Bulgarian National Bank

REPORT • January – June 2010

BANQUE NATIONALE DE BULGARIE

Bulgarian National Bank

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

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

Under the provisions of Article 1, paragraph 2 and Article 50 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's Semi-annual Report for the period ending 30 June 2010.

Ivan Iskrov
Governor
of the Bulgarian National Bank

BNB Governing Council

Sitting from left to right: Kalin Hristov, Ivan Iskrov, Rumen Simeonov, Dimitar Kostov.
Standing from left to right: Oleg Nedyalkov, Penka Kratunova, Statty Stattev.

Governing Council

Ivan Iskrov
Governor

Dimitar Kostov
Deputy Governor
Banking Department

Rumen Simeonov
Deputy Governor
Banking Supervision Department

Kalin Hristov
Deputy Governor
Issue Department

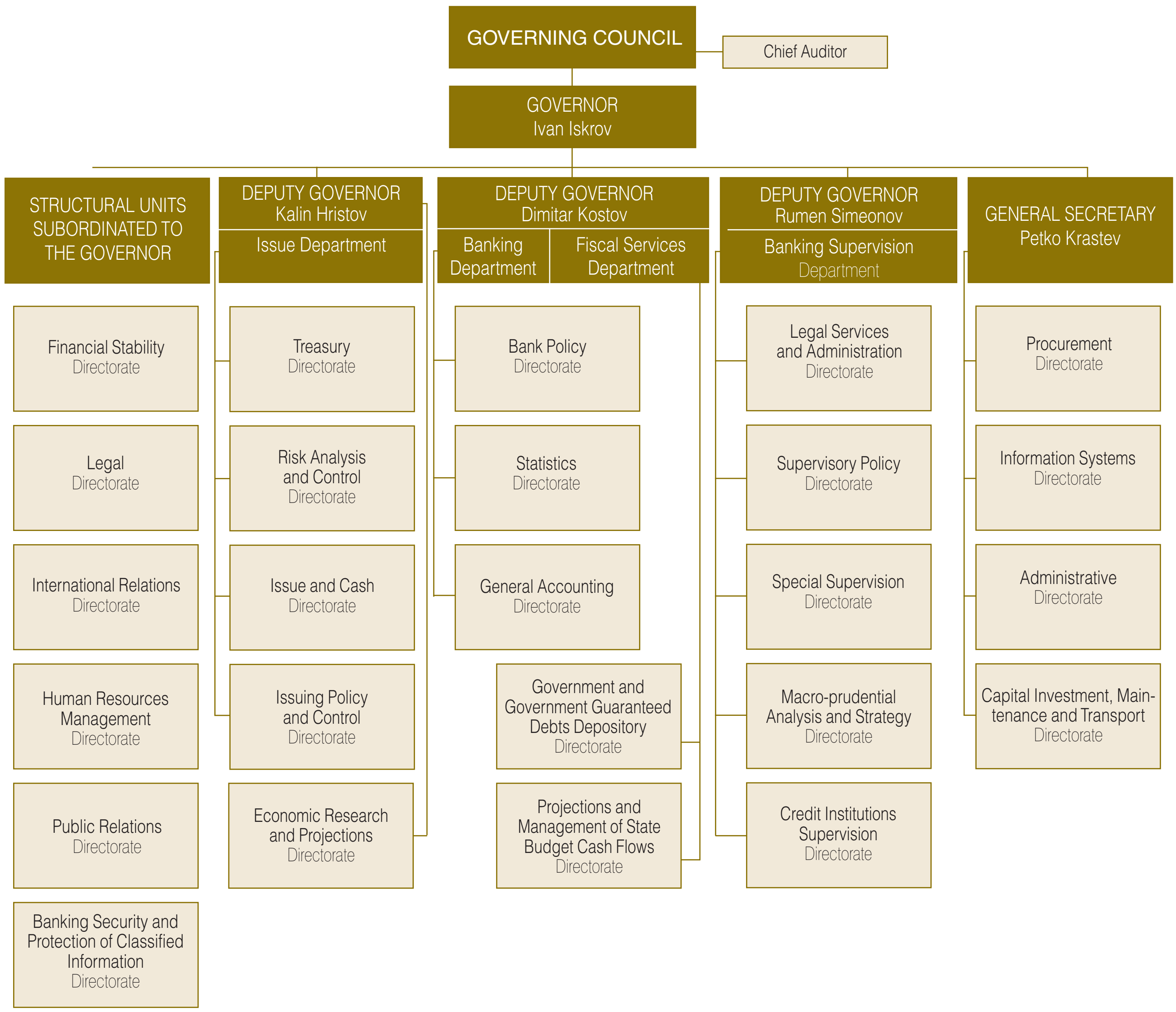
Oleg Nedyalkov

Penka Kratunova

Statty Stattev

Organisational Structure of the BNB

(as of 1 October 2010)



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Abbreviations

BIR	Base interest rate
BIS	Bank for International Settlements, Basle, Switzerland
BISERA	System for servicing customer payments initiated for execution at a designated time
BNB	Bulgarian National Bank
BORICA	Banking Organization for Payments Initiated by Cards
BSE	Bulgarian Stock Exchange
BTC	Bulgarian Telecommunication Company
CEFTA	Central European Free Trade Association
CIF	Cost, Insurance, Freight
CM	Council of Ministers
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Council
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union
FLIRBs	Front-loaded Interest Reduction Bonds
FOB	Free on Board
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IFO	Institute of Economic Research, Germany
IMF	International Monetary Fund
MF	Ministry of Finance
MFIs	Monetary financial institutions
NLO	National labour office
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
RINGS	Real-time Interbank Gross Settlement System
SBL	State Budget Law
SDR	Special Drawing Rights
TFP	Transitional and Final Provisions
VAT	Value Added Tax
ZUNK	Bulgarian abbreviation of the Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990 (LSNC)

Summary

In the first half of 2010 the global economic environment continued to improve. Despite enhanced optimism about output, employment, and new orders in industry and services, the recovery remained unstable. The spring saw increased tension on international financial markets. Fears that some euro area countries would face difficulties financing budget deficits and servicing debt hit the bond market, prompting significant differentiation in bond yields. Countries curbing budget deficits and debt enjoyed investor credibility and higher bond prices; those with significant fiscal deficits and public debt suffered sharp increases in risk premia and bond price falls.

Uncertainty on world financial markets meant new investment constraints for BNB gross international reserves to further reduce risks for the Bank. A temporary move in late April 2010 banned purchases of debt issued or guaranteed by countries with worsened fiscal positions and high public debt. This covered the Bank's entire portfolio, including portions managed by external managers. Exposure to banks in such countries was also circumscribed. Since then maturing funds and new gross reserve revenue are invested mainly into German and French government and government-guaranteed debt and short-term deposits to cut risk and maintain liquidity. Investment into assets with the highest long-term credit rating (AAA) averaged 52 per cent over the period. Investment constraints and market opportunities yielded EUR 38.79 million of income over the first half of the year. Net earnings from international reserve management were EUR 357.91 million: 3.22 per cent net profitability.

Maintaining banking system stability, an important BNB policy priority, reflected profound analyses to offer timely and adequate information on trends and risks in the banking system. The Bank assesses banking and financial system stability through early warning and risk estimation methods and analyses of diverse development scenarios. Publishing macro-prudential analyses helped inform the public on the state of the banking system.

Since banks amended strategies as the global crisis began in late 2008, their financing has depended on attracting domestic resource. Increased household thrift, decreased cosumption and sustained confidence in banks have boosted deposits despite falling interest rates. Taking advantage of this, and of low credit demand, banks used their increased liquidity to cut external debt by EUR 1107.6 million.

Turmoil in the world financial markets and low economic activity in Bulgaria continued to hit Bulgarian banks. Credit portfolio quality worsened further. Net interest margins, provisions, security on loans, and capital buffers helped offset the level of classified loans. Most institutions stayed in profit despite high impairment costs. Non-performing loans will probably continue increasing in the second half of 2010; consistent BNB anti-cyclic measures, accumulated capital, provision buffers, an excess of revenue over impairment costs, and current profits will help banks stay afloat.

In the first half of 2010 bank supervision was intensive and efficient. Regular reporting and on-site inspections provided data for monthly analyses of institution performance and for system risk profile and risk management status. Periodical stress tests assessed banks' stability and capacity to retain it under putative shocks of varying sharpness and scope. The results helped formulate supervisory measures and anti-cyclic policy.

Other important BNB functions involved guaranteeing effective payment systems and cash circulation. The first half of the year saw two most important projects in these areas completed.

In early February 2010 the Bank and the national banking community joined the Trans-European Automated Real-time Gross Settlement Express Transfer system (TARGET2). This was a great step to Bulgaria's integration into the European financial market and payment infrastructures. After Bulgarian entry, TARGET2 participants numbered 23, six of them outside the euro area.

In early April the new BNB Cash Centre opened, launching an important reorganisation of Bulgarian cash circulation. The Centre is among the most modern of its kind within the ESCB and features the strictest security measures. It raises BNB cash processing, storage, and destruction to a new level of reliability. The newly established Cash Centre continues to provide standard cash services to its customers and to service payments of individuals in national and reserve currency (euro).

On the international scene, the new EU financial supervisory architecture was at the focus of central banks' attention in the first half of 2010. The BNB actively participated in establishing the European Systemic Risk Board and supervisory bodies in the area of banking operations, insurance, securities, and pensions, as well as in amending sector directives related to the new supervisory framework.

Bank representatives participated in 82 European Commission, European Council, and ESCB committees and working groups, formulating monetary and banking policy and deliberating central banking issues.

Growing expert capacity and experience gained in recent years helped the BNB expand and deepen international cooperation and render technical assistance to neighbouring central banks.

I. Economic Development in the First Half of 2010

1. The External Environment

The global economy continued growing during the first half of 2010. Growth recovery was largely due to fiscal and monetary measures by the leading economies in 2009. Asia made an important contribution to the recovery with the highest growth over the half-year. The Chinese economy picked up by 11.9 per cent on an annual basis during the first quarter of 2010 and 11.1 per cent during the second quarter amid government steps to prevent overheating and curb property speculation. The euro area and United States economies grew by 2.4 and 0.8 per cent respectively on an annual basis during the first quarter, rising to 3.0 and 1.9 per cent respectively in the second quarter. Between January and June industry led the recovery, global output growing by some 10 per cent[1] on an annual basis on the same period a year ago, while trade grew by 21 per cent[2] on an annual basis by June.

Major Macroeconomic Indicators
(average annual change)

(%)

	Growth				Inflation				Unemployment			
	2008	2009	2010		2008	2009	2010		2008	2009	2010	
			I quarter	II quarter			I quarter	II quarter			I quarter	II quarter
EU-27	0.5	-4.2	0.7	1.9	3.7	1.0	1.7	2.0	7.0	8.9	10.1	9.5
Euro area-16	0.5	-4.1	0.8	1.9	3.3	0.3	1.1	1.5	7.5	9.4	10.4	9.9
EU-8	3.8	-3.0	1.0	2.0	6.6	3.7	3.0	2.8	6.5	8.3	10.5	9.8
EU-3	-0.2	-4.9	0.9	5.3	3.6	2.1	3.1	3.2	5.5	7.5	8.1	8.1
USA	0.0	-2.6	2.4	3.0	3.8	-0.3	2.4	1.8	5.8	9.3	9.7	9.7
Japan	-1.2	-5.2	4.4	1.9	1.4	-1.4	-1.2	-0.9	4.0	5.1	4.9	5.2
China	9.6	8.7	11.9	11.1	5.9	-0.7	2.2	2.9	4.2	4.3	:	:

Note: EU-8 includes the states that have joined the EU since 2004, excluding those that are already members of the euro area. EU-3 includes the United Kingdom, Sweden and Denmark. The EU-8 and EU-3 indicators have been calculated by weighing the time series, using the weights of the respective countries in the group's total GDP (in terms of growth), in the total value of the group's labour force (in terms of unemployment), while in weighing inflation – the weights of the EU-27 countries in HICP, calculated by Eurostat.

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

During the first six months of 2010 euro area economic indicators were relatively buoyant, despite fluctuations reflecting worries about budget deficit financing and government debt in set countries. The worries overcome, second quarter data were better than expected. The major contribution was by Germany where real GDP growth rose to 4.1 per cent on an annual basis during the second quarter because of higher goods exports to Asia.

The US recovery which started in mid-2009 continued despite moderating on a quarterly chain basis. Unemployment remained high at 9.5 per cent by June, job creation depending mainly on temporary factors. Household debt continued falling until the end of the second quarter. Consumer credit continued contracting, with rising mortgage applications reflecting refinancing of existing loans. Housing demand declined substantially after house buying tax relief ended.

In the first six months of 2010 global inflation picked up to an average of 3.5 per cent[3] on an annual basis against 2.15 per cent over the same period of 2009, developing economies contributing most. Main drivers were energy and commodity price rises on the international market. In June euro area inflation went up to 1.4 per cent on an annual basis

[1] World Bank data from 13 September 2010.
[2] CPB Netherlands Bureau for Economic Policy Analysis data from 23 September 2010.
[3] International Monetary Fund data from 20 September 2010.

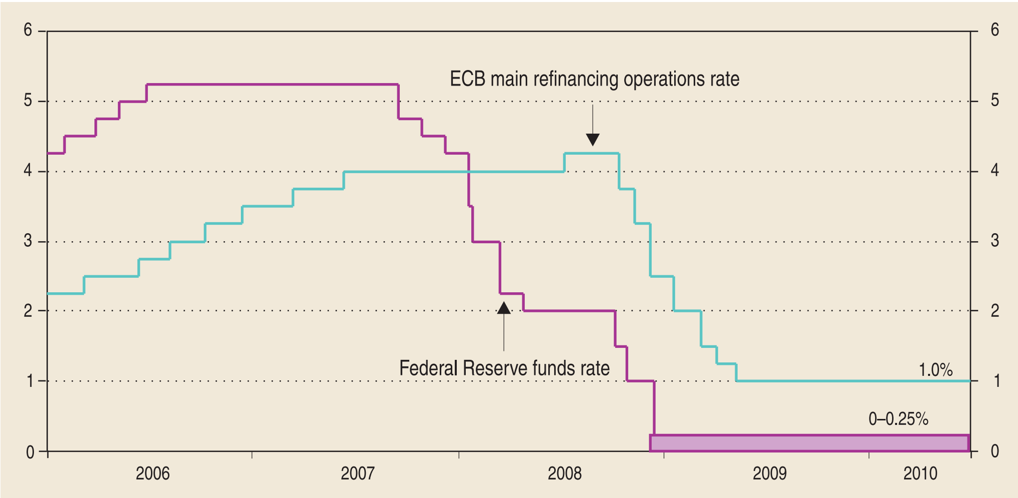
against 0.9 per cent by December 2009. Core inflation stabilised at 1.0 per cent on an annual basis in June against 1.1 per cent in December 2009. US inflation slowed from 2.8 per cent in December 2009 to 1.8 per cent in June 2010, core inflation falling from 1.8 per cent in December 2009 to 1.0 per cent in June 2010. Free production capacity and high unemployment continued restraining euro area and US consumer prices.

Brent crude prices remained relatively stable during the first half of 2010 at USD 77.7/EUR 59.2 per barrel on average, peaking at USD 84.9 in April. Food prices rose slightly in the first six months of 2010, the index rising 6.6 per cent on an annual basis by June. Economic and industrial output growth boosted commodity prices. Metals rose most at 47 per cent by June 2010 on an annual basis, iron ore and nickel rises of 85 and 29.9 per cent on an annual basis contributing most.

The ECB Governing Council kept repo interest at 1 per cent during the first half-year. In the second quarter the ECB extended the duration of unconventional money market measures. This reflected growing concerns about increasing fiscal imbalances in the euro area and emerging tensions in individual segments of the government securities market. The ECB's package of crisis measures included purchasing government and corporate securities (the Securities Markets Programme) and weekly sterilising operations to absorb the additional liquidity provided by the Banking System Programme. The Programme aimed to stabilise certain segments of the euro area government securities market and did not entail ECB monetary policy changes. The measures included an extraordinary supplementary six-month refinancing operation in May, and switching back to fixed-rate tenders with unlimited liquidity allotment in three-month long-term refinancing operations. The ECB restored swap lines with the Federal Reserve for US dollar refinancing. In addition, the minimum permissible rating of assets accepted as refinancing security (excluding ABS-instruments) remained BBB- until after the end of 2010. After the substantial Greek credit rating downgrade this requirement was suspended for debt issued or guaranteed by the Greek government.

Key Federal Reserve System and ECB Interest Rates

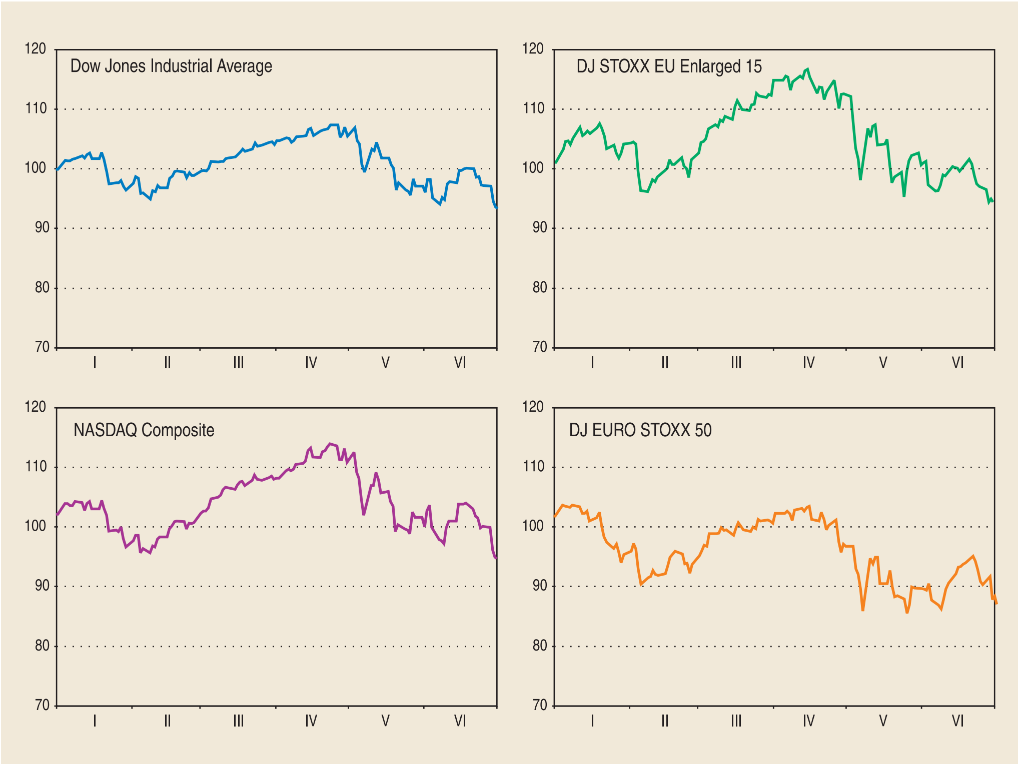
(%)



Sources: ECB, Federal Reserve System.

During the first half of 2010 the US reference interest rate stayed between nil and 0.25 per cent. To stabilise markets the Federal Reserve stopped injecting liquidity into financial institutions. TALF, the final programme for security-backed financing of new (after January 2009) commercial property mortgage-backed securities ended on 30 June. May saw USD swap lines with the British, Swiss, and Canadian central banks restored due to tensions arising from US dollar financing on financial markets hit by the public finance crisis in some euro area countries.

Major Stock Exchange Indices in the First Half of 2010



Note: Indices have been calculated based on December 2009 = 100.

Source: Bloomberg.

Stock market indices reached highs in April (up 6 to 14 per cent on December 2009). In early May fiscal tensions in Greece and concern about their impact across the euro area hit market optimism. By June the Dow Jones EURO STOXX 50 and Dow Jones STOXX EU Enlarged TM dipped by 9.2 and 1.4 per cent respectively on December 2009, while in the United States the Dow Jones Industrial dropped by 2.7 per cent and the NASDAQ Composite stayed close to its December 2009 level.

2. The Bulgarian Economy

The fall in real GDP continued in the first half of 2010, its annual rate decreasing from 4.9 per cent in 2009 to 3.2 per cent and 1.4 per cent in the first and second quarters respectively.

Real GDP Growth

(on the corresponding period on the previous year, not seasonnaly adjusted data)

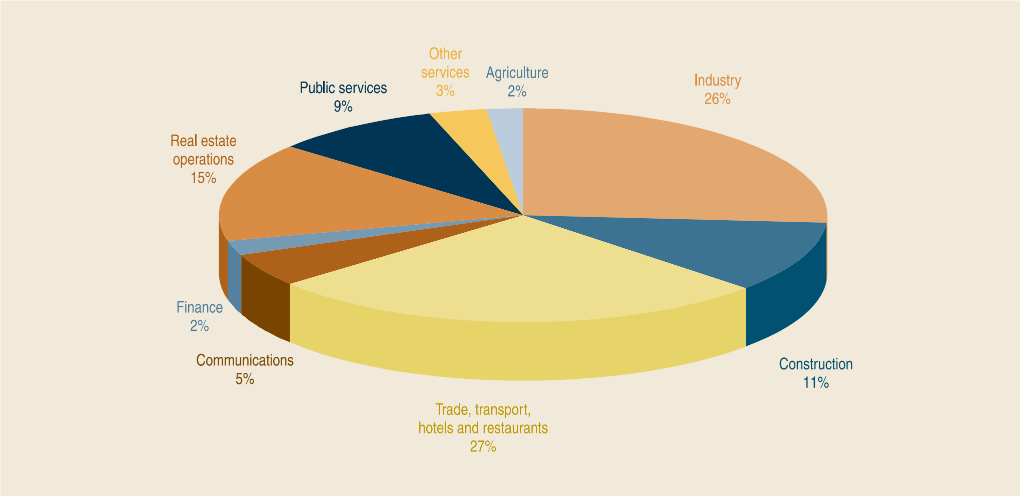
	2009				2010	
	January – June		July – December		January – June	
	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)
Produced GDP	-4.1	-4.1	-5.6	-5.6	-2.2	-2.2
Final consumption	-3.9	-3.4	-4.2	-3.4	-5.3	-4.5
Household consumption	-4.1	-2.9	-3.0	-1.9	-6.0	-4.2
Government final consumption expenditure	-8.8	-0.7	-8.0	-0.6	4.7	0.3
Collective consumption	1.6	0.1	-9.9	-0.9	-8.1	-0.7
Gross fixed capital formation	-19.6	-6.5	-36.6	-12.4	-13.3	-3.6
Physical change in inventories	-86.9	-4.6	-41.7	-1.2	73.5	0.5
Exports of goods and services	-16.0	-9.9	-5.2	-2.9	10.0	4.7
Imports of goods and services	-23.1	20.3	-19.9	14.2	-1.2	0.7

Source: NSI.

Private spending had a high negative contribution to GDP dynamics during the half-year. The decline of real household consumption moderated on an annual basis from 7.6 per cent in the first quarter to 4.6 per cent in the second quarter. Though the consumer confidence index kept rising during the half-year, an uncertain labour market and income worries continued to hold back consumer spending.

The unstable international economic environment, reduced credit demand, and tightened lending affected investing. Fixed capital investment dropped by 15 and 12 per cent on an annual basis in the first and second quarters: a considerable improvement on 2009. Over the half-year spending on fixed assets dropped by 7.5 per cent in nominal terms on the first half of the prior year, industry contributing most with 7 percentage points. On the other hand, fixed asset spending in construction, property and retail, transportation, and hotels and restaurants rose by 8.4, 69, and 16.7 per cent respectively on an annual basis over the half-year, having fallen more than the average in 2009. These sectors contributed 10 percentage points to fixed asset expenditure growth.

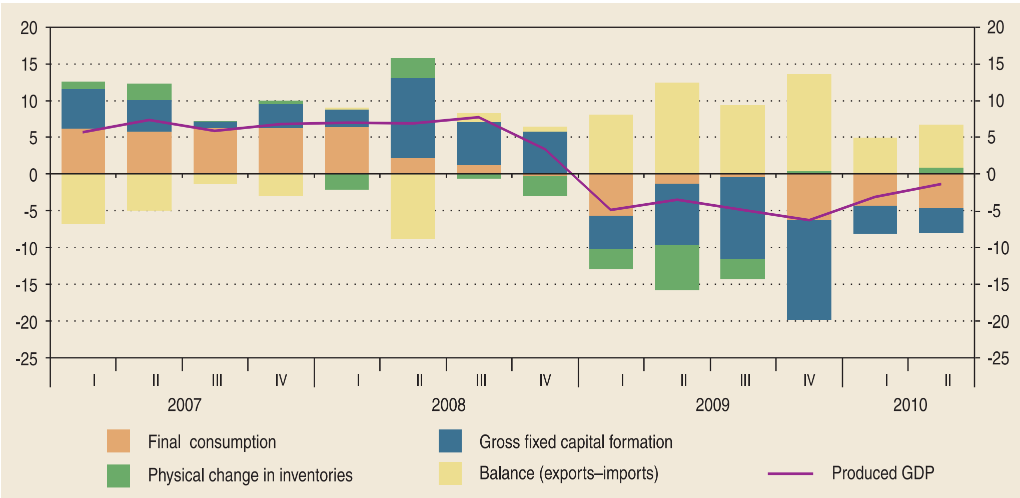
Structure of Expenditure on Acquisition of Fixed Assets by Economic Activity during the First Half of 2010



Source: NSI.

Contribution of Final Use Constituents to GDP Growth

(%, percentage points, on corresponding period of previous year)



Source: NSI.

Gross Value Added Real Growth

	2009				2010	
	January – June		July – December		January – June	
	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)
Gross Value Added	**-1.4**	**-1.4**	**-3.7**	**-3.7**	**-0.3**	**-0.3**
Agriculture and forestry	-7.2	-0.4	-1.5	-0.1	2.8	0.1
Industry	-8.5	-2.8	-5.9	-1.7	0.6	0.2
Services	2.8	1.7	-3.0	-1.9	-0.9	-0.6

Source: NSI.

Real annual export growth continued at 7.1 and 12.4 per cent respectively in the first and second quarters of 2010. This boosted imports of commodities for export output (oil, metals, and energy), slowing the first quarter imports drop to 2.6 per cent, while second quarter constant price goods and service imports reverted to their levels of the same period of the prior year.

During the first quarter of 2010 gross value added in the economy dipped slightly by 1.1 per cent on an annual basis in real terms, followed by 0.5 per cent of growth in the second quarter. Industry contributed greatly, its value added growing 1.4 per cent in the first quarter and 2.9 per cent in the second quarter as exports and home market sales rose. In services, where the crisis set-in somewhat late, real terms gross value added remained below its levels of the prior year, with the decline moderating to 1.5 and 0.3 per cent during the first and second quarters. The retail, transportation, and hotels and restaurants sector registered 3.8 per cent annual growth.

