



# Bulgarian National Bank

## ANNUAL REPORT • 2009



BANQUE NATIONALE DE BULGARIE







**Bulgarian National Bank**

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**ANNUAL REPORT • 2009**

Published by the Bulgarian National Bank  
1, Knyaz Alexander I Square, 1000 Sofia  
Tel.: (+359 2) 9145 1351, 9145 1209, 9145 1231, 9145 1978  
Fax: (+359 2) 980 2425, 980 6493  
Printed in the BNB Printing Centre

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ISSN 1313-1494

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Website: [www.bnb.bg](http://www.bnb.bg)

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

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

Under the provisions of Article 1, paragraph 2 and Article 51 of the Law on the Bulgarian National Bank, I have the honour of presenting the Bank's 2009 Annual Report.

A handwritten signature in black ink, appearing to read 'Ivan Iskrov', written over a horizontal line.

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

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**Ivan Iskrov**

Governor

**Dimitar Kostov**

Deputy Governor

Banking Department

**Rumen Simeonov**

Deputy Governor

Banking Supervision Department

**Kalin Hristov\***

Deputy Governor

Issue Department

**Penka Kratunova**

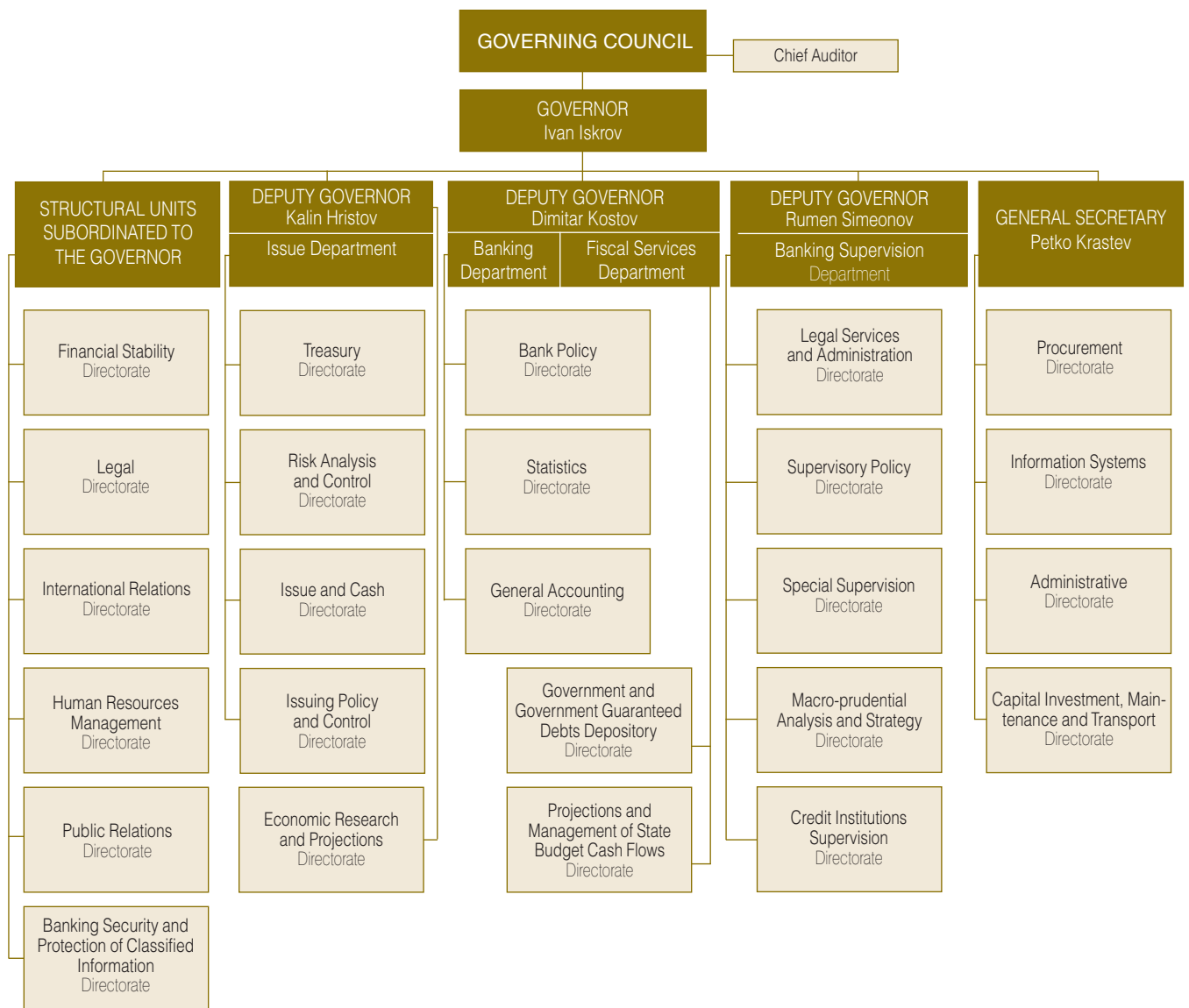
**Statty Stattev**

**Oleg Nedyalkov**

\* As of 23 October 2009 Kalin Hristov is a Deputy Governor heading the Issue Department. Until 22 October 2009 Tsvetan Manchev was a Deputy Governor heading the Issue Department.

# Organisational Structure of the BNB

(as of 1 March 2010)







In 2009 the Bulgarian National Bank – one of the first and oldest institutions dating back to the Bulgarian National Revival period – marked its 130 anniversary. With a view to its significant role in Bulgaria's past and present the BNB took a number of initiatives to celebrate the occasion. The anniversary provided great opportunities to familiarise the general public with the Bank's role and functions in the past, with its current objectives and activities and with its responsibilities as a national central bank and a member of the European System of Central Banks.

In early 2009 four students of economics who submitted essays on issues of great importance to the BNB received scholarships. The Bank minted a silver commemorative coin for its 130th Anniversary and published catalogues of Bulgarian coin and banknote specimens. Also published were the final four volumes of the BNB Archives covering the period between 1948–1990, and a short bilingual illustrated history of the Bank, as well as an album of 130 works of fine art from the BNB collection.

Open Days at the Bank ranked as the most popular of celebration events. More than four thousand people visited the BNB Building on 11 and 12 April to learn a lot about banking, price stability, and the past and present of the Bank through a multiplicity of information leaflets, exhibits, interactive displays, and games. To mark the anniversary, the Bank also held a celebration concert on 12 June at the Ivan Vazov National Theatre, playing host to the President, the President of the European Central Bank, government officials, representatives of financial bodies, central banks, and international organisations. The Bulgarian National Television broadcast the concert live. A documentary on the BNB, *Zlatnoto Doverie* ("Faith as Good as Gold") produced by Boyko Iliev and scripted by Yuriy Dachev, was also shot and shown by BNT.

The BNB held events to raise public awareness of the importance of financial stability, the role and nature of the currency board in Bulgaria, and the euro as the currency of united Europe and Bulgaria's coming adoption of it. An important mission of many initiatives was to acquaint the public with the rights of those who use financial, payment and information services. All BNB initiatives to celebrate the occasion were guided by those foremost principles of modern central banking: openness, transparency, and public accountability.

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\* The Articles of Association of the Bulgarian National Bank were approved on 25 January 1879. The first Governor was appointed on 4 April that year. The Bank was officially inaugurated on 23 May 1879 and BNB anniversaries are traditionally marked on 6 June, the day on which the Bank opened for business that year.



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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 2009 the global economic crisis deepened and broadened, yet signs of improvement emerged from mid-year. In the second half of 2009 world trade began recovering, growing by 8.1 per cent in the year to December. World industrial output also picked up to 4.4 per cent annual growth by December. By the close of the year real GDP growth in the euro area, the USA, and China was higher than expected earlier in 2009. Global inflation was 2.1 per cent on average but fuel and commodity prices began rising in the second quarter. Upon expiry of the effect of low interest rates on main refinancing operations by the Federal Reserve System (nil to 0.25 per cent) and the European Central Bank (1 per cent), the two leading central banks had recourse to untraditional measures to provide liquidity to banks, with money market interest rates normalising gradually.

In 2009 real GDP in Bulgaria fell by 5 per cent, value added falling by 3.8 per cent. Negative trends in economic activity were associated with the dramatically worsened external environment. Declining export sales and revenues and increasing unemployment also hit industries serving the domestic market. While exports rose moderately by the end of the year, domestic sales continued falling, contributing to an intensification of real GDP decline in the last quarter. Domestic demand was constrained by static incomes, growing unemployment (particularly in the second half), weaker foreign direct investment, and low lending rates. On the other hand, weak domestic demand for durables and investment goods cut imports by EUR 7.9 billion (-33.2 per cent). The export decline was smaller at EUR 3.4 billion (-22.5 per cent). Thus, the balance of trade and the balance of payments current account deficit also declined. According to preliminary data, between January and December 2009 foreign direct investment came to EUR 3.2 billion, covering the balance of payments current and capital accounts by 118.1 per cent.

The BNB performed comprehensive analyses of international and domestic developments. It focused on maintaining banking system stability, managing Bulgaria's international reserves, ensuring smooth payments and currency circulation, and acting as official fiscal agent and state depository. Within the European Union, the Bank helped draft and implement measures to address the global economic and financial crisis.

Maintaining banking system stability and providing direction to banks' efforts to parry the crisis and weak Bulgarian economic activity became BNB priorities. On 1 January the reserves which banks have to keep at the BNB were cut from 10 to 5 per cent of foreign funds and to nil on central and local government funds. This returned BGN 1.2 billion to the banks, allowing them to reduce obligations to non-residents. Banks worked to attract domestic rather than foreign funds which was reflected in deposit rate rises. As a result, attracted funds in 2009 retained their 2008 levels, changing their origin. Individual and household deposits rose by BGN 2.7 billion (12 per cent), making up for the decrease of non-residents' funds, while higher deposit rates raised the cost of credit, mainly to individuals.

Low credit demand, the relatively high price of borrowing, and tighter lending curbed the growth of claims on the non-government sector to 3.8 per cent by the end of 2009. Low credit growth rates in 2009 reflected a 39 per cent decrease in new loans to non-financial corporations and households on 2008. In nominal terms, claims on non-financial corporations rose by BGN 0.7 billion: 2.2 per cent annual growth by December. Claims on households increased by BGN 1.1 billion: 5.8 per cent annual growth. Growth in claims on the non-government sector in 2009 was also driven by net purchases of loans by banks (BGN 1.52 billion).

In 2009 Bulgaria's banking system remained stable. Major financial indicators reflected prior years' anti-cyclic moves by the BNB and banks' anti-crisis actions. Bulgaria's banks preserved their profit generating potential, retaining good liquidity, and boosting capital positions. Despite worsening loan portfolio quality, banks allocated provisions adequate to



the risk in their portfolios, strengthening credit risk protection. Bank managements worked to ease the pressures of worsening loan quality, maintain the stability of attracted funds, and cut costs. The results ranked Bulgaria's banking system among the EU's best performers for the year.<sup>1</sup> This is significant, for unlike most Member States, the Bulgarian government provided no support to its credit institutions. Early in 2009 the BNB recommended that banks should boost tier one capital by capitalising profits. The capital base rose by 18 per cent, benefiting from the capitalisation of 2008 profits and increased paid-up equity and tier two capital.

Based on audited data, banks made BGN 752 million of profits in 2009 after impairment deductions. Worsening loan quality exerted the strongest pressure on revenues in 2009 and impairment losses tripled to over BGN 1 billion. Nevertheless, banks generated gross operating revenue 2.35 per cent higher than that of 2008. Loan quality dropped throughout 2009, with the share of loans past due over 90 days reaching 6.4 per cent: a level considered manageable. System and individual bank sensitivity was analysed using scenarios with various risk types and negative effects to assess potential loan worsening and bank equity erosion. By the end of 2009 the most pessimistic scenarios of international institutions and analysts were not fulfilled, while BNB expectations of risk sharpness and system capacity to resist shocks were matched.

International reserve management is an important BNB function. Instability on international financial markets, volatile financial asset prices and risk premia, and credit rating downgrades for leading transnational institutions and banks called for precise structuring of investment portfolios and strict counterparty selection to preserve investment quality and minimise risk. In 2009 gross international reserves reached EUR 12,919 million, up EUR 205.7 million on 2008. Two major factors were at play.

In early 2009 gross international reserves declined as banks drew out the mandatory reserves which were released. They were in deposits included in BNB monetary liabilities under the Law on the BNB<sup>2</sup>. In the second half of the year the IMF allotted SDRs to member countries in proportion to quotas, with Bulgaria receiving SDR 610.9 million (EUR 665.7 million). This part of BNB's gross international reserves was not invested on world financial markets to yield income.<sup>3</sup> Hence, it is not included in the market value of international reserves which reached EUR 12,264 million or a decrease of EUR 475 million on 2008.

Amid an unfavourable external environment and lower international reserve market value in 2009, BNB income from international reserve investment came to EUR 286 million: 2.47 per cent profitability for the year. Net earnings from international reserve management came to EUR 443 million: 3.78 per cent net profitability.

Accumulated experience and prestige allowed the BNB to participate in various EU and ECB projects to provide technical assistance to third countries, with priority given to non-EU neighbours. In early 2009 the EC chose the Bank to manage a project to strengthening the regulatory and supervisory capacity of financial regulators in Montenegro. The BNB is one of 17 EU central banks in an ECB-managed technical assistance project to the National Bank of Serbia. Another ECB project in which the Bank works with seven EU central banks is a three-year banking supervision and regulation programme for the Central Bank of Egypt.

<sup>1</sup> For instance, latest averaged data on large complex bank groups (LCBG) show ROE (6.41 per cent), ROA (0.26 per cent), and capital adequacy (13.50 per cent) lower than reported by Bulgarian banks. A similar picture emerges when comparing Bulgaria's banks with those of other non-euro area Central and Eastern European Member States. Bulgarian banks are among those reporting the lowest values of non-performing loans, the best capital adequacy, and very good ROE.

<sup>2</sup> Under the Law on the Bulgarian National Bank, gross international reserves completely cover BNB monetary liabilities under the fixed exchange rate. See Chapter 2.

<sup>3</sup> Please see page 26.

# I. Economic Development in 2009

## 1. The External Environment

Trading slowed down globally during the first half of 2009 before starting to recover. The reversal of decline mostly reflected sizeable fiscal and monetary measures taken by the developed countries and China. At the close of 2009 reported data on growth in the euro area, the United States, and China were more favourable than expectations at the year's start. Nevertheless, uncertainty remained on whether world economic recovery was sustainable, and improvement was not uniform across the world. Asian economies reported considerably faster recoveries than the euro area and the United States. The Chinese economy grew at 10.7 per cent on an annual basis over the fourth quarter of 2009 and 8.7 per cent for the year. China's monetary policy contributed to the fast growth of new loans which came to 31.5 per cent of GDP in 2009. At the sectoral level, the optimistic expectations of industry contrasted with the cautious expectations of services.

International trade started recovering during the second half-year, growing by 8.1 per cent on an annual basis by December. The Asian region, where international trade grew by some 23.5 per cent, contributed most here. World industrial output also accelerated, posting 4.4 per cent annual growth.

### Major Macroeconomic Indicators (average annual change)

(%)

	Growth of real GDP			Inflation			Unemployment		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
EU-27	2.9	0.8	-4.2	2.4	3.7	1.0	7.1	7.0	8.9
Euro area-16	2.8	0.6	-4.1	2.1	3.3	0.3	7.5	7.5	9.4
EU-8	6.0	3.8	-3.1	4.4	6.6	3.6	7.6	6.4	8.3
EU-3	2.5	0.3	-4.9	2.2	3.6	2.1	5.3	5.5	7.5
USA	2.1	0.4	-2.4	2.8	3.8	-0.3	4.6	5.8	9.3
Japan	2.4	-1.4	-5.0	0.1	1.4	-1.4	3.9	4.0	5.1
China	13.0	9.0	8.7	4.8	5.9	-1.0	4.0	4.2	

**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.

The crisis in the euro area peaked in the first quarter when GDP dropped by 5 per cent on an annual basis. After March business climate and consumer sentiment started to improve slowly while the fall in GDP abated. Huge fiscal stimuli, ECB monetary policy, and efforts to prop financial market confidence helped. Despite the positive trends, uncertainty about euro area recovery continued, with restricted private sector credit, growing unemployment, and risks to public finances across most of the EU.

The tension on United States financial markets at the close of 2008 became entrenched in trading. During the first six months of 2009 household consumption contracted considerably amid growing unemployment, reduced disposable incomes, and restricted credit. Low capacity utilisation and tightened lending continued to hamper investment. During the second half of the year, however, conditions changed dramatically. Substantial monetary and fiscal stimuli improved the US economic climate and over the half year GDP grew by 0.1 per cent on an annual basis. Accelerating growth over the second half of 2009 was mostly because of temporary factors.

