, and the term for their exchange has not expired.

23. Capital and reserves

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

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

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

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

24. 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. The State, as represented by the Minister of Finance, holds 4.4 per cent of the company's equity – 3093 shares with par value of BGN 1000.

25. Monetary liabilities and gross international foreign exchange reserves

(BGN'000)

	30 June 2006	31 Dec. 2005
Gross international foreign exchange reserves		
Cash and deposits in foreign currency	4,398,401	3,430,616
Monetary gold and other instruments in gold	1,181,478	1,084,688
Securities investments	9,746,856	9,823,829
Equity investments and quota in IMF	75,257	78,198
	15,401,992	14,417,331
Monetary liabilities		
Banknotes and coins in circulation	5,977,068	5,867,213
Due to banks and other financial institutions	3,361,823	2,483,916
Liabilities to government institutions	4,245,652	4,120,515
Other borrowings	122,476	176,048
	13,707,019	12,647,692
Surplus of gross international foreign exchange reserves over monetary liabilities	1,694,973	1,769,639

For the purposes of disclosing gross international foreign exchange reserves and monetary liabilities in accordance with the Law on the Bulgarian National Bank, monetary gold is marked to market based on the euro/gold fixed exchange rate of the London Bullion Market at the BNB balance sheet date.

26. Related party transactions

(i) Bulgarian government

International Monetary Fund

All the borrowings of the Government of the Republic of Bulgaria and of the Bank from the IMF are undertaken through the Bank. The Government's borrowings from the IMF are matched by a receivable from the Government to the same amount. For the Bank to eliminate any foreign exchange risk, the Government receivable is also denominated in SDR.

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

The IMF quota is secured by promissory notes jointly signed by the Bank and the Government (ref. notes 19 and 20).

Government bank accounts

Government budget organizations and other government organizations have current accounts and time deposits with the Bank (ref. note 18).

Fiduciary activities

In accordance with the Law on BNB and under terms agreed upon with the Minister of Finance, BNB performs an agency function for government or government-guaranteed debts. With regard to this role, BNB performs agent and central depository services related to the administration and management of government securities issued by the Ministry of Finance. The Bank receives 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 30 June 2006, the par value of the total securities held in custody was BGN 2,983 million (31 December 2005: BGN 2,843 million).

27. Subsidiaries

(%)

Ownership interest	30 June 2006	31 Dec. 2005
State Mint	100	100
BNB Printing Works (ref. note 24)	95.6	95.6

The net income from subsidiaries for the period comprises net profit of BGN 600 thousand from the State Mint and BGN 404 thousand from the BNB Printing Works.

28. Risk management disclosures

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 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 means of strategic asset allocation and determination of the foreign exchange reserves benchmark, and applying investment limits. On an annual basis, the maximum allowable market risk is determined through the Value-at-Risk indicator.

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.

The investment limits set the framework within which the Bank's international reserves are managed. The main portfolios and the benchmarks corresponding to them, as well as all limits for credit, interest, currency and operational risk have been defined. An exhaustive list of approved issuers and debt instruments which the BNB may invest in, as well as a list of foreign financial institutions acting as BNB counterparties, have been prepared.

Rules of behaviour and procedures regulating the performance of the functions and tasks of the main structural units responsible for the foreign currency reserve management have been detailed.

In view of optimizing foreign currency reserves management, new financial instruments are periodically studied, analyzed, and proposed for approval. This is with a view to achieve high degree of diversification, hedging of market risks and additional incomes.

(a) Credit risk

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

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

- Bonds and commercial paper issued by countries, central banks and state-guaranteed institutions;
- Bonds and commercial paper issued by supranational financial institutions, short-term foreign currency and gold deposits placed with supranational financial institutions;
- Commercial paper issued by commercial banks and short-term foreign currency and gold deposits placed with commercial banks;
- Secured Eurobonds – these are relatively new financial instruments issued in many countries in the euro area, of which bonds issued by German and French financial institutions of the type Jumbo Pfandbriefe, Obligations Foncieres and Irish Asset Covered Securities are currently eligible for investment;
- Bonds issued by agencies and other financial institutions, which are not guaranteed by the state.