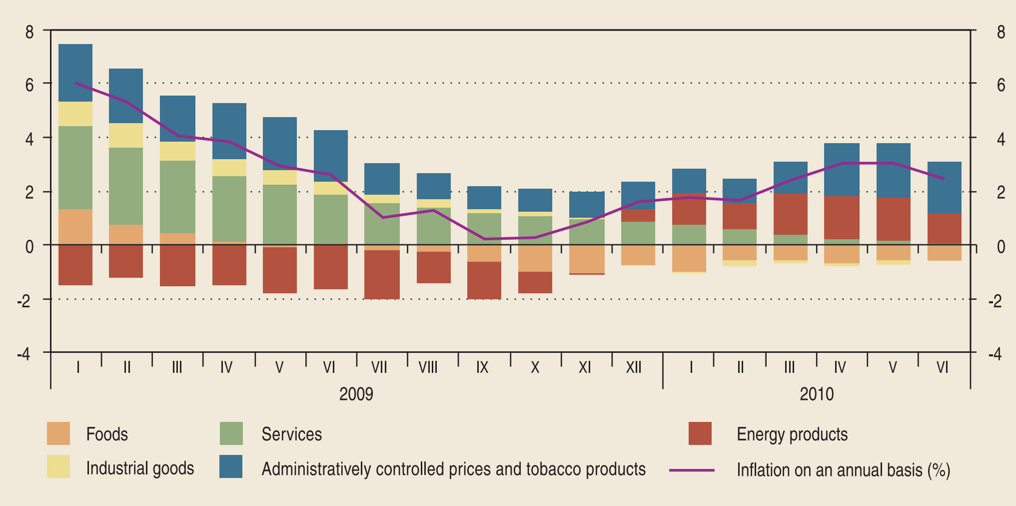
During the first half of 2010 the labour market continued to lag behind general economic dynamics. While the drop in real GDP definitely slowed, employment declined dramatically on the respective period a year ago, even in sectors showing signs of output recovery such as industry and some services. Nationwide accounting data show employment over the first half of 2010 down by 6.9 per cent on an annual basis against a fourth quarter 2009 drop of 5.6 per cent. The drop in industry was 8.3 per cent, with 7 per cent in retail, hotels and restaurants, and transport and communications.

Weaker demand for labour and limited job opportunities continued hampering the participation of people of working age in the labour market. The economic activity ratio of 15–64s dropped to 66.2 per cent against 67.3 per cent in the first half of 2009. The Labour Force Survey shows Bulgarian unemployment picking up to 10.2 per cent in the first quarter (from 7.9 per cent at the end of 2009) and staying at 10 per cent in the second quarter. Employment Agency data shows unemployment, measured by the number of people registered with labour offices, at 9.26 per cent in June; this fell in the second and third quarters, even allowing for seasonal factors. Employment is likely to recover slowly. The increased number of unemployed in the second quarter compared with a year earlier mainly reflected more long-term (over six months) unemployment.

Despite sizeable spare labour and still-subdued production, on an annual basis nominal wages (remuneration per employee) grew relatively strongly during the first two quarters of 2010: by 11.6 and 8 per cent respectively. A number of factors may explain this, most important being that companies manage labour costs mainly by reducing workforces; this kept the rise in overall labour costs to 2 per cent in the first quarter and -0.4 per cent in the second quarter on an annual basis. Productivity also started to recover to an annual growth of 4 and 5.5 per cent in the first and second quarters, with a trend to bringing profitability closer to pre-crisis levels. The third factor was a change in employment structure; for several quarters most of those declared redundant have been younger, less experienced and lower paid; more experienced, productive and higher paid people have stayed in work.

Inflation on an Annual Basis and Major Commodity Groups and Services

(percentage points, %)



Sources: NSI, BNB.

HICP Inflation Accumulated since Year's Start and Contribution*

	2009, January – June		2010, January – June	
Inflation	1.2%		2.0%	
	Inflation rate by group (%)	Contribution, p.p.	Inflation rate by group (%)	Contribution, p.p.
Foods	-2.2%	-0.53	-1.8%	-0.38
Processed foods	-2.1%	-0.33	-1.5%	-0.20
Unprocessed foods	-2.2%	-0.20	-2.1%	-0.18
Services	1.2%	0.37	-1.3%	-0.41
Public catering	2.3%	0.27	1.2%	0.15
Transportation services	-0.9%	-0.04	-1.7%	-0.08
Telecommunication	-0.7%	-0.03	-0.4%	-0.01
Other services	1.9%	0.17	-4.8%	-0.47
Energy products	5.5%	0.42	11.2%	1.04
Transportation fuels	6.9%	0.46	12.4%	1.04
Industrial goods	-0.2%	-0.03	-0.2%	-0.04
Goods and services with administratively controlled prices	1.6%	0.25	2.9%	0.44
Tobacco products	23.3%	0.67	34.4%	1.35

* This structure corresponds to the Eurostat classification with tobacco products and goods and services with administratively controlled prices shown as separate items. Administratively controlled prices are calculated at the elementary aggregate level in the consumer basket.

Sources: NSI, BNB.

Amid weak first-half trading, inflation remained relatively low at 2.5 per cent on an annual basis in June.[4] Though low domestic demand continued curbing inflation, tobacco excise duty rises in 2010 and higher world energy prices pushed it up and were the main factors behind annual inflation greater than the 1.6 per cent of late 2009. By June tobacco, fuel, and administratively controlled prices had contributed most to inflation at 1.4, 1.1, and 0.5 percentage points respectively.

The 2009 trend to falling food prices continued in the first half-year. If one were to disregard food, fuel, tobacco, and controlled prices, inflation fell from 1.8 per cent in December 2009 to 0.1 per cent by mid-2010. The drop in service prices played a major role in this. Following a temporary decrease on an annual basis over the half-year, in June non-food prices stood at their late 2009 level (around nil inflation); by component there was a contraction in the negative contribution of automobile prices, a stabilisation of falling clothing and footwear prices, and a decrease in non-durables' inflation.

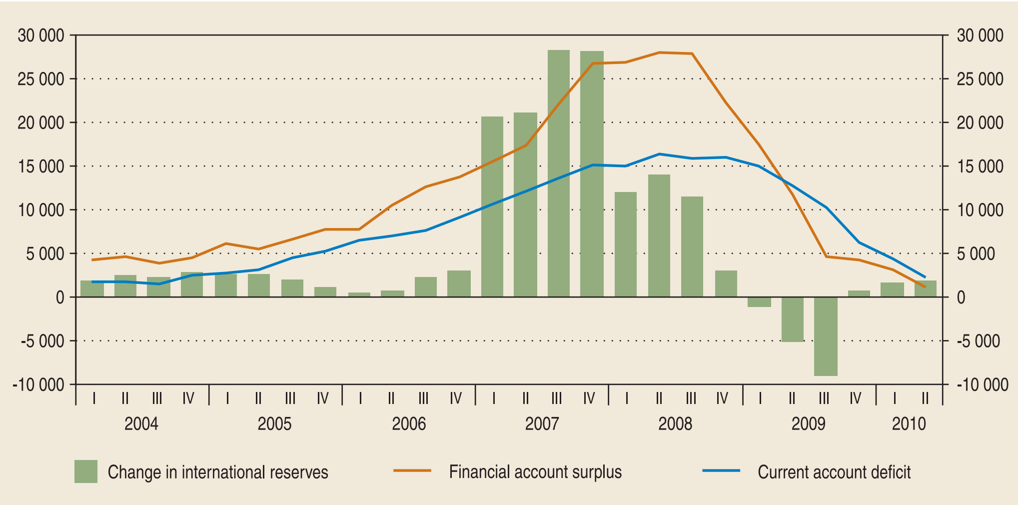
[4] The analysis employs HICP data.

The overall current and capital account deficit for the first six months of 2010 contracted to EUR 854.9 million (4.3 per cent of GDP) against a deficit of EUR 2.3 billion (17.2 per cent of GDP) between January and June 2009. This improvement was largely due to the contraction of the trade deficit which stood at EUR 1330.8 million in the first half-year: EUR 1082.3 million less than in the same period a year ago. The services balance also improved by EUR 263.3 million, alongside the revenue balance by EUR 197.5 million, and net transfers by EUR 300.4 million. The capital account accordingly worsened by EUR 351.4 million.

The balance of payments' financial account was negative to the extent of EUR 434.9 million for the half-year. Balance of payments' current, capital, and financial account flows contributed to BNB international reserves falling by EUR 1171.7 million between January and June 2010 prior to valuation adjustments.

Dynamics of the Current Account, Financial Account and International Reserves
(on an annual basis)

(million BGN)



Source: BNB.

The fall in the balance of payments' trade deficit resulted from the 26.8 per cent positive nominal growth in goods exports earnings during the first half of 2010 and the notably lower 4.7 per cent rate of growth in nominal goods imports. Base metals and their products (9.1 percentage points), machines, vehicles and appliances (6.4 percentage points), and mineral products and fuels (4.9 percentage points) were major contributors to export growth as external demand recovered and metal and energy prices rose. Imports of raw materials and mineral products and fuels played a major role in import growth (4.8 and 2.8 percentage points respectively), owing mainly to higher world prices. The negative contribution of investment goods (-3.3 percentage points) to total imports was preserved.

Net direct investment into Bulgaria was positive at EUR 604.5 million (6.6 per cent of GDP) in the first half of 2010. Foreign direct investment covered 152 per cent of the balance of payments' current and capital account deficits on an annual basis. Foreign investment went mainly into power and heating generation (30 per cent), property operations (27 per cent), construction (23 per cent), and industry (20 per cent).

Bank loan repayment and closures of non-resident deposits with local banks contributed most (EUR 570.1 million and EUR 832.3 million respectively) to the negative value of the balance of payments' financial account. The change in banks' strategies since the last quarter of 2008 requires domestic resources for financing. Household thrift and spending cuts, and confidence in banks, boosted bank deposits. Loan demand was weak. Banking liquidity was high, allowing banks to cut their gross external debt by EUR 1107.6 million in the first half-year, their share in Bulgaria's gross external debt falling to 19.6 per cent.

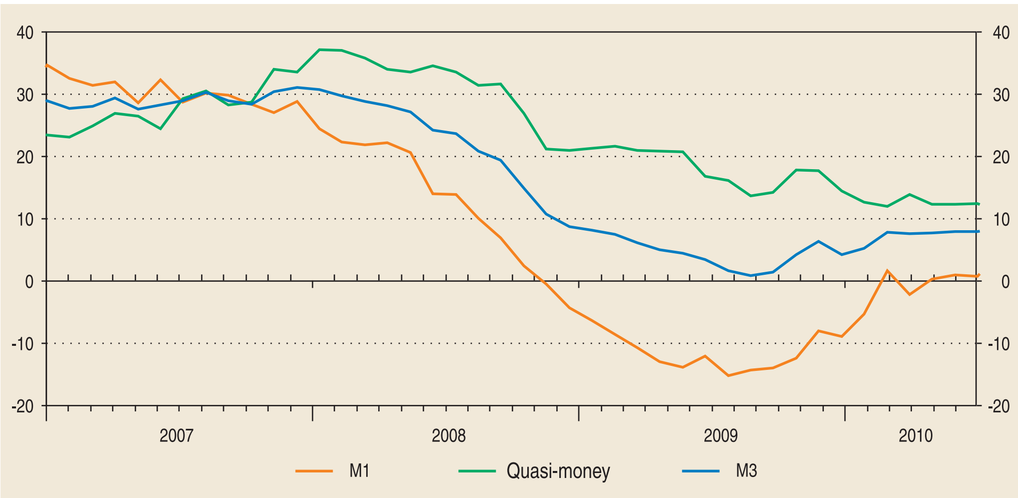
Between January and June 2010 gross external debt fell by EUR 610.7 million to EUR 37.1 billion (106.5 per cent of GDP), with banking the major contributor. The period saw loan and deposit receipts of EUR 3433.8 million[5] and principal payments of EUR 4527.2 million. Public and publicly guaranteed debt grew by EUR 111.5 million over the period due mainly to a European Investment Bank loan.

The BGN 1.2 billion increase in household bank deposits during the first half of 2010 boosted monetary aggregate growth. In late June broad money registered an annual growth of 8 per cent against 4.2 per cent in December 2009. The M1 monetary aggregate was the main driver behind accelerating broad money growth of 0.3 per cent on an annual basis by late June, against a decrease of 3.8 per cent in late 2009. Quasi-money growth continued slowing to 7.6 per cent in mid-year. The decline in money outside banks moderated to 3.6 per cent on an annual basis by June, while overnight deposits increased 3.8 per cent. Weaker demand for cash due to private spending cuts and lower inflation drove the dynamics of money outside banks, while overnight deposits grew as local government and social insurance funds deposited some BGN 742 million more than they had by June 2009.

Uncertainty about the rate of recovery, comparatively weak investment demand, and growing spare capacity pushed down loan demand. By late June the annual growth of claims on the non-government sector fell to 2 per cent against 3.8 per cent at the end of 2009. Over the half-year new loans to non-financial corporations and households came to BGN 5.7 billion: 14 per cent less than in the same period of 2009. By June claims on non-financial corporations began to tend towards growth stabilisation at around 1 per cent, while claims on households continued to moderate, reaching 3.7 per cent against 5.8 per cent in late 2009.

Monetary Aggregates
(annual change)

(%)



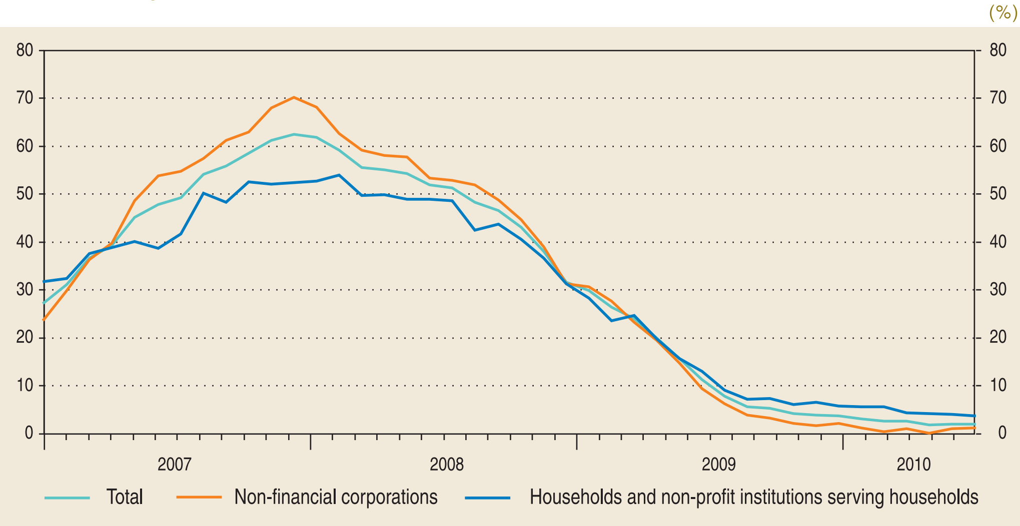
Source: BNB.

Despite slower lending, the claims on the non-government sector/GDP ratio continued growing to 75.1 per cent in the first half of the year against 74.5 per cent at the end of the prior year, reflecting the nominal GDP decrease.

Banks manage lev liquidity mainly by trading foreign exchange with the BNB. This enables the main function of the Currency Board: to buy and sell on demand national currency against the euro at the exchange rate fixed by the Law on the Bulgarian National Bank. Total foreign exchange market turnover was EUR 191 billion in the first half of 2010: down by 27.7 per cent on the same period a year ago. The main segments of the foreign exchange market (trading between the BNB and banks, and trading between banks or the BNB and final customers) also declined. Only interbank foreign exchange market trade (excluding the BNB) increased. The interbank currency structure changed, with euro transactions (excluding the BNB) up by 8.0 per cent entirely at the expense of US dollars

[5] Revolving and trade loans excluded.

Claims on Non-government Sector
(annual change)



Source: BNB.

transactions. During the half-year the BNB was a net seller of currency to the amount of EUR 513 million, greatly helping banks' current liquidity management. In the final customer market the BNB was a net purchaser of EUR 159.9 million of currency. Swap and forward transactions between banks and final customers in the first half of 2010 dropped by 50 per cent on the same period of 2009.

The interbank money market over the half-year featured high liquidity, prompting a significant drop in interest rates, especially in the overnight segment. Weak loan demand and the rise in attracted funds from residents contributed to the growth of free bank resource. The average interbank deposit and repo rate was 0.33 per cent, its monthly average moving between 0.50 per cent in January and 0.24 per cent in June. The spread between LEONIA and EONIA was negative for the whole period, hovering between 10 and 18 basis points. These spread levels signal interbank trade normalisation and improved banking liquidity in Bulgaria, and correspond to averages from before the summer of 2007. Interbank money market turnover fell by 39.0 per cent on the first half of 2009, but transaction totals increased gradually to BGN 7.2 billion by June: up some 47 per cent on December 2009 and close to pre-crisis levels. Deposits comprised 78 per cent of the turnover and

Average Interest Rate on Interbank Money Market

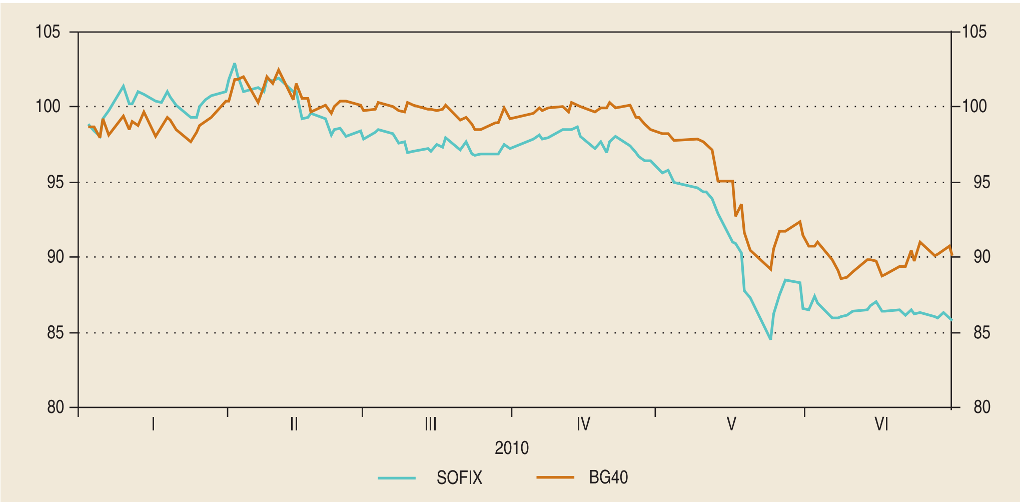
Source: BNB.

repos in government securities 22 per cent. One-day (in particular overnight) transactions prevailed among deposits at 81.7 per cent of transactions.

In the first half of 2010 the key challenges to fiscal policy were weaker than expected tax collectability and higher spending on pensions and liabilities assumed in prior years. By June 2010 the consolidated fiscal programme cash deficit was BGN 1515.4 million or 2.1 per cent of expected annual GDP, while the primary balance deficit was BGN 1212.3 million or 1.7 per cent of projected GDP.[6] As indirect and corporate tax revenue dropped because of depressed economic activity and collectability, total revenue and grants decreased by 13.6 per cent on the same period of 2009 to BGN 11,188.7 million. Consolidated fiscal programme expenditure over the first six months of 2010 was BGN 12,704.1 million: an annual decline of 0.6 per cent despite the 15 per cent rise in pension spending. The 28.4 per cent cut in capital expenditure contributed most to the spending reduction. Budget implementation issues early in the year required the National Assembly to amend the State Budget Law on 8 July 2010 to provide for a cash deficit of BGN 3.3 billion.[7] By late June the fiscal reserve was BGN 6029.0 million: down BGN 1643.9 million (27.3 per cent) on December 2009.

During the half-year the Ministry of Finance pursued an active issuing policy to provide liquidity for budget deficit financing and repay government securities maturing over the period. There were twice as many auctions as in the same period of 2009, with two of them unscheduled. The Ministry approved BGN 542.3 million total nominal value, including the lev equivalent of an issue in euro with a maturity of two years and six months: almost three times more than in the same period of 2009 (BGN 196.2 million). All issues were of fixed rate tap securities. The nominal value of bids approved by the Ministry of Finance at the auctions of the new ten-year (ten years and six months) bonds issue came to BGN 195.0 million. After the three openings the volume of the seven-year bond issue came to BGN 100 million. In the three openings of the 2009 five-year issue the nominal value of bids approved by the Ministry of Finance was BGN 130 million. For the first time since 2005 there was an issue denominated in euro with a maturity of two years and six months. The volume of the issue totalled EUR 60 million. Demand for securities continued to exceed supply.[8]

Bulgarian Stock Exchange Indices
(December 2009 = 100)



Source: BNB.

Secondary market outright transactions in Bulgarian government securities between banks totalled BGN 393.0 million at market value[9]: 2.5 times more on the first half of 2009. BGN-denominated bond turnover rose to BGN 386.0 million on BGN 159.7 million in the

[6] GDP projections for 2010 come to BGN 70.68 billion.
[7] See also Economic Review, 2/2010, p. 38.
[8] For further details, see Section VIII.
[9] Based on the statistics of operations with a flow on the current accounts with the BNB.

first half of 2009. EUR-denominated bond turnover was worth BGN 8.2 million against BGN 0.1 million between January and June 2009, while USD-denominated turnover was just BGN 14,000 against BGN 16,000 in the same period of 2009. The lively secondary market reflected active Ministry issuing and a relatively quiet capital market.

By the end of the review period EUR-denominated global bonds maturing in 2013 were quoted at 108.9 (3.7 per cent yield) and USD-denominated global bonds maturing in 2015 at 108.6 (6.0 per cent yield).[10] By the end of June 2009 the respective prices were 105.1 (5.8 per cent yield) and 105.4 (7.1 per cent yield). Global bond price rises reflected higher demand and the decline in the Bulgarian risk premium. The price of USD-denominated ZUNK bonds hovered around the nominal, as it did a year ago.

During the first half of the year capital market trading volumes were low, the SOFIX and BG40 indices fluctuating relatively little. Between January and April the indices experienced no significant changes. In May, however, they dipped by some 14 and 10 per cent respectively amid Greece's fiscal problems on global capital markets. The half-year share turnover on the secondary market declined to BGN 207.2 million: 46 per cent down on the same period a year ago. The volume of *bourse* trade in bonds fell by 31 per cent to BGN 57.1 million. Over-the-counter transactions totalled BGN 3 million. By mid-year Bulgarian Stock Exchange, Sofia market capitalisation came to BGN 10.4 billion or 15.3 per cent of GDP (against 17 per cent of GDP at the close of 2009).

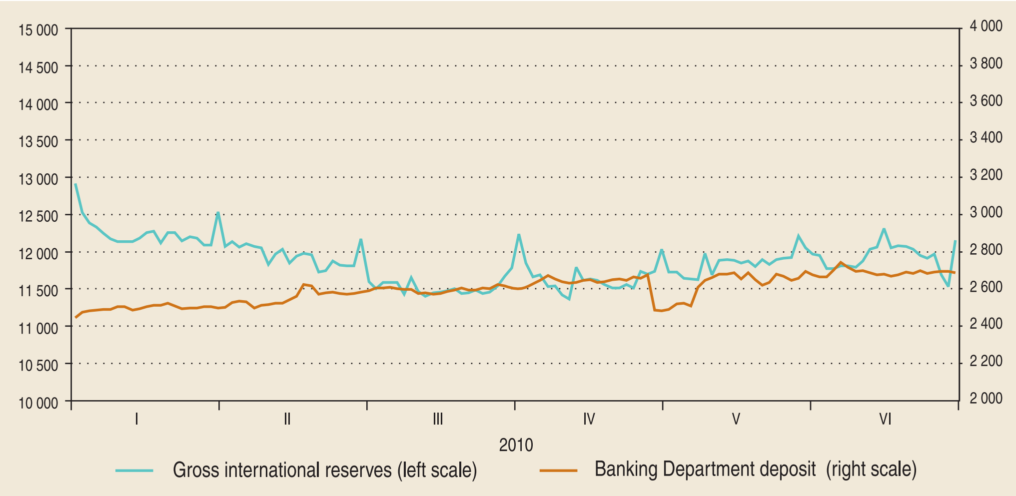
[10] Reuters data.

II. Gross International Foreign Exchange Reserves

Gross international reserves are managed to requirements and constraints in the Law on the Bulgarian National Bank and opportunities offered by world financial markets.[1] They comprise the assets on the Issue Department's balance sheet and provide complete cover for monetary liabilities under the lev to euro fixed rate.[2] 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.[3]

Gross International Reserves and Banking Department Deposit

(million EUR)



Note: The chart reflects daily dynamics of the Issue Department balance sheet figure and Banking Department deposit in the Issue Department balance sheet in which the two tranches of SDR 610.9 million are included. The BNB received these tranches in August and September 2009 under the SDR allotment by the IMF.

Source: BNB.

1. The Amount and Structure of Gross International Reserves

At the end of the half-year the market value of gross international reserves was EUR 11,401.90 million: a fall of EUR 862.14 million or 7.03 per cent on the end of 2009. This did not include the SDR 610.9 million allotted in 2009 to IMF member countries under the right to buy 75 per cent of their IMF quotas. Weighing up alternatives for managing these SDRs, the BNB Governing Council decided to keep them for an extended term on the BNB account with the IMF. Because of their special status, they are not included in the present analysis of gross international reserves.[4]

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[1] The period under review saw no Law on the BNB amendments concerning gross international reserve management.

[2] Pursuant to Article 28, paragraph 2 of the Law on the BNB, the Bank's monetary obligations include all circulating banknotes and coins issued by the BNB, and all BNB account balances except those of the IMF.

Article 28, paragraph 3 of the Law on the BNB comprehensively lists assets which may comprise gross international reserves: monetary gold; Special Drawing Rights; banknotes and coins in freely convertible foreign currency; funds in freely convertible foreign currency held by the BNB at foreign central banks or other financial institutions with one of the two highest ratings by two internationally recognised credit rating agencies; securities issued by foreign governments, central banks, other foreign financial institutions, or international financial organisations assigned one of the two highest ratings by two internationally recognised credit rating agencies with the exception of secured debt instruments; the balance on accounts receivable and payable on BNB forward or repo agreements with (or guaranteed by) foreign central banks, public international financial organisations or other foreign financial institutions with one of the two highest ratings from two internationally recognised 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 be estimated at market value.

[3] Pursuant to Article 28, paragraph 1 of the Law on the BNB, "the aggregate amount of the monetary liabilities of the BNB shall not exceed the lev equivalent of gross international reserves," with the lev equivalent determined through the fixed exchange rate.

[4] For further details see Annual Report of the BNB, 2009, p. 25.

The decrease in gross international reserves was mainly the result of foreign currency (EUR) net sales to banks and the corresponding fall in their funds on minimum reserve accounts with the BNB.[5]

Largest Cash Flows

(million EUR)

External flows	2010, January – June	2009, January – June
I. Purchases and sales of euro		
At tills:	-10	-22
Banks, incl.	-735	-1 288
purchases by banks	34 002	59 877
sales to banks	-34 737	-61 165
Total I	-744	-1 310
II. Flows on accounts of banks, the MF, *etc.*		
Minimum required reserves	-297	-71
Government and other depositors	-192	310
Total II	-489	238
Total I+II	-1233	-1072

Source: BNB.

In the first half of 2010 EUR 735 million of sales dominated BNB reserve currency trading with banks.[6] Over the same period the Bank refunded EUR 297 million held in banks' minimum required reserve accounts.[7] The downward trend in the balances on government and other budget organisations' accounts continued in the half-year, unlike the same period of 2009, when they grew. This impacted gross international foreign exchange reserves.[8] On the other hand, currency and gold revaluations had a positive effect on reserves.

The gross international reserve structure changed with an increased share of gold, following gold price rises on international markets. In the first half of 2010 the average share of euro-denominated assets fell to 88.92 per cent from 90.99 in 2009, while gold rose to 10.02 from 7.69 per cent in 2009.

Currency Structure of Gross International Reserves

(%)

Currency	Issue Department balance sheet assets 2010, January – June	2009
Euro	88.92	90.99
US dollars	0.70	0.95
Gold	10.02	7.69
Special Drawing Rights	0.34	0.36
Swiss franks	0.01	0.01

Note: Average data for the period. The SDR 610.9 million received in 2009 by the BNB as a member country of the IMF are not included in gross international reserves.
Source: BNB.