In 2009 global inflation hit a historic low of 2.1 per cent<sup>4</sup> on average. The demand side driver were dropping household disposable incomes which greatly reduced durable and

<sup>4</sup> IMF data (International Financial Statistics, 16 March 2010).

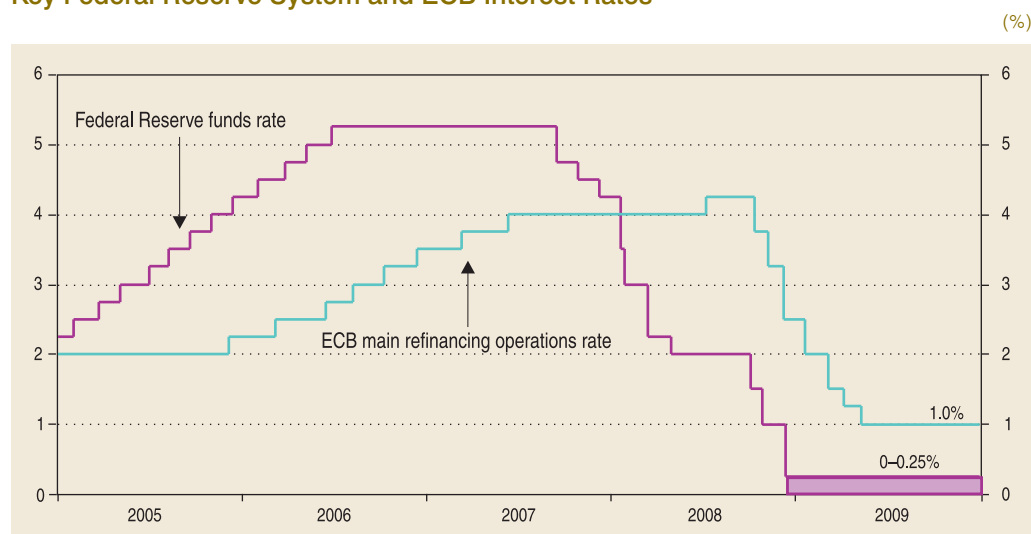
fuel sales, while the supply side driver were falling commodity prices and the ensuing fall in producer prices. Food prices also fell, driven by good harvests. Over the year most developed economies saw deflation or inflation close to zero. Euro area average annual inflation for the period was 0.3 per cent, growing to 0.9 per cent on an annual basis by December. The United States reported deflation (0.3 per cent) for the year. Moderate core inflation indicators of 1.1 per cent on an annual basis by December in the euro area and 1.8 per cent in the United States indicated lack of inflationary pressure. Substantial free production capacity and continuing uncertainty about consumer spending and investment should keep inflation low in leading economies over an extended period.

Brent crude traded at about USD 61.9 *per barrel* (EUR 44.6) on average during the year. Amid a serious drop in demand during the first quarter, oil traded at USD 40 to 50 *per barrel*. In subsequent quarters the price tracked optimistic expectations of world economic recovery and the rise of the US dollar against the euro. Crude picked up by almost 70 per cent to settle at USD 70 to 80 *per barrel*. Food prices also tended to gradual growth during the second half-year to rise by 25.4 per cent on an annual basis. Rises were mainly in vegetable oils, drinks, and sugar. Metal prices also rose by 25.3 per cent on December 2008. Non-ferrous metals such as lead, copper, and zinc rose fastest at 140, 125, and 113 per cent respectively. Drivers were favourable industry prospects underpinned by fiscal stimuli in leading economies, and great demand by China.

During 2009 the ECB further cut interest on main refinancing operations to 1 per cent. The rate's cumulative decline came to 150 basis points between January and May. The corridor of standing facilities narrowed to 150 basis points (-50 basis points) and ECB deposit and loan interest was fixed at 0.25 and 1.75 per cent respectively. Key to ECB policy were a programme to purchase secured Eurobonds (EUR 60 billion) and a maturity extension of long-term refinancing operations of up to a year. Three one-year operations cost EUR 614 billion. The injection of significant liquidity into banking was the main reason for considerable interbank interest falls. Interest on deposits with maturities of up to six months fell below the reference repo rate, hitting record lows at the close of the year: 0.41 per cent for overnights (-194 basis points) and 0.70 per cent for the three-month EURIBOR (-219 basis points). Expecting stronger recovery in the euro area and globally, by late December 2009 the ECB began withdrawing non-standard measures. It gradually decreased the provision of additional liquidity to banks, starting with the termination of one-year repo operations and continuing by reducing the frequency of other long-term operations.

In 2009 the United States Federal Reserve kept federal funds interest steady within the range of nil to 0.25 per cent. Early in the year, purchases of long-term securities amplified short-term facilities amid deepening recession and declining consumer and investor confidence. Following the unprecedented Federal Reserve intervention the money mar-

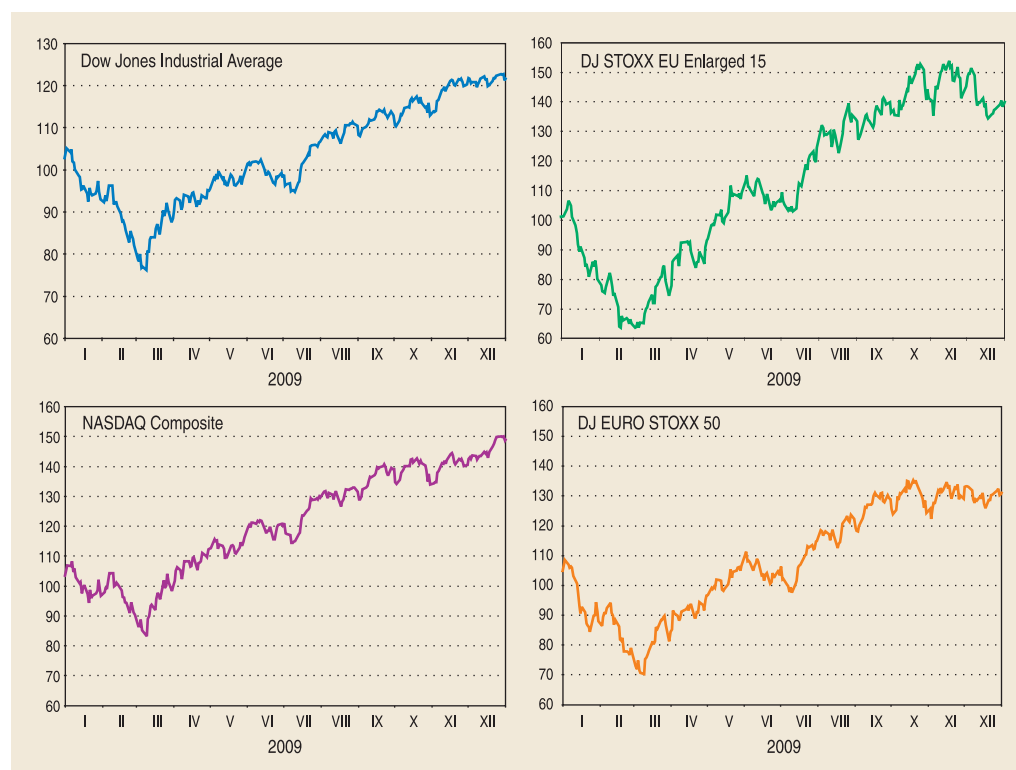
### Key Federal Reserve System and ECB Interest Rates



Sources: ECB, Federal Reserve System.

ket normalised gradually and risk premia within the three- to six-month horizon fell. Banks maintained very high liquidity which focused interest on Federal Reserve programmes at the expense of the money market. Subsequently, the amount and frequency of individual operations decreased several fold, many ending. At its last meeting for 2009 the Federal Reserve Open Market Committee resolved to end short-term extraordinary liquidity operations in late January 2010, and long-term security purchases in late March.

### Major Stock Exchange Indices



Note: Indices have been calculated based on December 2008 = 100.

Sources: Dow Jones, NASDAQ, STOXX.

After leading stock exchange indices lost 20 to 30 per cent of their value in the first quarter of 2009 on December 2008, healthy increases followed. Favourable macroeconomic data restored traders' expectations of rapid recovery by leading economies. European stock exchange indices Dow Jones EURO STOXX 50 and Dow Jones STOXX EU Enlarged 15 went up by 30.2 and 40.9 per cent respectively, the US NASDAQ Composite and Dow Jones Industrial rising by 45.5 and 21.4 per cent.

## 2. The Bulgarian Economy

In 2009 real GDP dropped by 5 per cent.<sup>5</sup> The global financial and economic crisis impacted all sectors, hitting consumer and business confidence and eroding export opportunities and capital inflows.

Investment was the final use component most strongly affected by the crisis. Bulgaria's dynamic economic growth in recent years entailed intensive commissioning of new production capacity and accumulation of reserves by emerging and expanding businesses. In 2009, growing uncertainty, declining demand, and restricted finance drove fixed capital investment down by 27 per cent in real terms, capital formation contributing by 12.5 percentage points to real GDP decline.

<sup>5</sup> The 5 per cent annual GDP decline in Bulgaria echoed the 4.2 per cent average fall in EU trading. Concerns by a number of international analysts that the crisis would hit Bulgaria considerably more, and of some 7 per cent decline in its economy, did not materialise.

NSI quarterly business statistics showed fixed asset spending dropping by 28 per cent in nominal terms. It fell by some 45 per cent in the property-related sectors of construction and real estate operations, while industry and retail contributed most (by 16.8 percentage points) to its overall drop.

### Real GDP Growth by Final Use Component

	2008		2009	
	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)
<b>Produced GDP</b>	<b>6.0</b>	<b>6.0</b>	<b>-5.0</b>	<b>-5.0</b>
Final consumption	3.9	3.3	-6.2	-5.2
Household consumption	4.9	3.3	-6.3	-4.3
Government final consumption expenditure	1.9	0.1	-5.3	-0.4
Collective consumption	-1.4	-0.1	-5.7	-0.5
Gross fixed capital formation	20.4	6.1	-26.9	-9.0
Physical change in inventories	-15.2	-1.1	-69.6	-3.5
Exports of goods and services	2.9	1.8	-9.8	-5.9
Imports of goods and services	4.9	-4.2	-22.3	18.5

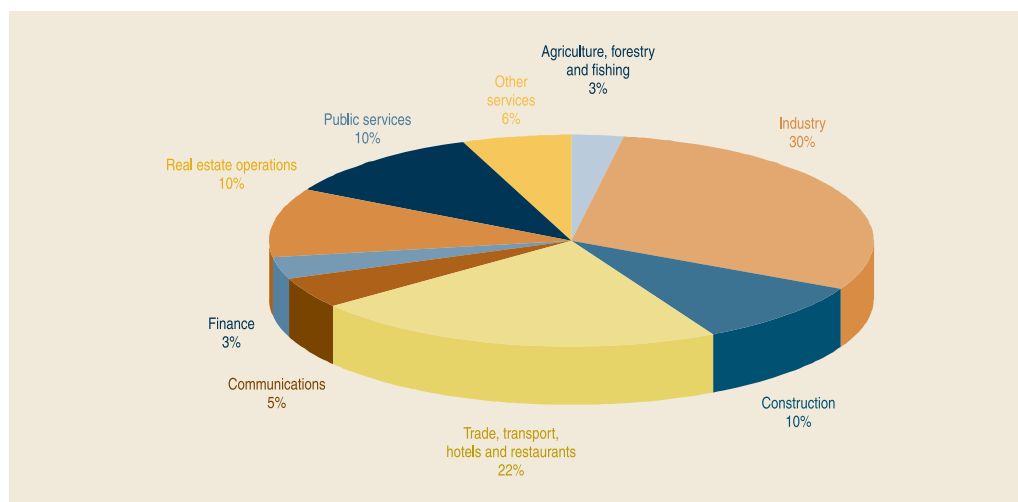
Source: NSI.

### Gross Value Added Real Growth

	2008		2009	
	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)
<b>Gross value added</b>	<b>6.1</b>	<b>6.1</b>	<b>-3.8</b>	<b>-3.8</b>
Agriculture and forestry	24.6	1.5	-3.3	-0.2
Industry	3.0	1.0	-8.1	-2.5
Services	5.9	3.6	-1.7	-1.0

Source: NSI.

### Structure of Expenditure on Acquisition of Fixed Assets by Economic Activity in 2009



Source: NSI.

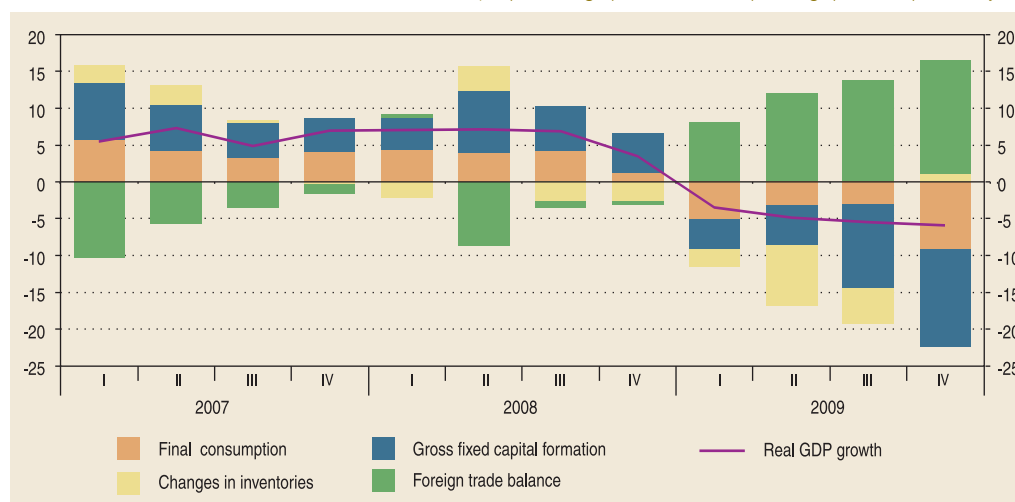
Household consumption contracted by 6.3 per cent in real terms. Consumer confidence weakened with increasing unemployment and curbed income growth. Households cut purchases of durables to maintain spending on foods and other necessities. Households spending cuts and savings in 2009 stemmed from uncertainty about employment and future incomes. Greater savings fuelled growing household bank deposits. General government spending fell by 5.5 per cent in real terms because of fiscal consolidation efforts during the second half-year.



Due to weaker final and intermediate domestic demand, in particular for investment goods, imports dropped by 22 per cent. The decline in exports was smaller, leading to a positive balance of trade contribution to real GDP. During the year the decline in exports slowed and during the fourth quarter they picked up by 0.8 per cent (including commodity exports by 2.8 per cent) on a year earlier.

### Contribution of Final Use Components to GDP Growth

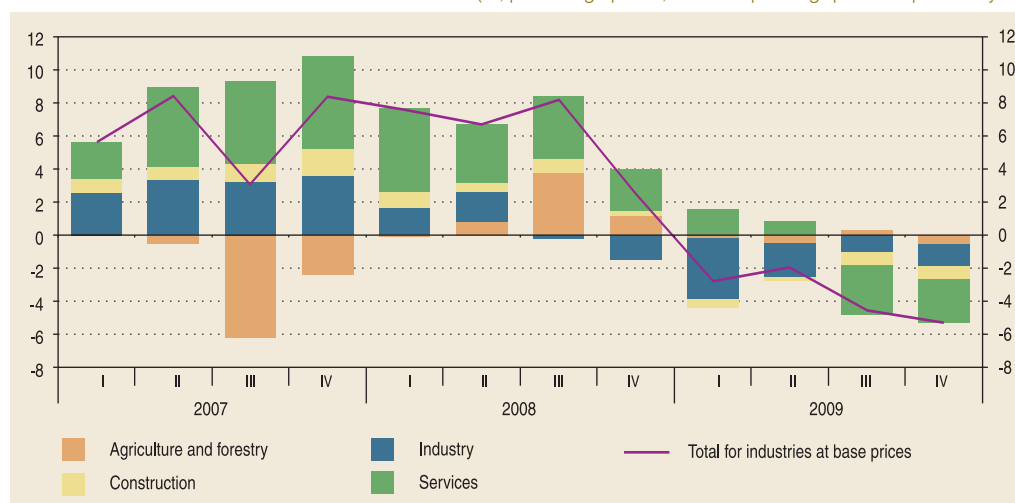
(%, percentage points, on corresponding quarter of previous year)



Source: NSI.

### Change in Value Added in Real Terms and Contribution by Sector

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



Source: NSI.