In the preceding year 2005 the Bank included a new financial instrument – bond and interest rate futures traded on the international regulated markets in the management of the foreign currency reserves. The Bank has started its participation in two new securities lending agreement programmes. The securities lending transactions are performed by the intermediation of a bank agent or the depository of the securities.

For all instruments issued by states, central banks or state-guaranteed financial institutions there is a minimum exposure limit. This limit ensures that certain part of the foreign currency reserves will be invested in the most risk-free and highly-liquid class of assets. For the other asset classes above, there are maximum exposure limits both in terms of balance levels and by portfolio. All limits directly depend on the inherent credit risk of the respective class of assets.

An approved policy has been developed in the Bank with regard to the BNB counterparties involved in the gross international reserves management, which sets forth the rules for the selection, review and rating of counterparties, and any changes made to the list of counterparties. According to the current policy, the BNB uses the ratings of the following three internationally recognized rating agencies – Standard and Poor's, Moody's and Fitch Ratings. Foreign financial institutions acting as BNB counterparties are divided into two groups:

- 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.
- 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 share 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 or foreign currency placed with commercial banks, and of the commercial paper issued by them.

(b) Liquidity risk

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

The Bank's customers are determined by the Law on the BNB. It attracts funds by means of a number of instruments – deposits/investment accounts, a structured indexed account (SIA), settlement accounts and other borrowed funds established by law. The Bank strives to maintain a balance between the maturity of borrowed funds and that of assets through investments in financial instruments with a range of maturities. The Bank is able to provide the required liquidity by investing in various types of instruments. There are limits to ensure minimum liquidity *per* currency type. This liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments.

The Bank has set 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 meeting its goals and targets set in terms of the overall Bank strategy. To ensure its future payments, the Bank holds portfolios of liquid assets denominated in euro and US dollars as part of its overall liquidity risk management strategy.

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

(BGN'000)

As at 30 June 2006	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Total
Assets						
Cash and deposits in foreign currency	4,398,401	-	-	-	-	4,398,401
Gold, instruments in gold and other precious metals	499,972	133,660	-	74,068	492,861	1,200,561
Investment in securities	1,409,484	1,752,117	4,522,347	1,938,405	124,502	9,746,855
Equity investments and quota in IMF	75,257	-	-	-	1,416,082	1,491,339
Receivables from the Republic of Bulgaria Government	7,397	47,074	138,870	426,530	-	619,871
Property, equipment and intangible assets	-	-	-	-	169,808	169,808
Other assets	3,913	14,921	17,557	8	874	37,273
Total assets	6,394,424	1,947,772	4,678,774	2,439,011	2,204,127	17,664,108
Liabilities						
Banknotes and coins in circulation	-	-	-	-	5,977,068	5,977,068
Due to banks and other financial institutions	3,369,788	-	-	-	-	3,369,788
Liabilities to Government, government institutions and other borrowings	4,338,447	-	21,678	-	-	4,360,125
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	1,381,864	1,381,864
Borrowings from general resources of IMF	7,397	47,074	138,870	426,530	-	619,871
Accruals and other liabilities	4,007	692	3,328	8,799	2,602	19,428
Total liabilities	7,719,639	47,766	163,876	435,329	7,361,534	15,728,144
Asset-liability maturity mismatch	(1,325,215)	1,900,006	4,514,898	2,003,682	(5,157,407)	1,935,964

(BGN'000)