There was no significant change in the structure of assets by instrument, with securities decreasing insignificantly to 78.99 per cent. Money market instruments, mostly short-term deposits and funds with prime-rate foreign banks, declined slightly.

Structure of Gross International Reserves by Financial Instrument

(%)

Instruments	2010, January – June	2009
Vault cash*	2.71	1.72
Deposits**	14.29	13.73
Securities**	78.99	81.48
Gold in the vault	4.01	3.07

* Balances on accounts and payments.
** Including instruments in foreign currency and gold.
Note: Average data for the period. The SDR 610.9 million received in 2009 by the BNB as a member country of the IMF are not included in gross international reserves.
Source: BNB.

5 See Section VI on details of banks' behaviour over the first half of 2010.
6 These operations are consistent with banks' policy to use their high liquidity to repay external obligations.
7 Banks reduced their EUR-denominated reserve assets over the review period. See Section IV for the change in the foreign currency structure of minimum required reserves,
8 Banks' funds, as well as government and budget organisation deposits with the BNB represent part of the Bank's monetary obligations. Changes to them directly affect gross international reserves.

The structure of gross international reserves by residual term did not change much from the 2009 average. The main portion (61.49 per cent on average) continued to be in the one year sector: current accounts, short-term foreign exchange and gold deposits, and short-term securities. The one to three years maturity sector grew slightly on late 2009 at the expense of up to one year investment.

Structure of Gross International Reserves by Residual Term to Maturity

(%)

Maturity sectors	2010, January – June	2009
Up to 1 year	61.49	64.38
From 1 to 3 years	26.68	23.39
From 3 to 5 years	8.63	8.30
From 5 to 10 years	2.58	3.32
From 10 to 30 years	0.62	0.61

Note: Average data for the period. The SDR 610.9 million received in 2009 by the BNB as a member country of the IMF is not included in gross international reserves.

Source: BNB.

2. Gross International Reserves Risk and Yield

The Market Environment

Recovery in the euro area and the USA continued in the first half of 2010.[9] The business climate continued improving, with industry and services optimistic about output, employment, and new orders. The ECB and the Federal Reserve kept interest on money market operations at 1.0 per cent and 0.0–0.25 per cent respectively. In the second quarter the ECB extended non-conventional money market measures by continuing variable interest rate tender bid refinancing until the last quarter of 2010. The Federal Reserve and the Bank of England announced they would not sell securities acquired in non-conventional liquidity provision.

The public finance crises in euro area countries Greece,[10] Portugal, Ireland, and Spain fuelled fears about their ability to service debt. Uncertainties around fiscal position sustainability led to turmoil in the government securities market and a significant increase in credit premia on government securities issued by countries with significant budget deficits and high public debts. German two-year government bond yields reached a low since the onset of the global crisis following the Lehman Brothers bankruptcy. The increased risk in euro area markets compared with US market risk depressed the euro US dollar rate to 1.20 for a short time before returning to the 1.22–1.32 band. Gold was perceived as safer than securities, boosting its price.

Government Securities Yield Curve

Since the middle of the second quarter of 2010 the euro area yield curve slope, measured by the spread between two-year and ten-year German bond yields, has flattened. Yields in the short maturity sectors decreased over the review period, albeit slower than the longer end of the curve, which dipped significantly in early May. Public finance crises in set euro area countries curbed investor risk appetite and boosted demand for German, Dutch, French, and Finnish securities, perceived as low risk. This cut German benchmark government securities yields. Investors fled Greek, Portuguese, Irish, and Spanish securities, leading to a significant increase in government debt issue yield and widened secondary market bid-offer spreads.

From April, risk and yield perception differentiated euro area government securities. Countries which strictly control budget deficits and government debt won investor readiness to pay higher prices and expect lower yields. Yields from countries reporting significant fiscal deficits and high public debt increased sharply along with higher risk premia *vis-à-vis* Germany. By late June German two-year bond yields fell to 0.60 per cent, down 73 basis points from early 2010. At the same time, Greek two-year bond yields rose to 10.04 per cent, up 660 basis points from early 2010 levels.

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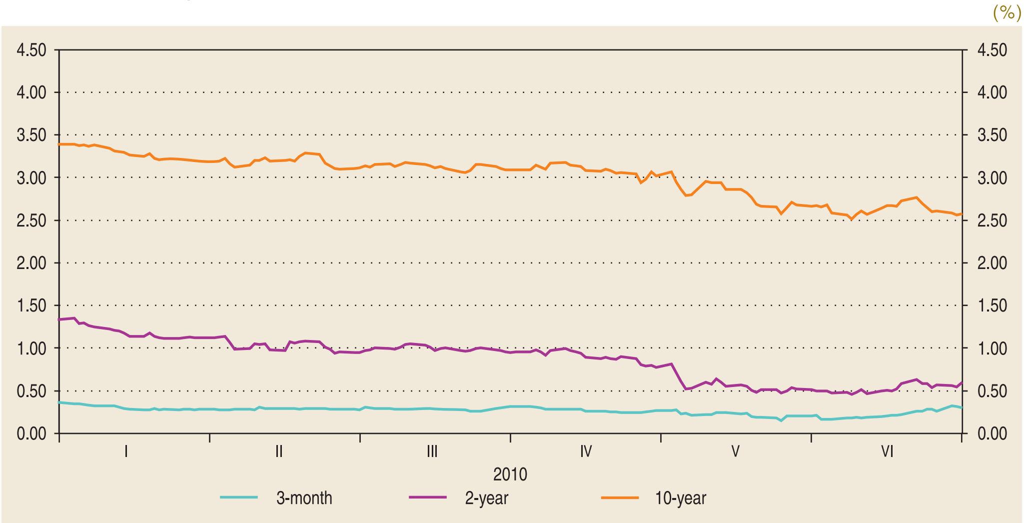
[9] For further details see Section I.

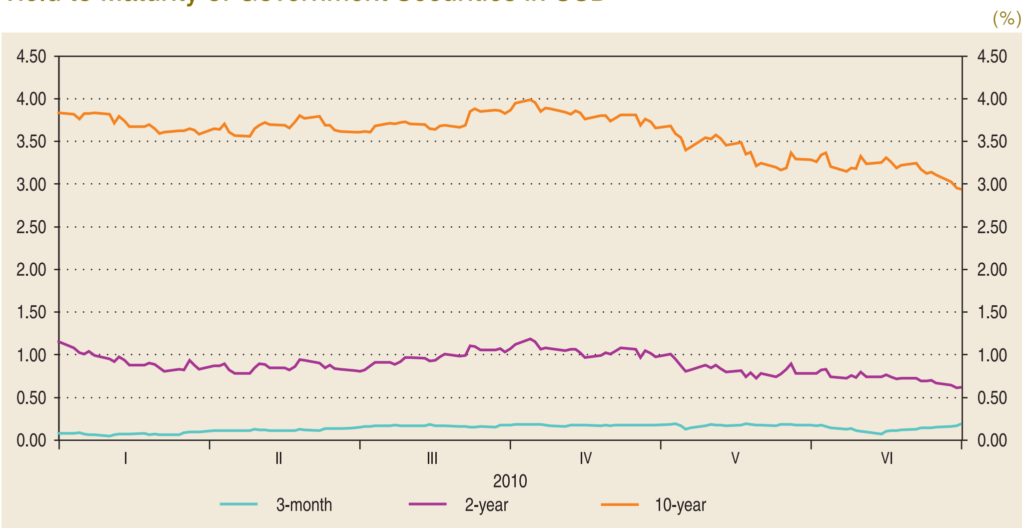
[10] Article 28, paragraph 3 of the Law on the BNB sets a minimum credit rating which debt instruments issued or guaranteed by the Greek government did not meet.

Yield to Maturity of Government Securities in Euro



Source: BNB.

Yield to Maturity of Government Securities in USD



Source: BNB.

Gold and the Exchange Rate

In the first half of 2010 the US dollar appreciated cumulatively by 14.61 per cent on the single European currency within the broad range of 0.69–0.84. Risk aversion, concerns about Greek, Portuguese, Irish, and Spanish public finances, and macroeconomic data outlining uncertain prospects for US and Japanese growth were major factors affecting the US dollar euro rate.

The US dollar spot price of gold rose significantly by 13.25 per cent on an annual basis. It varied within the USD 1063 to USD 1257 per troy ounce interval, the average price rising to USD 1153. This reflected mainly demand for physical gold for safe haven investment, and US dollar rate dynamics.

US Dollar Price in Euro

(EUR)

Source: BNB.

One Troy Ounce Gold Price in US Dollars

(USD)

Source: BNB.

One Troy Ounce Gold Price in Euro

(EUR)

Source: BNB.

Major Types of Risk

Over the review period BNB gross international reserves were invested to long-term risk tolerance set by the Governing Council as regards net value[11] in the Issue Department balance sheet: -2.5% ≤ VaR ≤ 0 per cent at 95 per cent confidence level.[12]

In the first six months of 2010 international reserve **interest risk** measured by reserves' average modified duration was 0.80. This matched the 2009 level (0.83), with a downward trend in asset duration observed in early May (0.70).

International reserve **currency risk** was constrained by Law on the Bulgarian National Bank provision that the sum of the absolute values of open foreign currency positions[13] in currencies other than the euro, SDR, and monetary gold, should not exceed 2 per cent of the market value of monetary liabilities in these currencies. In the reporting period minimum open currency positions in currencies other than the euro were maintained, the open gold position posing the major currency risk.

Since early 2010 credit risk reflected world financial markets tensions from fiscal and debt problems in Greece. In the second half of April they spread to other euro area countries such as Portugal, Spain, Ireland, and to some extent Italy. The significant fluctuations in the iTraxx investment grade high volume index measuring European companies' credit risk premia signalled this increased uncertainty. It was 53 basis points higher than in late 2009 (76 basis points) ending at 129 basis points. At 85 basis points by 30 June the analogous US iBox index exhibited no significant volatility compared with the close of 2009 (86 basis points).

Increased uncertainty on financial markets meant new constraints to investing BNB gross international reserves to reduce **credit risk**. In late April there was a temporary ban on debt instruments issued or guaranteed by countries with worsened fiscal positions and high public debt. This applied to portfolios managed by internal and external managers. In addition, exposures to banks in these countries were limited. Since April, reinvested maturing funds and new gross reserve receipts were invested mainly into German and French government and government guaranteed debt and in short-term deposits to reduce credit risk and maintain high liquidity. Funds invested into assets with the highest long-term credit rating (AAA) averaged 52 per cent over the review period.[14]

Operational risk was managed by strict monitoring and control of investment restrictions and business procedures for international reserve management.

Yield and Efficiency

Net income from assets in euro comprised: i. income from investment of gross international reserves in original currency; ii. currency imbalance yield;[15] and iii. expenditure on liabilities. Over the review period BNB income from international reserve investment came to EUR 38.79 million (0.35 per cent yield). Currency imbalance yielded EUR 320.84 million, primarily due to the open position in monetary gold. Interest expenditure on Issue Department balance sheet liabilities[16] was EUR 1.71 million. Reflecting these three components, net income from BNB international reserve management came to EUR 357.91 million: 3.22 per cent net yield for the period.

[11] "Net value" means the Banking Department Deposit item in the Issue Department balance sheet.

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

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

[14] Under investment restrictions, financial instruments into which the Bank may invest, and counterparties where it may place short-term deposits, have to have at least an AA- rating by Standard & Poor's and Fitch Ratings or Aa3 by Moody's. All financial instruments or counterparties should have one of the above ratings assigned by at least two internationally recognised credit rating agencies.

[15] Currency imbalance yield is the sum total of the effects of exchange rate movements on assets and liabilities open foreign currency positions.

[16] Data on the Issue Department liabilities are not entered directly into the information system for international reserve management; they are provided to it via the accounting system interface.

Earnings and Profitability* of International Reserves, January – June 2010

(million EUR)

Quarters	Earnings, net (1)+(2)+(3)	Investment earnings (1)	Earnings from currency imbalance between assets and liabilities (2)	Expenditure (interest) on liabilities (3)
First quarter	132.03	57.55	75.47	-0.99
Second quarter	225.89	-18.76	245.36	-0.72
Total	357.91	38.79	320.84	-1.71
Total (%)	3.22	0.35	2.90	-0.02

* The profitability shown in the table covers the six-month period.

Note: The SDR 610.9 million received by the BNB as a member country of the IMF are not included in gross international reserves.

Source: BNB.

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

Profitability and Risk of Portfolios, January – June 2010

Portfolio	Portfolio's base currency	Profitability		Risk (Volatility)		Information coefficient***
		Absolute (%)	Relative (basis points)*	Absolute (basis points)	Relative (basis points)**	
Investment 1	EUR	0.35	-40	71	56	-2.86
Investment 2	EUR	0.34	-44	86	69	-2.53
External manager A	EUR	1.06	-13	141	66	-0.95
External manager B	EUR	1.07	-15	124	45	-1.54
Liquidity	EUR	0.13	4	2	2	11.21
Liquidity	USD	0.12	5	6	7	2.77

* The positive relative profitability of an individual portfolio is the profit compared with benchmark profitability. If the relative profitability were negative, it would be shown as a loss of profit in portfolio management. The relative profitablility has been rounded to 1 basis point; within the range (-0.5, 0) it is marked with "-0" and in the range (0, 0.5) with "+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 risk is on an annual basis.

*** The information coefficient is the ratio between the expected relative profitability of an individual portfolio and its relative risk (on an annual basis).

Note: The SDR 610.9 million received by the BNB as a member country of the IMF are not included in gross international reserves.

Source: BNB.

By 30 June 2010, external managers at international financial institutions managed 6.2 per cent of international reserves. Beside additional diversification, using external managers helped exchange expertise in international market investment. Liquid portfolios assisted immediate payment. To diversify management styles and reduce operational risk, most euro-denominated assets continued to be in two investment portfolios with identical benchmarks and investment limits, managed by different BNB teams.

III. The National Payment System

The Law on the Bulgarian National Bank tasks the Bank with organising, supporting, and developing payment systems by implementing, operating, and overseeing efficient payment mechanisms. Reducing systemic risk and creating conditions for Bulgarian integration into the euro area payment infrastructure were Bank priorities.

Payment systems for settlement in levs in Bulgaria are:

- RINGS, a real-time gross settlement system operated by the Bulgarian National Bank;
- ancillary systems:
  - BISERA, a system for servicing customer transfers to be settled at a designated time, operated by BORIKA-Bankservice;
  - BORIKA, a system for servicing bank card payments in Bulgaria, operated by BORIKA-Bankservice. BORIKA–Bankservice is a MasterCard Europe Member Service Provider and a Visa International Processor Company;
  - SEP, a system for mobile phone electronic payments, operated by SEP Bulgaria.

On 1 February 2010 euro settlement payment systems were launched:

- TARGET 2-BNB, the national system component of TARGET 2, operated by the BNB;
- BISERA7-EUR, an ancillary system for servicing transfers up to EUR 50,000 at a designated time, operated by BORIKA–Bankservice.

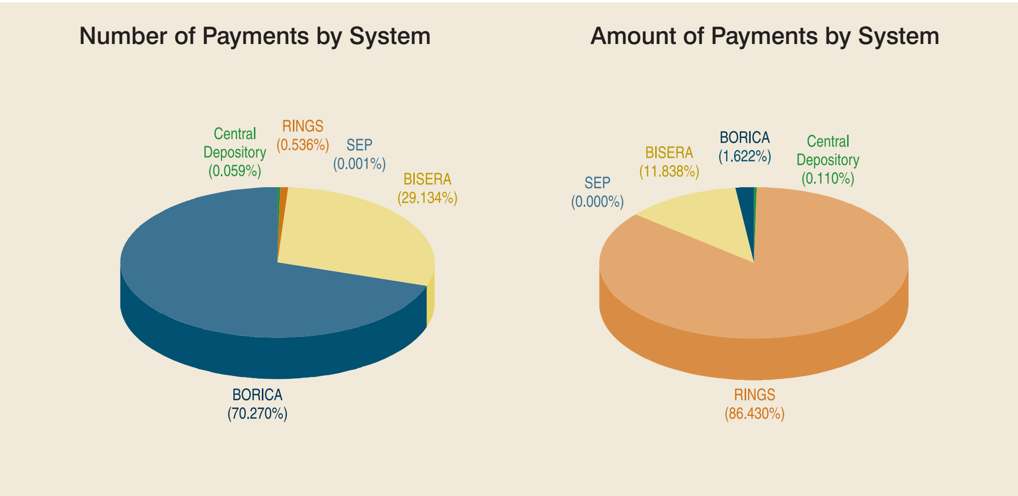
Securities settlement systems in Bulgaria are:

- the BNB system for registering and servicing transactions in book-entry government securities;
- the Central Depository system for registering and servicing transactions in book-entry securities.

During the first six months of 2010 RINGS processed over 86 per cent of payments by value in Bulgaria. Values around 80 per cent are optimal for the operation of real-time gross settlement systems. RINGS processed 0.5 per cent of all non-cash payments: a slight drop on the first half of 2009.

BORIKA payments rose by 7.2 per cent on first half of 2009, with value up 3 per cent. The increased number of payments reflected growing bank card payments and cash withdrawals. The growth in POS terminal transactions was 24 per cent on the first half of

Distribution of Payments in Bulgaria, January – June 2010



Source: BNB.

2009, their value falling by 4.2 per cent over the same period. The rise in the number of transactions shows that cardholders are using cards more frequently to pay for goods and services.

Compared with the first half of 2009, transactions through BISERA decreased by 4.5 per cent in value and 5.4 per cent in number.

Equity market declines resulted in a dramatic drop in the value (35.9 per cent) and number (44.3 per cent) of transactions through the Central Depository on the first six months of 2009.

The SEP share in the volume of transactions in Bulgaria was negligible. This is because only a few Bulgarian banks participate in SEP. Nevertheless, the number and value of SEP payments grew. Mobile payments allow banks to broaden the range of payment options offered to customers.

1. The RINGS Real-Time Gross Settlement System

A major Bank goal is for RINGS to process most payments, cutting payment system risks. In the review period RINGS processed BGN 461,947 payments totalling BGN 296,710 million. Compared with the first half of 2009, daily average numbers fell by 4.2 per cent, while daily average value went down 18.6 per cent, reflecting smaller daily averages in interbank transactions.

During the first six months of 2010, 44.8 per cent of payments by value were processed by noon and 76.4 per cent by 2:30 pm. As regards system traffic, 86.4 per cent of RINGS payments were effected by 2:30 pm, this indicator rising slightly on the first half of 2009.

In the first half of 2010 no payments were rejected by the close of the RINGS' system day due to insufficient funds on participants' accounts, indicating good liquidity management by banks. The Bank took no radical measures to provide participants with liquidity. Over the review period there was no recourse to the Reserve Collateral Pool established as an interbank insurance mechanism to guarantee settlement of payment and securities settlement system operators' orders.

During the half-year RINGS offered 100 per cent availability[1].

The number of participants in RINGS remained unchanged at 30.

2. Payment Systems for Settlement in Euro

On 1 February 2010 the Bulgarian National Bank and the national banking community joined the Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET2). This is a great step towards Bulgarian integration into European financial market and payment infrastructures.

The national system component, TARGET2-BNB, includes the BNB and 17 participating banks, as well as the BISERA7-EUR ancillary system for designated time transfers up to EUR 50,000. With the Bulgarian banking community's entry into TARGET2, participants in this system became 23, six of them outside the euro area.

Accession to TARGET2 facilitates convergence with the European payment systems and market and the BNB's payment systems strategy to reduce system risk and set the basis of Bulgarian integration into the euro area payment system. TARGET2 provides mechanisms for business stability and sustainability. From the business vantage, TARGET2 helps shape banks and ancillary systems, as well as the final customers of payment services. Bulgarian banks in the system enjoy real-time settlements in euro, improving security and cutting the time for settling in euro with European Economic Area countries. Participation offers effective settlement and liquidity management mechanisms. TARGET2 makes retail payment systems more competitive and broadens their scope through services in euro taking into account the requirements of banks and their customers.

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[1] The ratio of time when RINGS is operational to RINGS operating time.

Bulgarian banks and payment systems may now take part, on equal price terms, in a modern payment system with up-to-date technical infrastructure, functionality and organisation, and high security and efficiency. The system offers mechanisms for monitoring and managing liquidity in euro, cost efficiency and a high service level, optimising the payment process and increasing the speed and security of customers' transfers in euro.

Through the TARGET2 National Service Bureau, the BNB operates the TARGET2-BNB national system component and is responsible for the business relations of participants in the component and coordination with the European Central Bank and participating central banks. TARGET2 accession on 1 February 2010 has offered experience in working with European payment mechanisms and laid the foundations of future payment systems development in Bulgaria. Between the launch of the TARGET2 national system component and the end of June, TARGET2-BNB processed 23,938 payments totalling EUR 51,523 million. Over the period 86.1 per cent of payments worth 91.9 per cent in value were directed to banks by other system components. The daily average number of payments was 226 and daily average value was EUR 486 million. During the same period the BISERA7-EUR ancillary system processed 449 payments to the value of EUR 4,184,000.

3. Regulatory Changes

Amendments to the Law on Payment Services and Payment Systems transposed Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims, as well as Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

Amendments to Directive 98/26/EC on settlement finality introduced the concepts of interoperability and system operator, and clarified system operator responsibilities. Directive 2009/110/EC sets a clear legal framework for electronic money issuing and introduces adequate supervision over it.

4. Payment System Developments

To preserve the compatibility of Bulgarian payment systems with the European payment market, retail payments system operator Bankservice merged with card payments operator BORIKA. On 22 June 2010 the companies held general meetings at which equity holders expressed consensus on forming BORIKA – Bankservice. On 3 June the BNB licensed BORIKA–Bankservice to operate payment systems. The licence comes into effect upon Commercial Register entry of the merger, which is pending. The new company will operate three settlement systems: BORIKA for card payments, BISERA 6 for payments in levs, and BISERA7-EUR for payments in euro.

5. Payment System Oversight

Cutting system risk and promoting the soundness and efficiency of Bulgarian payment systems are the main tasks of payment system oversight. This involves implementing and monitoring standards and recommendations of the Bank for International Settlements, the International Organisation of Securities Commissions, the European Central Bank, and the European System of Central Banks.

Under the 1 November 2009 Law on Payment Services and Payment Systems, in January 2010 the BNB updated the licences of money remittance companies Coinstar Money Transfer (Bulgaria), Choice Money Transfer Bulgaria, M Secured and Change Centre – Bulgaria. The BNB updated the licences of payment system operators Bankservice, BORIKA and SEP. Within three months of the entry into force of the Law on Payment Services and

Payment Systems, a number of payment service providers submitted licensing applications. On 23 June the Governing Council licenced Diners Club Bulgaria, Transcard Financial Services, Intercard Finance, and TBI Credit under the Law on Payment Services and Payment Systems. As Bankservice and BORIKA were to merge, on the same day the BNB Governing Council examined the applications of the BISERA 6 and BORIKA payment system operators for a new payment system operator's licence for successor BORIKA–Bankservice; the new licence will come into force upon corporate registration.

IV. Banks' Reserves at the BNB

During the first half of 2010 there were no regulatory changes to banks' minimum required reserves rate or to the deposit base on which they are calculated. The February launch of the TARGET2 national system component was accompanied by amendments to Ordinance No 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks (Article 4, paragraph 2). These are recognised as reserves funds on banks' TARGET2 settlement accounts equal to 10 per cent of the average daily amount of successfully settled payment orders for the period in Article 7. This effectively reduced banks' minimum required reserves.

During the first half of 2010 funds attracted by banks on which minimum required reserves accrue went up by 1.85 per cent in total, including an increase of 4.40 per cent in lev liabilities and 0.34 per cent in foreign currency liabilities. Concurrently, reserves in levs picked up by 8.80 per cent on 2009, their value being double that needed to cover payments. Reserves in foreign currency declined by 1.62 per cent on the first half of the prior year, their relative share in total reserves during individual months fluctuating between 35.85 and 51.97 per cent. Due to high banking liquidity, the share of excess reserves in the total reserves reached 5.46 per cent.

V. Cash in Circulation

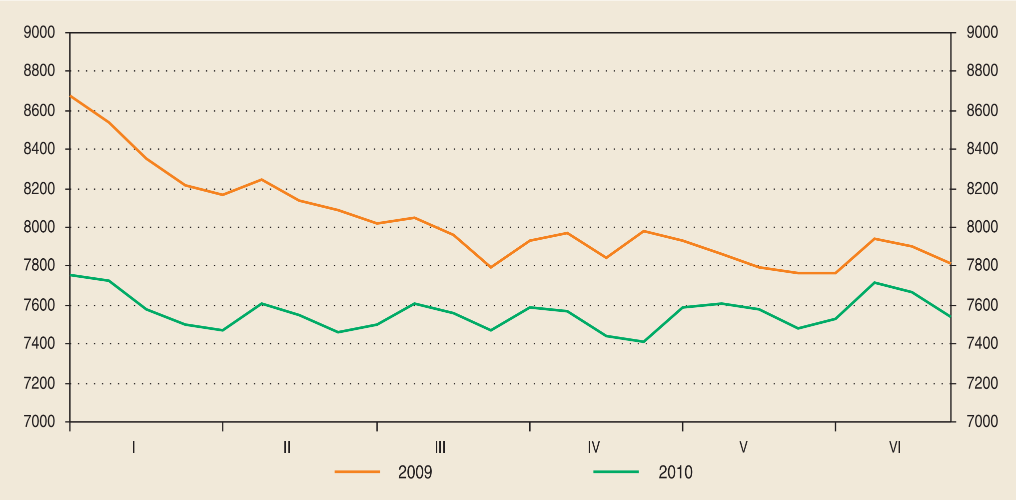
The Bulgarian National Bank holds the Bulgarian banknote and coin monopoly.[1] Banknotes and coins issued by the Bank are legal tender mandatorily acceptable as payment at full face value without restriction. The BNB prints banknotes, mints coins, and safeguards uncirculated and withdrawn banknotes and coins.

Banknotes and Coins in Circulation (Outside BNB Vaults)

Cash in circulation[2] by 30 June 2010 reached BGN 7542.8 million, down BGN 506.3 million or 6.29 per cent since early 2010. Year-on-year cash in circulation (on the end of June 2009) fell by BGN 267.0 million or 3.42 per cent, matching the 3.87 per cent decrease in the June 2008 to June 2009 period. The lower demand for cash reflects cuts in private spending and low inflation.[3]

Banknotes and Coins in Circulation

(million BGN)



Source: BNB.

In late June 2010, 290.8 million banknotes worth BGN 7383.5 million were in circulation, down 19.7 million (6.36 per cent) in number and BGN 508.6 million (6.44 per cent) in value. In a year, banknotes in circulation have fallen by 5.7 million (1.91 per cent) in number and BGN 276.6 million (3.61 per cent) in value. Banknotes comprised 97.89 per cent of the total value of cash outside BNB vaults by 30 June 2010.

BGN 50 banknotes had the largest value share among denominations in circulation. By the end of June 50.6 million of them were in circulation, worth BGN 2527.5 million in nominal value (34.23 per cent of the value of all banknotes in circulation), followed by BGN 100 banknotes and BGN 20 banknotes with shares of 28.60 and 25.97 per cent respectively.