Gross value added in the economy declined by 3.8 per cent. Value added in manufacturing fell by 8.1 per cent, contributing by 1.2 percentage points to the overall decline. Worsened export conditions and, even more, reduced domestic demand impacted the sector. Over the year manufacturing turnover fell by 26 per cent, with domestic turnover contributing by 16 percentage points to this. Negative growth in industry related to declines in construction (-7.2 per cent) which utilises the bulk of intermediate consumption products, and retail (-6.1 per cent). Reduced foreign trade was a key factor behind falls in transport and communications where value added dropped by 7 per cent.

Owing to the deterioration in market conditions companies in most industries cut material and labour spending to protect the narrowing gross operating surplus in gross output.<sup>6</sup>

<sup>6</sup> The gross operating surplus to gross output ratio is an indicator of output profitability.

During 2009 this share went up on the previous year in manufacturing, construction, energy, and transport and communications, while dropping to 52.7 per cent in the financial sector from 54.3 per cent in 2008.

Weaker trading also hit the labour market in 2009. Employment declined by 2.9 per cent on 2008 as layoffs intensified: during the first half-year employment fell by 1.1 per cent, with another 4.7 per cent in the second half. The crisis affected the labour market with a delay; employers were in good financial health when it arrived and could afford to postpone layoffs pending a recovery. The initial shock hit exporters and took time to affect those serving the domestic market. This was apparent in the sectoral pattern: in the first half-year services employment continued growing, while in the next six months it fell by 6.2 per cent on 2008.

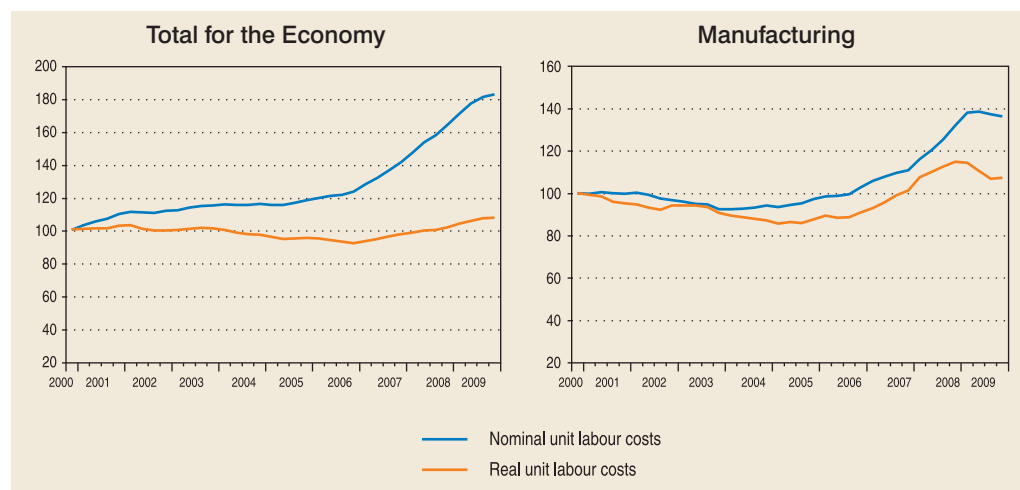
Unemployment reached 7.9 per cent by the close of the year according to the Labour Force Survey. Some unemployed people, termed “discouraged unemployed,” chose not to seek new work. This depressed the economic activity ratio for 15 to 64 year olds from 67.8 per cent in 2008 to 67.2 per cent in 2009.

Nominal wage growth slowed to 9.4 per cent in 2009 from 22 per cent in 2008. Constraints were more apparent in the second half of 2009 and especially in the fourth quarter (3.5 per cent on an annual basis) when companies could opt to cut or dispense with annual bonuses. Relatively high annual wage growth in the first half-year reflected the 9 per cent rise in the statutory minimum wage and the more than 20 per cent hike in social security thresholds.

Labour productivity declined by 3.1 per cent on an annual basis in the first half-year. As layoffs began in the second half-year its fall was arrested to 1 per cent, and to 0.1 per cent in the fourth quarter. As output began rising along the manufacturing chain (real growth in the second half of 2009 was 5.6 per cent on the first half of the year), productivity grew by 6.1 per cent between July and December 2009 on the same period of the prior year.

Unit labour costs in the economy continued rising in 2009 by 10.6 per cent in nominal terms (5.8 per cent in real terms), though for reasons different from those of 2007 and 2008. In recent years unit labour costs grew alongside profits; in 2009 they grew due to falling demand and delayed layoffs. During the fourth quarter unit labour cost growth slowed considerably to 3.7 per cent (1.8 per cent in real terms). Retail and agriculture contributed most to the rise at 4.2 percentage points in nominal terms (about 1.5 percentage points in real terms). Labour costs in agriculture are conditional due to the great number of self-employed people drawing mixed labour and rent incomes. Manufacturing contributed most (by -0.7 percentage points) to restraining real terms unit labour costs. The sector is critical to Bulgarian exports and its unit labour costs have a direct bearing on national competitiveness.

### Unit Labour Costs (moving average, 2000 = 100)



Sources: NSI, BNB.

In 2009 inflation declined greatly on the prior year to 1.6 per cent on an annual basis in December. Average annual inflation dropped to 2.5 per cent.<sup>7</sup> Good local and world harvests brought more produce to the market, while oil prices had fallen dramatically in late 2008. This curbed the prices of the commodities which had contributed most to 2008 inflation and eased inflationary pressure by cutting intermediate consumption. World energy price falls cut administratively controlled prices for items such as electricity for households and heating.

By the close of 2009 oil price rises increased annual inflation from 0.2 per cent in September to 1.6 per cent in December. Services and tobacco products prices boosted accumulated inflation by 0.9 and 0.7 percentage points respectively.

### HICP Inflation Accumulated since Year's Start and Contribution\*

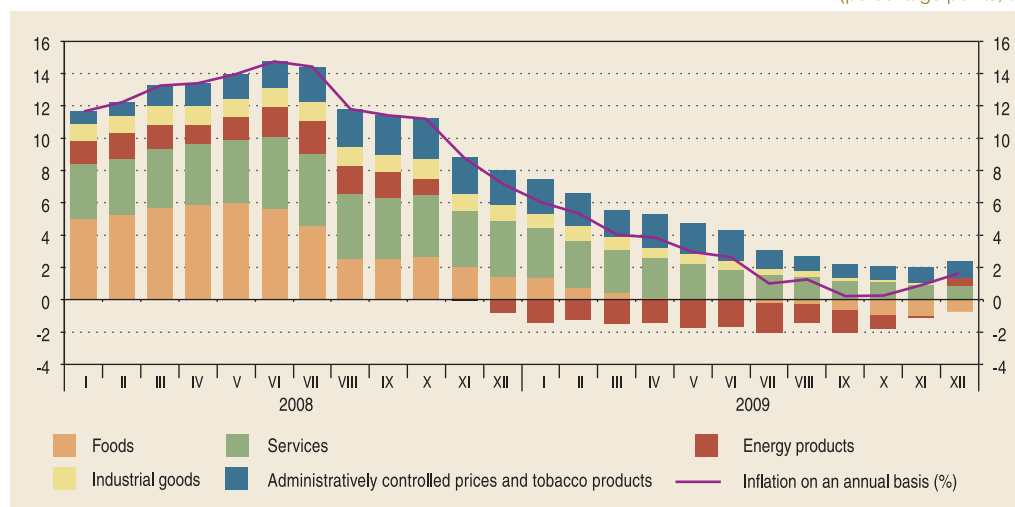
Inflation	2008		2009	
	7.2%		1.6%	
	Inflation rate by group (%)	Contribution, p.p.	Inflation rate by group (%)	Contribution, p.p.
Foods	5.8	1.46	-3.0	-0.73
Processed foods	5.2	0.82	-2.6	-0.39
Unprocessed foods	6.8	0.65	-3.6	-0.33
Services	11.8	3.41	2.9	0.88
Public catering	14.9	1.58	4.4	0.52
Transportation services	16.0	0.81	-1.2	-0.06
Telecommunication	-1.2	-0.05	-1.0	-0.04
Other services	12.0	1.07	4.9	0.46
Energy products	-9.4	-0.80	6.4	0.49
Transportation fuels	-13.0	-1.01	8.2	0.54
Industrial goods	5.4	0.95	0.0	-0.01
Goods and services with administratively controlled prices	10.2	1.65	2.0	0.31
Tobacco products	15.1	0.52	23.9	0.69

\* This structure corresponds to the Eurostat classification with tobacco products and goods and services with administratively controlled prices shown as separate items.

Sources: NSI, BNB.

### Inflation on an Annual Basis and Contribution of Major Commodity Groups and Services

(percentage points, %)

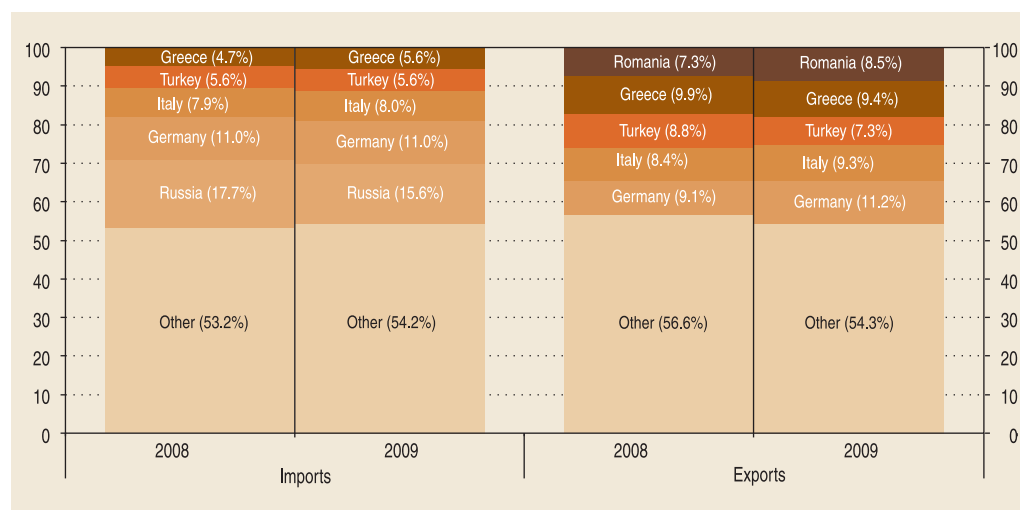


Sources: NSI, BNB.

<sup>7</sup>The analysis is based on HICP data.

Bulgarian goods exports dropped by EUR 3.4 billion (-22.5 per cent) in 2009 on the prior year due to the crisis and the dramatic fall in external demand. The major contributors to decline were *oil products* (by -5.5 percentage points), *non-ferrous metals* (by -3.7 percentage points) and *cast iron, iron and steel* (by -3.3 percentage points). Despite recession in Bulgaria's major EU trade partners, exports of some commodity groups grew on 2008, with *foods, medicines and cosmetics*, and *unprocessed tobacco* contributing by 0.4, 0.4, and 0.3 percentage points respectively. Reduced domestic demand and particularly declining investment depressed goods imports by EUR 7.9 billion (-33.2 per cent).<sup>8</sup> *Crude oil and natural gas, vehicles, and machines, equipment and appliances* led the imports contraction at 7.4, 4.2, and 3.4 percentage points respectively. The balance of trade deficit fell to EUR 4.1 billion (12.1 per cent of GDP), down by EUR 4.5 billion on 2008. The geography of Bulgaria's foreign trade changed a little, with a moderate trend towards growing intra-Community trade. Bulgarian exports to the EU fell by 16.8 per cent, while those elsewhere by 31 per cent. Goods imports from the Community decreased by 29.5 per cent, while those from elsewhere by 37.3 per cent.

### Geographic Structure of Exports and Imports



Source: BNB.

Declining investment into Bulgaria entailed weaker foreign direct investment which in 2009 remained positive at levels lower than in 2008. Foreign direct investment was EUR 3.2 billion<sup>9</sup> (9.5 per cent of GDP) and covered the balance of payments' current and capital account deficits by 118.1 per cent. It went mainly into *financial intermediacy* (22.9 per cent), *property and business services* (20.3 per cent), and *manufacturing* (18.3 per cent). The balance of payments' financial account was in surplus by EUR 2.2 billion in 2009 (6.4 per cent of GDP). Increased net financial loans to the private non-bank sector and the general government sector contributed by EUR 317.8 billion and EUR 227.4 billion respectively to this, alongside foreign direct investment.

The overall current and capital account deficits declined to EUR 2.7 billion in 2009 (8 per cent of GDP) against EUR 7.9 billion (23.2 per cent of GDP) in 2008. The current account was in deficit by EUR 3.2 billion (9.4 per cent of GDP) against EUR 8.2 billion (24 per cent of GDP) in 2008. All other current account components (alongside trade deficit) improved on 2008: the balances on services (by EUR 223.8 million), income (by EUR 184.4 million), and net current transfers (by EUR 100 million). The balance of payments' current account deficit was cut without shocks and in accord with preliminary expectations, foreign direct investment covering it above 100 per cent. The capital account surplus reached EUR 477 million in 2009, up by EUR 199.6 million on the prior year.

<sup>8</sup> For more information on balance of payments changes in 2009, see the BNB *Economic Review* quarterly, 4/2009.

<sup>9</sup> Data on foreign direct investment are subject to regular revisions upon additional information from companies. Recent years have witnessed systematic upward revisions of first-release data on foreign direct investment inflows; therefore, a mechanical comparison of 2009 data with 2008 data revised several times may be misleading.

BNB international reserves picked up by EUR 205.7 million to EUR 12.9 billion. During the second half-year reserves increased by over EUR 1 billion, reversing the earlier decline caused by reduced bank reserves.<sup>10</sup> The increase in international reserves in the second half of 2009 was because of an IMF quota-based SDR allocation which gave Bulgaria EUR 665.7 million, and because of the EUR 517.6 million balance of payments surplus between September and December 2009.<sup>11</sup>

Gross external debt went up by EUR 605.7 million in 2009 to EUR 37.7 billion (111.3 per cent of GDP) at the close of the year. Private sector external debt, 88.9 per cent of the total, was EUR 33.5 billion (99 per cent of GDP). In 2009 Bulgaria's foreign indebtedness pattern stabilised following rapid increases over recent years. Private non-guaranteed external debt climbed during the year by EUR 348.9 million. Public and publicly guaranteed debt rises of EUR 256.9 million mostly reflected a World Bank financial loan. Reductions in statutory reserves since early 2009 allowed banks to cut their external debt by EUR 691.9 million over the year, their share in gross external debt falling to 22.2 per cent. Intercompany loans grew by some EUR 1 billion on 2008, pointing to foreign investors' long-term interest in Bulgaria.

The cash balance on the consolidated fiscal programme for 2009 was in deficit by BGN 576.4 million or -0.9 per cent of GDP.<sup>12</sup> Total revenue and grants came to BGN 25,041.2 million (down by 8.3 per cent on 2008). Indirect tax revenue fell by BGN 1359.3 million (-11.6 per cent), mainly through 14.1 per cent lower VAT revenue on an annual basis. Weaker trading cut corporate tax revenue by BGN 446 million or 20.9 per cent on 2008. Consolidated fiscal programme spending in 2009 (EU budget contribution included) came to BGN 25,617.6 million, an annual growth of 1.2 per cent. Social and health insurance spending grew dramatically by BGN 1210.5 million or 13.8 per cent; pension rises in January, April, and July (by 15.8 per cent in total) were the main contributor. Capital and operating expenditure dropped by 16 and 17.4 per cent on an annual basis respectively, mainly through measures to minimise the cash budget deficit in the last quarter of 2009.

Until the third quarter of 2009 monetary aggregate dynamics slowed as trading declined, inflation fell, and lending remained subdued. During the last months of the year aggregate growth accelerated to a certain extent, the annual increase in broad money coming to 4.3 per cent. This relatively weak showing was determined by an 8.8 per cent decline in M1, while quasi-money grew by 14.5 per cent. Amid falling employment, lower wage growth, relatively high deposit interest, and corporate liquidity constraints, money outside banks continued declining in 2009, by -11.4 per cent by December. Overnight deposits decreased by 7 per cent on December 2008, reflecting weak bank lending and a shift from overnight to time deposits.