As at 31 December 2005	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Total
Assets						
Cash and deposits in foreign currency	3,194,792	235,824	-	-	-	3,430,616
Gold, instruments in gold and other precious metals	582,145	-	-	67,745	452,202	1,102,092
Investment in securities	592,982	1,926,517	2,231,059	2,354,527	2,718,744	9,823,829
Equity investments and quota in IMF	78,199	-	-	-	1,472,986	1,551,185
Receivables from the Republic of Bulgaria Government	23,104	358,835	175,389	537,028	-	1,094,356
Property, plant, equipment and intangible assets	-	-	-	-	171,397	171,397
Other assets	14,553	12,678	52	1,331	118	28,732
Total assets	4,485,775	2,533,854	2,406,500	2,960,631	4,815,447	17,202,207
Liabilities						
Banknotes and coins in circulation	-	-	-	-	5,867,213	5,867,213
Due to banks and other financial institutions	2,485,207	-	-	-	-	2,485,207
Liabilities to Government, government institutions and other borrowings	4,273,419	21,854	-	-	-	4,295,273
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	1,438,739	1,438,739
Borrowings from general resources of IMF	23,104	358,835	175,389	537,028	-	1,094,356
Accruals and other liabilities	17,862	-	2,322	-	2,389	22,573
Total liabilities	6,799,592	380,689	177,711	537,028	7,308,341	15,203,361
Asset-liability maturity mismatch	(2,313,817)	2,153,165	2,228,789	2,423,603	(2,492,894)	1,998,846

(c) Market risk

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

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

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations. Interest-earning assets (including investments) and interest-bearing liabilities mature or reprice at different times or in different amounts. The Bank uses modified duration as a key measurement for interest rate risk. Modified duration measures the effect of the change of the market value of an asset (liability) in response to 1 per cent change of the interest rate levels. 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.

With regard to assets and liabilities with floating interest rates, the Bank is exposed to the risk of change in the base which serves to determine interest rates.

In 2005 the bond and interest rate futures were included in the allowed tradable financial instruments as part of the efforts of the BNB to improve the efficiency of the foreign currency reserves' management. Futures are highly liquid financial instruments with low transaction costs and are used in cases when the financial instruments portfolios need to be rebalanced.

The periods of interest rate scale change are given below. The maximum period for all assets and liabilities under the scale is one year.

(BGN'000)

As at 30 June 2006	Effective rate	Total	Floating rate instruments	Fixed rate instruments		
				Less than 1 month	Between 1 month and 3 months	Between 3 months and 1 year
Assets						
Cash and deposits in foreign currency	2.91	4,385,782	6,743	4,379,039	-	-
Gold, instruments in gold and other precious metals	0.15	707,385	-	499,963	133,660	73,762
Investment in securities	3.04	9,660,626	-	1,400,041	1,738,574	6,522,011
Equity investments and quota in IMF	-	75,257	-	75,257	-	-
Receivables from the Republic of Bulgaria government	-	619,871	619,871	-	-	-
Other interest-bearing assets	-	20,914	-	20,914	-	-
Non interest-bearing assets	-	2,194,273	-	-	-	-
Total		17,664,108	626,614	6,375,214	1,872,234	6,595,773
Liabilities						
Due to banks and other financial institutions		3,369,788	-	3,369,788	-	-
Liabilities to Government, government institutions and other borrowings	2.54	3,626,669	146,687	3,458,468	-	21,514
Borrowings from general resources of IMF	-	619,871	619,871	-	-	-
Non interest- bearing liabilities	-	8,111,816	-	-	-	-
Total		15,728,144	766,558	6,828,256	-	21,514
Assets/Liabilities gap		1,935,964	(139,944)	(453,042)	1,872,234	6,574,259

(BGN'000)

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

(d) Currency risk

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

As a result of the currency board arrangement in Bulgaria, the Bulgarian currency is fixed to the euro. As the currency in which the Bank presents its financial statements is the Bulgarian lev, the Bank's financial statements are impacted by movements in the exchange rates between the currencies outside the euro area and the lev.

The Bank's transactions give rise to foreign exchange gains and losses that are recognized in the income statement and may then be transferred to special reserves.

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

BGN and foreign currency denominated assets and liabilities could be analyzed as follows:

(BGN'000)

	30 June 2006	31 Dec. 2005
Assets		
Bulgarian levs and euro area currencies	14,253,835	13,173,795
US dollars	103,983	285,148
Japanese yen	36	55
Pound sterling	356	494
SDR	2,102,463	2,636,920
Gold	1,200,255	1,099,117
Other	3,180	6,678
	17,664,108	17,202,207