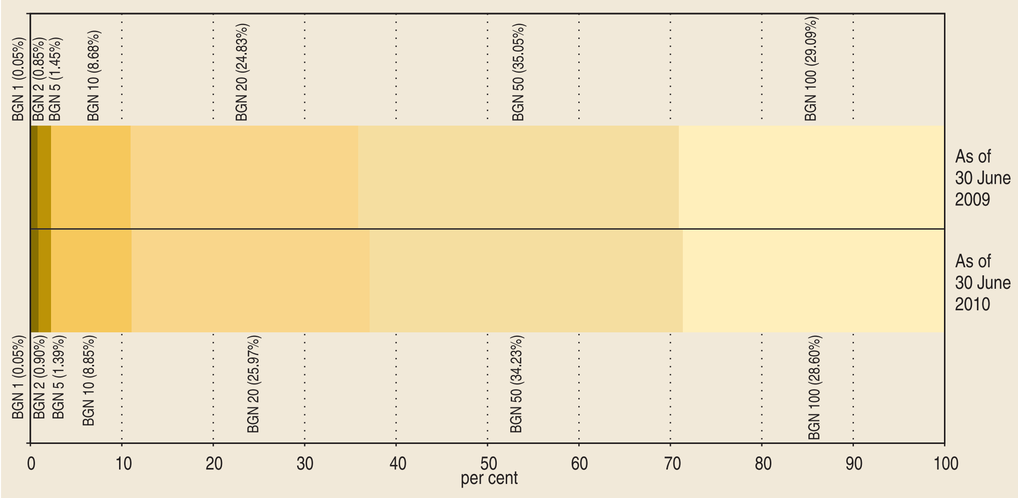
As regards number, BGN 20 and BGN 10 banknotes had the largest share at 55.46 per cent. By the end of the review period BGN 20 banknotes numbered 95.9 million and BGN 10 banknotes 65.4 million, or 32.98 and 22.4 per cent of the total number of banknotes in circulation. BGN 100 and BGN 50 banknotes followed at 7.26 and 17.39 per cent respectively.

In the first half of 2010 there was a decline in the number of banknotes of all denominations, with BGN 10 banknotes declining most by BGN 7.0 million or 9.66 per cent. The number of BGN 100, BGN 50 and BGN 20 banknotes declined by between 4.65 and 7.64

[1] Article 2, paragraph 5 and Article 25 of the Law on the BNB.
[2] Banknotes and circulating or commemorative coins issued after 5 July 1999. Under BNB Governing Council Resolution No 110 of 6 October 2005, banknotes and circulating coins whose exchange term has not expired and which have not returned to BNB vaults are deducted from cash in circulation. To allow comparisons, their lev value is also deducted from the amounts of cash in circulation for previous years.
[3] See Section I.

Denomination Composition of Circulating Banknotes

(share of total value)



Source: BNB.

per cent, while that of BGN 2 and BGN 5 banknotes declined by 1.83 and 5.82 per cent respectively.

The value of the average banknote in circulation by 30 June 2010 was BGN 25.39. Compared with late 2009, it had decreased by BGN 0.03 or 0.1 per cent because of higher decline rates in the number of BGN 100 and BGN 50 banknotes in overall cash in circulation.

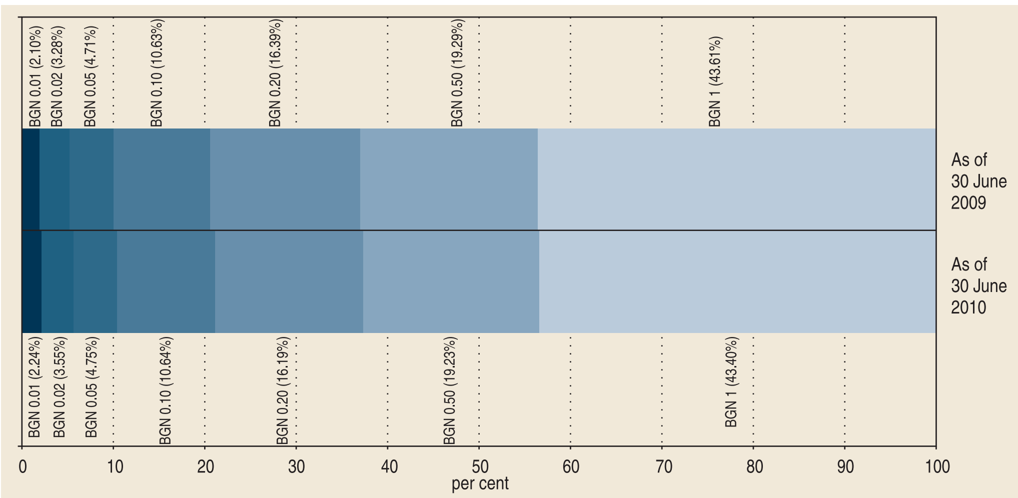
By the end of June 2010, 1180.6 million coins were in circulation, amounting to BGN 154.2 million. Since the start of 2010 coins outside BNB vaults grew by 42.6 million (3.75 per cent) in number and BGN 2.2 million (1.43 per cent) in value. Within a year, circulating coins grew by 108.6 million (10.13 per cent), their value rising by BGN 9.1 million (6.24 per cent). By 30 June 2010 the share of circulating coins accounted for 2.04 per cent of the total value of banknotes and coins outside BNB vaults.

The structure of circulating coins continued the long-lasting downward trend in the share of high-value coins and the upward trend in that of low-value coins. The share of low-value coins of BGN 0.01 and BGN 0.02 in the total number of coins in circulation came to 29.27 and 23.16 per cent respectively. By June 2010 the average coin in circulation matched its level of late 2009 at BGN 0.13.

Commemorative coins outside BNB vaults came to BGN 5.1 million, comprising 0.07 per cent of the value of cash in circulation.

Denomination Composition of Circulating Coins

(share of total value)



Source: BNB.

Non-genuine Banknotes and Coins

Over the first half of 2010 the National Analysis Centre retained 5453 non-genuine Bulgarian banknotes, of which 5428 had entered into circulation. The number of retained non-genuine banknotes fell by 27.82 per cent on the same period of 2009. Comparison of these data with the actual number of circulating banknotes (290.8 million at the end of June 2010) shows that the relative share of non-genuine Bulgarian banknotes was very small.

BGN 50 banknotes had the largest share in total non-genuine banknotes registered in the first half of 2010 (59.97 per cent). By 30 June 2010 they comprised 0.00647 per cent of total circulating BGN 50 banknotes. BGN 20 banknotes occupied 38.60 per cent, followed by BGN 2, 5, 10 and 100 at 1.43 per cent (78 in number). Over the review period non-genuine Bulgarian coins numbered 399: 397 of BGN 0.50 nominal value and two of BGN 1 nominal value.

In evaluating suspect foreign banknotes and coins in Bulgaria in close cooperation with the BNB, the ECB, the European Anti-Fraud Office (OLAF), and others, in the first half of 2010 the National Analysis Centre retained 1107 euro banknotes, 1760 US dollar banknotes, and 53 other foreign banknotes.

BNB Issue and Cash Activities

BNB cash operations comprise delivering, accepting, repaying, processing, authenticating, and physically monitoring banknotes and coins, keeping Bulgarian and foreign currency, exchanging damaged cash, and destroying unfit Bulgarian banknotes and coins.

The BNB commissioned its new Cash Centre in early April, completing an important stage of the BNB Development Strategy for Reorganising Cash in Bulgaria which ushers modern requirements in cash storage and processing. The Centre is one of the most modern facilities within the ESCB system, with strictest security observed in its construction. It fully discharges the Bank's cash management duties, including cash processing, storing, and destruction in a manner guaranteeing procedural integrity. The Centre provides standard cash services to customers to the General Terms for Supplying Banknotes and Coins at an Announced Value and services individuals in levs and the reserve currency (euro).

Between January and June 2010, 45.4 million new banknotes and 79.0 million new coins worth BGN 100.9 million were supplied under contracts with producers. In the first half-year the BNB launched two commemorative coins planned in its 2010 minting programme under Article 25, paragraph 1 of the Law on the BNB.[4]

Banknotes and circulating coins deposited with and withdrawn from the BNB totalled BGN 10,234.4 million in the first six months of 2010. Banks deposited Bulgarian banknotes and circulating coins worth BGN 5370.4 million with the BNB: down BGN 1524.7 million or 28.39 per cent on the same period of 2009. Banknotes and coins withdrawn from the BNB in the first six months of 2010 totalled BGN 4864.0 million: down BGN 661.4 million or 11.97 per cent.

Over the first half of 2010 BNB sorting machines processed 296.8 million banknotes worth BGN 5350.8 million and 57.6 million circulating coins worth BGN 19.6 million. The number of processed banknotes in the review period decreased by 79.3 million (21.09 per cent) compared with the same period of the prior year, while circulating coins went up 2.7 million (4.91 per cent). BGN 10, BGN 20 and BGN 50 banknotes and BGN 1, BGN 0.10 and BGN 0.20 coins had the largest shares in the nominal value structure of cash processed by the BNB.

Following machine processing and fitness checks at the BNB, banknotes retained as unfit numbered 52.1 million, up 0.3 million or 0.55 per cent on the same period of 2009. In the first half of 2010 banknotes of BGN 10, 2 and 20 had the largest shares (31.76 per cent, 22.12 per cent, and 21.92 per cent respectively) of all banknotes retained as unfit.

Over the review period BNB reserve currency purchases came to EUR 0.3 million, including EUR 0.1 million from budget organisations and EUR 0.2 million from individuals. Over the same period the Bank sold EUR 10.0 million of reserve currency, including EUR 4.0 million to budget organisations and EUR 6.0 million to individuals.

[4] The BNB website publishes information on commemorative coins.

VI. Maintaining Banking System Stability

1. State of the Banking System

Between January and June 2010 banks continued to contain major risks. Despite a progressive deterioration of credit portfolios since late 2009 and increasing impairment costs, risk to assets remained acceptable. The net interest margin, provisions, security on loans, and capital buffers helped offset the level of classified loans. Most institutions remained in profit despite high impairment costs. Non-performing loans are expected to continue growing in the second half of 2010. Nevertheless, an excess of operating revenue over impairment costs and buffers like current earnings, provisions, and capital surpluses will help banks bear the impact.

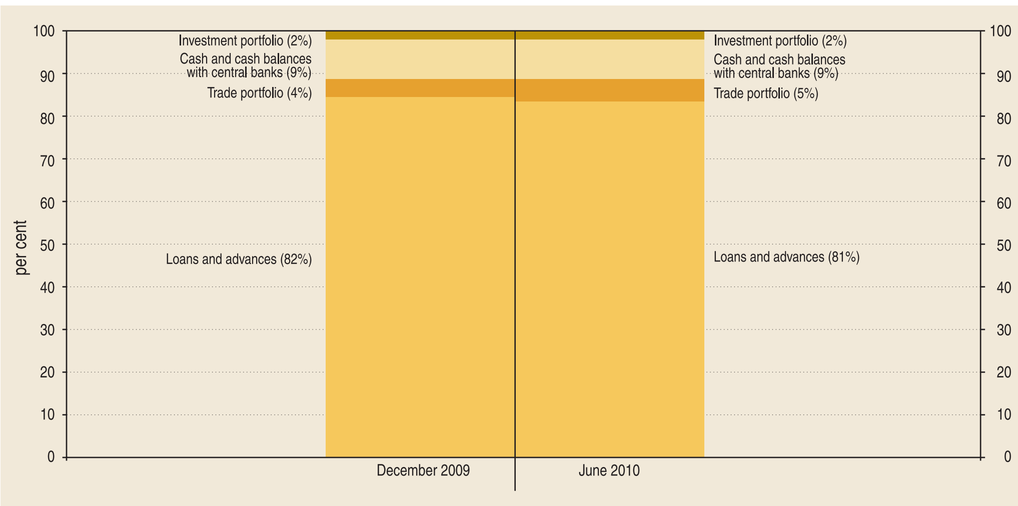
Since the last quarter of 2008 banks have focused on attracting domestic resource. Despite a drop in deposit rates since the second half of 2009, the volume of residents' funds in banks attests to considerable confidence. The uncertain recovery, relatively weak investment demand, and growing spare production capacity have depressed demand for loans. Reduced household spending and increased savings determine low demand for consumer loans and mortgages, alongside tightened lending criteria. Low credit portfolio growth reflects mostly weak demand from corporates and households. Banking liquidity remains adequate to the structure of the balance sheet, liabilities maturity and concentration therein. Parent banks abroad continue to maintain significant resource at subsidiaries, boosting their liquidity.

Structural Changes in the Banking System Balance Sheet

Between January and June total banking system assets were BGN 71 billion: a slight growth (0.3 per cent) on the end of 2009. The rate of banking expansion slowed down on an annual basis, assets growing by BGN 1.6 billion (2.2 per cent) against BGN 3.7 billion (5.7 per cent) between June 2008 and June 2009. Between January and June a BGN 269 million (6.0 per cent) increase in securities offset declines of BGN 337 million in loans and advances and BGN 63 billion in cash. Banks invested free funds mostly into foreign issuers' low-risk debt instruments, leading to a slight fall in the share of Bulgarian government securities. The net issue of the latter was negative in the first half of 2010. Approximately three quarters of placements into foreign debt were in nil per cent credit risk weighted instruments.

Structure of Assets

(%)



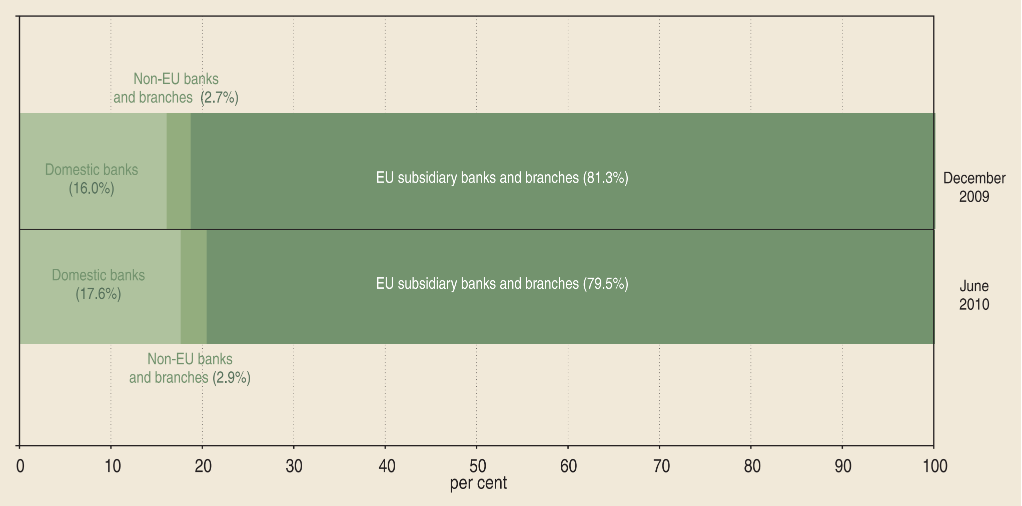
Source: BNB.

The big five banks reported asset decreases on the end of the prior year, their market share dropping 1.7 percentage points to 56.3 per cent. Small and medium banks, and to an extent foreign bank branches, managed to expand market shares to 38.6 per cent and 5.1 per cent respectively.

The contraction of the Group One banks' market position affected EU subsidiary banks whose share went down by about 2 percentage points to 75.1 per cent by the end of June. Dominant Bulgarian banks were more active in attracting domestic resource, boosting their market share from 16 per cent at the end of 2009 to 17.6 per cent by the end of June. The shares of other credit institutions, EU banks' branches, and branches of banks outside the EU did not change essentially.

Market Shares of Domestic and Foreign Banks

(%)



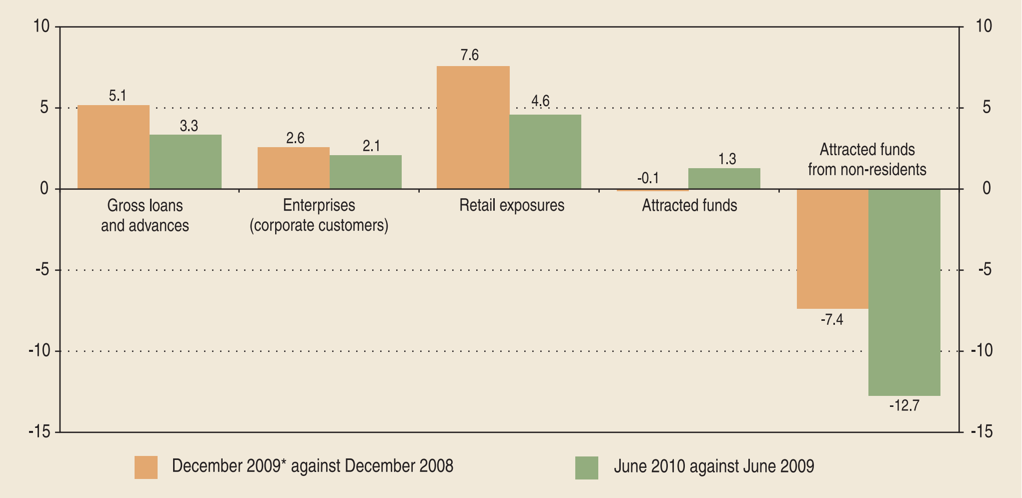
Source: BNB.

Lending

Gross loans (excluding those to credit institutions) totalled BGN 53 billion by the end of June: an increase by 0.3 per cent (BGN 142 million) on the end of 2009. Lending to the corporate sector increased slightly on 2009, mostly as short-term working capital loans and overdrafts. On the other hand, credit to households declined, mostly because of lower consumer lending. The contraction of this segment by 1.7 per cent on the end of 2009 was due to household spending cuts reflecting pessimism about employment and income, and higher savings. All three bank groups reported consumer lending declines on December.

Dynamics of Selected Balance Sheet Indicators

(%)



* Audited annual data.

Source: BNB.

A mortgage lending increase of 1.5 per cent on late 2009 partly offset this at the largest banks; small and medium ones and foreign bank branches reported mortgage lending declines.

Within the credit portfolio currency structure EUR-denominated loans increased their share to 58.4 per cent between January and June 2010, while the lev component fell to 37.6 per cent. Other currencies accounted for 4.0 per cent. About two thirds of loans to households and under a quarter of loans to corporations were denominated in levs.

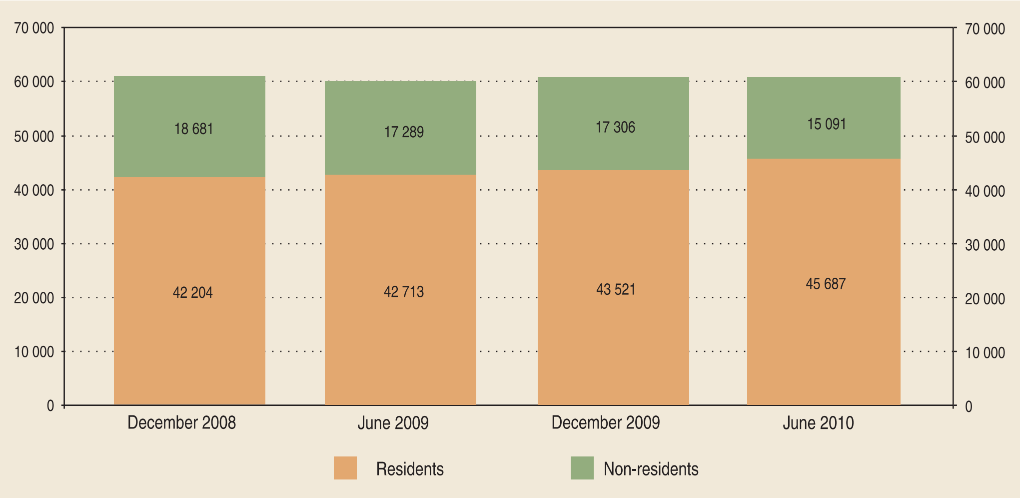
Gross banking system loans (credit institutions excluded) went up by some 3 per cent (BGN 1.5 billion), all other segments (except loans to non-credit institutions) also growing. The share of corporate lending in gross loans and advances fell slightly to 54.7 per cent; consumer and household mortgages stand even at 15 per cent each.

Attracted Funds

Attracted funds stood about where they were at the close of 2009 (BGN 61 billion), a slight decrease resulting from a drop in the inflow of funds from parent companies to Bulgarian subsidiaries. Between January and June 2010 central financing of local subsidiaries and branches dropped by 15 per cent, most funds arriving in the form of deposits and to a lesser extent of short-term finance.

Attracted Funds

(million BGN)



Source: BNB.

Household propensity to save more with banks grew sustainably despite falling deposit interest rates. Between January and June 2010 individual and household deposits rose by BGN 1.5 billion or 6 per cent on the end of 2009. Funds from non-credit institutions also increased by 1.4 per cent. Changes in financing sources boosted the share of residents' funds to 75.2 per cent against 71.5 per cent at the end of 2009. With the higher growth of individuals' deposits, their share in the structure of attracted funds reached 43 per cent by the end of June, funds from credit institutions falling to 22 per cent. Within the structure of internal resources the share of euro was 55 per cent, of levs 38 per cent, and of other currencies 7 per cent.

Balance Sheet Equity

Banking system balance sheet equity continued growing in the first half of 2010, though at lower rates than in the corresponding period of 2009. Between January and June 2010 it went up by 1 per cent on the end of 2009 (BGN 94 million) and 8 per cent (BGN 690 million) on an annual basis. Most banks capitalised their 2009 profits in the form of reserves. Between January and June 2010 issued capital picked up by BGN 39 million and premium reserves increased by BGN 69 million.

Due to growing impairment costs and limited opportunities for increasing revenue, banking system profit was lower than in the corresponding period of the prior year at BGN 352 million, down 29 per cent on the first half of 2009 (BGN 498 million).

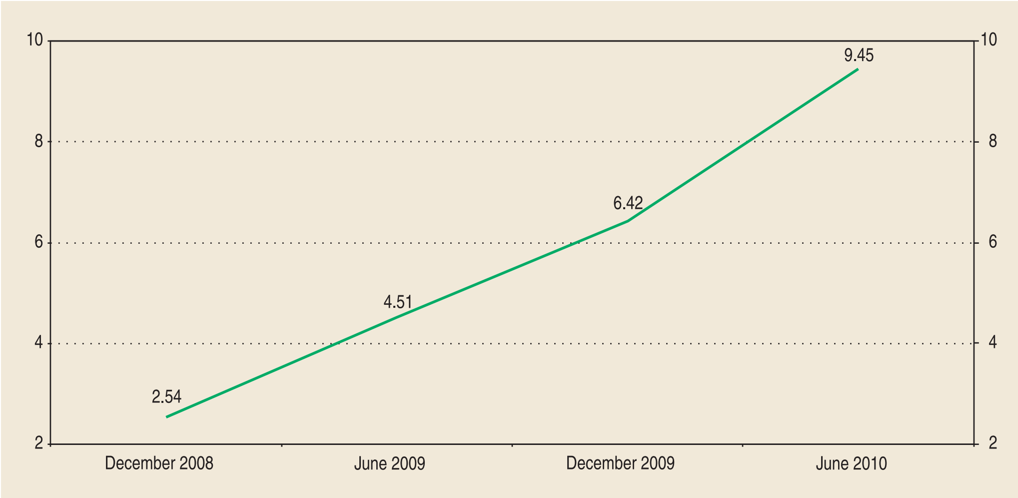
System Risk Profile

System risk profile in the first half of 2010 continued reflecting unfavourable Bulgarian and regional conditions. Contracting corporate sales and revenue, stagnant incomes, and growing unemployment hit economic actors' ability to service obligations. Credit risk sharpness increased, limiting banks' business and revenue development potential.

Between January and June 2010 *asset risk* continued rising, entirely due to banks' credit portfolios. Problematic corporate loans increased on the end of the prior year, while retail non-performing exposures past due over 90 days remained unchanged.

Share of Classified Loans Past Due over 90 Days in Gross Loans
(excluding those to credit institutions)

(%)

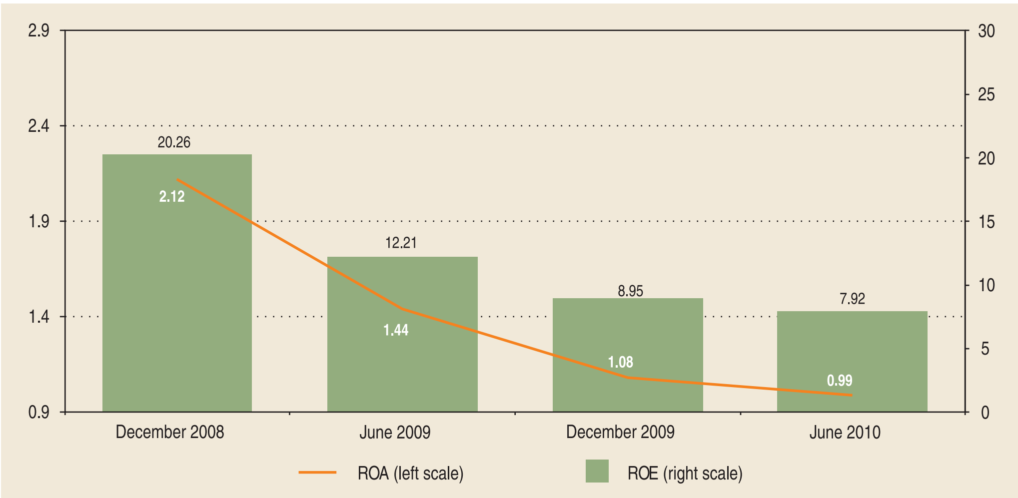


Source: BNB.

Lower lending and growing impairment charges and specific provisions to cover credit risk impacted banks' profitability. The potential to generate stable revenue remained limited over the first half of the year amid a lack of alternative placements and more conservative strategies. Nevertheless, banking remained profitable and reported good financial results.

Return on Assets and Return on Equity

(%)

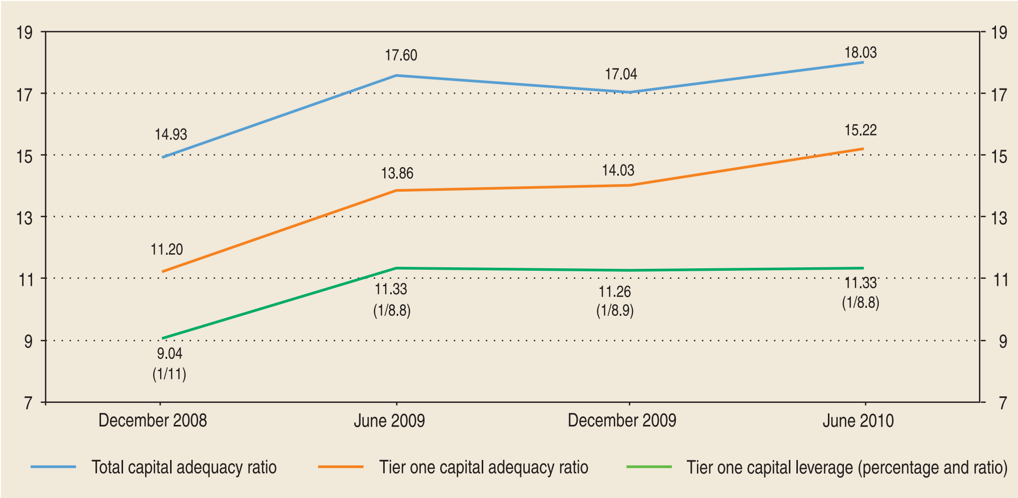


Source: BNB.

The system retained a *stable capital position* and remained capable of meeting shocks. Banks adhered to conservative management of own funds in support of capital, mostly by capitalising 2009 profits. There were no great changes in capital requirements and capital adequacy ratio was 18.03 per cent: higher than at the end of 2009. Capital surplus was BGN 3072 million, underwriting system stability amid a highly uncertain economic climate and growing risks.