Macroeconomic deterioration because of the global crisis hit borrowing and led banks to tighten lending. In 2009 credit growth moderated to an annual increase of claims on the non-government sector of 3.8 per cent.<sup>13</sup> This reflected the fall to BGN 13.3 billion (down by 39 per cent on 2008) in new loans to non-financial corporations and households. The BGN 1.1 billion increase in loans to households (5.8 per cent annual growth) contributed most to the rise in claims on the non-government sector by BGN 1.9 billion in 2009. Claims on non-financial corporations picked up by BGN 0.7 billion (2.2 per cent annual growth). Net purchases of loans by banks, totalling BGN 1.52 billion for the year, also influenced the increase in claims on the non-government sector. Despite less buoyant credit, the claims on the non-government sector to GDP ratio continued rising owing to the nominal decline in GDP, reaching 77.9 per cent by the close of the year.

<sup>10</sup> Under the Law on the Bulgarian National Bank gross international reserves completely cover BNB monetary liabilities under the fixed exchange rate. See also Section II here.

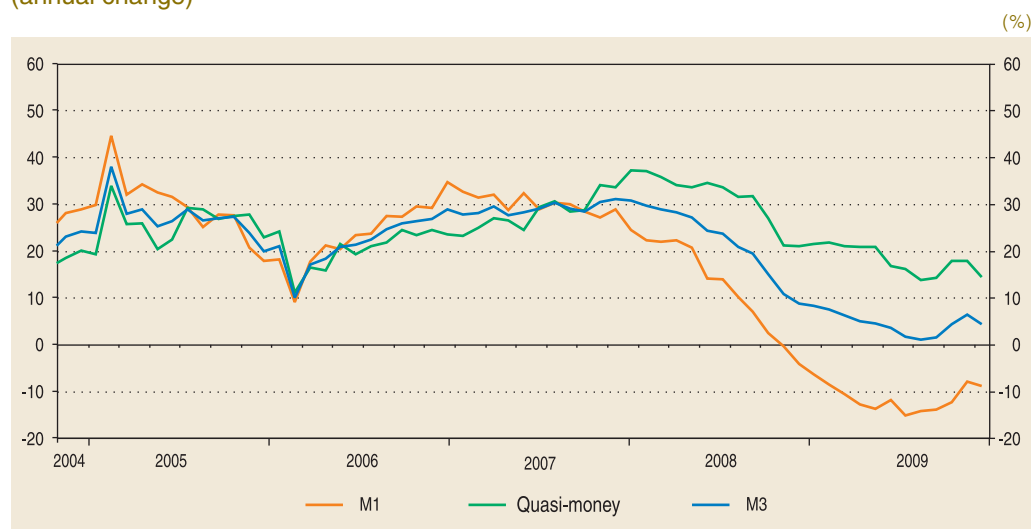
<sup>11</sup> See Section II here.

<sup>12</sup> This analysis uses statistics on the implementation of the consolidated fiscal programme following the cash-based national methodology.

<sup>13</sup> By comparison, 0.7 per cent growth in claims on the non-government sector was reported in the euro area in 2009, while eleven EU countries noted credit declines. In the EU8, only Poland and the Czech Republic posted positive growth (8.2 per cent and 1.9 per cent respectively) alongside Bulgaria.



### Monetary Aggregates (annual change)



Source: BNB.

The 1 January 2009 halving of minimum required reserves from 10 to 5 per cent on foreign attracted funds and their reduction from 10 to nil per cent for central and local government budget funds freed some BGN 1.2 billion<sup>14</sup> for the banks, allowing them to decrease funds attracted from non-residents by BGN 1.3 billion. Deposit increases by households (by BGN 2.4 billion) and financial institutions (by BGN 1.3 billion) provided a lending resource, while deposits of non-financial corporations dropped by BGN 1.4 billion. Amid uncertainty on international financial markets and following a BNB recommendation, banks capitalised their 2008 profits. As a result, their 2009 capital and reserves grew by BGN 1.5 billion.

Foreign exchange transactions with the BNB were the banks' major lev liquidity lever. These operations enabled the important currency board function of unhindered lev euro and euro lev exchanges. Thus, currency trade volumes (sales and purchases) exceeded interbank cash trade volumes several fold. Total foreign exchange market volume in 2009 was EUR 499 billion<sup>15</sup>: an annual drop of 10.4 per cent. The drop affected all segments: trades between the BNB and banks, the interbank market (excluding BNB participation), and trades with end-users. Unlike recent years, the BNB's net position on the foreign exchange market in 2009 came to EUR -338.1 million, with transactions with banks coming to EUR -846.3 million due mainly to reduced minimum required reserves.

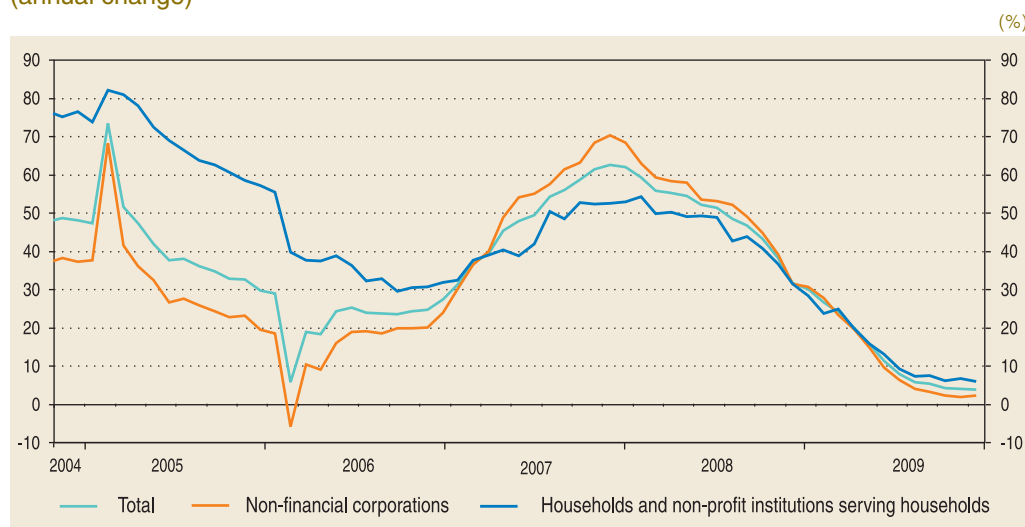
The interbank money market in 2009 witnessed a gradual return of confidence and a decline in interest rates. Anti-cyclic measures by the BNB at the turn of 2009 contributed to the gradual fall in the price of money. Average interbank deposit and repo interest was 2.37 per cent, its average monthly value falling from 3.94 to 0.64 per cent over the year. Low interbank interest rates in the euro area and decreased risk premia for Bulgaria helped the fall. The total volume of interbank money market transactions dropped by 19.8 per cent on an annual basis. Deposits comprised 89.5 per cent of turnover and repos 10.5 per cent.

Net government securities issues were negative in 2009 at BGN -71.5 million. During 2009 the total nominal value of government securities issues approved by the Ministry of Finance was BGN 488.7 million. The 63.8 per cent (BGN 298.3 million) increase on 2008 was partly determined by 26.5 per cent higher repayments. In 2009 BGN-denominated government securities issues included three-month discount treasury bills and five- and ten-year fixed rate treasury bonds. During the year five-year government securities from 2006 and 2007 were opened several times. Unlike 2008, the year saw three issues of

<sup>14</sup> See Section IV here.

<sup>15</sup> This turnover comprises transactions by banks and the BNB in foreign currency against levs with spot value dates of up to two business days and includes the double volume of BNB trade with banks and the trade between banks.

### Claims on Non-government Sector (annual change)



Source: BNB.

### Average Interest Rate on Interbank Money Market



Source: BNB.

three-month discount government securities. Their total nominal value came to BGN 43.2 million against BGN 45 million in 2008. Nominal approved bid value for 2009 five-year securities was BGN 103.0 million, 21.5 per cent up on 2008. The opening of the 2006 five year issue totalled BGN 70 million nominal, while those of the 2007 five-year issue totalled BGN 115 million nominal. Only the nominal value of ten-year government securities was 6.5 per cent less on the prior year, its five openings coming to BGN 157.5 million. The average-weighted yield of the new issues was higher on the prior year across all maturities. Average returns in the second half-year fell on the first half, reflecting government securities market normalisation. The average weighted bid-to-cover ratio at government securities primary auctions declined to 2.24 in 2009 from 2.93 in the prior year, demand still substantially exceeding supply.

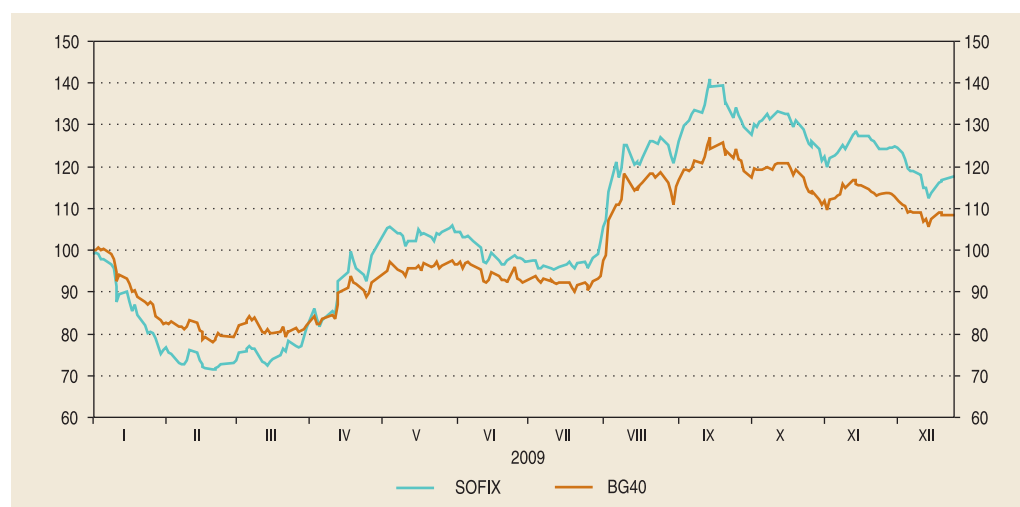
Outright transactions in Bulgarian government securities between banks in the secondary market totalled BGN 597.5 million at market value<sup>16</sup> while trade volume contracted more than four fold on 2008. The decline reflected a base effect: during the first quarter, a good volume of government securities sales resulted from a new primary dealer selection criterion of a threshold share of secondary market turnover. Growing world financial market

<sup>16</sup> Data are based on the statistics of operations with a flow of funds on current accounts with the BNB.

uncertainty and worsened Bulgarian economic conditions boosted investor interest in government securities, further decreasing secondary market turnover. The turnover of BGN-denominated bonds dropped to BGN 564.7 million on BGN 2511.5 million in 2008, that of USD-denominated ones falling to BGN 4.4 million on BGN 8.5 million in 2008 and that of EUR-denominated ones rising to BGN 28.4 million in 2009 on BGN 7.9 million in 2008.

The price of the Bulgarian government's EUR-denominated global bonds maturing in 2013 was 109.1 per cent at the close of the year, while that of USD-denominated global bonds maturing in 2015 was 116.4 per cent. The rise on 2008 when they were 101.5 per cent and 99.3 per cent respectively reflected higher demand and reduced Bulgarian risk premia. The price of the USD-denominated bonds issued under ZUNK fluctuated around the nominal and their dynamics was almost the same as that in the prior year.<sup>17</sup>

### Bulgarian Stock Exchange Indices (December 2008 = 100)



Source: BNB.

The world financial market crisis hit capital market trading and in 2009 the SOFIX and BG40 indices fluctuated considerably. After a dramatic decline in the first quarter an upward trend was observed, followed by adjustments in the closing months of the year. SOFIX and BG40 annual growth was 18.8 per cent and 8.3 per cent respectively, the Bulgarian indices following those of leading markets. In 2009 the turnover of shares on the secondary market went down to BGN 667.5 million, about a third of its 2008 value. The total volume of bourse trade in bonds decreased by 33 per cent to BGN 167.8 million, over half of it resulting from trading in bonds issued by one company. Over-the-counter transactions totalled BGN 29.7 million. By the year's end capitalisation of the Bulgarian Stock Exchange Sofia market was BGN 11.6 billion or 17.5 per cent of GDP, against 18.7 per cent of GDP in 2008.

<sup>17</sup> According to Bloomberg data.

## II. Gross International Foreign Currency Reserves

Gross international reserve management complies with the Law on the Bulgarian National Bank and makes use of international financial market opportunities.<sup>18</sup> These reserves are the assets on the Issue Department's balance sheet. They have to provide complete cover for monetary liabilities under the fixed exchange rate of the lev to the euro.<sup>19</sup> The excess of gross international reserves over monetary liabilities forms the *Banking Department Deposit* item or the net value of the Issue Department's balance sheet.<sup>20</sup>

### 1. The Amount and Structure of Gross International Foreign Currency Reserves

At the close of 2009 gross international reserves were EUR 12,918.9 million: EUR 205.7 million or 1.6 per cent more than a year earlier. The change was mainly because of reduced bank mandatory reserves and because of receipts of SDR 610.9 million (EUR 665.7 million) from the IMF. Investment income began declining in the second quarter as international market yields fell significantly. This continued until the close of 2009 (see *Market environment*, item 2 in this Chapter).

The decrease in gross international reserves mainly reflects net euro sales by the Bank after the minimum required reserves cut in early 2009.<sup>21</sup> Over the year banks paid in EUR 159 million of reserves, while the BNB sold them EUR 1247 million of reserve currency. In 2008, bank reserves and reserve currency sales had flowed in the opposite direction (see table on p. 30).

#### Largest Cash Flows

(million EUR)

External flows	2009	2008
<b>Purchases and sales of euro</b>		
At tills:	-35	-54
Banks, incl.	-1 247	1 275
purchases by banks	112 527	125 543
sales to banks	-113 774	-124 268
<b>Total I</b>	<b>-1 282</b>	<b>1 222</b>
<b>Flows on accounts of banks, the MF, etc.</b>		
Minimum required reserves	159	-657
Government and other depositors	859*	-509
<b>Total II</b>	<b>1 018</b>	<b>-1 166</b>
<b>Total I+II</b>	<b>-265</b>	<b>55</b>

\* The SDR 610.9 million (EUR 665.7 million) received by the BNB as a member country of the IMF are included in the *Government and Other Depositors* item for the whole year. The IMF allotted SDRs between member countries on the basis of their right to acquire up to 75 per cent of their quota in the IMF.

Source: BNB.

<sup>18</sup> There were no Law on the Bulgarian National Bank (LBNB) amendments concerning the regulatory framework for gross international reserve management during the review period.

<sup>19</sup> Under Article 28, paragraph 2 of the Law on the BNB, the Bank's monetary obligations included all circulating banknotes and coinage issued by the BNB, and all other entities' account balances at the Bank, except the IMF. Article 28 Paragraph 3 of the Law on the BNB comprehensively lists assets deemed as gross international reserves: monetary gold; Special Drawing Rights; convertible foreign currency; convertible foreign currency in BNB accounts at foreign central banks or other financial institutions or international financial organisations assigned the two highest ratings by two internationally recognised credit rating agencies; securities issued by foreign countries, central banks, other foreign financial institutions, or international financial organisations assigned one of the two highest ratings by two internationally recognised credit rating agencies except collateralised debt; the balance on accounts receivable and payable on BNB forward or repo agreements with (or guaranteed by) foreign central banks, public international 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 are estimated at market value.

<sup>20</sup> Article 28, paragraph 1 of the Law on the BNB states, "the aggregate amount of the BNB's monetary liabilities shall not exceed the lev equivalent of gross international reserves," that equivalent depending on the fixed exchange rate.

<sup>21</sup> Banks' deposits with the BNB represent part of the monetary obligations of the central bank and changes in them affect gross international reserves directly. For details, see Chapter IV on banks' minimum required reserves maintained by banks with the Bulgarian National Bank.

In the second half of 2009 the IMF freed SDRs worth some 75 per cent of member countries' quotas. The G20 London summit on 2 April 2009 decided to release this USD 250 billion of SDRs to ease the global financial and economic crisis. On 7 August an 85 per cent majority of IMF votes approved the move. The BNB received its initial SDR 474.6 million on 28 August 2009. Final ratification of the 1997 Fourth Amendment to the Fund's Charter freed an additional allotment of SDR 42.8 billion. Having ratified the amendment in 1999, Bulgaria received SDR 136.3 million under it on 9 September 2009. The two allocations of SDR 610.9 million were worth EUR 665.7 million at receipt. They formed part of BNB gross international reserves and were duly included in the Banking Department Deposit item in the Issue Department balance sheet.

The Governing Council resolved to keep the SDRs long-term in the BNB's IMF account.<sup>22</sup> This protects them from risks (interest, currency, credit, *etc.*) attending other reserves, maintains their market value in original currency, and diversifies the international reserve currency structure. Because of their special status, SDRs are not included in the below statement on gross international reserve market value, structure, profitability and risk. At the close of 2009 the market value of gross international reserves was EUR 12,264 million: a decrease of EUR 475 million or 3.72 per cent on the end of 2008.