Liabilities and equity		
Bulgarian levs and euro area currencies	15,552,968	14,385,697
US dollars	107,588	281,227
Japanese yen	-	-
Pound sterling	41	5
SDR	2,000,533	2,532,218
Gold	-	-
Other	2,978	3,060
	17,664,108	17,202,207
Net position		
Bulgarian levs and euro area currencies	(1,299,133)	(1,211,902)
US dollars	(3,605)	3,921
Japanese yen	36	55
Pound sterling	315	489
SDR	101,930	104,702
Gold	1,200,255	1,099,117
Other	202	3,618

29. Commitments and contingencies

(i) Participation in the Bank for International Settlements

The Bank holds 8000 shares of the capital of BIS, Basle, each amounting to SDR 5000. Twenty-five per cent of the equity investment in BIS Basle is paid up. The capital subscribed but not paid in is with an option to be paid in within three months following a decision of the BIS' Board of Governors. The contingent amount as at 30 June 2006 is BGN 68,278 thousand.

(ii) IMF quota and borrowings

The IMF quota and borrowings are supported by promissory notes jointly signed by the Bank and the Government of the Republic of Bulgaria amounting to BGN 2,014,698 thousand (2005: BGN 2,443,937 thousand).

(iii) Capital commitments

As at 30 June 2006, the Bank has committed to BGN 6537 thousand to purchase non-current assets.

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

30. Events subsequent to the balance sheet date

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

Major Resolutions of the BNB Governing Council

12 January *Methods of Determining and Updating the Selling Prices of Banknotes and Coins sold by the BNB at a price other than the nominal value* were approved.

19 January As of 14 February 2006 the BNB put in circulation a coloured silver commemorative coin 'Vine-growing and Wine Production' with a nominal value of BGN 5, issue 2006.

2 February *Amendments to BNB Ordinance No. 3 on Funds Transfers and Payment Systems* were adopted.

Amendments to BNB Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes were adopted.

17 February Procedure for open tender requited disposal of ownership of a BNB estate, a part of a building located in 6A, Slaveikov Square, Sofia was approved.

24 February *Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks* were adopted.

New format and content of commercial bank reports under ordinance No. 21 and instructions for their completion were approved.

Amendments to BNB Ordinance No. 8 on the Capital Adequacy of Banks were adopted.

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

2 March *Amendments to BNB Ordinance No. 3 on Funds Transfers and Payment Systems* were adopted.

23 March The Report on the Implementation of the 2005 BNB Budget was approved.

As of 19 April 2006 the BNB put in circulation a silver commemorative coin 'Bulgarian Black Sea Coast', National Parks and Reserves series, with a nominal value of BGN 10, issue 2006.

List Including the Types of Documents Used by the BNB was approved.

6 April *Manual of BNB Internal Audit Work* was approved.

General Terms of the Bulgarian National Bank for Supplying Banknotes and Coins at an Announced Value were approved.

Tariff of Fees Collected by the Bulgarian National Bank for Banknote and Coin Supply was approved.

Corporate Policy for BNB IT Security was approved.

20 April *The BNB Annual Report for 2005* was approved.

4 May *Amendments to BNB Ordinance No. 5 on the Terms and Procedure for Acquisition, Redemption and Trade in Government Securities* were approved.

Amendments to BNB Ordinance No. 15 on the Control over Transactions in Book-entry Government Securities were approved.

Tariff of Fees and Commission for Processing of Government Securities Transactions was approved.

Internal Rules for the Work of the Programme Council of Banking and Finance History Research and Publications were approved.

As of 23 May 2006 the BNB put into circulation a partially gold-plated silver commemorative coin 'Treasures of Bulgaria – Letnitsa' with a nominal value of BGN 10, issue 2006.

18 May *The BNB Staff Code of Ethics* was supplemented.

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

Amendments to BNB Ordinance No. 22 on the Central Credit Register of Banks were approved.

13 June As of 3 July 2006 the BNB put into circulation as legal tender a banknote of BGN 50 nominal value, issue 2006.

Additional members of the BNB Consultative Council were included.

29 June *Amendments to BNB Ordinance No. 36 on Custodian Banks under the Social Security Code* were approved.

Internal Rules on the Selection Procedures for Subcontractors of Public Awards were approved.

CD Contents

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