Selected Capital Indicators

(%)

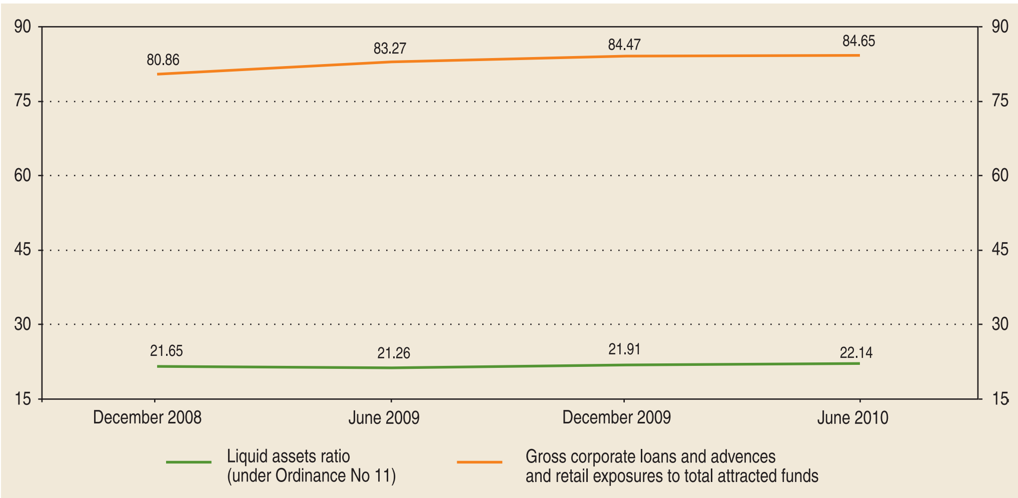


Source: BNB.

Liquidity maintenance in the first half of 2010 was in line with cash flow structure and volume. Liquid assets of BGN 13,512 million covered liabilities by 22.14 per cent; their share in banks' balance sheets did not fluctuate greatly.

Selected Liquidity Indicators

(%)



Source: BNB.

2. Supervisory Actions to Limit the Crisis Impact on the Banking System

Supervisory Policy

A supervisory policy priority between January and June 2010 was to harmonise national regulation with modified European supervision bank directives. Anti-cyclic measures continued to maintain a flexible and stable bank market.

Amendments to BNB Ordinance No 8 on Capital Adequacy of Credit Institution boosted banks' capital reserves and operational risk cover. Current and prior year profits are now automatic elements of the capital base, with no need for shareholder approval. To align national and EU legislation, two standard credit risk approach classes were downgraded, with retail exposure risk weight dropped from 100 to 75 per cent, and that of exposures secured by property dropped from 50 to 35 per cent. Licensing for the use of a standard operational risk approach eased, allowing banks to manage and control that risk more creatively.

Pending draft amendments to Ordinance No 7 on Large Bank Exposures, a proposed Ordinance 8, and a proposed Ordinance No 11 on Bank Liquidity Management and Supervision reflect new EU supervision directives. They harmonise criteria, requirements, large equity exposure and bank liquidity limits. The Bank aligned its instructions on bank liquid buffer levels, composition, quality, and periods of survival with Committee of European Banking Supervisors (CEBS) ones.

Following publication of the new Consolidated Financial Reporting Framework (CFRF), step-by-step design began of detailed instructions and reporting tables of various scopes for banks. Monitoring of Financial Institutions System (MFIS) reporting tables now give more detail on set balance sheet and off-balance sheet items.

Macro-prudential Analyses and Strategies

The major priority in supervisory macroanalyses and strategies was to assess bank stability and hence national financial system sustainability. Methods for early identification of risk sharpening saw intensive use alongside probability estimations of diverse banking scenarios. Intensive analyses and studies of underlying trends and factors monitored the extent of banking risk continuously. Publishing macro-prudential analyses kept the public advised of the state of banking.

Actively communicating risk analyses and business forecasts to banks deepened knowledge of major factors influencing risk sharpness and effect. Studies on changing customer behaviour, the business environment, and the effects of the crisis pinpointed gaps in banks' product ranges, pricing, balance sheet restructuring, and expectations of results for this year and the next.

Periodical stress testing assessed banking system sustainability and individual banks' capacities to meet a variety of shocks. The results pointed-up required supervisory and anti-cyclic policy measures.

Licencing, Permits and Approvals

No credit institution licensing opened in the first half of 2010. Electronic money licensing in progress since 2009 for TBIeCard EAD ended with application withdrawal. T. C. Ziraat Bankasi of Turkey was licensed to offer payment services.

The period under review did not see significant changes in the structure of qualified domestic bank shareholders. The Central Cooperative Bank acquired control of the Stater Banka AD of Kumanovo in Macedonia. Two banks increased their capital for supervisory purposes by attracting subordinated term debts, and another two repaid obligations on such instruments in advance. Planned bank management changes resulted in 12 approvals for members of supervisory and management boards and boards of directors. Eight credit institutions submitted notifications of intent to operate in Bulgaria, their total number reaching 178. Following notification from the Bundesanstalt für Finanzdienstleistungsaufsicht (the German Federal Financial Supervisory Authority), a subsidiary of the German-licensed Turkish private Ishbank prepared to open a Bulgarian branch. Over the first six months of 2010 no serious supervisory measures were imposed. Four banks were subject to supervisory measures.

Based on conducted inspections, supervisory inspectors suggested improvements to risk management at two banks, a plan to increase capital at one, and called for the managers of another bank to improve service after complaints from borrowers.

Credit Institutions Supervision

Work continued on expanding GSAS functionality to support the MF flexible issuing policy under changing market environment and reflect issuer's additional criteria for approval of auction results and new statements of primary dealers' participation in government securities auctions. After successful testing, the expanded GSAS functionality went live at the end of the review period.

In the first half of 2010 bank supervision was active and efficient. System risk profile and risk management at individual institutions emerged from monthly performance analyses of regular reporting and on-site inspections. Reports of financial ratios and indicators allowed assessments and pointed to financial performance, risk profile, and solvency changes. Supervisory reviews and off-site assessments paved the road for on-site inspections of risk management quality, alerted of underestimated risks and increased solvency risk.

To prevent contagion from processes in the real economy, on-site inspections focused on credit and liquidity risk management and capital adequacy. In the first half of 2010 there were 11 supervisory inspections. The comprehensive supervisory review suggests that banks maintained solvency higher than statutory requirements, had good liquidity, and managed credit risk reasonably. The review found 28 regulatory violations and made 63 recommendations to managements. The violations resulted in administrative enforcement against several banks.

Special Supervision

Over the review period work continued on neutralising equity structure risk and providing stable and transparent shareholding patterns. Supervision assessed equity holders' financial standing and their capacity to support capital if necessary. There were no deviations from good banking practice on equity holder structure clarity and fund origins.

Consistent action against money laundering, terrorist financing, and financial fraud was a supervisory priority in the review period. The banking sector assumed additional duties to monitor cash payments. The supervisory review found that banks generally kept to international standards on countering money laundering and implemented effective policies and procedures against the transfer of funds with unclear or criminal origins. Regular contacts with bodies fighting fraud and money laundering developed further to EC and other international institutions' assessment report guidelines.

Experts formulated opinions on issues deliberated by the Committee of European Banking Supervisors (CEBS) and the EC Committee on the Prevention of Money Laundering and Terrorist Financing. Supervisory practice against money laundering, terrorism financing, and financial fraud is converging as part of European supervisory cooperation.

Corporate management supervision is also improving and converging in line with legal requirements and trends. Efforts focus on transparency through additional financial and other information.

In registering financial institution operations efforts went on completing the Single Data Depository project by including a new Financial Institutions module providing rapid and detailed data on institutions.

Under memoranda of understanding and cooperation the Bank exchanged supervisory information with cross-border bank groups in Bulgaria. BNB experts took part in bank fora deliberating external corporate control mechanisms, strengthening capital markets, and improving the investment climate. Serious effort went on correcting unfair assessments of Bulgarian banking, with the reported results confirming supervisory assessments.

VII. The Central Credit Register

The Central Credit Register provides information on customer debt to Bulgarian banks and financial institutions. It was developed by the Bulgarian National Bank and is maintained by it.[1]

All loans by banks and financial institutions have to be reported to the Register, regardless of extent. Exceptions are loans to the government and the BNB, and overdrafts under BGN 1000, provided they are standard exposures in the sense of Ordinance No 9 of the BNB on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk. Since Ordinance No 22 came into force in October 2009 financial institutions whose subject is financial leasing without taking deposits or other refundable sources also have to report to the Register.[2]

In the first half of 2010, 52 financial institutions (out of 152 known to the Banking Supervision Department to meet relevant criteria) have applied for inclusion into the Register under Ordinance No 22, Article 6. The process of including them into the Register, and into the Banking Supervision Department public register, continues.

The broadening of the Register's scope has increased the number of known loans. By 30 June 2010 it was 3,958,169 (against 3,059,154 by 30 June 2009 and 3,209,731 by 31 December 2009), with a balance sheet exposure of BGN 53,860 million (against BGN 50,289 million by 30 June 2009 and BGN 52,452 million by 31 December 2009).

By 30 June 2009 the Register listed 2,020,241 borrowers, including 1,918,012 individuals, 8278 self-employed people, 91,278 legal entities, and 2673 non-residents.

Ordinance No 22 overhauled Register function. An updated information system has improved Register integrity, removing the need to collect parallel information for the Banking Supervision Department Credit Portfolio. Streamlined information flows have allowed data to be used in analyses, for calculating individual financial stability indicators, as well as helping banks and financial institutions.

Changes in the Register's reporting scope have enabled a greater number of statement types to be developed, allowing more detailed analysis and evaluation of credit risk and borrower probity. Provided in real time, customer debt information includes the current status of loans, any arrears on current and extinguished loans for five years back, and borrower history. Loan information is by classification group, offering opportunity for timely analysis and preventive measures by reporting units for extending loans to reliable customers with good credit history.

By 30 June banks and financial institutions conducted 1,783,000 inspections (1,269,000 individuals and 514,000 legal entities) *via* digital certificates. This was 270,000 more than in the same period of 2009 (1,513,000 inspections). There were some 297,000 monthly inspections on average.

Ordinance No 22 governs access to Register data. Banks and financial institutions and the heirs of deceased persons must apply for statements and pay a fee to a scale set by the BNB. During the first half of 2010 there were 2299 applications for statements: 2235 from individuals and 64 by legal entities.

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1 CCR business is regulated by BNB Ordinance No 22 on the Central Credit Register of 16 July 2009.

2 The inclusion of financial institutions into the Central Credit Register is partly governed by Ordinance No 26 on Financial Institutions of 23 April 2009. After Ordinance No 26 listing into the public register, financial institutions meeting the criteria of Law on Credit Institutions Article 56 have to apply for inclusion into the information system of the CCR.

VIII. The Fiscal Agent and State Depository Function

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

The Bank continually develops and improves systems linked with these duties: the GSAS system for conducting government securities auctions, the ESROT electronic system for registration and servicing trade in government securities, the GSSS government securities settlement system, the Register of Pledges, the AS ROAD automated system for registering and servicing external debt, and the IOBFR system for budget and fiscal reserve information servicing.

Revenues from the Bank's agency functions came to BGN 852,300,000 over the reporting period: 26 per cent up on the same period of 2009. They included BGN 447,300,000 of fees and commissions from government securities transactions: double the BGN 272,700,000 collected in the same period last year. The rise was mainly from auction fees and commissions and from government securities registration and settlement in the primary market, reflecting active MF issuing in the review period.

Information Service

The BNB's state budget duties under the agreement with the MF include monitoring operations and balances on budget, extra budgetary, deposit, foreign currency, and letter-of-credit accounts of budget entities (including municipalities) in levs and foreign currency with the BNB and other Bulgarian banks and reporting to the MF *via* IOBFR. The BNB also monitors security pledged by each budget servicing bank and compares it with reported balances.

On 30 June 2010 budget entities had BGN 7050.4 million[1] in the BNB and other domestic banks, of which BGN 5673.8 million in the fiscal reserve.[2] A year earlier these figures were BGN 9444.0 million and BGN 8107.4 million. The share of budget funds on BNB accounts by 30 June 2010 matched its June 2009 level at 77 per cent.

In early 2010 the MF asked for changes to the scope and frequency of some statements on budget entities' operations and balances. The number of summarised standard statements drawn up in the first half of 2010 increased by 11 per cent on the same period of the prior year to 404, including 149 fiscal reserve statements. In parallel, the BNB completed certificating summarised quarterly reports (103) drawn up by first level budget spending entities.

The AS ROAD system continued to maintain up-to-date information on Bulgaria's foreign financial obligations on which the BNB is agent. There were 16 regular payments effected after coordination with the MF worth EUR 123.6 million,[3] comprising EUR 20.7 million principal and EUR 102.9 million interest. By 30 June the system logged EUR 2522.6 million[4] of obligations.

Servicing Government Securities Trading

There were 16 MF-scheduled auctions held via GSAS in the first half of 2010: double the number in the same period of 2009. There was a euro-denominated issue for the first time since 2005. Government securities sales came to BGN 542.3 million, including a lev equivalent of EUR 60 million, increasing 2.8 times on the same period of 2009. Average annual yields of 2.5-year, five-year, seven-year, and 10.5-year issues attained at auction were 3.40 per cent, 4.46 per cent, 5.70 per cent, and 6.11 per cent respectively.

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1 Balances on foreign currency accounts are recalculated in levs at the BNB exchange rate of relevant currencies for 30 June 2010.
2 In accordance with MF methodology, these accounts do not cover temporary deposits and funds at disposal, which are included in the Single Account, as well as other high liquid foreign assets of the Central Government sector.
3 The payments total was recalculated in euro at the BNB rate for 30 June 2010.
4 The payments total was recalculated in euro at the BNB rate for 30 June 2010.

Demand continued to exceed supply, with a 2.29 average bid-to-cover ratio against 1.49 in the same period of the previous year, despite greater supply. Of the 81 average primary dealers' bids per auction, 33 were approved. There were significantly more bids for 10.5-year government securities (93 on average), with the highest bid-to-cover ratio at 2.58. The bulk of bids (some 76 per cent) was through the universal electronic signature web interface, with the balance through SWIFT. There were no GSAS malfunctions during auctions and system availability was 100 per cent.[5]

Under MF and BNB Ordinance No 5 on the Terms and Procedure for Acquisition, Registration, Redemption and Trade in Government Securities, ESROT registered primary acquisitions and payments on maturing government securities of BGN 1205.7 million,[6] up 66.2 per cent on the same period of 2009. Of this, newly acquired auctioned government securities amounted to BGN 542.3 million against BGN 196.2 million in the first half of 2009 (up 176.4 per cent). Principal and interest at maturity totalled BGN 663.4 million, including principal at BGN 591.1 million and interest at BGN 72.3 million, up 25.4 per cent on the same period of 2009, reflecting higher principal payments. By 30 June 2010 ESROT reported BGN 2981.1 million of tradable government securities[7] issued by the government on the domestic market.

In the first half of 2010 the secondary government securities market was most buoyant. The nominal volume of secondary market transactions in government securities over the first half of 2010 totalled BGN 27,005.1 million, up 29.5 per cent on the same period of 2009. Repos had the largest share (56.6 per cent), followed by blocking and unblocking (36.7 per cent), deals with or between ESROT participants' customers (4.9 per cent), and outright sales (1.8 per cent). Repos with a flow of funds on current accounts had the largest share at 81.8 per cent of the total volume. Their average weighted annual yield declined significantly on the first half of 2009 at between 0.19 per cent in one-day transactions and 2.14 per cent in over 30-day transactions. As in the past, trading intensified on days when new government securities were sold and when budget organisations' funds with banks changed dynamically.

By holder, government securities held by insurance companies and pension funds increased by 24 per cent. Those held by non-bank financial institutions, corporations, and individuals increased by 18.7 per cent. Banks' share declined slightly to 4.2 per cent. By late June distribution by holder was 55 per cent banks; 26 per cent non-bank financial institutions, corporations, and individuals; 18 per cent insurance companies and pension funds; and 1 per cent foreign investors.

Most ESROT-registered blocking and unblocking operations in domestic government securities related to securing funds in budget entities' bank accounts under the Republic of Bulgaria 2010 State Budget Law Transitional and Final Provisions § 22.[8] Average daily nominals of blocked government securities were BGN 714.3 million, EUR 104.4 million, and USD 28.1 million. The fall on the same period a year ago (BGN 952.8 million, EUR 115.8 million, USD 48.2 million) was because of decreased budget balances in servicing banks. The number and volume of blocking and unblocking operations increased due to banks' ability to regulate collateral by government securities in real time. To secure budget accounts, servicing banks also blocked foreign government securities not registered by ESROT by transferring them to dedicated BNB accounts. Over the review period average daily nominals of blocked government securities were BGN 167.6 million, EUR 104.1 million and USD 246.1 million, an increase in the euro-denominated share on the same period of 2009.

[5] The ratio of the time when the system is operational to scheduled operating time.

[6] The lev equivalent of payments on foreign currency denominated government securities issues was calculated at the BNB rate on the date of payment.

[7] The debt was recalculated in levs at the BNB rate for 30 June 2010.

[8] According to § 22, paragraphs 2 and 5, funds in all the accounts, deposits and letters of credit in the domestic and in foreign currencies of budget entities, including those of municipalities, with banks are secured by servicing banks in favour of the MF through blocking Bulgarian domestic and external debt government securities. Government securities are blocked at the BNB, with the legal effect of a special pledge on them in favour of the MF. Only government securities free of encumbrances or security are blocked.

Following registrations of circumstances with regard to deleting pledges on government securities under the Law on Registered Pledges, BGN 16.2 million[9] of government securities was unblocked in ESROT. By 30 June 2010 blocked government securities amounted to BGN 85.6 million, down 22.3 per cent on June 2009 (BGN 110.2 million).

Over the review period 6518 notifications and requests for registering transactions in government securities were submitted, up 31.8 per cent on the same period a year ago. Of them, 17.3 per cent came through SWIFT to ISO 15022 and 82.7 per cent through the ESROT web interface with universal electronic signatures. There were no refusals due to insufficient funds on participants' current accounts. Over the first half of the year ESROT offered 99.4 per cent availability,[10] with outages handled under contingency rules for BNB systems.

By 30 June 2010, 1532 accounts were kept with the government securities settlement system under BNB Ordinance No 31 on Government Securities Settlement. Of them, 39 were for government securities of the issuer (the MF), 617 for participants' own government securities portfolios, 519 for government securities market participants' customers, and 357 for encumbered government securities. Government securities on these accounts totalled BGN 2981.1 million in nominal value.

System Development

The recent years' policy aimed at continually improving the systems through further automation of processes and implementation of contemporary control mechanisms to ensure minimisation of operational risks and to boost the quality of offered services continued in the first half of 2010. The purpose is to attain optimum compliance of system functionality with the increasing requirements of the participants in applying European conventions and standards.

To optimize the IOBFR functioning under the increased MF requirements for submitted information and to create technological conditions required for its upgrade, a project was launched in 2009 on developing and updating the system, with the first stage finalized in the beginning of the review period. At this stage, improvements were made in the base and application software while expanding the existing functionality. In parallel, a new module 'Collateral' was created to enter, store and calculate all data required for daily monitoring of collateral provided by each budget servicing bank and checking the enforceability of requests for unblocking government securities on external debt. This module was developed in compliance with the effective joint instructions by the Minister of Finance and the BNB Governor and relevant BNB internal rules regulating individual structural units' responsibilities in respect of collateral.

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

[10] See footnote 5.

IX. International Relations and Participation in the ESCB

Coordinating efforts to overcome the negative effects of the global crisis and create a new supervisory architecture for the EU financial sector were at the core of central bank cooperation in the first half of 2010. The BNB participated in regulating the establishment of the European Systemic Risk Board and European supervisory bodies in banking, insurance, securities, pensions, and in formulating directives such as the *Omnibus Directive* amending sectoral directives in line with the new supervisory framework, and the Capital Requirements Directive (*CRD III*). Public consultations concerned changing the Capital Requirements Directive (*CRD IV*) and improving the financial stability framework to overcome the crisis and provide for sustainable growth. International financial institutions adhered to their commitments to help Central and Eastern Europe overcome the crisis.

BNB representatives worked in 82 European Commission, Council, and ESCB committees and working groups formulating monetary and banking policy and solving other central banking issues. Growing expert capacity and recent experience helped expand and deepen international cooperation and render technical assistance to neighbouring central banks.

Participation in the European System of Central Banks

The BNB Governor is a member of the ECB General Council and sits on its meetings with central bank governors from EU Member States and the ECB President and Vice-President. BNB representatives participated in 12 ESCB committees and 36 working groups, as well as in the Human Resources Conference (HRC) and in the ESCB Research Network on supervisory macroeconomic research. Through representatives on ESCB bodies, committees, and working groups, the Bank contributed to drafting ECB legal instruments, forming and developing monetary and banking infrastructure, payment and settlement systems, statistical reporting, and other central banking issues. The BNB took an active part in formulating ECB positions on European financial supervisory reform.

EU Member States have to consult the ECB in writing on legislative bills within its purview. This duty binds the BNB and government bodies in Bulgaria. The Ministry of Finance held two consultations with the ECB on Bills to amend the Law on the BNB, the Law on Preventing and Disclosing Conflicts of Interest, the Administrative Procedure Code, and a Bill concerning BNB powers under the Currency Law and the Law on Measures against Money Laundering. The ECB wrote to the Chair of the National Assembly on failure to consult the ECB on a Bill to amend the Law on the Financial Supervision Commission.

Under the duty of EU Member States with regard to ESCB communication policy, cooperation continued on translating and publishing major ECB publications in Bulgarian: the Annual Report 2009, the Convergence Report 2010, and quarterly Monthly Bulletins.

Participation in Ecofin Council Meetings and in the EU Council and European Commission Committees and Working Groups

The BNB Governor participated in ECOFIN informal meetings. The April 2010 meeting in Madrid discussed world financial market tension relating to public finance crises in some euro area countries. On 18 May the ECOFIN Council adopted conclusions on crisis prevention, management, and resolution.

The Bank's representatives on the Economic and Finance Committee helped formulate EU policy on issues related to economic and financial sector development.

BNB representatives participated in Council and Commission committees and working groups, contributing to EU financial sector policy reform since 2008. In the past six months the emphasis was on a new supervisory architecture for the EU financial sector. The new European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS) comprise three bodies: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). The BNB prepared national positions at all stages.

BNB representatives on the Committee of European Banking Supervisors (CEBS) and its working groups helped harmonise national financial legislation. Bank representatives on EU Council and European Commission working groups discussed issues of interest to BNB in banking regulation, payment services, and payment systems. There was intensive debate on the new supervisory framework, along with the *Omnibus Directive* amending a number of instruments on EU supervisory bodies. Amendments to the Capital Adequacy Directive (Directives 2006/48/EC and 2006/49/EC) were further debated. The Bank advised banking experts on coming reform at the national level.

The BNB representatives on the Council for European Affairs formulated national positions and policy on issues within the Bank's purview: banking and financial services, supervisory practice convergence, payment systems, and the new supervisory architecture.

Pursuing transparency, the BNB raised awareness of EU financial policy through regular seminars for bankers, financiers, and civil servants.

Convergence Reports

On 11 May the ECB and EC adopted convergence reports on the past two years' progress to convergence by EU Member States outside the euro area. These Member States with derogation[1] are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Sweden.[2] Reports examine compatibility between national legislation and central banks statutes with the Treaty Establishing the European Community and the Protocol and Statute of the ESCB and the ECB, and the degree of sustainable convergence of Member States with derogation. The reports were particularly important in view of Estonia's intention to join the euro area on 1 January 2011.[3]

There was much greater attention to national legislations and their practical application than in the 2008 convergence reports. The Commission and ECB examine not only formal incompatibility with the Treaty and the Statute but also whether interpretations and usage reflect convergence towards economic and monetary union.

The reports show that most countries with derogation had not attained full compatibility with the Treaty and Statute. Seven of them, including Bulgaria, had legal inconsistencies relating to central bank independence, the prohibition on monetary financing, and integration into the Eurosystem. Only Estonia had attained full legislative compliance.

Relations with International Financial Institutions

The BNB Governor attended the regular bimonthly meetings of Bank for International Settlements (BIS) central bank governors. They are a major forum of cooperation between member central banks and for discussion of world economic development and prospects, financial markets, and challenges to central banking from globalised finance. At its Annual General Shareholder Meeting in late June 2010, the BIS Board of Governors declared a dividend of SDR 374.1 million (SDR 685 *per* share) for participating central banks. The BNB's dividend for its 8000 BIS shares, SDR 5,480,000 (EUR 6.5 million), was received on 8 July 2010.

In the first half of 2010 the IMF Dutch Group met in The Hague (February) and Jerusalem (June), with the BNB Governor taking part. At Jerusalem, a quota and voting reform package was discussed, along with improvements in IMF governance, global financial stability, and a strengthened supervisory role for the IMF. In February the BNB took part in preparing the 61st issue of the IMF Annual Report on Exchange Arrangements and Exchange Restrictions to indicate changes in currency legislation. In April the IMF and BNB held a joint seminar on defining a vulnerability assessment methodology.

The 19th annual meeting of the European Bank for Reconstruction and Development was in Zagreb in May. It resolved to raise Bank capital by 50 per cent to boost investment in the coming five years.

In January 2010 the BNB made its third annual contribution of USD 8500 to the IASC Foundation in line with a 2008 commitment to help finance it for three years.

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[1] Reports are published on 12 May 2010 and are available on www.ecb.int and www.ec.europa.eu.

[2] The United Kingdom and Denmark were not assessed in the convergence reports as they have not requested to launch the euro and have opt-out clauses in their accession treaties.

[3] On 13 July 2010 the ECOFIN Council allowed Estonia to introduce the euro on 1 January 2011. For details see BNB Economic Review quarterly, 2/2010, p 18.

Bilateral Cooperation with Central Banks

The BNB is most active in providing technical assistance in South Eastern Europe. Over the first half-year the Bank continued implementing several such projects.

The project on Strengthening the Regulatory Supervision Capacity of Financial Regulators in Montenegro continued with 18 expert missions. Twenty-two tasks were implemented and nine were completed. Twenty-one planned results were attained and 11 partially attained. The review period saw 155 person-days generated with 159 experts participating. The most significant project success involved the gap analysis of Montenegro's legal and institutional financial framework, supervisory capacity, and challenges to effective legal function. It was a key to further action for Montenegrin supervisors and provided important information for European Commission assessment of harmonisation with *acquis communautaire*. The Commission monitored the project for the first time between 19 and 23 April, rating it highly. Efficiency – key indicator of project management quality – got the highest rating of A. The gap analysis was especially highly assessed.

A European Union-funded three-year cooperation programme with the Central Bank of Egypt on bringing banking supervision into line with Basel II principles continued successful implementation. It involves the ECB and seven EU central banks. The BNB helps in three strategic areas: own funds, a standardised approach to credit risk, and reporting. BNB experts helped a quantitative study on the effects of Basel principles on the capital base of Egypt's banks, including reporting forms and technical instructions for the study.

BNB expert capacity and technical assistance experience made the Bank a preferred partner in regional projects. Cooperation in the region has deepened already intensive bilateral relations.

X. Statistics

The Bulgarian National Bank collects, compiles and disseminates statistics under the Law on the BNB Article 42 and as a member of the ESCB under Article 5 of the Protocol on the Statute of the ESCB and the ECB. The 2009 amendments to Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the European Central Bank posed additional requirements for BNB statistics.

Methodological instructions and reporting forms to Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (ECB/2008/30) began to be implemented.

In monetary and interest rate statistics, methodological instructions and new reporting forms to Regulation (EC) No 25/2009 of the European Central Bank of 19 December 2008 concerning the balance sheet of the monetary financial institutions sector (Recast) (ECB/2008/32) and Regulation (EC) No 290/2009 of the European Central Bank of 31 March 2009 amending Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans *vis-à-vis* households and non-financial corporations (ECB/2009/7) were completed and preparation for their implementation began.