Over the year the proportions of currencies in the gross international reserve remained almost unchanged on 2008. Euro-denominated assets dominated at 91 per cent and monetary gold occupied about 8 per cent.

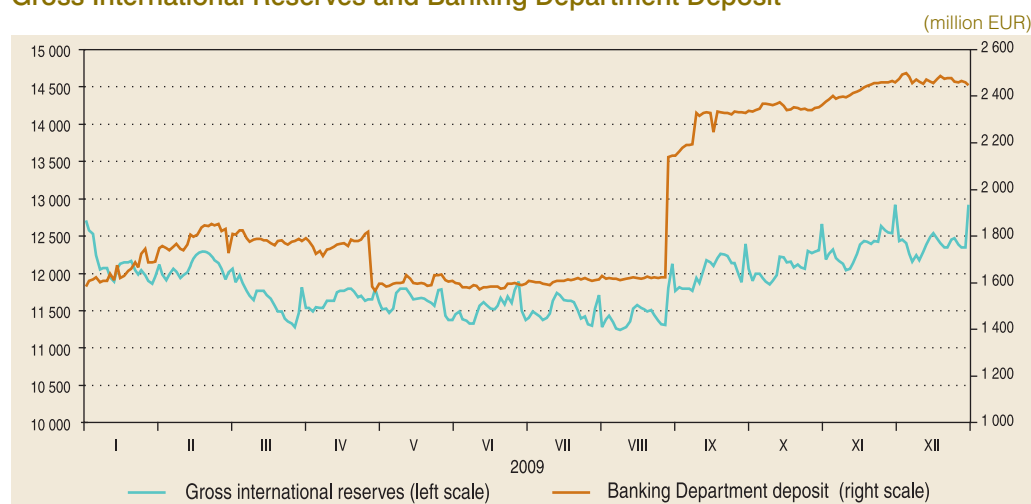
### Currency Structure of International Reserves

Currency	Issue Department balance sheet assets	
	2009	2008
Euro	90.99	93.05
US dollars	0.95	0.86
Gold	7.69	5.78
Special Drawing Rights*	0.36	0.30
Swiss francs	0.01	0.01

Notes: Average data for the period. 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.

### Gross International Reserves and Banking Department Deposit



Source: BNB.

The proportions of assets by financial instrument also changed very little, as did the share of securities (81 per cent). Money market instruments (mostly short-term overnight deposits and funds with top rated foreign banks) declined slightly.

<sup>22</sup> Resolution No 140 of 10 December 2009 of the Governing Council of the BNB.



**Structure of Gross International Reserves by Financial Instrument**

(%)

Instruments	2009	2008
Vault cash*	1.72	2.37
Deposits**	13.73	14.24
Securities**	81.48	81.07
Gold in the vault	3.07	2.32

\* Balances on accounts and payments.

\*\* Including instruments in foreign currency and gold.

**Notes:** Average data for the period. 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.

The structure of gross international reserves by residual term to maturity changed. The share of short-term investment (maturity of up to a year) fell by 23 per cent at the expense of increased investment in the one- to ten-year maturity sectors. The main reason behind this was the early 2009 change in the euro assets reference portfolio (or benchmark) and the increase in its duration.

**Structure of Gross International Reserves by Residual Term to Maturity**

(%)

Maturity sectors	2009	2008
Up to 1 year	64.38	86.97
From 1 to 3 years	23.39	10.19
From 3 to 5 years	8.30	1.36
From 5 to 10 years	3.32	1.08
From 10 to 30 years	0.61	0.40

**Notes:** Average data for the period. 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.**2. Gross International Foreign Currency Reserve Risk and Yield****The Market Environment**

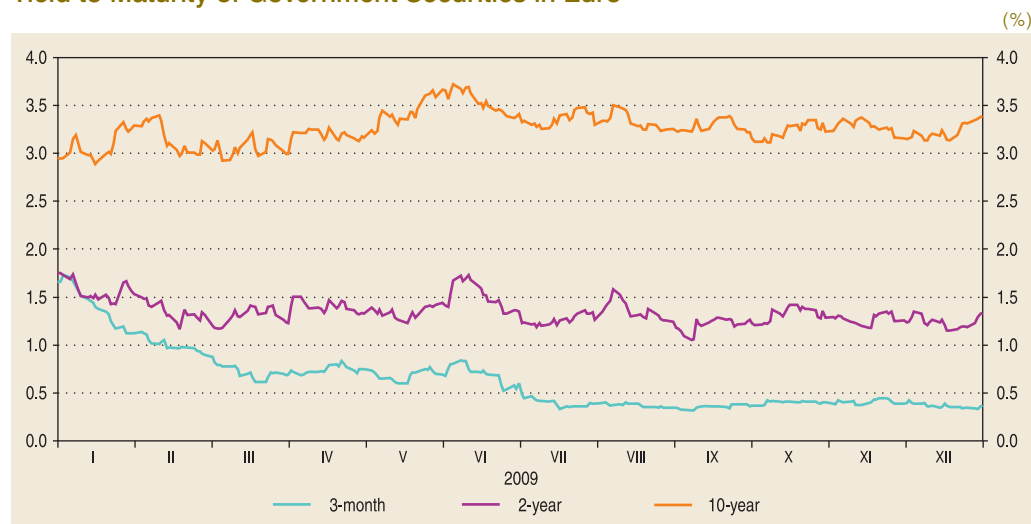
Early 2009 saw high volatility in financial markets on which the BNB participates. The financial crisis peaked in late March, followed by initial signs of market stabilisation. A gradual improvement of investment expectations and perceptions followed, risk appetite started climbing, and securities prices were less volatile. Sizeable fiscal and monetary stimuli by developed and some developing countries boosted market expectations.

Amid improving macroeconomic indicators and returning market confidence, some central banks (including those of Australia, Norway, and Israel) raised key interest rates in the last quarter of 2009. The Federal Reserve and the ECB remained cautious. The end of 2009 saw an increase in risk premia on government debt and loans, reflecting high budget deficits in some euro area countries such as Greece, Spain, Portugal, and Ireland.

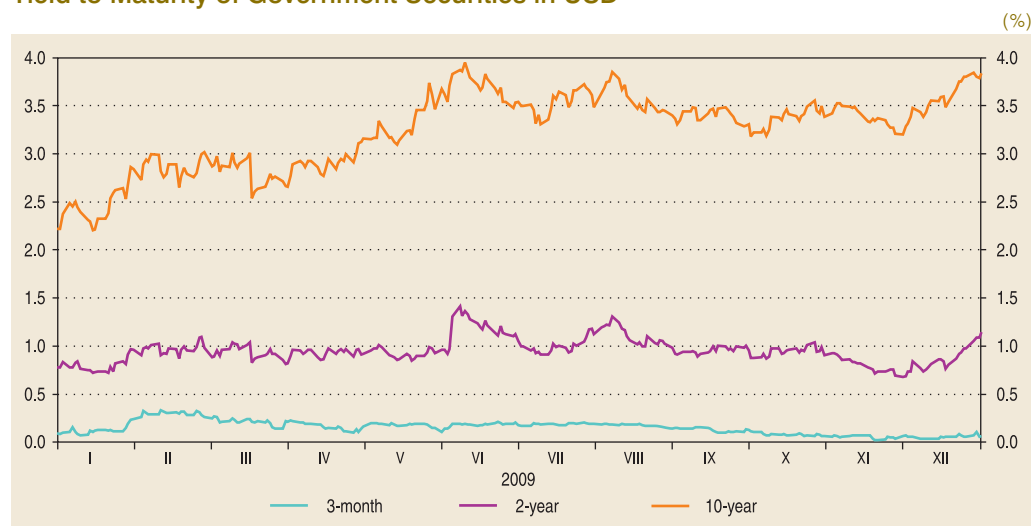
**Euro Area Government Securities Yield Curve**

In 2009 the euro area government securities yield curve steepened. Short maturity sectors dipped more steeply while all sectors with maturities of over five years rose. The trend to a long-end yield increase was mainly in the first half year, reflecting large volumes of government securities offered on some euro area primary markets. The cuts in ECB interest on main refinancing operations and lower inflationary risk continued to depress shorter-term yield. Unorthodox ECB measures to boost money supply and excess euro area bank liquidity made fixed income paper yet more interesting.

## Yield to Maturity of Government Securities in Euro



## Yield to Maturity of Government Securities in USD



## Gold and Exchange Rates

In 2009 the US dollar depreciated cumulatively by 2.7 per cent on the single European currency. The *EUR/USD* spot rate moved within a wide band (1.25 to 1.51), its annual average falling to 1.35 on 1.47 in the prior year. The main drivers were changes in investor risk appetites, monetary and fiscal measures in the USA and the euro area, and macroeconomic data on growth outlook.

The spot price of gold in US dollars picked up by 25.5 per cent on an annual basis. It varied between USD 806 and 1214 per troy ounce, the average rising to USD 974 on USD 872 in 2008. This was mostly because of falling investor risk appetites, inflation concerns, and USD rate movements.

### US Dollar Price in Euro



Source: BNB.

### One Troy Ounce Gold Price in US Dollars



Source: BNB.

### One Troy Ounce Gold Price in Euro



Source: BNB.

## Major Types of Risk

Over the review period BNB international reserves were invested to long term risk tolerances of VaR = 0 per cent at 95 per cent<sup>23</sup> confidence as regards the net value<sup>24</sup> in the Issue Department balance sheet. Set early in the year, these tolerances proved untenable in the second quarter due to the increased amount of gold in the reserve and extreme gold price fluctuations amid the capital market crisis. The Governing Council then set risk tolerances within the -2.5 to 0 per cent band until the long-term risk tolerance became attainable. The temporary tolerances remained in force until the year's close.

Over the reporting period gross international reserve **interest rate risk** measured by average modified duration was almost 0.83 against 0.50 in 2008. The increase was because of anticipated international financial market changes and because the interest rate restriction on euro assets with six month durations ended in early 2009.

A BNB Law stipulation (that absolute value of open foreign currency positions<sup>25</sup> in currencies except the euro, SDR, and monetary gold should not exceed 2 per cent of the market value of monetary liabilities in these currencies) constrained gross international reserve currency risk. Open positions in currencies other than the euro stayed at a minimum over the reporting period. The open monetary gold position posed the major currency risk to the Bank.

Over the year the Bank gradually dropped earlier temporary measures against international reserve **credit risk**. This became possible as financial markets stabilised after interventions by the governments of major world economies gradually restored confidence and injected significant additional liquidity. In early 2009 a new class of assets joined existing investment opportunities. Emerging in late 2008 as part of the aforementioned measures, it was short- or long-term debt issued by private institutions or governments under unconditional and irrevocable state guarantee. This asset class quickly attracted institutional investors, turning into an alternative to government securities.

In 2009 many leading financial institutions had serious difficulty with short-term liabilities, suffering successive credit rating downgrades. The credit limits for all the Bank's long-standing counterparties were cut, with some deleted from the list. Over the year exposure to non-resident counterparty banks fell to 11 per cent of total assets against 14 per cent in 2008. Funds invested into assets with the highest long-term credit rating (AAA) averaged 51 per cent.<sup>26</sup>

Strict attention to investment restrictions and international reserve management procedures contained **operational risk**.

A new system developed in early 2009 restricts **liquidity risk** by making receipts of large international reserve outflows more timely at acceptable transaction costs amid illiquid financial markets.

## Yield and Efficiency

At the start of 2009 the Bank removed the international reserves interest rate restriction that was imposed in 2009 on assets with maximum durations of six months. Its deletion reflected international conditions, particularly the close-to-zero interest rate policies of leading economies. The maximum duration of the euro-denominated asset benchmark rose from around 0.5 to 0.83.

Over the review period BNB income from international reserve investment came to EUR 286 million: a 2.47 per cent yield. Currency imbalance yield<sup>27</sup> was EUR 172 million mainly because there was monetary gold in international reserves. Interest on Issue Department balance sheet liabilities<sup>28</sup> was EUR 14 million. Overall net earnings from BNB international reserve management came to EUR 443 million: a 3.78 per cent net yield.

<sup>23</sup> Net value risk measured by VaR=-X% (X>0) at 95 per cent confidence level and allowing for normal yield allocation means that 95 per cent of the time maximum net value loss would not exceed X per cent.

<sup>24</sup> "Net value" means the Issue Department balance sheet item Banking Department deposit.

<sup>25</sup> An open foreign currency position is the difference between the values of assets and liabilities in any currency other than euro.

<sup>26</sup> 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 have to have one of the above ratings assigned by at least two internationally recognised credit rating agencies.

<sup>27</sup> Currency imbalance yield is the sum total of the effects of exchange rate movements on asset and liability open foreign currency positions.

<sup>28</sup> Data on Issue Department liabilities are not entered directly into the information system for international reserve management, being provided *via* the accounting system interface.

**Earnings and Profitability of International Reserves in 2009**

(million EUR)

Quarters	Earnings, net (1)+(2)+(3)	Investment earnings (1)	Earnings from currency imbalance between assets and liabilities (2)	Expenditures (interest) on liabilities (3)
I	189.33	117.50	81.17	-9.34
II	19.99	68.32	-44.54	-3.79
III	104.48	70.80	34.99	-1.31
IV	129.42	29.32	100.05	0.05
Earnings, total	443.23	285.95	171.67	-14.39
Profitability, total, %	3.78	2.47	1.45	-0.14

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 by base currency and investment goal. Each portfolio has a benchmark, investment objectives, and restrictions. The table below lists major BNB portfolios and management outcomes.

**Profitability and Risk of Portfolios in 2009**

Portfolio	Portfolio's base currency	Profitability		Risk (Volatility)		Information coefficient***
		Absolute (%)	Relative (basis points)*	Absolute (basis points)	Relative (basis points)**	
Investment 1	EUR	2.63	67	52	20	3.33
Investment 2	EUR	3.09	113	55	21	5.24
Liquidity	EUR	0.63	7	3	1	4.65
Liquidity	USD	0.40	24	14	14	1.64
External manager A	EUR	3.88	22	127	11	1.96
External manager B	EUR	4.05	-14	120	41	-0.34

\* 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 profitability 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.

External managers at international financial institutions managed 6.11 per cent of BNB gross international reserves. Besides additional diversification, using them helped build expertise in international investment management.

Liquid portfolios assisted immediate payment needs. 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 teams.



## III. The National Payment System

The Law on the Bulgarian National Bank entrusts the Bank with organising, supporting, and developing payment systems by operating and overseeing efficient payment mechanisms. Reducing systemic risk and integrating Bulgaria's payment system into the euro area payment infrastructure were among the Bank's major goals.

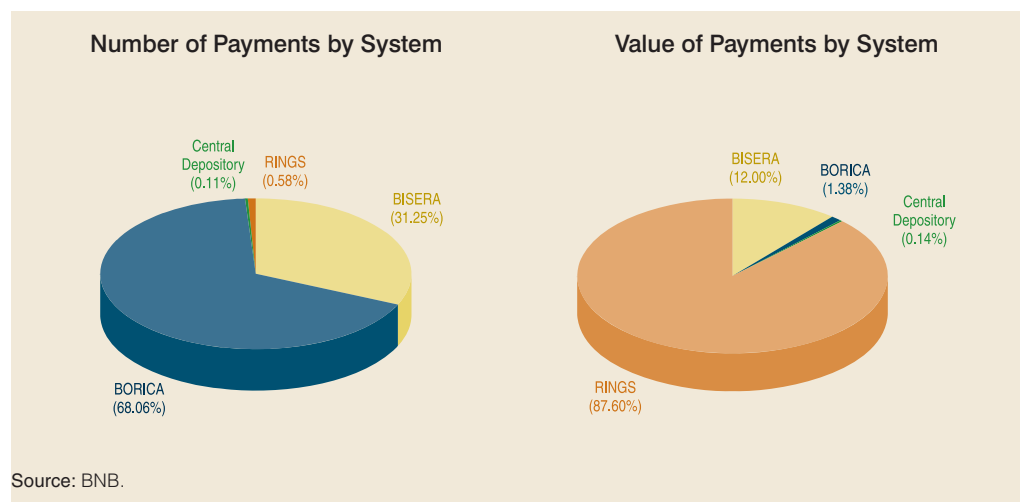
Bulgaria's payment systems are:

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

Bulgaria's securities settlement systems are:

- The BNB system for registering and servicing payments for book-entry government securities;
- The Central Depository system for registering and servicing payments for book-entry securities.

### Distribution of Payments in Bulgaria



In 2009 RINGS processed over 87 per cent of Bulgarian payments. Values around 80 per cent are considered optimal for such systems. RINGS processed 0.6 per cent of non-cash payments.

Over the year BORICA payments rose by 5.9 per cent in number and 3.2 per cent in value on 2008. This reflected growing consumer use of bank cards for easy access to bank accounts in paying and drawing cash. The rise in POS terminal use continued.

BISERA transactions in 2009 fell by 2.3 per cent in value and 4 per cent in number on 2008.

The global financial crisis hit equity trading in 2009 as shown by the drop of Central Depository transactions by value (by 32.8 per cent) and number (by 47.7 per cent).

The SEP's share of Bulgarian transactions declined significantly in 2009. Only certain Bulgarian banks participate in the system. Mobile payments are a novelty in Bulgaria. They supplement traditional payment methods and broaden the range of payment options banks offer. This, and high payment security, should expand their share of Bulgarian payments.

## 1. The RINGS Real-time Gross Settlement System

Processing most payments by value through RINGS cuts risks in the payment system: one of the Bank's major goals. In 2009 the system processed 993,375 payments totalling BGN 698,663 million. Compared with 2008, the daily average number fell by 9.2 per cent and daily average value declined by 11.8 per cent. The number of participants remained unchanged at 30.

In 2009 34 per cent of payments were processed by noon and 73 per cent by 2:30 pm. As regards system traffic, 86 per cent of RINGS payments were effected by 2:30 pm.

During the year no payments were rejected by the close of a RINGS' system day due to insufficient funds, indicating good liquidity management by banks. There was no call for radical BNB intervention to provide participants with liquidity. There was no recourse to the Reserve Collateral Pool: an interbank insurance mechanism to guarantee settlement of payment and securities system operators' orders.

In 2009 RINGS offered 99.99 per cent availability<sup>29</sup>: an increase on 2008.

## 2. Regulatory Changes

The Law on Payment Services and Payment Systems, adopted in March 2009, transposed Directive 2007/64/EC of the European Parliament and the Council on Payment Services in the Internal Market. Entering into force on 1 November 2009, it replaced the Law on Fund Transfers, Electronic Payment Instruments and Payment Systems.

Ordinance No 3 on the Terms and Procedure for the Execution of Payment Transactions and Use of Payment Instruments, Ordinance No 13 on the Application of International Bank Account Numbers and Bank Identifier Codes, and Ordinance No 16 on Payment Institutions and Payment System Operators Licensing entered into force on 1 November 2009. They reflect changes in payment legislation and practices introduced by the Law on Payment Services and Payment Systems.

## 3. Payment System Developments

The National Payment Systems Council sat on 6 February 2009. It is an advisory body representing the BNB, the Ministry of Finance, the Association of Banks in Bulgaria, and system operators. Its brief is to organise and coordinate Bulgaria's integration into euro area payment systems and the Single Euro Payments Area (SEPA). The Council discussed coming priorities, timescales for developing Bulgaria's payment systems and instruments, and legislative issues.

The Council recommended that the BNB, the Ministry of Finance, banks, and system operators continue developing the national standard and lev payment instruments to European Payments Council requirements while maintaining the current volume and level of information security for budget purposes.

The BNB and banks actively worked towards joining the TARGET2 real time gross settlement system for euro payments on 1 February 2010. The national system component, TARGET2-BNB, and related legal, business, and technical tasks were successfully implemented.

<sup>29</sup> The ratio of time when TARGET is operational to TARGET operating time.

## 4. Payment System Oversight

Limiting system risk and improving payment systems' reliability and efficiency were the major supervision goals. They were pursued through monitoring adherence to Bank for International Settlements, International Organization of Securities Commissions, European Central Bank, and European System of Central Banks standards and recommendations.

Under the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems, the BNB updated the licences of payment operators Bankservice AD, BORICA AD, and SEP Bulgaria AD.

Between November 2008 and May 2009 the Bank conducted a supervisory inspection at the United Bulgarian Bank AD with regard to open loan bank cards and acceptance of Transcart AD non-bank payment cards by UBB terminals. The BNB recommended that payment should be through merchants' bank accounts at commercial banks which accept payments from Transcart AD POS terminals.

Between May 2009 and June 2009 the BNB conducted a supervisory inspection at Investbank AD with regard to payment card issue and the acceptance Transcart AD non-bank credit cards at Investbank terminals. The BNB recommended that Investbank AD should update its general terms and conditions for electronic payments.

Between September 2009 and November 2009 the Bank conducted a supervisory inspection at M Secured OOD with regard to possible cash transfers under BNB Licence No 4702-10498 of 30 October 2008. The inspection established that M Secured OOD had not transferred cash under the Licence.

On 23 April 2009 the BNB Governing Council deliberated SOCCRAT EAD's application for a system operator's licence under Articles 61 and 62 of the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems. Finding that the applicant failed to fulfil some payment system operator requirements, the Council refused the application.

## N. Bank Reserves at the BNB

By the end of 2008 the BNB took measures to facilitate banks' liquidity management as a follow-up of its anti-cyclical policy. Amendments were made to Ordinance No 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks:

- 1) recognizing 50 per cent of cash in vaults as reserve assets, which gave banks easier access to their reserves with the BNB (with effect as of 1 October 2008).
- 2) reducing the minimum required reserves on all funds attracted by the banks from 12 per cent to 10 per cent as of 1 December 2008.
- 3) reducing the minimum required reserves on funds attracted by banks from abroad from 10 per cent to 5 per cent and removing the minimum reserve requirements on funds attracted from state and local government budgets as of 1 January 2009.

Regardless of the unfavourable environment the average amount of banks' attracted funds increased on 2008 by 1.12 per cent (with a decrease in lev liabilities of 8.04 per cent and an increase in those in foreign currency of 7.44 per cent). Meanwhile the reserves due on these funds contracted by 32.8 per cent on the previous year as a result of the above listed amendments to Ordinance No 21.

Banks reserve assets in levs remained at their 2008 levels, while foreign currency reserve assets fell to less than 47 per cent on the prior year, their relative share fluctuating between 42.45 per cent and 49.56 per cent. Banks' excess reserves went up by more than 47 per cent and exceeded the 1 per cent share of total reserves maintained for many years.

The main instruments used by banks to manage short-term liquidity were BNB foreign currency sales with the same-day value date and simultaneous spot purchase and over-night interbank market transactions.

In order to facilitate banks' access to their resources with the BNB in the last quarter of 2008 the methodology used to calculate the penalty interest rate in the event of non-compliance with the requirements of Ordinance No 21 was changed as follows:

- The penalty interest rate under Article 11, paragraph 4 for using more than 50 per cent of reserve assets on a certain day was abolished. In such cases the banks should pay to the BNB penalty interest equal to LEONIA for the respective day;
- the Article 13 penalty minimum reserve shortfalls if 1.12<sup>th</sup> was replaced by pay interest on the shortfall equal to the average LEONIA for the maintenance period.

In 2009 banks made use of these opportunities, paying the BNB BGN 400,485.53 in levies on released funds required under Ordinance No 21.

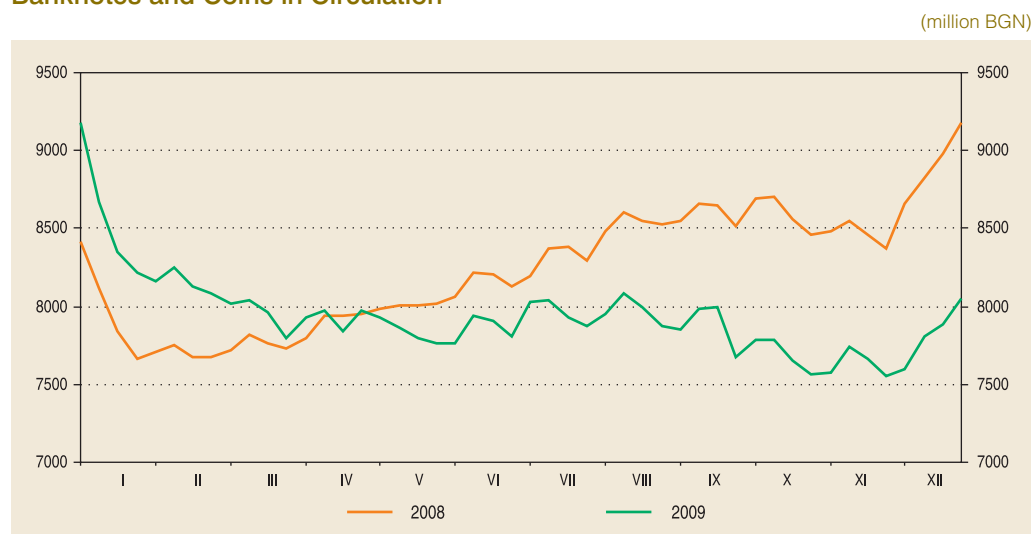
## V. Cash in Circulation

### Banknotes and Coins in Circulation (Outside BNB Vaults)

The Bulgarian National Bank has a monopoly on banknote and coin issue in Bulgaria.<sup>30</sup> 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.

At the close of 2009 cash in circulation<sup>31</sup> came to BGN 8049.1 million in nominal terms, down BGN 1130.3 million or 12.31 per cent on the end of 2008.

### Banknotes and Coins in Circulation



Source: BNB.

By end-2009 the share of banknotes was 98.05 per cent of the total value of cash in circulation: a 0.35 percentage point decrease at the expense of an increased share of circulating and commemorative coins by 0.34 and 0.01 percentage points. The number of banknotes in circulation was 310.5 million with a total value of BGN 7892.1 million. This decreased by 47.7 million (13.32 per cent) and its nominal value by BGN 1140.0 million (12.62 per cent) on the prior year.

By denomination, at the end of 2009 BGN 20 banknotes occupied the largest share at 33.02 per cent of banknotes in circulation and numbered 102.5 million. In a year, the shares of BGN 100, BGN 20 and BGN 2 banknotes in circulation increased by 0.85, 0.05, and 1.24 percentage points. The nominal value of BGN 50 banknotes was BGN 2650.9 million, giving them a lead at 33.59 per cent of the total value of banknotes in circulation, followed by the shares of BGN 100 and BGN 20 banknotes at 28.97 per cent and 25.99 per cent.

The average banknote in circulation at the end of 2009 was worth BGN 25.42, up BGN 0.21 or 0.82 per cent, mainly because of the growth of the share of BGN 100 banknotes at the expense of other denominations.

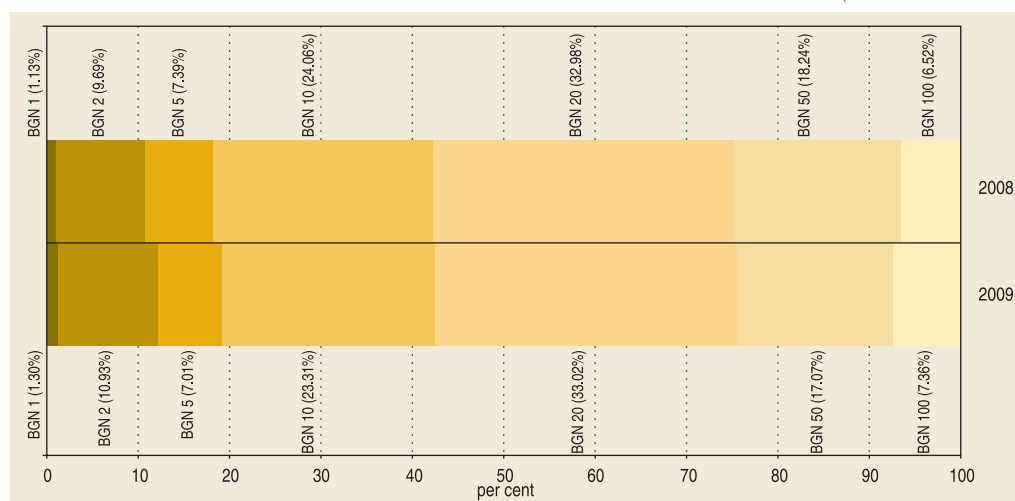
At the close of 2009 the number of circulating coins was 1138.0 million with a total value of BGN 152.0 million. In a year they increased by 110.6 million (10.77 per cent) and their value by BGN 9.1 million (6.40 per cent). Changes in the structure of circulating coins followed the long-term downward trend in higher value coins and the upward trend in lower value coins.

<sup>30</sup> Article 2, paragraph 5 and Article 25 of the Law on the BNB.

<sup>31</sup> 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 were deducted from cash in circulation.

### Denomination Composition by Number of Circulating Banknotes

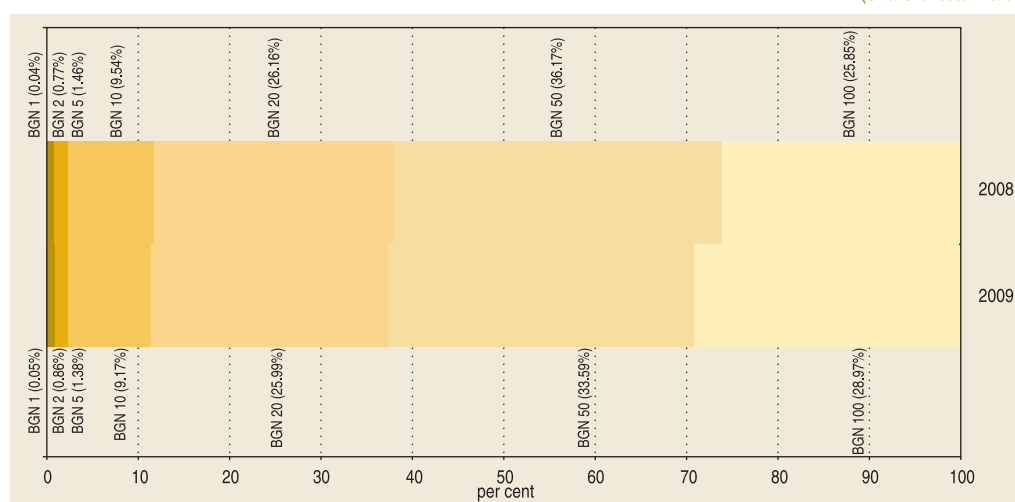
(share of total number)



Source: BNB.

### Denomination Composition by Value of Circulating Banknotes

(share of total value)



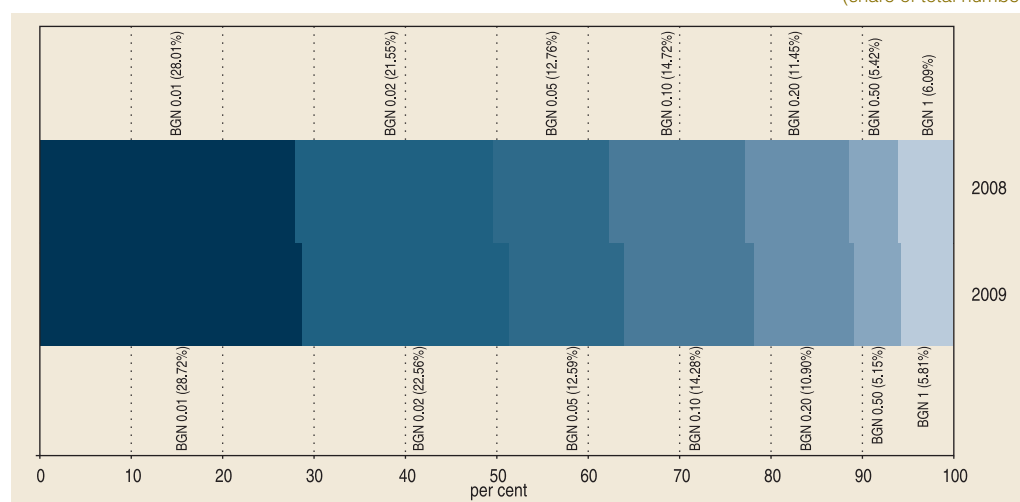
Source: BNB.

In a year, the share of BGN 0.01 and BGN 0.02 coins among coins in circulation rose by 0.71 and 1.01 percentage points, while that of BGN 0.05, 0.10, 0.20, 0.50, and BGN 1 declined by 0.17, 0.44, 0.56, 0.27, and 0.28 percentage points respectively. The share of coins came to 1.89 per cent of the total value of cash in circulation. BGN 1 coins had the largest share at 43.49 per cent of the total value of circulating coins, followed by BGN 0.50 and BGN 0.20 coins with 19.27 per cent and 16.31 per cent shares. In a year, the average coin value dropped by BGN 0.01 or 7.14 per cent to BGN 0.13.

The share of commemorative coins in circulating cash was 0.06 per cent, up 0.01 percentage points on an annual basis, reflecting mainly the drop in the value of circulating banknotes.