Since early 2010 balance of payments and international position statistics were reported according to the amended BNB Regulation No 27. In line with Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community, the threshold for statistical data on transfers and payments to other countries by individuals and firms changed from BGN 25,000 to BGN 100,000. The reporting thresholds for claims and liabilities to non-residents on commercial loans and transactions other than financial loans by legal entities and sole proprietors were equilised to BGN 50,000. The amendments to the Ordinance aimed to reduce the burden on reporting units and to improve the quality of information.

After a random sample border survey of Bulgarians and foreigners by the BNB, in March 2010 revised data on the balance of payments travel, passenger transportation, compensation of employees – credit, and current transfers – credit items were published.

Work on developing and implementing a new integrated system for balance of payments, international investment position, and other statistics, continued. Its major goal is to automate to the utmost the receipt, management, processing, and dissemination of statistics. Preparations to replace the fifth edition of the Balance of Payments Manual (IMF, 2008) with the sixth began. In view of the substantial volume of work and of the need to harmonise the new methodological principles with those of the European system of accounts, the ECB Statistics Committee and the Eurostat Committee on Monetary, Financial and Balance of Payments Statistics decided to introduce the sixth edition of the Balance of Payments Manual in 2014. The new manual makes significant changes to definitions and the manner of presenting balance of payments items. In this respect, changes to the legal framework relating to balance of payment statistics and international investment position statistics reporting are pending.

Cooperating with the ESCB, the BNB continued active support for the Centralised Securities Database project, statistics on securities holdings, and the future database of Bulgarian securities.

The BNB continued compiling data on the quarterly financial accounts of the General Government sector to Regulation (EC) No 501/2004 of the European Parliament and of the Council of 10 March 2004 on quarterly financial accounts for general government, as well as data on government financial statistics. The National Statistical Institute, the Bulgarian National Bank, and the Ministry of Finance signed a Memorandum of Cooperation for developing, producing, and disseminating government financial statistics and national financial accounts. Helped by the NSI, the Bank continued to send to the ECB and BIS information on macroeconomic indicators. Regular updates and metadata certification under the Special Data Dissemination Standard were made in line with IMF methodological requirements and data dissemination schedule.

XI. Research

Economic research, analysis of Bulgarian economic processes, and macroeconomic forecasts prepared by the BNB support the Bank's management in making decisions and formulating economic policy. In the first half of 2010 research reflected the BNB priorities of successful participation in the ESCB. Work focused on studying economic agents' behaviour through microdata, financial sector modelling, and developing macroeconomic forecasting models.

Specialised research under the Research Plan for 2009 and 2010 supported BNB operations by analysing individual economic processes and issues and improving forecasting and modelling tools. In the first half-year of 2010 work addressed labour market flexibility, price and wage-setting mechanisms, short-term GDP forecasting, evaluating the budget balance cyclical component based on the disaggregated approach applied by the ESCB, empirical sectoral analysis of pricing based on Bulgarian exports, Bulgarian competitiveness, interest rate modelling, and the dynamic stochastic general equilibrium model. The review period saw testing and honing of the basic model for improving BNB macroeconometric forecasting. Technical reports and seminars organised by the BNB for experts from relevant bodies, academia, and non-governmental organisations, presented research results.

In April 2010 an IMF technical mission supported the BNB forecasting and its use of dynamic stochastic general equilibrium models. The experts reviewed progress, consulted the BNB on modeling specific issues, and outlined future goals.

The Guest Researcher Programme supports BNB research and helps establish fruitful cooperation with experts from Bulgaria and abroad on subjects of interest to the Bank. Between January and June 2010 two guest researchers worked on behavioural finance and financial stability.

In 2010 the Editorial Board of the Discussion Papers series held two meetings, reviewed four new submissions (one rejected), and made recommendations to authors on improving contents.

The Programme Council for Banking and Finance History continued its work. In March the European Association for Banking and Financial History (the BNB is a member since 2002) published the study *The Bulgarian National Bank and its Role in the Communist Economy, 1945–1989* in its Bulletin. In May the BNB published the book *Marko Riaskow. Erinnerungen und Dokumente* on an eminent Bulgarian banker in German. To mark Asen Hristoforov's 100th anniversary in the autumn, a three-volume edition of *Asen Hristoforov: Selected Works and Documents* will be published under the BNB Banking Finance and History/Heritage series, alongside an exhibition of documents from his private archive.

XII. Information Infrastructure

BNB information system development relies on projects for technological upgrades and smooth and reliable information system operation, as well as integrating the BNB information and communication systems with those of the ESCB.

In respect of databases and application systems, information system development during the first half-year included mainly broadening their scope and expanding their functionality. The Central Credit Register project was typical: upgrades and updates developed new data controls and functionalities, enabling new statements or improvements to existing ones, and introducing new reporting units to the Register under Ordinance No 22 and Ordinance No 26.

Detailed specifications for a new BNB cash reporting, control and management system (Cash System) were developed in relation with the BNB Cash Centre.

The Financial Institution File subsystem within the Single Data Depository – Banking Supervision Reports information system is being developed under Ordinance No 26.

The main task in data processing over the half-year remained ensuring information system integrity and reliability through launching newer versions and ensuring higher capacity.

XIII. Human Resource Management

Human resource management focuses on the successful implementation of BNB functions and duties. The Bank aimed to improve procedures and mechanisms to European standards and practice. Human resource management rests on optimising recruitment, motivation, development, and training of Bank personnel.

Recruitment sought employees qualified to fill up-to-date requirements and job descriptions. The BNB participation in the KARIERI 2010 student training and career forum is becoming traditional. For a third consecutive year the Bank enjoyed great interest from many young people. Over 300 undergraduates and post-graduates visited the BNB stand.

In the first half of 2010, the Bank appointed 47 new employees (35 in the same period of 2009). Twenty-one left the BNB, of whom 11 retired. Over the same period of 2009, 23 left the BNB.

The staff age structure remained broadly unchanged, with the under 30 age group expanding. Graduates occupied the largest share in line with the BNB policy on hiring and retaining young, qualified, and motivated people. The upward trend in the share of graduates continued, as expected of a professional structure dominated by analysts.

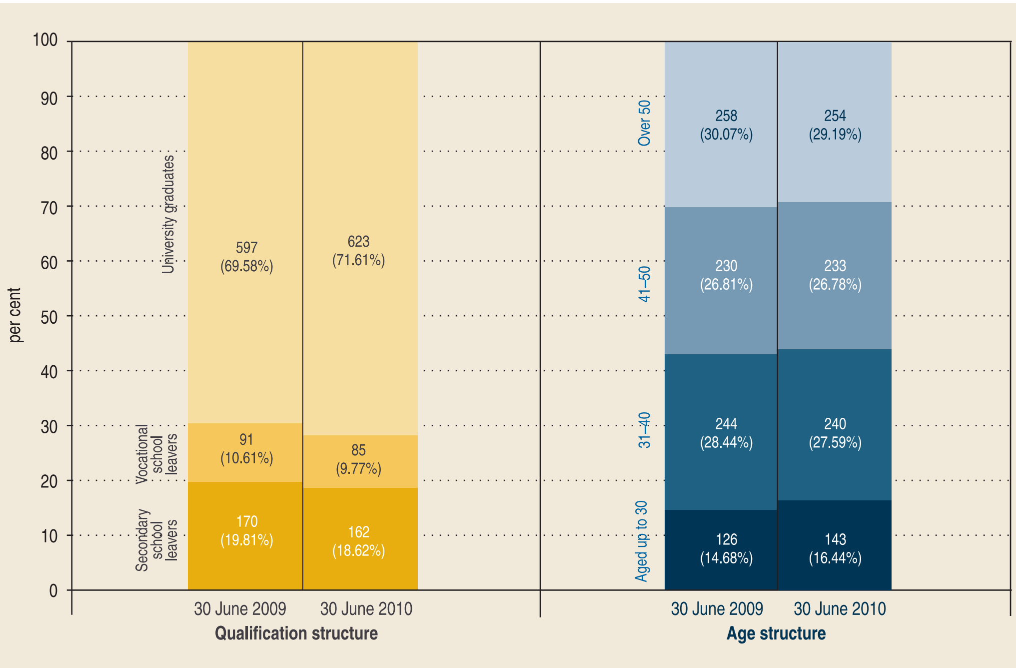
Over the review period internal and external staff mobility was further encouraged. Three BNB employees took on short-term assignments at the ECB. Employees moving between units became a common practice. This boosted staff expertise and intensified the exchange of knowledge and experience within the Bank. The employees who moved to other structural units numbered 28.

In the first half of the year BNB employees participated actively in various forms of training for raising their qualifications: in addition to the well-known programmes, new forms were launched.

In line with the annual BNB Staff Education and Professional Training Programme, BNB employees took part in various training courses and seminars organised by foreign banks and international financial institutions.

Staff Structure

(number, per cent)



Source: BNB.

BNB employees continued active participation in seminars and training courses on ESCB committees. In the first half of 2010, 84 employees took part in courses and seminars by foreign banks and international financial institutions. Three employees took part in the finance and law specialised training programme organized by the Wim Duisenberg School of Finance supported by the Dutch Ministry of Foreign Affairs. In the first half of 2010, 29 employees boosted their educational attainments without discontinuing work by reading for doctors', masters', and bachelors' degrees, against 23 in the same period of 2009.

Strong interest in various distance learning programmes continued: 17 in International Banking Institute programmes, five in the Chartered Financial Analysts Institute programme, three in the Chartered Certified Accountants programme and one in the Institute of Internal Auditors programme. Employees from relevant structural units attended specialised courses on changes in social security legislation, health and safety at work, and public tendering.

BNB employees continued to attend courses in English, French, and German to attain proficiency levels specified by job descriptions and improve language skills.

XIV. Facilities Management

The BNB mainly trades from owned premises and properties. This provides the degree of independence, security, and protection required of a central bank. Property spending was mainly on implementing the investment programme in line with the BNB annual budget and included construction, refurbishment and modernisation, deliveries and equipment, repairs, vehicles, supplying assets and cash processing consumables, storing and using consumables and office materials at structural units, and optimising power, heating, and water use at BNB buildings.

No property was pledged or granted and no new vehicles were purchased in the first half of 2010.

XV. Internal Audit

Between January and June 2010 there were five audits under the BNB Internal Audit annual programme and one under the ESCB Internal Auditor Committee programme.

Two of the audits were on cash operations, addressing banknote printing management and control at the BNB Printing Works and coin, order and medal minting management and control at the State Mint. Attention focused on policy and procedure observance, fidelity to statutory instruments and principal instructions, production reporting and control, customer relations, organisational structure, staff recruitment and remuneration, stocks, and risk management.

An audit addressed bank supervision and its contribution to banking stability through examining the accomplishment of supervision tasks and objectives, workflow and planning efficiency, the division of responsibility in on-site inspections, and information reliability.

Auditors assessed the ability of the Bank's international reserves information system, Trema Finance Kit, to contribute to the Bank's strategic goals.

Under the Internal Audit annual programme the Bank's Chief Auditor reviewed implementation of recommendations from prior audits deadlined by 31 December 2009. The BNB Chief Auditor organised the examination of recommendations implementation and assessed the effectiveness, adequacy and timeliness of the measures undertaken by the managers of the respective units.

EURO1 and TARGET2 supervision at the local level was audited under the 2010 ESCB Internal Auditor Committee's programme. This involved assessing supervision's contribution to euro area financial stability and its ability to generate reasonable Eurosystem adequacy and efficiency.

The audits were as follows:

BNB Functions	Audits under the BNB Internal Audit Programme
Banknote production	Banknote printing management and control at the BNB Printing Works
Coin production	Coin, order and medal minting management and control at the State Mint
Supervision and financial stability	Supervisory monitoring on credit institutions
Implementation of monetary policy and market operations	Trema Finace Kit international reserve management system at the BNB
Internal Audit	Implementation of Bank's Chief Auditor's recommendations

ESCB Functions	Audits under the ESCB Internal Auditors Committee Programme
Bank services provided to the ESCB central banks	Supervision of EURO1 and TARGET2 payment system

Source: Audit documents.

As most cash operations moved to the new Cash Centre by June 2010, the Internal Audit Department monitored the Cash Centre Project, issuing opinions on draft internal regulations on cash operations and human resources management.

The Chief Auditor managed and coordinated internal auditing with external controlling bodies.

Between January and June the Operational Risk Methods and Consolidation Division worked to a plan approved by the Operational Risk Management Committee, coordinating planning to circumscribe operational risks identified in 2009. The Committee and the Governing Council examined the plans after formulation. Assessment of 2010 operational risks began in June. After updating process descriptions and criticality evaluations by units involved since 2009, work began on self-evaluation of risk. The Committee has set newly included units the task of passing through all stages of risk assessment by the close of 2010.

XVI. Budget Implementation

The Governing Council adopted the BNB Budget by Resolution 124 at its 17 November 2009 meeting.

This Budget report comprises two sections pursuant to Governing Council internal rules on drafting, implementing and reporting the BNB Budget: operational expenditure and the investment programme.

1. Operational Expenditure

During the first six months of 2010, the BNB spent BGN 39,118,000 or 43.3 per cent of its 2010 budget.

Currency circulation cost BGN 7,707,000 or 39.8 per cent of budget and 19.7 per cent of overall operating spending. Banknote and coin production cost BGN 7,364,000 or 40.0 per cent of budget, including BGN 4,118,000 (38.1 per cent of budget) on printing and BGN 3,246,000 on minting, of which BGN 3,089,000 on circulation. Commemorative coins cost BGN 157,000 (13.3 per cent) in line with the Governing Council's coin programme.

Cash processing consumables cost BGN 50,000 or 20.4 per cent of budget.

Cash circulation equipment cost BGN 51,000 or 25.5 per cent of budget.

Renting premises at the BNB Printing Works, at the State Mint and at the Cash Services Company cost BGN 241,000 or 61.8 per cent of budget.

Materials, services, and depreciation spending totalled BGN 20,005,000 or 46.1 per cent of budget.

Of this, materials comprised BGN 422,000. Major expenditure in this group comprised, *inter alia*, BGN 122,000 on office consumables, BGN 133,000 on fuel and spares for the transport fleet, and BGN 109,000 on inventories.

Expenditure on hired services was BGN 9,668,000 or 43.6 per cent of budget. Significant items include software maintenance and subscriptions at BGN 3,162,000, Bloomberg, Reuters, internet and other systems at BGN 457,000, and Bankservice subscriptions at BGN 253,000.

Power bills were BGN 361,000 and mail, telephone and telex came to BGN 431,000. Property and refuse collection levies were BGN 864,000. Property insurance cost BGN 148,000.

The Bank spent BGN 1,284,000 on its security contract with the Ministry of the Interior and other organisations. Since the year's start expenses on major building maintenance totalled BGN 1,072,000 or 53.2 per cent of budget.

Consultancy services cost BGN 105,000 or 13.7 per cent of budget. They included analysing infrastructure, formulating development strategy, and publications and research on monetary and financial history by the Programme Council for Banking and Finance History.

Over the first six months of 2010 depreciation expenditure amounted to BGN 9,915,000 or 49.9 per cent of budget. Depreciation on property, plant, equipment, and intangible assets is to the straight-line method.

Wages, social, and healthcare costs totalled BGN 10,299,000 or 48.6 per cent of budget. Under IAS 19, Income of Hired Persons, here the Bank reported BGN 1,424,000 of current retirement obligations and unused paid leave.

Social expenditure amounted to BGN 373,000 or 18.2 per cent of budget.

Miscellaneous administrative expenditure was BGN 412,000 or 1.1 per cent of all operating expenditure. Inland travel involved mainly cash logistics in regional cash centres and checks there, at BGN 21,000.

Foreign travel covered participation in seminars and staff training. Spending on it was BGN 130,000 or 21.5 per cent of budget.

Under the annual BNB Staff Education and Professional Training Programme, employees took part in various training courses and seminars by foreign banks and international financial institutions. Staff training expenses were BGN 205,000 by 30 June 2010.

Bank representative and protocol expenses came to BGN 50,000 or 25 per cent of budget.

In the first half of 2010 spending on ESCB participation was BGN 322,000. The cost of BNB representatives' participation in ESCB commissions and committees was BGN 276,000. Telecommunication line rental cost BGN 16,700 and staff training cost BGN 17,000. Expenditure on organising working meetings in Sofia was BGN 11,500.

2. The Investment Programme

The Investment Programme section of the BNB's 2010 budget came to BGN 761,000 or 4.9 per cent of the annual budget. Extended procedures for public tender subcontractors are among the reasons for this low expenditure rate, alongside the low rate of IT budget implementation. Over the review period priorities changed, with spending cuts and shifts to future reporting periods.

BGN 2000 went on metal fencing for the BNB Cash Centre under the construction, refurbishment, and modernisation item.

In the period under review, BGN 308,000 or 16.2 per cent of budget went on machines and equipment, vehicles, and sundry equipment.

In the reporting period BGN 32,200 went on furniture and BGN 6900 on kitchen equipment. Four multifunction photocopiers worth BGN 58,000 and cleaning equipment and waste containers equipped the BNB Cash Centre.

Computerisation cost BGN 451,000 of which BGN 125,000 for hardware and BGN 326,000 for software. Hardware worth BGN 37,400 included computer equipment, of which BGN 14,600 for a LED system and LCD displays and BGN 22,800 for Cash Centre printers and scanners. Investment into communications equipment was BGN 87,600. Software licences for the TurboSwift and IT security systems cost BGN 44,000. The Bank spent BGN 282,000 to expand the functionality of existing programmes.

Over the review period no investment was made into BNB membership in the ESCB.

Implementation of the BNB Budget as of 30 June 2010

Indicators	Report 30 June 2010 (BGN'000)	Budget 2010 (BGN'000)	Implementation (%)
Section I. BNB operational expenditure	**39 118**	**90 238**	**43.3**
Currency circulation expenditure	7 707	19 353	39.8
Materials, services and depreciation expenditure	20 005	43 354	46.1
Salaries and social security expenditure	10 299	21 195	48.6
Social activity expenditure	373	2 048	18.2
Other administrative expenditure	412	2 007	20.5
BNB expenditure on membership in ESCB	322	2 281	14.1
Section II. Investment programme	**761**	**15 455**	**4.9**
Expenditure on construction, reconstruction and modernsation	2	810	0.2
Expenditure on acquiring machines, motor vehicles and other equipment	308	1 905	16.2
Expenditure on BNB computerisation	451	12 544	3.6
Investment related to BNB membership in ESCB	0	196	0.0

XVII. Bulgarian National Bank Consolidated Financial Statements as at 30 June 2010

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

The Law on the Bulgarian National Bank requires the Governing Council of the Bulgarian National Bank to prepare financial statements for each reporting period to present the Bank's financial position and performance for the period.

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

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

Ivan Iskrov

Governor of the BNB

Consolidated Statement of Comprehensive Income for the Period Ended 30 June 2010 (unaudited)

(BGN'000)

	Note	30 June 2010	30 June 2009
Interest income	7	218,210	369,188
Interest expense	7	(5,037)	(64,154)
Net interest income		**213,173**	**305,034**
Fee and commission income		4,351	4,115
Fee and commission expense		(1,760)	(1,767)
Net fee and commission income		**2,591**	**2,348**
Net profit/(loss) from financial assets and liabilities at fair value through profit or loss	8	509,227	93,975
Other operating income	9	28,196	18,613
Total income from banking operations		**753,187**	**419,970**
Administrative expenses	10	(50,635)	(51,565)
Profit for the period		**702,552**	**368,405**
Other comprehensive income			
Other comprehensive income		(32)	55
Other comprehensive income, total		**(32)**	**55**
Total comprehensive income for the period		**702,520**	**368,460**
Profit attributable to:			
Majority owners		702,479	368,275
Minority interest		73	130
Profit for the period		**702,552**	**368,405**
Total comprehensive income attributable to:			
Majority owners		702,447	368,330
Minority interest		73	130
Total comprehensive income for the period		**702,520**	**368,460**

The accompanying notes on pages 69 to 92 form an integral part of the consolidated financial statements.

Consolidated Statement of Financial Position as at 30 June 2010 (unaudited)

(BGN'000)

	Note	30 June 2010	31 June 2009
ASSETS			
Cash and deposits in foreign currencies	11	5,206,929	4,144,152
Gold, instruments in gold and other precious metals	12	2,573,240	1,937,132
Financial assets at fair value through profit or loss	13	15,950,014	19,142,156
Financial assets available for sale	14	1,561,226	1,416,503
Tangible assets	15	245,397	253,950
Intangible assets	16	11,708	14,302
Other assets	17	62, 354	47,742
Total assets		**25,610,868**	**26,955,937**
LIABILITIES			
Banknotes and coins in circulation	18	7,542,740	8,049,100
Due to banks and other financial institutions	19	5,020,267	4,924,976
Liabilities to government institutions and other liabilities	20	5,849,686	7,390,220
Borrowings against Bulgaria's participation in international financial institutions	21	2,869,726	2,594,546
Other liabilities	22	120,689	137,145
Total liabilities		**21,403,108**	**23,095,987**
EQUITY			
Capital	23	20,000	20,000
Reserves	23	4,183,984	3,836,247
Minority interest	24	3,776	3,703
Total equity		**4,207,760**	**3,859,950**
Total liabilities and equity		**25,610,868**	**26,955,937**

The accompanying notes on pages 69 to 92 form an integral part of the consolidated financial statements.

Consolidated Statement of Cash Flows for the Period Ended 30 June 2010 (unaudited)

(BGN'000)

	Note	30 June 2010	30 June 2009
Operating activities			
Net profit		702,552	368,460
Adjustments for matching with the net cash flow from operating activities:			
Dividend income		(12,732)	(4,554)
Depreciation	15, 16	13,072	11,040
Loss on disposal of tangible assets		90	-
(Profit)/loss on financial assets and liabilities arising from market movements		(389,187)	28,356
(Profit)/loss of associates		-	-
Other adjustments		(29)	(18)
Net cash flow from operating activities before changes in operating assets and liabilities		**313,766**	**403,284**
Change in operating assets			
(Increase) in gold, instruments in gold and other precious metals		(14)	(3,754)
Decrease in financial assets at fair value through profit or loss		3,075,692	1,824,044
Increase in other assets		(18,140)	(5,280)
Change in operating liabilities			
Increase in currency in circulation		(506,360)	(1,369,634)
(Decrease)/increase in due to banks and other financial institutions		95,291	(579,835)
(Decrease)/increase in due to government institutions and other liabilities		(1,540,534)	313,236
Increase in borrowings from IMF of total allocation of SDR		-	-
Decrease/increase in other liabilities		(16,456)	20,895
Net cash flow from operating activities		**1,403,245**	**602,956**
Investing activities			
Purchase of tangible and intangible assets		(2,018)	(28,526)
Dividends received		12,732	4,554
Net cash flow from investing activities		**10,714**	**(23,972)**
Financing activities			
Payments to the Government		(354,710)	(400,955)
Net cash flow from financing activities		**(354,710)**	**(400,955)**
Net decrease in cash and cash equivalents		**1,059,249**	**178,029**
Cash and cash equivalents at beginning of period		**4,172,475**	**2,682,385**
Cash and cash equivalents at end of period	11, 17	**5,231,724**	**2,860,414**

The accompanying notes on pages 69 to 92 form an integral part of the consolidated financial statements.

Consolidated Statement of Changes in Equity for the Period Ended 30 June 2010 (unaudited)

(BGN'000)

Source of changes in equity	Capital	Revaluation of non-monetary assets	Special and other reserves	Total	Minority interest	Total equity
Balance as of 1 January 2009	**20,000**	**138,272**	**3,265,492**	**3,423,764**	**3,548**	**3,427,312**
Profit for the period	-	-	368,275	368,275	130	368,405
Other comprehensive income:						
Other income	-	(11)	66	55	-	55
Other comprehensive income, total	-	(11)	66	55	-	55
Total comprehensive income for the period	-	(11)	368,341	368,330	130	368,460
Changes in reserves resulting from realization of securities	-	-	73,804	73,804	-	73,804
Contributions by and distributions to owners:						
Contribution to the budget of the Republic of Bulgaria	-	-	(400,955)	(400,955)	-	(400,955)
Transactions with owners, total	-	-	(400,955)	(400,955)	-	(400,955)
Balance as of 30 June 2009	**20,000**	**138,261**	**3,306,682**	**3,464,943**	**3,678**	**3,468,621**
Balance as of 1 January 2010	**20,000**	**138,381**	**3,697,866**	**3,856,247**	**3,703**	**3,859,950**
Profit for the period	-	-	702,479	702,479	73	702,552
Other comprehensive income:						
Other income	-	(32)	-	(32)	-	(32)
Other comprehensive income, total	-	(32)	-	(32)	-	(32)
Total comprehensive income for the period	-	(32)	702,479	702,447	73	702,520
Contributions by and distributions to owners:						
Contribution to the budget of the Republic of Bulgaria	-	-	(354,710)	(354,710)	-	(354,710)
Transactions with owners, total	-	-	(354,710)	(354,710)	-	(354,710)
Balance as of 30 June 2010	**20,000**	**138,349**	**4,045,635**	**4,203,984**	**3,776**	**4,207,760**

The accompanying notes on pages 69 to 92 form an integral part of the consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Statute and principal activities

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

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

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

- maintaining price stability through ensuring national currency stability;
- exclusive right to issue banknotes and coins;
- regulation and supervision of other banks' activities in Bulgaria with a view to banking system stability maintenance;
- establishment and operation of efficient payment systems and their oversight;
- the Bank may not provide credit to the State or to state-owned institutions, other than credit for purchase of Special Drawing Rights (SDR) from the International Monetary Fund (IMF) in accordance with terms set by law;
- the Bank may not provide credit to banks except in the case of liquidity risk threatening to affect the stability of the banking system;
- the Bank may not deal in Bulgarian government securities;
- the Bank may not issue Bulgarian levs in excess of the Bulgarian lev equivalent of the gross international foreign currency reserves;
- under terms agreed with the Minister of Finance, the Bank acts as agent for public debts or for debts guaranteed by the State;
- the Bank acts as a central depository of government securities.

The Governing Council of the BNB approved the consolidated financial statements set out on pages 63 to 92 on 4 November 2010.

2. Applicable standards

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Commission.

3. Basis of preparation

The financial statements are presented in Bulgarian levs rounded to the nearest thousand (BGN'000). The financial statements are prepared on a historical cost basis, except for derivative financial instruments, financial assets and liabilities for trading and available-for-sale assets which are presented at fair value.

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

Changes in the accounting policy

In preparing these financial statements, the BNB applied for the first time the revised IAS 1 – *Presentation of Financial Statements* (2007) effective as of 1 January 2009. All changes related to equity of the owner are presented in the statement of changes in equity. Changes not related to the equity of the owner are presented in the comprehensive income statement.

Comparative information for the previous reporting period has been revised and presented in accordance with the provisions of the revised standard.

The change in the accounting policy affects solely the financial statement presentation and does not lead to changes in the financial performance of the Bank.

Other developments in the standards

The Bank applies the amended Financial Instruments Disclosures (amendments to IFRS 7) published in March 2009, which require additional disclosures of the fair value of financial instruments.

These changes introduce a three-level hierarchy for fair value measurement disclosures, which reflects the significance of the inputs used in making the measurements of financial instrument fair value. Additional disclosures are required for fair value measurements in Level 3 (unobservable inputs) of the fair value hierarchy. Changes require in case of significant transfers between level 1 and level 2 of the fair value hierarchy, these transfers to be disclosed separately by distinguishing the transfers between and into each level. In addition to this, changes in evaluation techniques between the periods and reasons thereto should be disclosed for each class of financial instruments.