### Denomination Composition by Number of Circulating Coins

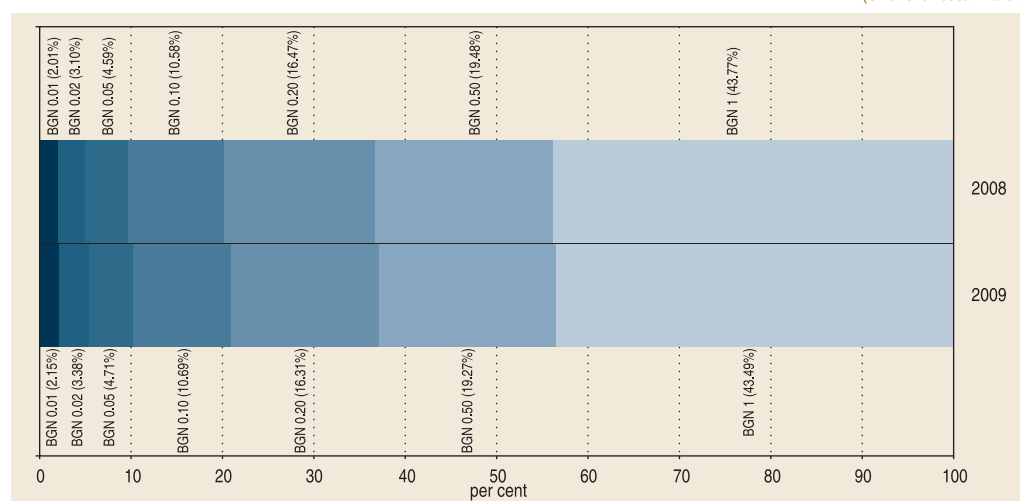
(share of total number)



Source: BNB.

### Denomination Composition by Value of Circulating Coins

(share of total value)



Source: BNB.

#### Non-genuine Banknotes and Coins

In 2009 the number of non-genuine Bulgarian banknotes retained and removed from circulation was 14,784, up 5997 on 2008. Their share of the total number of circulating banknotes was 0.00476 per cent. BGN 20 banknotes had the largest share of all retained non-genuine banknotes at 82 per cent, followed by BGN 50 (15.25 per cent) and BGN 10 (1.52 per cent). Reported non-genuine BGN 2, BGN 5 and BGN 100 banknotes numbered 183 (1.23 per cent). The review period saw authenticity evaluations of 794 non-genuine coins, including 780 BGN 0.50 and 14 BGN 1 coins.

Evaluating suspect foreign cash, in 2008 the BNB retained 9233 euro, 1620 US dollar, and 206 other banknotes.

The BNB provides timely guidance to the public and cash handlers on spotting non-genuine and counterfeit banknotes. The Bank regularly updates information on newly reported non-genuine Bulgarian banknotes, and tips on how to identify them. The BNB trains professional cash handlers to counteract the spread of non-genuine cash.



**BNB Issue  
and Cash  
Activities**

The BNB performs its issue and cash functions by printing new banknotes, processing incoming banknotes and coins, safeguarding Bulgarian cash and foreign currency, and exchanging and destroying unfit Bulgarian cash.

In 2009, printers and minters supplied 185.2 million new banknotes and 150 million new coins worth BGN 3683.9 million. The Bank launched the four commemorative coins planned in its 2009 minting programme<sup>32</sup>. As part of consistent attention to counterfeit protection, in 2009 the BNB circulated a new BGN 5 banknote. It has improved counterfeit protection while retaining the size, design, and colour of the 1999 BGN 5 banknote which remains legal tender.

Cash deposited with and withdrawn from the BNB totalled BGN 22,895.6 million in 2009. Banks deposited BGN 12,013.2 million of cash with the BNB: down BGN 333.0 million or 2.70 per cent on 2008. Over the same period the BNB issued Bulgarian cash worth BGN 10,882.4 million: down BGN 2223.2 million or 16.96 per cent on the prior year. In 2009 average recirculation of banknotes at BNB tills picked up on the previous year to 2.2 times per annum.

To maintain the quality of banknotes and coins in circulation, in 2009 sorting machines tested 665.2 million banknotes and 107.6 million coins. Compared with 2008, the number of processed banknotes decreased by 62.5 million (8.59 per cent), while that of coins increased by 45.3 million (72.83 per cent). BGN 10 and BGN 20 banknotes and BGN 0.10, BGN 0.20 and BGN 1 coins were most frequently processed.

Unfit banknotes retained in processing numbered 100.7 million: down 8.6 million (7.84 per cent) on 2008. In 2009 the share of unfit banknotes in total banknotes processed by the BNB remained close to the previous year's 15 per cent. In a year, processing and fitness checks revealed 0.3 million unfit coins, down 0.76 per cent on 2008.

In 2009 BNB reserve currency purchases came to EUR 1.5 million, including EUR 0.5 million from budget entities and EUR 1 million from individuals. Over the same period BNB reserve currency sales were EUR 39.4 million, including EUR 9.4 million to budget entities and EUR 30 million to individuals.

During the year the BNB consistently applied legislation on banknote and coin quality and recycling. The Bank checked the functionality of sorting machines used by banks and other cash handlers. In line with statutory requirements, the Bank regularly updated the roll of sorting machines and customer-operated machines which meet manufacturer and BNB identification and fitness standards.

Construction and equipment of the new BNB cash centre in Sofia progressed to schedule.<sup>33</sup>

<sup>32</sup> Information on new banknotes and circulating and commemorative coins appears on the BNB website.

<sup>33</sup> The new BNB cash centre has offered standard services to customers since early April.

## VI. Maintaining Banking System Stability

### 1. State of the Banking System

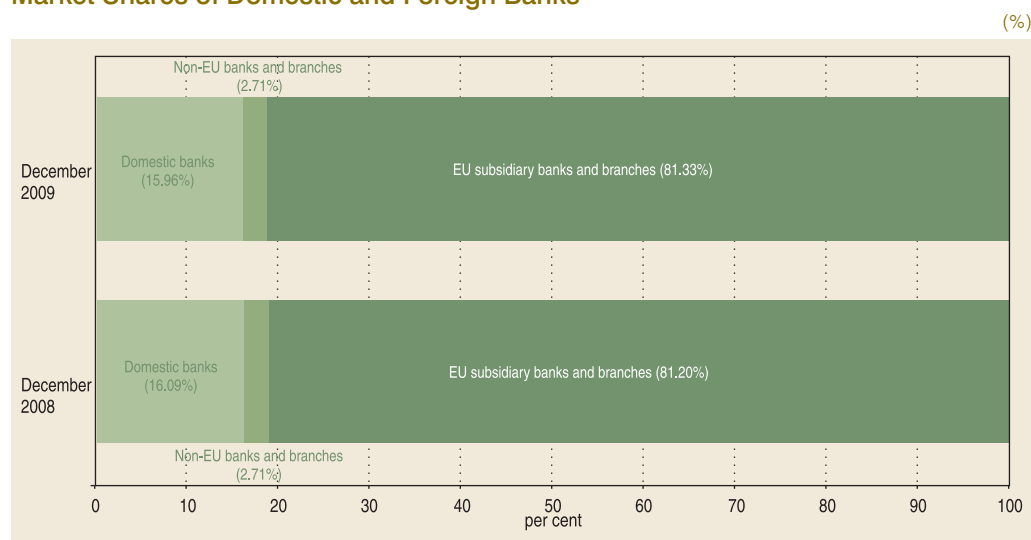
In 2009 Bulgaria's banking system remained stable. Major financial indicators reflected both the anti-cyclic measures taken by the BNB in recent years and action by institutions to offset the crisis. Over the year Bulgaria's banks preserved their profit potential, retained good liquidity, and strengthened capital. Despite worsening loan portfolio quality, they managed to allocate provisions adequate to the risk in their portfolios, strengthening protection against credit risk. Managements focused on tackling loan quality, attracting funds, and cutting costs. As a result Bulgaria's banking system ranked among the best in the EU<sup>34</sup>. This is particularly notable since no Bulgarian institution received any government support, unlike those in most Member States. Banks preserved their 2008 asset levels and increased lending marginally amid a significantly worse business environment.

#### Structural Changes in the Banking System Balance Sheet

Changes in the business climate altered the structure of assets and liabilities somewhat.<sup>35</sup> In 2009 the share of loans and advances grew, while that of government securities portfolios (up to 6.3 per cent of the balance sheet) fell. Changed minimum required reserves did not lead to a significant decline in monetary funds which accounted for 9 per cent by the end of 2009. Within a one-year horizon attracted funds featured an increase in the share of domestic resources, mostly from individuals. Total banking assets rose 1.8 per cent or BGN 1.3 billion on 2008, coming to BGN 70.8 billion by the year's close.<sup>36</sup>

The market share of the big five banks grew by a percentage point to 58 per cent on an annual basis. There were no changes in institutions' proprietorships. The strengthened market position of the big five boosted the share of EU subsidiaries from 76.3 to 76.9 per cent, while that of branches of foreign banks from the EU dropped to 4.5 per cent. By the end of 2009 Bulgaria had 30 credit institutions, reflecting sustained and strict BNB licensing of new banks.

#### Market Shares of Domestic and Foreign Banks



Source: BNB.

<sup>34</sup> For instance, the latest averaged data on large complex bank groups (LCBG) show ROE (6.41 per cent), ROA (0.26 per cent), and capital adequacy (13.50 per cent) lower than reported by banks in Bulgaria. Similar patterns emerge from comparisons of Bulgaria's banking system with those of several non-euro area Central and Eastern European Member States. Bulgarian banks are among those reporting the lowest values of non-performing loans and correspondingly the best capital adequacy ratios and very good ROE.

<sup>35</sup> The insignificant difference in banking system indicators here and in Chapter I is down to methodological differences in data for supervisory and statistical purposes. Monetary statistics data is used in Chapter I.

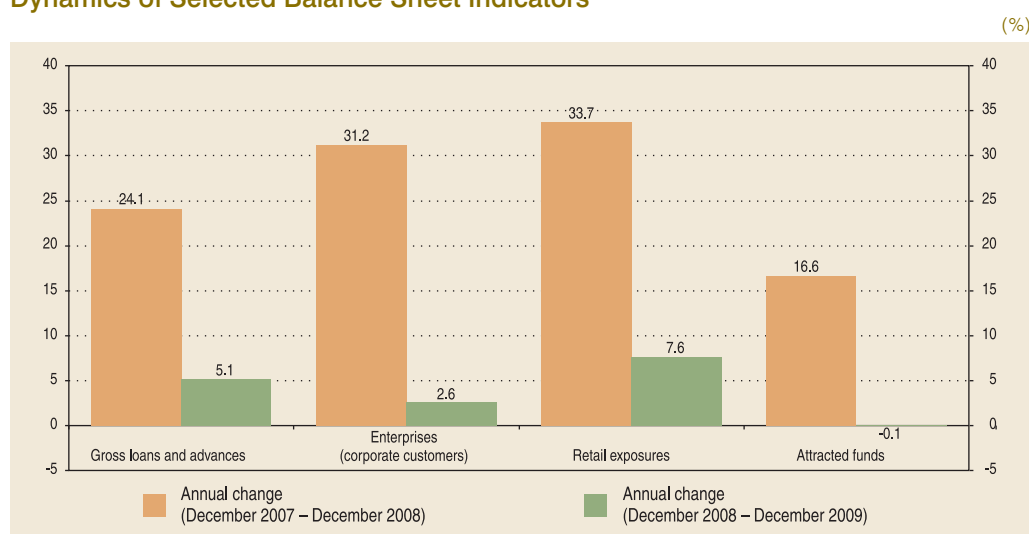
<sup>36</sup> The analysis and charts include audited data.

Domestic institutions and non-EU banks and branches retained their 2008 shares at 16 per cent and 2.7 per cent of banking assets by December 2009.

## Lending

In 2009 lending was subject to demand and supply side factors. Worsening business conditions sharply reduced solvent demand for credit. Banks reacted by tightening lending criteria, further restricting loan growth. Nevertheless, gross lending did grow in all portfolio segments, with total loans (excluding those to credit institutions) rising by 4.5 per cent (BGN 2.3 billion)<sup>37</sup>. Retail exposures rose by BGN 1.3 billion (7.6 per cent). Mortgages grew faster than consumer loans at 8.4 per cent. Loans to companies increased by BGN 0.8 billion (2.6 per cent), medium and small banks contributing most. The share of corporate loans in gross loans and advances dropped to 54.7 per cent. In 2009 the lev component of the credit portfolio continued falling gradually. By the end of 2009 euro loans and advances reached 57.9 per cent, lev loans and advances 38.5 per cent, and other currencies 3.6 per cent.

## Dynamics of Selected Balance Sheet Indicators



## Attracted Funds

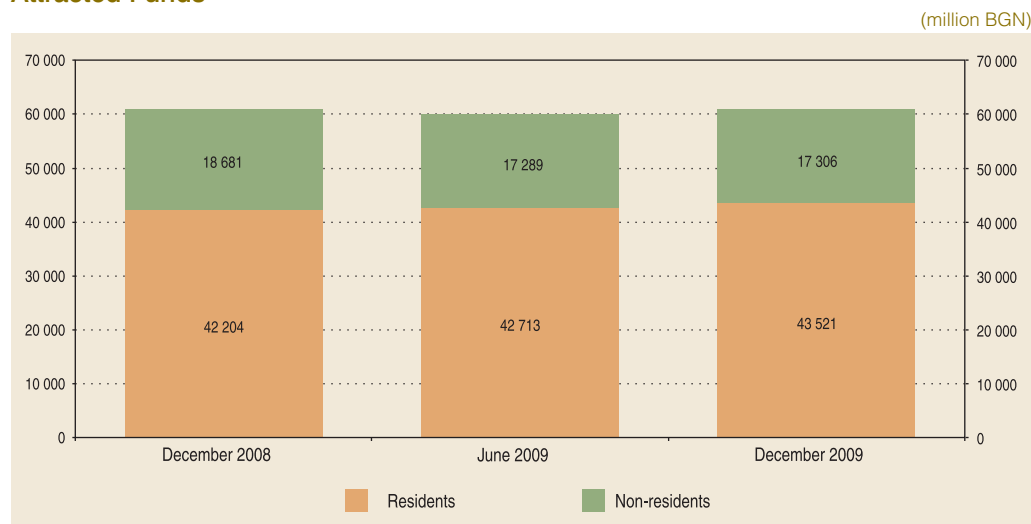
The amount of attracted funds matched the level of late 2008. The sources of funds changed. Because of lower lending and limited opportunities for foreign parent companies to invest, funds from non-resident institutions declined, as did those from other businesses. Individual and household deposits grew by BGN 2.7 billion (12.1 per cent), entirely offsetting this. Banks changed their product policies by raising deposit rates and boosting fixed interest funds. Despite a gradual interest fall in the last quarter of 2009 individuals' deposits grew faster, their share reaching 40.8 per cent of total attracted funds by the close of the year. The shares of funds from credit institutions and corporates fell to 0.25 and 30.7 per cent respectively. As regards financing sources the substitution was accompanied by an increase in the amount and number of deposits covered by the Deposit Insurance Fund.

The lev component contracted across banking's balance sheet liabilities. By December 2009 the euro component comprised 58.7 per cent of total attracted funds, the lev component 35.4 per cent, and other currencies 5.8 per cent.

The share of non-residents' funds in total attracted funds did not change much at 28.5 per cent at the close of 2009 on 30.7 per cent a year earlier. These funds' contribution to loan financing (excluding loans to credit institutions) declined by 4 percentage points to 33 per cent over the year.

<sup>37</sup> Growth was registered irrespective of the effect of the repurchased loans amounting to BGN 1.5 billion.

### Attracted Funds



Source: BNB.

### Balance Sheet Equity

Balance sheet equity grew much faster than assets and loans over the year, rising by BGN 1.5 billion or 19 per cent. This followed BNB recommendations for banks to maintain higher primary capital minima and capitalise profits to boost surplus capital. Over 2009 equity issues grew by BGN 700 million, premium reserves by BGN 45 million, and revaluation reserves by BGN 126 million.

Despite increased impairment costs and limited revenue opportunities banking reported BGN 752 million of profits in 2009. Though 45 per cent down on 2008, this created an additional cushion against shocks.

The movements and composition of banks' balance sheet items in 2009 give grounds for confidence that despite the impact of worsening trading on banking, the sector rests on firm ground.

### System Risk Profile

Banking's risk profile directly reflected the economic travails experienced by Bulgaria in 2009 through:

- increased credit risk acuity, especially at individual credit institutions;
- decreasing revenue due to narrower interest margins and increased impairment costs due to worsened credit quality;
- increasing capital to absorb shocks after BNB and in-house measures amid negative credit portfolio trends;
- managing liquidity to ensure client service, with growing deposits from individuals and households reflecting sustained confidence in banking stability.