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

Associated companies

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

5. Principal accounting policy elements

(a) Income recognition

Interest income and expense are recognised in the comprehensive income statement on an effective interest rate basis. The effective interest rate is the rate which precisely discounts the expected future cash payments and income over the term of the financial asset or liability to the book value of the asset or liability. The effective interest rate is determined on the initial recognition of the financial asset or liability and does not change thereafter.

The calculation of the effective interest rate includes all commissions received or paid and any discounts or premiums which are integral parts of the effective interest rate. Transaction costs are intrinsic costs directly attributable to the acquisition, issue or derecognition of a financial asset or liability.

Interest income and expense in the comprehensive income statement include:

- interest on financial assets and liabilities at amortised cost calculated by the effective interest rate method;
- interest on investment securities available for sale calculated by the effective interest rate method.

Dividends are recognised in the comprehensive income statement when the Bank establishes the right to their receipt. Exchange rate gains or losses from available-for-sale investments are recognised in the comprehensive income statement.

Net profit/loss from financial assets and liabilities at fair value through profit or loss includes net gains from operations in securities, net gains from operations in foreign currency, net revaluation gains on securities, net gains from gold revaluation, net gains from revaluation of futures, net gains from revaluation of assets and liabilities denominated in foreign currencies.

(b) Financial instruments

1) Classifications

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

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

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

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

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

2) *Recognition*

The Bank recognises trading financial assets and investments, the bank's loans and receivables, and financial liabilities at amortised cost on the settlement date. All other financial assets and financial liabilities are recognised on the trade date when the Bank becomes a party to the financial instruments contracts. From that moment on, any gains and losses arising from changes in their fair value are recognised by the Bank.

Financial instruments are initially recognised at fair value, and the financial instruments which are not recognised at fair value through profit or loss include the transaction costs.

3) *Amortised cost measurement*

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured upon the initial recognition, minus principal repayments, plus or minus cumulative amortisation, using an effective interest rate for the difference between the initially recognised amount and the amount at maturity minus depreciation costs.

4) *Fair value measurement and disclosure principles*

Fair value is the amount at which an asset can be exchanged or a liability can be settled between informed consenting parties in a direct deal on the measurement date.

Whenever possible, the Bank measures the fair value of an instrument using quoted prices in an active market of this instrument. A market is considered active if quoted prices are regular and easily accessible and there are actual regular and direct market transactions.

If the market of a financial instrument is not active, the Bank shall measure the fair value using evaluation techniques. The evaluation techniques include recent direct deals between informed consenting parties (if any), comparison with the current fair values of other similar instruments, analysis of discounted cash flows, and models with option prices. The chosen evaluation technique maximally uses market data, relies to the least possible extent on specific for the bank measurements, includes all factors which market participants would take account of in pricing, and agrees with the adopted pricing methods for financial instruments.

The data for the evaluation techniques adequately present the market expectations and measures of the risk factors and profitability of the financial instrument. The Bank checks the evaluation techniques and tests their validity using prices of current market transactions in the same instrument seen in the market, or the prices are based on other available market data.

The best indicator of a financial instrument's fair value upon its initial recognition is the deal price, i.e. the fair value of the given or received investment, unless the fair value of this instrument is defined in comparison with other evident current market transactions in the same instrument (i.e. without changes or regroupings) or on the basis of evaluation techniques whose variables include only data obtained from the market. When the deal price is the best indicator of the fair value upon the initial recognition, the financial instrument is initially measured at deal price, and every difference between this price and the value obtained at first from the evaluation model is recognised later through profit or loss depending on the facts and circumstances of the transaction, but not later than the time when the measurement is entirely supported by evident market data or the transaction is completed.

Assets and long positions are measured at 'ask' price; and liabilities and short postions are measures at 'bid' price. When the Bank has positions with set-off risk, average market prices are used to measure the positions with set-off risk, and an adjustment by respectively 'ask' or 'bid' price is made only for the net open position. Fair values reflect the credit risk of the instrument and include adjustments for the credit risk of the Bank and of the counterparty, if necessary. The fair value measures obtained from the model are adjusted according to all other factors, such as liquidity risk or uncertainty of the model, to the extent in which the Bank believes that a third party in the market would take them into consideration in evaluating a transaction.

5) *Derecognition*

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire, or when it transfers the rights to the receipt of the contractual cash flows from the financial asset in the transaction in which all material risks and profits from the holding of the financial asset are transferred. Any holding in transferred financial assets, which has been originated or kept by the Bank, is recognised as a separate asset or liability.

The Bank derecognises a financial liability when its contractual obligations have been fulfilled or cancelled or have extinguished.

The Bank conducts transactions for transferring assets recognised in the balance sheet, but it keeps all or almost all material risks and profits from the transferred assets or a portion of them. If some or all material risks and profits have been kept, then the transferred assets are not derecognised from the balance sheet. A transfer of assets with keeping some or all material risks and profits is, for instance, a securities lending agreement or a repurchase transaction.

In transactions where the Bank does not keep, nor does it transfer all material risks and profits from the holding of a financial asset, it derecognises the asset if it does not keep control of that asset. The rights and obligations kept in the transfer are recognised separately as assets and as liabilities respectively. In transactions where control of the asset is kept, the Bank goes on recognising the asset up to its participation, depending on the extent to which the Bank is exposed to changes in the value of the transferred asset.

In some transactions, the Bank keeps its obligation to service the transferred financial asset against payment. The transferred asset is fully derecognised if it meets the derecognition criteria. The asset or liability is recognised in the service contract depending on whether the service charge is more than sufficient (asset) or less than sufficient (liability) for the service.

6) *Set off*

Financial assets and liabilities are set off and the relevant net value is entered in the balance sheet when the Bank has a legal right to set off the recognised values and intends to settle the asset and the liability on a net basis.

Income and expenses are reflected on a net basis only in the cases allowed by the accounting standards, or from profits or losses arising from a group of similar transactions, such as those resultant from the Bank's trading operations.

7) *Impairment of assets*

Financial assets which are not recognised at fair value through profit or loss are reviewed at each balance sheet date to determine whether there is evidence of impairment. A financial asset is impaired if there is objective evidence of impairment as a result of a loss event that occurred after the initial recognition of the asset and that the loss event had an impact on the estimated future cash flows of the asset, and a reliable estimate of the loss can be made.

Objective evidence of impairment loss from financial assets, including equity instruments, is a default or a borrower's inability to repay his obligations, restructuring of loans under unfavourable financial conditions for the Bank, indications that a borrower or the issuer of a financial instrument would go out of business, the disappearance of an active security market, or another public information. Furthermore, in case of a continuous or significant fall in the market value of an investment in equity instruments, there is objective evidence of impairment of these equity instruments.

The Bank judges the need of impairment of loans or investments to maturity on an individual or a group basis. All individually important loans and investments to maturity are evaluated for specific impairment. All individually important loans and investments to maturity on which no specific impairment losses have been charged are evaluated on a portfolio basis. Loans and investments to maturity which are not individually important are evaluated for impairment as a group by forming groups of loans and securities to maturity with similar risk characteristics. For the impairment on a portfolio basis, the Bank uses statistical models based on historical experience of non-repayment probability, the time for the reversal of impairment losses, and the loss amount which is adjusted according to the management's judgement whether the current economic and credit conditions are such that the actual losses are higher or lower than the results from the historical modelling. The default percentages, losses, and the expected period of reversal of losses are regularly compared with real data so as to validate the evaluation models.

Impairment losses from assets entered at amortised cost are measured as the difference between the book value of the financial asset and the present value of the approximately estimated future cash flows discounted by the initial effective interest rate of the asset. Losses are recognised in profits and losses and go to a corrective account against loans and receivables. Interest on the impaired asset is still recognised through depreciation of the discount. When a subsequent event reduces the impairment loss, the reduction in the impairment loss is reversed in profits and losses.

Impairment losses from available for sale investment securities are recognised by transferring the accumulated loss directly recognised in the own funds to profits and losses. The accumulated loss transferred from equity and recognised in profits and losses is the difference between the purchase price, net of all principal repayments and depreciations, and the present fair value minus all impairment losses recognised before that in profits and losses. If in a subsequent period the fair value of an impaired debt security available for sale increases and the increase can be objectively linked to an event that occurred after the impairment loss had been recognised in profits and losses, then the impairment loss is reversed and the reversed amount is recognised in profits and losses. Any subsequent recovery in the fair value of an impaired equity instrument available for sale, however, is directly recognised in equity.

8) Financial assets and liabilities held for trading

Financial assets at fair value through profit or loss include instruments for trading which the Bank holds primarily for the purpose to sell or repurchase them in short terms or holds them as part of a portfolio which is managed as a whole with the purpose of short-term profit.

Financial assets and liabilities for trading are initially recognised at fair value in the balance sheet and the purchase costs go directly to the income statement. All changes in the fair value are recognised as net income from trading operations in the income statement. Financial assets and liabilities for trading may not be reclassified after their initial recognition and over the year the amended IAS 39 Reclassification of Financial Assets (amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures) has not been applied.

Investments are initially recognised at fair value, and the fair value of the investments which are not recognised at fair value through profit or loss includes the direct costs for the acquisition of the investments. Upon any subsequent measurement, depending on the classification, investments are entered as investments to maturity or available for sale.

9) Investments

(1) Held-to-maturity investments

Held-to-maturity financial assets are non-derivative assets with fixed or determinable payments and fixed maturity that the Bank has the intent and ability to hold to maturity, are not classified at fair value through the income statement, and are not available for sale financial assets.

Held-to-maturity investments are recognised at amortised cost on the basis of an effective interest rate. In case of sale or reclassification of more than an insignificant part of the assets held to maturity which do not mature in the near term, there should be a reclassification of the entire portfolio of investments held to maturity in the group of available for sale investments. As a result of this reclassification, the Bank may not classify investments as investments held to maturity in the current year, and in the next two years.

(2) Financial assets available for sale

Available-for-sale investments are non-derivative assets that cannot be classified in any other category of financial assets. Equity investments not quoted in the market and whose fair value cannot be reliably defined are recognised at cost. All other available for sale assets are recognised at fair value.

Differences in the fair value are recognised directly in equity until the investment is sold or fully depreciates, when the cumulative income and expense recognised in equity are recognised in the comprehensive income statement.

(c) Gold and other precious metals

The BNB as a central bank maintains particular volumes of gold as part of Bulgaria's international reserves. In compliance with the requirements of the Law on the Bulgarian National Bank, the Bank may take any necessary action in connection with the acquisition, possession and sale of gross international foreign reserves, including monetary gold. Consequently, monetary gold as part of international foreign reserves may be immediately used by the BNB without further constraints which determines it as a monetary asset and it should be valued at fair value. With regard to the set characteristics of the monetary gold, the management considers that IFRS does not provide a reliable base for the reporting of this asset. Therefore, pursuant to the requirements of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' the Bank defines the recognition and valuation of the monetary gold as a financial asset at fair value through profit or loss as the most reliable and appropriate base for a subsequent valuation of this financial asset.

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

(d) Equity investments

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

Details of investments held by the Bank are set out in note 14.

(e) Property, plant, equipment and intangible assets

The Bank pursues a policy of recognising land and buildings at revaluated cost as per the alternative approach allowed in IAS 16 Property, Plant and Equipment. The other groups of property, plant, equipment and intangible assets are stated in the balance sheet at their acquisition cost, less accumulated depreciation and impairment losses.

Land and buildings are recognised at fair value which is regularly assessed by professional qualified evaluators. The revaluation of property is done asset by asset, and the accrued depreciation at the revaluation date is derecognised on the gross balance sheet account on the assets side, and the net value is recalculated against the revaluation of the asset. When the value of assets increases as a result of revaluation, the increase goes directly to the revaluation reserve in the own funds. When the value of assets decreases as a result of revaluation, the decrease is recognised in decreasing the revaluation reserve in the own funds, and in case of shortage, the difference is recognised as expense in the comprehensive income statement.

1) Subsequent expenditure

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

2) Depreciation

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

(%)

Buildings	2–4
Plant & Equipment	3–15
Computers	30–33.3
Fixtures and fittings	15–20
Motor vehicles	8–25
Intangible fixed assets	20–25

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

3) Calculation of recoverable amount of assets

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

4) *Reversals of impairment*

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

(f) Foreign exchange

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

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

The exchange rates of the major foreign currencies as at 30 June 2010 and 31 December 2009 are as follows:

Currency	30 June 2010	31 December 2009
US dollars	1 : BGN 1.59386	1 : BGN 1.36409
Euro	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rights	1 : BGN 2.35716	1 : BGN 2.13069
Gold	1 troy ounce : BGN 1977.830	1 troy ounce : BGN 1488.400

(g) Taxation

The Bank is not subject to income tax on income from its main activities. Tax on the profit from subsidiaries for the period comprises current tax and deferred tax. Current tax comprises tax payable calculated on the basis of the expected taxable income for the period, using the effective tax rate or the current one on the balance sheet date. Deferred tax is derived using the balance sheet liability method on all temporary differences between the carrying amounts for financial reporting purposes and the amounts used for taxation purposes.

(h) Profit distribution policy of the Bank

The Bank's policy of distribution of profit from banking operations is defined in the Law on the BNB. New BNB Financial Statements and Accounting Policy Internal Rules were adopted by a resolution of the BNB Governing Council in accordance with Article 36, paragraphs 1 and 2 of the Law on the BNB and are effective from 1 January 2007. According to these rules, the Bank allocates to special reserves unrealised net gains and losses arising from revaluation of assets and liabilities denominated in foreign currency or gold. According to the requirements of Article 8, paragraph 2 of the Law on the BNB, the Bank sets aside 25 per cent of the excess of its annual revenue over its annual expenditure into a Reserve Fund. According to Article 8, paragraph 3 of the Law on the BNB, after the allocation to the Reserve Fund, the Bank may allocate reserves to cover market risk losses and other reserves by a decision of the Governing Council. Subsequent to the allocation of reserves as required by the Law on the BNB, the Bank stipulates the remainder to be paid into the State Budget. The distribution of income over expenditure is set out in note 23.

(i) Cash in hand and deposits in foreign currency

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

(j) Employee benefits

The Bank has the obligation to pay certain amounts to each employee who retires from the Bank in accordance with the requirements of Article 222, § 3 of the Labour Code in

Bulgaria. According to these Labour Code requirements, on termination of the employment contract of an employee who has become entitled to retirement, the employer is obliged to pay him/her compensation amounting to twice his/her gross monthly salary. If the employee has been employed by the Bank for ten or more years by the date of retirement, the amount of the compensation is six gross monthly salaries. As at the statement date, the Management of the Bank estimates the approximate amount of the potential expenditures for every employee based on a calculation performed by an actuary using the projected unit credit method. The estimated amount of the obligation and the main assumptions, on the base of which the estimation of the obligation has been made, is disclosed to the financial statements in note 10.

Termination benefits

Termination benefits are recognised as an expense when the Bank is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognised as an expense if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably. If benefits are payable more than 12 months after the reporting period, then they are discounted to their present value.

Short-term employee benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Bank has a present legal or constructive obligation to pay this amount as a result of past services provided by the employee, and the obligation can be estimated reliably. The Bank recognises as a liability the undiscounted amount of the estimated costs related to annual leave expected to be paid in exchange for the employee's service for the period completed.

(k) International Financial Reporting Standards (IFRS) and interpretations adopted from European Commission not yet effective as of the date of the statement

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2009, and have not been applied in preparing these consolidated financial statements.

- IFRS 9 Financial Instruments, published on 12 November 2009 as part of phase I of the IASB's comprehensive project to replace IAS 39, deals with classification and measurement of financial assets. The requirements of IFRS 9 represent a significant change from the existing requirements in IAS 39 in respect of financial assets. The standard contains two primary measurement categories for financial assets: amortised cost and fair value. A financial asset would be measured at amortised cost if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and the asset's contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding. All other financial assets would be measured at fair value. The standard eliminates the existing IAS 39 categories of held to maturity, available for sale and loans and receivables. For an investment in an equity instrument which is not held for trading, the standard permits an irrevocable election, on initial recognition, on an individual share-by-share basis, to present all fair value changes from the investment in other comprehensive income. No amount recognised in other comprehensive income would ever be reclassified to profit or loss at a later date. However, dividends on capital instruments are recognised through profit or loss, rather than other comprehensive income unless they clearly represent a partial recovery of the cost of the investment. Investments in equity instruments in respect of which an entity does not elect to present fair value changes in other comprehensive income would be measured at fair value with changes in fair value recognised in profit or loss. IFRS 9 requires that derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not separated; instead the hybrid financial instrument is assessed in its entirety as to whether it should be measured at amortised cost or fair value. IFRS 9 is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. The management is currently in the process of evaluating the potential effect of this standard.
- Revised IFRS 3 Business Combinations (2008) is effective for annual periods beginning on or after 1 July 2009. Management does not expect Revised IFRS 3 to have an effect

on the consolidated financial statements as the Bank does not have any interests in subsidiaries that will be affected by the revisions to the standard.

- Amendments to IAS 27 Consolidated and Separate Financial Statements are effective for the first financial year beginning on or after 1 July 2009. Management does not expect Revised IFRS 27 to have an effect on the consolidated financial statements as the Bank does not have any interests in subsidiaries that will be affected by the revisions to the standard.
- Changes in IAS 32 Financial Instruments: Presentation: Classification of Rights Issues is effective for the first financial year beginning on or after 1 February 2010. Management does not expect Amendment to IAS 32 to have an effect on the consolidated financial statements as the Bank has not issued such instruments at any time in the past.
- Changes in IAS 39 Financial Instruments: Recognition and Measurement: Eligible Hedged Items are effective for the first financial year beginning on or after 1 July 2009. Management does not expect Amendments to IAS 39 to have an effect on the consolidated financial statements as the Bank does not apply hedge accounting.
- IFRIC 12 Service Concession Arrangements is effective, at the latest, for first annual reporting period beginning on or after 1 April 2009. Management does not expect IFRIC 12 to have an effect on the consolidated financial statements as none of the Bank entities have entered into any service concession arrangements.
- IFRIC 15 Agreements for the Construction of Real Estate is effective for the first financial year beginning on or after 1 January 2010. Management does not expect IFRIC 15 to have an effect on the consolidated financial statements as the Bank does not provide real estate construction services or develop real estate for sale.
- IFRIC 16 Hedges of a Net Investment in a Foreign Operation Estate is effective for the first financial year beginning on or after 1 July 2009. Management does not expect IFRIC 16 to have an effect on the consolidated financial statements as the Bank does not have any investments in a foreign operation.
- IFRIC 17 Distributions of Non-cash Assets to Owners is effective, at the latest, for the first financial year beginning on or after 1 November 2009. As the Interpretation is applicable only from the date of application, it will have no impact on the financial statements for periods prior to the date of adoption of the interpretation. Further, since it relates to future dividends that will be at the discretion of the General Meeting, it is not possible to determine the effects of application in advance
- IFRIC 18 Transfers of Assets from Customers is effective prospectively, at the latest, for the first financial year beginning on or after 1 November 2009. IFRIC 18 is not relevant to the financial statements as the Bank does not normally receive contributions from customers.

Management believes that it is appropriate to disclose that the following revised standards, new interpretations and amendments to current standards, which are already issued by the International Accounting Standards Board (IASB), are not yet endorsed for adoption by the European Commission, and therefore are not taken into account in preparing these financial statements. The actual effective dates for them will depend on the endorsement decision by the European Commission.

- Improvements to IFRSs 2009 (issued in April 2009), various effective dates, generally 1 January 2010;
- Amendment to IFRS 2 Group Cash-Settled Share-based Payment Transactions (issued in June 2009), effective from 1 January 2010;
- Amendment to IFRS 1 Additional Exemptions for First Time Adopters (issued in July 2009), effective from 1 January 2010;
- Amendments to IAS 32 Classification of Rights Issues (issued in October 2009), effective from 1 February 2010;
- Revised IAS 24 Related Party Transactions (issued in November 2009), effective from 1 January 2011;
- IFRS 9 Financial Instruments (issued in November 2009), effective from 1 January 2013;
- Amendments to IFRIC 14 Prepayments of a Minimum Funding Requirement (issued in November 2009), effective from 1 January 2011;
- IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments (issued in November 2009), effective date: 1 July 2010.

As of the date of preparing the present financial statement, the Bank's management has not finished analyzing the possible effects of the revised standards in the future, and the new interpretations and amendments to the existing standards.

6. Financial risk management policy disclosure

(a) Introduction and overview

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

- credit risk;
- liquidity risk;
- market risk;
- operational risk.

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

General provisions of risk management

The process of the BNB management of the gross international reserves looks to the high security and liquidity of the assets first, and then to maximizing returns 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 international reserves is invested in low-risk discount and coupon securities issued by governments, government agencies or supranational financial institutions, short-term foreign currency and gold deposits placed with first-rate foreign banks. The remaining portion is held in SDRs, and in monetary gold kept in the Bank's vaults.

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

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

The international reserves management is governed by rules of behaviour and procedures regulating the performance of the functions and tasks of the main structural units involved in the process. The rules and procedures are included in the Manual of Business Procedures for Foreign Currency Reserve Management.

(b) Credit risk

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

From credit risk perspective, the Bank can currently invest in the following types of financial instruments:

- Central banks' investment programmes;
- Automatic borrowing/lending of securities with the main depository;
- Lending of securities deposited with a bank acting as an agent;
- Deposits in foreign currency (term deposits and funds on current accounts) with Group I counterparties and/or central banks;
- Deposits in foreign currency (term deposits and funds on current accounts) with Group I counterparties and/or central banks;

- Commercial securities issued by:
  Governments (or government guaranteed);
  Supranational institutions or agencies;
  Specialised financial agencies not guaranteed by a state;
  Banks;
  Issuers of European covered bonds;
- Bonds issued by:
  Governments or government guaranteed agencies;
  Supranational institutions;
  Specialised financial agencies;
  Other financial institutions: French covered bonds of the type Obligations Foncières;

All bonds should be with a one-off payment of the nominal value on the maturity date and without integrated options.

- Purchases and sales of foreign currency:
  with a value date of no more than 2 business days (spot);
- Futures – interest rate and bond (long and/or short positions are allowed) traded on the international regulated markets.

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

- Group One – financial institutions to which the BNB may have a credit exposure. They should have long-term credit rating higher or equal to AA- according to S&P and Fitch Ratings, or Aa3 according to Moody's by at least two of the above indicated agencies.
- Group Two – financial institutions with which the BNB may conclude DVP (Delivery Versus Payment) transactions for the sale or purchase of securities. They should have a short-term credit rating higher or equal to A-1 per S&P, F-1 according to Fitch Ratings or P-2 according to Moody's by at least two of the above agencies.

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

The ban on purchasing government debt issued by the Republic of Ireland was extended until the end of March 2010. Due to strongly increased uncertainty on the European government securities market a ban was again imposed on the purchase of government and government guaranteed debt of four countries: Ireland, Spain, Italy and Portugal. Foreign currency operations with one of the BNB counterparties have been temporarily discontinued since mid-June, and another bank was excluded from the list of approved counterparties following the downgrades of their credit ratings.

(c) Liquidity Risk

Liquidity risk arises in the funding of the Bank's core activities and in the management of positions. It has two aspects. The first aspect is the risk for the Bank of being unable to meet its obligations when due. The second aspect comprises the risk of being unable to liquidate an asset at a fair value within an appropriate time frame in compliance with the respective market conventions.

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 seeks to maintain a balance between the maturity of borrowed funds and that of assets through investments in financial instruments with a range of maturities. Limits are set to ensure minimum liquidity by type of currency. Liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments. To better manage the liquidity risk from liquidating positions in financial instruments approved for investment, these are grouped into liquidity ranks subject to the degree of difficulty (i.e., discount to fair value) to sell in the market in critical times. There are limits for the various asset classes based on the liquidity ranks.

The Bank continually assesses liquidity risk by identifying and monitoring changes in funding required for meeting its goals and targets set in terms of the overall Bank strategy. As part of its overall liquidity risk management strategy, the Bank has defined some requirements for the management of a portfolio of liquid assets denominated in euro and for maintaining assets denominated in other currencies for the purposes of meeting its cash inflows and outflows.

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

(BGN'000)

As at 30 June 2010	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Undefined maturity	Total
Financial assets							
Cash and deposits in foreign currencies	5,206,929	-	-	-	-	-	5,206,929
Gold, instruments in gold, and other precious metals	204,358	1,317,259	-	-	-	1,051,623	2,573,240
Financial assets at fair value through profit or loss	1,011,192	2,458,095	4,491,642	7,317,739	671,346	-	15,950,014
Financial assets available for sale	79,737	-	-	-	-	1,481,489	1,561,226
Total financial assets	**6,502,216**	**3,775,354**	**4,491,642**	**7,317,739**	**671,346**	**2,533,112**	**25,291,409**
Financial liabilities							
Banknotes and coins in circulation	-	-	-	-	-	7,542,740	7,542,740
Liabilities to banks and other financial institutions	5,020,267	-	-	-	-	-	5,020,267
Liabilities to government institutions and other borrowings	5,528,131	300,016	21,539	-	-	-	5,849,686
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	2,869,726	2,869,726
Total financial liabilities	**10,548,398**	**300,016**	**21,539**	**-**	**-**	**10,412,466**	**21,282,419**
Asset-liability maturity mismatch	**(4,046,182)**	**3 475,338**	**4,470,103**	**7,317,739**	**671,346**	**(7,879,354)**	**4,008,990**

(BGN'000)

As at 31 December 2009	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Undefined maturity	Total
Financial assets							
Cash and deposits in foreign currencies	4,144,152	-	-	-	-	-	4,144,152
Gold, instruments in gold, and other precious metals	331,443	813,935	-	-	-	791,754	1,937,132
Financial assets at fair value through profit or loss	659,899	2,502,051	7,247,056	7,896,911	836,239	-	19,142,156
Financial assets available for sale	71,835	-	-	-	-	1,344,668	1,416,503
Total financial assets	**5,207,329**	**3,315,986**	**7,247,056**	**7,896,911**	**836,239**	**2,136,422**	**26,639,943**
Financial liabilities							
Banknotes and coins in circulation	-	-	-	-	-	8,049,100	8,049,100
Liabilities to banks and other financial institutions	4,924,976	-	-	-	-	-	4,924,976
Liabilities to government institutions and other borrowings	7,368,628	21,592	-	-	-	-	7,390,220
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	2,594,546	2,594,546
Total financial liabilities	**12,293,604**	**21,592**	**-**	**-**	**-**	**10,643,646**	**22,958,842**
Asset-liability maturity mismatch	**(7,086,275)**	**3,294,394**	**7,247,056**	**7,896,911**	**836,239**	**(8,507,224)**	**3,681,101**

The outstanding contractual maturities of the Bank's financial liabilities are as follows:

(BGN'000)

	Book value	Gross nominal outgoing cash flow	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	Over 5 years
As at 30 June 2010							
Currency in circulation	7,542,740	7,542,740	-	-	-	-	7,542,740
Due to banks and other financial institutions	5,020,267	5,020,267	5,020,267	-	-	-	-
Liabilities to government institutions and other borrowings	5,849,686	5,849,843	5,528,189	300,046	21,608	-	-
Liabilities against participations in international financial institutions	2,869,726	2,869,726	-	-	-	-	2,869,726
	21,282,419	**21,282,576**	**10,548,456**	**300,046**	**21,608**	**-**	**10,412,466**
As at 31 December 2009							
Currency in circulation	8,049,100	8,049,100	-	-	-	-	8,049,100
Due to banks and other financial institutions	4,924,976	4,924,976	4,924,976	-	-	-	-
Liabilities to government institutions and other borrowings	7,390,220	7,390,268	7,368,652	21,616	-	-	-
Liabilities against participations in international financial institutions	2,594,546	2,594,546	-	-	-	-	2,594,546
	22,958,842	**22,958,890**	**12,293,628**	**21,616**	**-**	**-**	**10,643,646**

(d) Market risk

Market risk

All financial instruments are subject to market risk, i.e. the risk of impairment as a result of changes in the market conditions. The instruments are evaluated on a daily basis at fair market value which best reflects current market conditions for the respective type of financial instrument. The Bank manages its portfolios in response to changing market conditions. Exposure to market risk is managed in accordance with the risk limits set in the Investment Limits to the Management of the Gross International Foreign Currency Reserves.

The table below describes one important measure of market risk: value at risk (VaR) VaR is an indicator of the maximum loss over a certain period of time (holding period) and with a certain probability (confidentiality level). The VaR used in this report is based on 95 per cent confidentiality level and a one-day holding period.

The table below describes VaR of the BNB Issue Department assets at 95 per cent confidentiality level. The empirical distribution of the return on assets obtained from time series with a length of 30-day surveys was used in computing VaR.

(BGN'000)

	30 June 2010	Average	Maximum	Minimum
Currency risk	(38,710)	(29,074)	(61,795)	(5,724)
Interest rate risk	(6,855)	(6,766)	(17,957)	(795)
Correlation	(0.30)	(0.13)	(0.25)	(0.56)
Total	**(41,456)**	**(29,886)**	**(59,779)**	**(3,996)**
	31 December 2009	**Average**	**Maximum**	**Minimum**
Currency risk	(37,276)	(25,674)	(54,516)	(6,569)
Interest rate risk	(4,539)	(6,787)	(16,109)	(904)
Correlation	0.08	0.10	0.69	(0.37)
Total	**(31,558)**	**(34,876)**	**(64,272)**	**(4,630)**

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations which affect the prices of interest-earning assets (including investments) and interest-bearing liabilities. The Bank uses modified duration as a key measurement for interest rate risk. Modified duration measures the effect of the change in the market value of an asset (liability) in percentage points in response to 1 basis point (1/100th of 1 per cent) change in the interest rate levels. In addition, portfolios' technical parameters such as convexity, duration in a fixed point of the yield curve, etc. are monitored on a daily basis. For each portfolio held by the BNB, the interest rate is limited by a benchmark (model portfolio) and by the investment limits for a maximum allowable deviation of the modified duration of the portfolio from that of the respective benchmark.

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

(BGN'000)

As at 30 June 2010	**Effective interest rate (%)**	**Total**	**Floating interest rate**	**Fixed rate instruments**		
				Up to 1 month	**From 1 to 3 months**	**Over 3 months**
Interest-earning assets						
Cash and deposits in foreign currencies	0.21	5,085,568	1,485,377	3,600,191	-	-
Gold, instruments in gold and other precious metals	0.02	1,500,841	-	183,608	1,317,233	-
Financial assets at fair value through profit or loss	1.15	15,837,093	1,201,495	1,005,528	2,415,321	11,214,749
Financial assets available for sale		79,736	-	79,736	-	-
Other interest-earning assets		24,795	5,079	151	3,000	16,565
Total		**22,528,033**	**2,691,951**	**4,869,214**	**3,735,554**	**11,231,314**
Interest-bearing liabilities						
Due to banks and other financial institutions		5,020,267	-	5,020,267	-	-
Liabilities to government institutions and other borrowings	0.08	5,849,531	-	5,528,017	300,000	21,514
Liabilities against Bulgaria's participation in international financial institutions		1,439,931	1,439,931	-	-	-
Total		**12,309,729**	**1,439,931**	**10,548,284**	**300,000**	**21,514**
Interest-bearing assets/liability gap		**10,218,304**	**1,252,020**	**(5,679,070)**	**3,435,554**	**11,209,800**

(BGN'000)

As at 31 December 2009	**Effective interest rate (%)**	**Total**	**Floating interest rate**	**Fixed rate instruments**		
				Up to 1 month	**From 1 to 3 months**	**Over 3 months**
Interest-earning assets						
Cash and deposits in foreign currencies	0.08	4,002,872	1,308,632	2,694,240	-	-
Gold, instruments in gold and other precious metals	0.01	1,007,200	-	193,276	813,924	-
Financial assets at fair value through profit or loss	1.01	18,978,406	528,028	649,284	2,477,295	15,323,799
Financial assets available for sale		71,835	-	71,835	-	-
Other interest-earning assets		28,323	9,877	7,433	5,322	5,691
Total		**24,088,636**	**1,846,537**	**3,616,068**	**3,296,541**	**15,329,490**
Interest-bearing liabilities						
Due to banks and other financial institutions		4,924,976	-	4,924,976	-	-
Liabilities to government institutions and other borrowings	0.05	4,766,311	-	4,744,797	21,514	-
Liabilities against Bulgaria's participation in international financial institutions		1,301,587	1,301,587	-	-	-
Total		**10,992,874**	**1,301,587**	**9,669,773**	**21,514**	**-**
Interest-bearing assets/liability gap		**13,095,762**	**544,950**	**(6,053,705)**	**3,275,027**	**15,329,490**

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

The standard scenarios include the following changes in yield curves: 100 basis points instant and parallel increase; 100 basis points instant and parallel decrease; 50 basis points parallel increase in the yield curves for a period of 12 months; and 50 basis points parallel decrease in the yield curves also for a period of 12 months. The second two scenarios assume that the change in yields takes place at the beginning of the period and over the one-year period the yield curve remains unchanged.

The analysis of the sensitivity of the Bank's assets (to first approximation) to changes in interest rates, assuming a constant balance sheet position and parallel movements of the yield curves of the relevant assets is as follows:

(BGN'000)

	100 b.p. parallel increase	100 b.p. parallel decrease	50 b.p. parallel increase in 1 year	50 b.p. parallel decrease in 1 year
As at 30 June 2010	(156,302)	156,302	203,936	178,723
As at 31 December 2009	(174,002)	174,002	223,790	171,197

Currency risk

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

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

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

(BGN'000)

	30 June 2010	31 Dec. 2009
Assets		
Bulgarian lev and euro area currencies	19,948,490	22,152,103
US dollar	151,336	204,416
Japanese yen	37	81
Pound sterling	183	76
SDR	2,971,037	2,687,877
Gold	2,536,329	1,908,991
Other	3,456	2,393
	25,610,868	**26,955,937**
Liabilities		
Bulgarian lev and euro area currencies	22,586,812	24,154,135
US dollar	151,747	205,507
Japanese yen	-	-
Pound sterling	-	-
SDR	2,869,918	2,594,172
Other	2,391	2,123
	25,610,868	**26,955,937**
Net position		
Bulgarian lev and euro area currencies	(2,638,322)	(2,002,032)
US dollar	(411)	(1,091)
Japanese yen	37	81
Pound sterling	183	76
SDR	101,119	93,705
Gold	2,536,329	1,908,991
Other	1,065	270

(e) Using accounting judgements and assumptions

The Governing Council discusses the development, choice, and disclosure of essential accounting policies and measurements, as well as their implementation.

These disclosures supplement the notes to the financial risk management.

The Bank is operating in an intensely changing worsened global economic and financial environment which at the end of 2009 negatively affected the Bulgarian market as well and would have an impact on the Bank's results and risk. The management has already taken measures, and its major priorities in the next few years will still be to keep the Bank's stable liquidity position and the continuous improvement in its evaluation methods, foreign exchange reserves quality control and management.

Major sources of evaluation uncertainty:

1) Determination of fair values

The determination of fair values of financial assets and liabilities for which there is no monitored market price requires the use of evaluation techniques described in the accounting policy. For rarely traded financial instruments whose price is not transparent, the fair value is less objective and requires various degrees of judgement depending on: liquidity, concentration, market factors uncertainty, price assumptions, and other risks affecting the particular instrument.

2) Measurement of financial instruments

The Bank measures the fair value of financial instruments using the following hierarchy of methods:

- Level 1: A market quote or a price for closing positions for which there is a reliable market;
- Level 2: Evaluation techniques based on actual market information. This category of methods is used to evaluate debt securities for which there is no reliable market.

The fair values of financial assets and liabilities traded in international financial markets for which there is accessible market information are based on market quotes or prices formed at the closing of a market. The use of actual market prices and information reduces the need for managerial judgement and assumptions, and the uncertainty surrounding the determination of fair values. The availability of actual market prices and information varies depending on products and markets and changes because of specific events and the general conditions of financial markets. The Bank determines the fair values of all other financial instruments for which there are no current market quotes by using an evaluation technique based on a net present value. The net present value is computed by means of market yield curves and credit spreads, where necessary, for the relevant instrument. The purpose of the evaluation techniques is to determine a fair value which reflects the price of the financial instrument on the reporting date.

The Bank has established a control environment for measuring fair values. The fair values of financial instruments are set by an independent risk analysis and control unit. Specific controls include: checking the actual price information; regular reviews of current evaluation models and, if necessary, development, approval and introduction of new evaluation models; follow-up verification by means of analysis and comparison of data from various information sources, etc.

- Level 3: evaluation techniques, where incoming data on financial assets and liabilities are not based on available market information.

The table below analyses financial instruments reported at fair value using evaluation models. The data does not include equity instruments reported at acquisition cost (Note 14).

(BGN'000)

	Level 1: Market quotes in active markets	Level 2: Evaluation techniques using market data	Total
30 June 2010			
Cash and deposits in foreign currency	5,206,929	-	5,206,929
Gold, instruments in gold and other precious metals	2,573,240	-	2,573,240
Financial assets at fair value through profit or loss	13,821,546	2,128,468	15,950,014
Total	**21,601,715**	**2,128,468**	**23,730,183**

7. Interest income and expense

(BGN'000)

	30 June 2010	30 June 2009
Interest income		
- on securities	213,686	354,183
- on deposits	4,518	14,106
- on other	6	899
	218,210	**369,188**
Interest expense		
- on deposits	5,036	21,558
- on other	1	42,596
	5,037	**64,154**

Interest expenses paid on government deposits in levs as at 30 June 2010 were BGN 2016 thousand and BGN 1010 thousand in foreign currency. Interest expenses paid on deposits in levs of other government organisations as at 30 June 2010 are BGN 65 thousand and BGN 130 thousand in foreign currency. Interest expenses as at 30 June 2010 include BGN 36,728 thousand amortisation of securities premium.

8. Net gains/(losses) from financial assets and liabilities at fair value through profit or loss

(BGN'000)

	30 June 2010	30 June 2009
Net gains/(losses) from operations in securities	(108,740)	48,201
Net gains from operations in foreign currency	424	-
Net revaluation (losses) on futures	(10,606)	(11,016)
Net revaluation (losses) on securities	(15,408)	(81,517)
Net revaluation gains on foreign currency assets and liabilities	7,463	168
Net revaluation gains on gold	636,094	138,139
	509,227	93,975

9. Other operating revenue

(BGN'000)

	30 June 2010	30 June 2009
Turnover of subsidiaries	13,249	13,263
Net income from disposal of fixed assets	-	11
Income from sale of coins	522	509
Dividend income	12,732	4,554
Other income, net	1,693	276
	28,196	18,613

10. Total administrative expenses

(BGN'000)

	30 June 2010	30 June 2009
Personnel costs	14,076	16,123
Administrative expenses	23,030	22,088
Depreciation	13,072	11,040
Other expenses	457	2,314
	50,635	51,565

Personnel costs include salaries, social and health insurance costs charged under the local legislation provisions as of 30 June 2010, respectively for the BNB – BGN 10,672 thousand, for the BNB Printing Works AD – BGN 2038 thousand, and for the Bulgarian Mint EOOD – BGN 1366 thousand. The number of employees of the Bank and its subsidiaries is 1235 in 2010 (2009 – 1217), including the BNB staff of 870 in 2010 (2009 – 850).

Based on actuarial calculations, the Bank has accrued its compensation liabilities to the personnel on retirement and for unused paid annual leave at BGN 53 thousand and BGN 1371 thousand respectively (30 June 2009 – BGN 28 thousand and BGN 1217 thousand). The retirement and unused paid annual leave compensations for the Bank's subsidiaries as of 30 June 2010 were BGN 515 thousand (30 June 2009: BGN 434 thousand).

Administrative expenses include also the BNB's currency circulation expenses of BGN 7707 thousand as of 30 June 2010 (30 June 2009: BGN 12,624 thousand).

11. Cash and deposits in foreign currencies

(BGN'000)

	30 June 2010	31 Dec. 2009
Foreign currency cash	120,633	140,501
Current accounts in other banks	1,484,011	1,306,928
Foreign currency deposits	3,602,285	2,696,723
	5,206,929	4,144,152

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

(BGN'000)

	30 June 2010	31 Dec. 2009
Euro area residents		
In EUR	1,533,413	1,620,893
In other currencies	100,447	115,982
	1,633,860	1,736,875
Non-euro area residents		
In EUR	2,093 999	1,021,109
In other currencies	1,479,070	1,386,168
	3,573,069	2,407,277
	5,206,929	4,144,152

12. Gold, instruments in gold, and other precious metals

	30 June 2010		31 December 2009	
	'000 troy ounces	BGN'000	'000 troy ounces	BGN'000
Gold bullion in standard form	513	1,014,712	513	763,613
Gold deposits in standard form	769	1,521,618	769	1,145,378
Gold in other form	16	32,495	17	24,571
Other precious metals	-	4,415	-	3,570
		2,573,240		1,937,132

Gold in standard form includes gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 0.04 per cent per annum. Gold in other form includes commemorative gold coins of BGN 32,495 thousand. Other precious metals include silver commemorative coins of BGN 450 thousand and platinum commemorative coins of BGN 3965 thousand. Gold deposits are held with banks whose liabilities are rated with one of the two highest ratings given by two internationally recognized rating agencies.

13. Financial assets at fair value in the profit or loss

(BGN'000)

Securities at fair value through profit or loss	30 June 2010	31 Dec. 2009
Foreign treasury bills, notes and bonds	15,950,014	19,142,156
	15,950,014	19,142,156

Securities comprise both coupon and discount securities denominated in euro. The coupon interest of the EUR-denominated securities reached 3.29 per cent in 2010 (31 December 2009: 3.77 per cent).

The value of securities pledged as collateral on futures transactions amounts to BGN 29,497 thousand as at 30 June 2010 (31 December 2009: BGN 29,496 thousand).

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

(BGN'000)

	Issuer's credit rating	30 June 2010	31 Dec. 2009
Investment graded securities	AAA	8,770,791	10,740,711
	AA+	1,162,261	2,186,051
	AA	986,829	30,560
	AA-	3,520,735	4,736,947
	A+	1,509,398	1,447,887
		15,950,014	19,142,156

14. Financial assets available for sale

(BGN'000)

	30 June 2010	31 Dec. 2009
Republic of Bulgaria's quota in the IMF	1,509,167	1,364,444
Equity investments in international financial institutions	28,193	28,193
Investments in associates	23,866	23,866
	1,561,226	1,416,503

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 79,736 thousand of the Republic of Bulgaria's quota in the IMF represents the reserve tranche held with the IMF. The IMF pays remuneration (interest) to those members who have a remunerated reserve tranche position, at an average rate of 0.25 per cent.

Equity investments in international financial institutions include the equity investment in the Bank for International Settlements (BIS), Basle, and 25 per cent of the equity investment in BIS Basle is paid up. The current value of 10,000 thousand shares in SDR equals BGN 23,950 thousand as of 30 June 2010 (as of 31 December 2009: BGN 26,593 thousand – ref. note 28.1).

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

Equity investments in international financial institutions do not exceed 10 per cent of the subscribed share capital of the respective institution.

The BNB is a member of the ESCB. In accordance with the current regulatory framework, the national banks of the countries which have not adopted the euro pay effectively 7 per cent of the subscribed equity investment. The BNB's capital contribution in the ESCB is EUR 3503 thousand or BGN 6850 thousand.

The Bank has an interest in the capital of the Cash Services Company, holding 2500 shares of the capital with a par value of BGN 1000 each.

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

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

In 2010 Bankservice AD and BORICA AD associated companies initiated merger activities due to their close functions and operations. The companies merged on 12 August 2010, with BORICA–Bankservice AD being a universal predecessor of BORICA AD and Bankservice AD.

15. Tangible assets

(BGN'000)

	Land and buildings	Plant and equipment	IT-equipment	Office equipment	Other equipment (including motor vehicles)	Tangible assets in progress	Total
As at 1 January 2010	182,569	111,298	27,511	8,901	6,270	3,436	339,985
Additions	1	879	18	21	23	620	1,562
Disposals	-	(7)	(172)	(84)	(11)	(87)	(361)
Transfers	2,334	(937)	372	155	14	(1,938)	-
As at 30 June 2010	184,904	111,233	27,729	8,993	6,296	2,031	341,186
Depreciation and impairment loss							
As at 1 January 2010	(11,603)	(50,089)	(16,624)	(3,518)	(4,201)	-	(86,035)
Charge for the period	(2,904)	(4,019)	(2,374)	(477)	(248)	-	(10,022)
On disposals	-	1	172	84	11	-	268
As at 30 June 2010	(14,507)	(54,107)	(18,826)	(3,911)	(4,438)	-	(95,789)
Net book value as at 30 June 2010	**170,397**	**57,126**	**8,903**	**5,082**	**1,858**	**2,031**	**245,397**
Net book value as at 31 December 2009	**170,966**	**61,209**	**10,887**	**5,383**	**2,069**	**3,436**	**253,950**

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

16. Intangible Assets

(BGN'000)

	Software	Other intangible assets	Intangible assets in progress	Total
As at 1 January 2010	36,425	41	346	36,812
Additions	30	-	426	456
Disposals	-	-	-	-
Transfers	570	-	(570)	-
As at 30 June 2010	37,025	41	202	37,268
Depreciation and impairment loss				
As at 1 January 2010	(22,473)	(37)	-	(22,510)
Charge for the period	(3,048)	(2)	-	(3,050)
On disposals	-	-	-	-
As at 30 June 2010	(25,521)	(39)	-	(25,560)
Net book value as at 30 June 2010	**11,504**	**2**	**202**	**11,708**
Net book value as at 31 December 2009	**13,952**	**4**	**346**	**14,302**

Software includes, as of 30 June 2010, all licenses purchased by the BNB to the total amount of BGN 44 thousand (31 December 2009: BGN 1848 thousand), and software products to the amount of BGN 106 thousand (31 December 2009: BGN 1430 thousand).

17. Other assets

(BGN'000)

	30 June 2010	31 Dec. 2009
Balances of subsidiaries held with local banks	24,795	28,323
Commemorative coins for sale	363	390
Inventories	18,392	14,038
Accounts receivable	17,906	2,477
Deferred charges	529	2,300
Other receivables	369	214
	62,354	47,742

18. Currency in circulation

(BGN'000)

	30 June 2010	31 Dec. 2009
Banknotes in circulation	7,383,432	7,892,082
Coins in circulation	159,308	157,018
	7,542,740	8,049,100

19. Due to banks and other financial institutions

(BGN'000)

	30 June 2010	31 Dec. 2009
Demand deposits from banks and other financial institutions		
- in BGN	2,870,699	2,233,442
- in foreign currency	2,149,568	2,691,534
	5,020,267	4,924,976

The Bank does not pay interest on demand deposits from banks and other financial institutions. Demand deposits include BGN 4985 million representing the required reserves, which all local banks are required to maintain with the Bank as part of their current accounts (31 December 2009: BGN 4896 million).

20. Liabilities to government institutions and other borrowings

(BGN'000)

	30 June 2010	31 Dec. 2009
Current accounts		
- in BGN	601,565	2,006,422
- in foreign currency	172,084	617,487
Time deposit accounts		
- in BGN	3,420,071	3,186,000
- in foreign currency	1,655,966	1,580,311
	5,849,686	7,390,220

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in euro and in levs earn interest between 0.9 per cent and 0 per cent.

21. Borrowings against Bulgaria's participation in international financial institutions

The liabilities against Bulgaria's participation in the IMF as of 30 June 2010 amount to BGN 1,342,343 thousand or SDR 604,750 thousand (as of 31 December 2009: BGN 1,334,801 thousand or SDR 604,863 thousand).

Borrowings from the IMF are denominated in SDRs. Borrowings related to Bulgaria's quota in the IMF are non-interest bearing with no stated maturity. This note includes account No. 1 of the IMF for administrative expenses denominated in BGN amounting to BGN 3603 thousand (as of 31 December 2009: BGN 3582 thousand).

22. Other liabilities

(BGN'000)

	30 June 2010	31 Dec. 2009
European Commission funds	105,180	117,750
Salaries and social security payable	803	1,340
Deferred income	777	276
Other liabilities	13,929	17,779
	120,689	137,145

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

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 revaluation reserves comprise the net change in fair values of property, equity investments and other non-current assets.

Pursuant to Article 36 of the Law on the Bulgarian National Bank, unrealised gains/losses arising from the revaluation of assets and liabilities denominated in foreign currencies or gold are transferred to a special reserve account and form special reserves.

Other reserves include the transfers to reserves of 25 per cent of the annual excess of revenue over expenditure after the allocation to special reserves, as well as reserves upon a decision of the BNB Governing Council.

(BGN'000)

	30 June 2010	30 June 2009
Profit for the period	**702,552**	**368,405**
Unrealised (gains) from gold revaluation	(636,094)	(138,139)
Unrealised (gains)/loss on revaluation of financial assets at fair value through profit or loss	116,450	92,532
Unrealised foreign currency valuation (gains)/losses	(7,463)	(168)
Result after allocation to special reserve	**175,445**	**322,630**

Unrealised gains from revaluation of financial assets, recognized at fair value through profit or loss (BGN 116,450 thousand) include unrealized gains from revaluation of securities and futures to the amount of BGN 10,606 thousand.

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. In 2005 the Government, as represented by the Minister of Finance, acquired 4.4 per cent of the company's capital (3093 shares with par value of BGN 1000).

25. Monetary liabilities and gross international foreign currency reserves

(BGN'000)

	30 June 2010	31 Dec. 2009
Gross international foreign exchange reserves		
Cash and deposits in foreign currencies	5,206,929	4,144,152
Monetary gold and other instruments in gold	2,536,329	1,908,991
Security investments	15,950,014	19,142,156
Equity investments and quota in the IMF	79,736	71,835
	23,773,008	25,267,134
Monetary liabilities		
Currency in circulation	7,542,740	8,049,100
Due to banks and other financial institutions	5,019,073	4,897,212
Liabilities to government institutions	5,403,178	7,150,724
Other liabilities	552,881	385,010
	18,517,872	20,482,046
Surplus of gross international foreign exchange reserves over monetary liabilities	5,255,136	4,785,088

Interest receivable and interest payable are carried to the relevant financial assets and liabilities.

Monetary gold and other instruments in gold are revaluated on a daily basis based on the euro fixing of the London Bullion Market closing price.

26. Related party transactions

Bulgarian Government

International Monetary Fund

All the borrowings of the Government of the Republic of Bulgaria from the IMF are undertaken (on-lent) through the BNB. The Government's borrowings from the IMF are matched by a receivable of the Bank from the Government. For the Bank to eliminate any exchange rate fluctuations, the government receivables are denominated also in SDR.

The interest on these borrowings is paid by the Government. Accordingly, no interest is charged on the receivables from the Government, nor is any interest expense included on the Government's portion of the IMF borrowings.

As of 30 June 2010 the Republic of Bulgaria has not received funds under IMF agreements.

The Republic of Bulgaria's quota in the IMF is secured by promissory notes jointly signed by the Bank and the Government (ref. note 21).

Government bank accounts

Government budget organizations have current accounts and time deposits with the Bank (ref. note 20).

Fiduciary activities

In accordance with the Law on the BNB and under the terms agreed upon with the Minister of Finance, the BNB acts as an agent in government or government-guaranteed debts. With regard to this role, BNB performs agent and central depository services related to the administration and management of government securities issued by the Ministry of Finance. The Bank receives commission for providing these services. These government securities are not assets or liabilities of the BNB and are not recognized in its consolidated balance sheet. The Bank is not exposed to any credit risk relating to government securities as it does not guarantee them. As of 30 June 2010 the par value of the total securities held in custody was BGN 2981 million (31 December 2009: BGN 3009 million).

27. Subsidiaries

(%)

Ownership interest	30 June 2010	31 Dec. 2009
State Mint EOOD	100	100
BNB Printing Works AD (ref. note 24)	95.6	95.6

The net income from subsidiaries for the period comprises net profit of BGN 654 thousand from the State Mint EOOD (30 June 2009: BGN 340 thousand) and BGN 1658 thousand from the BNB Printing Works AD (30 June 2009: BGN 2962 thousand).

28. Commitments and contingencies

1) *Participation in the Bank for International Settlements*

The Bank holds 8000 shares of the capital of BIS, Basel, each amounting to SDR 5000. Twenty-five per cent of the equity investment in BIS, Basel is paid up. The capital subscribed but not paid in is with an option to be paid in within three months following a decision of the BIS Board of Governors. The contingent amount as of 30 June 2010 is BGN 63,921 thousand (31 December 2009: BGN 63,921 thousand).

2) *IMF quota and borrowings*

The IMF quota is secured by promissory notes jointly signed by the Bank and the Government of the Republic of Bulgaria amounting to BGN 1,342,343 thousand.

3) *Capital commitments*

As of 30 June 2010 the Bank has committed to BGN 1514 thousand to purchase non-current assets (31 December 2009: BGN 1349 thousand).

4) *Other commitments and liabilities*

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

29. Post-balance-sheet events

There are no post-balance-sheet events that would require additional disclosure or adjustments to the Bank's consolidated financial statements.

Major Resolutions of the BNB Governing Council

7 January	As of 22 February 2010 the Bulgarian National Bank put in circulation a silver commemorative coin with partial gold-plating "140 years Bulgarian Exarchate" of BGN 10 nominal value.
21 January	Ordinance on Amendment of BNB Ordinance No 21 of 1998 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks was adopted. Ordinance on Amendment of BNB Ordinance No 20 of 2009 on the Issuance of Approvals under Article 11, paragraph 3 of the Law on Credit Institutions was adopted. The accession of the BNB and participating banks in the TARGET2-BNB national system component to TARGET2 as of 1 February 2010 was approved.
4 February	Ordinance No 14 of 2010 on the Content of the Audit Report for Supervisory Purposes was adopted.
25 February	Ordinance on Amendment to BNB Ordinance No 8 of 2006 on Capital Adequacy of Credit Institutions was adopted. As of 22 April 2010 the Bulgarian National Bank put in circulation a silver commemorative coin "Belogradchik Rocks" of BGN 10 nominal value, issue 2010.
23 March	Report on BNB Budget Implementation as of 31 December 2009 was approved.
7 April	New Internal Rules for Selection and Work with BNB Scholarship Students, effective as of 15 April 2010, were adopted.
21 April	The BNB Annual Report for 2009 was approved. In accordance with Article 8, paragraph 4 of the Law on the BNB, it was decided the BNB to transfer to the MF BGN 354,710,127.92 or 75 per cent of the excess of Bank revenue over expenditure as of 31 December 2009.
3 June	The BNB Governing Council approved the proposals made by Board of Directors of BORICA AD and Bankservice AD on the merger of these companies, as well as all related documents. The BNB issued a license for conducting activity as a payment institution to the following companies: Diners Club Bulgaria AD, Intercard Finance AD and TBI Credit EAD to perform payment services within the meaning of Article 4, item 4 (b) and item 5 of the Law on Payment Services and Payment Systems; Transcard Financial Services EAD to perform payment services within the meaning of Article 4, item 1, item 2, item 3 (b), item 4 (b) and item 5 of the Law on Payment Services and Payment Systems. The BNB issued a license for carrying out activities as a payment system operator to the newly established company BORICA–Bankservice (in a process of establishment) which is formed as a result of the merger of BORICA AD and Bankservice AD.