### Asset Quality

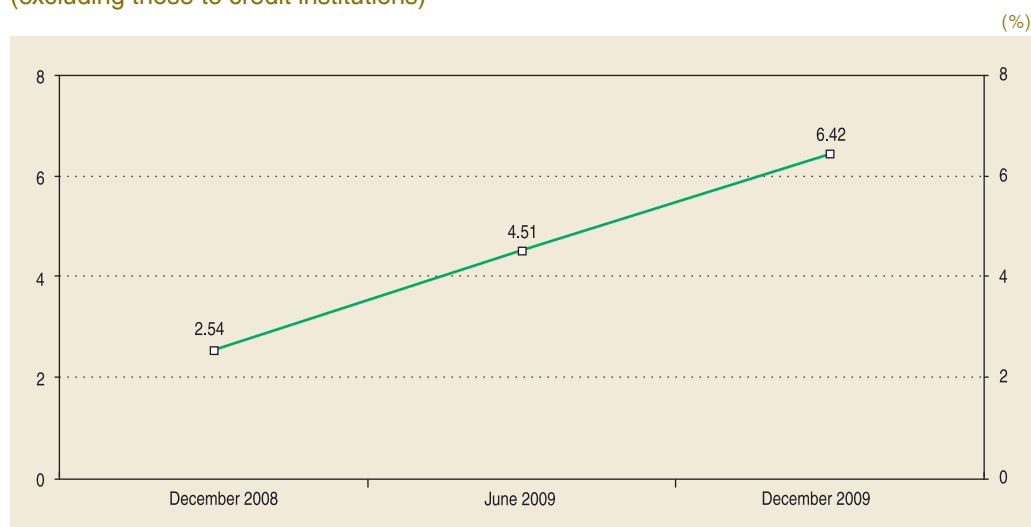
Loan servicing was the principal difficulty experienced by the system and individual banks. Classified assets rose some 2.5 fold against a growth by 71 per cent in the 2007–2008 period. Loan quality worsened throughout 2009, with the share of loans past due over 90 days reaching 6.4 per cent.

Banks worked to optimise loan repayment by offering facilities on concluded agreements, particularly in the second half of 2009. This increased the number and volume of renegotiated exposures to 24 per cent of gross loans (excluding loans to credit institutions).

The conservative approach to security encouraged by the BNB and followed by banks since before the crisis offered additional protection. Despite falling housing prices the cover of extended mortgages averaged 62 per cent for the banking system (*e. g.*, the value of mortgaged properties exceeded the amount advanced by 38 per cent) by late 2009.

Banks' provisions against impairment and credit risk reached some 81 per cent of loans past due over 90 days by the end of 2009.

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



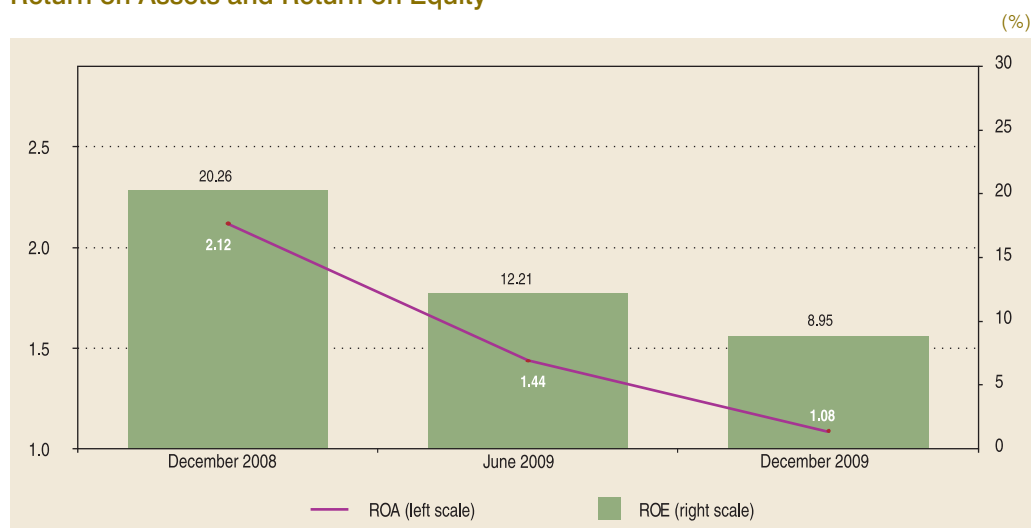
Source: BNB.

### Profitability

Despite the business environment banks made profits of BGN 752 million. Worsening loan quality exerted the strongest pressure on 2009 revenues and impairment losses grew three-fold to over BGN 1 billion. Nevertheless, gross operating income for 2009 was BGN 1899 million, a 2.35 per cent (BGN 43.5 million) increase on 2008.

Net interest income remained the major profitability driver, its volume by the close of 2009 practically matching that of 2008. Revenues successfully withstood the pressure of sharpening risk on portfolios and helped generate capital and liquidity. A lower financial result, however, depressed return on assets and return on equity. ROA went down from 2.12 to 1.08 per cent for the year and ROE from 20.26 to 8.95 per cent, with the parallel growth of equity adding to the downward effect. The returns were nevertheless higher than in many EU banking systems and match pre-crisis ROA and ROE levels typical of many larger and more advanced banking systems.

### Return on Assets and Return on Equity

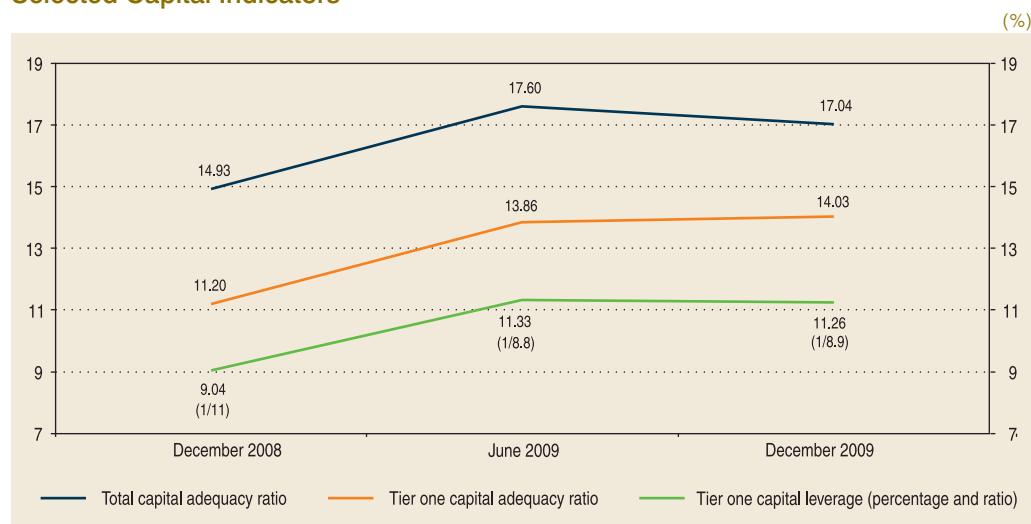


Source: BNB.

## Equity

System regulatory capital is healthy and in keeping with credit institutions' risk profile. Banks continued strengthening their capital potential to absorb shocks. In 2009 the capital base benefited from the capitalisation of 2008 profit and increased paid-up equity and tier two capital. The slowdown in lending and correspondingly slower growth of capital requirements for credit risk also contributed to the stability of banks' equity. By the end of 2009 the total capital adequacy ratio rose to 17.04 against 14.93 per cent in late 2008 and the system's capital surplus over the 12 per cent regulatory minimum was BGN 2.8 billion. BNB recommendations for 10 per cent minimum primary capital drove tier one capital adequacy up to 14.03 per cent at the end of 2009. Leverage also improved. While at the end of 2008 a unit of tier-one capital supported 11 units of assets, by 2009 it supported 8.9.

### Selected Capital Indicators

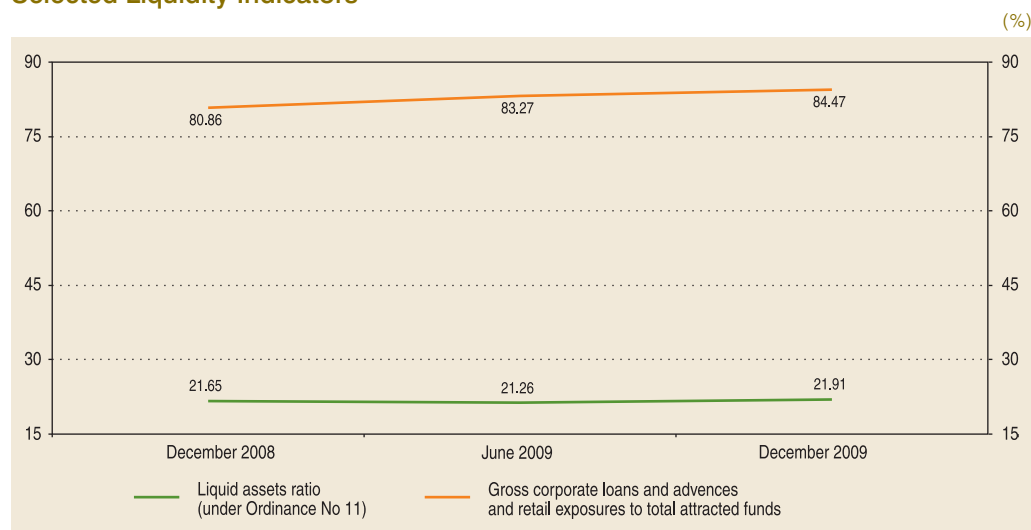


Source: BNB.

## Liquidity

Banking's liquid assets ratio improved over 2008 to reach 21.9 per cent by the end of 2009. All banks had sufficient liquidity for normal functioning. They followed BNB recommendations on liquidity minima relative to corporate and individual deposits as an additional guarantee of adequate coverage of attracted funds. Increased balances on accounts and demand deposits exceeded the fall in monetary funds. By the end of 2009 system liquid assets reached BGN 13.4 billion, covering 31 per cent of funds attracted from corporate customers, individuals, and households.

### Selected Liquidity Indicators



Source: BNB.

## 2. Compliance with Prudent Banking Requirements

In early 2009 the BNB recommended additional measures to boost capital and liquidity and control spending. Monitoring of credit institutions' performance through regular analyses of off-site reports and on-site inspections showed violations and deviations from supervisory regulations and BNB recommendations. Relevant supervisory corrective actions were initiated.

<b>Capital Adequacy</b>	No bank reported a dip beneath the 12 per cent statutory minimum total capital adequacy ratio. Supervisory measures forced individual banks to match their capital bases to their risk profiles.
<b>Large Exposures</b>	Throughout 2009 several breaches on individual large exposures and lending to economically related parties led to supervisory measures. The remaining credit institutions observed the Law on Credit Institutions Article 44 and BNB Ordinance No 7.
<b>Investment into Fixed Assets</b>	No departure from levels in Law on Credit Institutions Article 47 and BNB Ordinance No 17 was established. The amounts of security acquired by banks on non-performing loans in the form of fixed assets was insignificant and the ratio of total investment was well under limits.

## 3. Banking Supervision

Banking supervisors initiated actions in several major directions in response to the global economic crisis and its effects on Bulgaria's economy.

<b>Supervisory Policy</b>	<p>At the policy level effort was made to reinforce the basis of a flexible and stable banking market by improving national legislation and formulating measures adequate to current market conditions and trends.</p> <p>BNB Ordinance No 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk and Ordinance No 8 on the Capital Adequacy of Credit Institutions were amended. The changes will facilitate bank operations and converge with international practice on classifying and provisioning against credit loss. They provide for renegotiation under existing loan contracts as a better portfolio management practice amid unfavourable conditions. The scope of security also expanded to ensure compliance with credit risk protection in BNB Ordinance No 8.</p> <p>New quarterly and annual report forms provide more information on local and foreign bank financial stability for ESCB purposes. The Bank acknowledged the decisions of the Committee of European Banking Supervisors (CEBS) on bank and investment company manager remuneration and issued instructions on linking remuneration to risks and sustainable results within a medium term.</p> <p>The BNB participated in diverse European committees, supervisory bodies, and international fora on developing EU banking and supervision, dealing with the implications of the crisis, and improving European supervision. Coming up with solutions to the crisis in Europe and developing a new supervisory architecture entailed an intensive exchange of expert opinions, with many experts commenting on the BNB's anti-cyclic measures. Expert capacity was provided for the increased requirements of intersupervisory cooperation in the context of gloom regional forecasts. With international relations intensifying since early 2009, a new Banking Supervision Department division was to coordinate operational supervision with foreign bodies.</p>
<b>Macro-prudential Analyses and Strategies</b>	At the macro level the major objective remained maintaining the main pillar of the financial system – the banking sector – stable. Growing external influence on the system increases its sensitivity to operational risks, calling for continuous improvement of stress testing. This sensitivity was analysed using scenarios assuming diverse risks and sharpness. Taking into account the most pessimistic IMF, EC and ECB forecasts for Bulgaria's



economy, the scenarios assessed potential developments in loan quality and bank equity.

Special surveys provided important information on particular parameters and risk areas, and on bankers' views on the effectiveness of measures. They supplemented reporting data, improving the set of used indicators and expanding opportunities for macro analyses. Assessments of major financial parameters and the results of stress tests and surveys were published in various BNB titles to advise the public on banking performance.

Expert opinions were prepared on issues for deliberation within EU bodies. The Bank exchanged information with the ECB, other international financial institutions, and supervisory bodies under bilateral and multilateral memoranda of understanding.

Progress on the Single Data Depository/Banking Supervision Reports project involved adding supervisory reporting data on banks and registering and financial reporting data under the Law on Credit Institutions Article 3, paragraph 2.

### **Credit Institutions Supervision**

Structural and functional changes in 2009 synchronised off-site and on-site supervision better. Supervision frequency, intensity, and efficiency increased within available resources. The system's risk profile and risk management at individual banks emerged from monthly performance analyses, banks' reports, and on-site inspections. Ongoing reviews and assessments provided material for on-site inspections and alerts about underestimated risks and heightened risk to solvency.

In 2009, 36 supervisory inspections were carried out. They focused on credit and liquidity risk management and capital adequacy. Operational risk levels and management were assessed at some institutions. Banks maintained higher than statutorily required solvencies, good liquidities and credit risk management adequate to prevailing conditions. Continuous supervisory reviews found 35 formal regulatory breaches and resulted in 155 recommendations. The year saw a review of credit institutions' own capital adequacy analyses which were assessed as satisfactory.

The BNB participated actively in joint supervision of cross-border bank groups operating in Bulgaria, exchanging experience and supervisory information in compliance with the signed memoranda of understanding and data exchange.

### **Special Supervision**

Neutralising risks stemming from banks' equity structures was a major special supervision priority. The objective was to obtain settled and clear equity holder patterns, to assess the financial standing of equity holders in a timely and unbiased manner, and to survey their capacity to offer support if necessary. The year saw no deviation from good banking practice on equity holder structure clarity and fund origin.

Consistently combating money laundering, terrorist financing, and fraud was also a 2009 priority. The main finding was that banks and financial houses lived up to money laundering prevention through procedures and policies that minimised the risk of handling funds with unclear or criminal origins. Regular contacts with bodies fighting fraud and money laundering developed to EC assessment report guidelines. European supervisory cooperation involved converging supervisory practices against money laundering and terrorist financing. The Council of Europe Committee of Experts on the Evaluation of anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) assessed positively BNB action to prevent the use of banks for fraud and money laundering.

The extensive supply of financial services outside the banking sector prompted changes to the Law on Credit Institutions. They tighten rules and introduce new reporting and monitoring requirements in financial institutions registration and operation.

There was action to converge and develop supervisory practice for improving corporate management in line with new legislation and trends. Indonesian and Chinese regulators and supervisors, among others, received expert assistance under the Technical Assistance and Information Exchange (TALEX) of the European Commission Directorate-General for Enlargement.

**Supervisory  
Administration,  
Licensing, and  
Permits**

The year saw legislative changes relating to bank and financial institution operation. Under Directive 2006/48/EC the approval regime for acquiring large equity stakes in credit institutions in the Law on Credit Institutions was significantly extended and redefined. Non-bank companies which provide financial services (financial institutions) are now subject to registration. The certification of bank executives effective since 1997 gave way to fit-and-proper assessments which are more comprehensive and compliant with international corporate management standards. Bulgarian bank license changes reflected the amendments.

Licensing proceedings opened in late 2008 for Danubius Bank, Bulgaria AD (a joint project of Bulgaria's Alpha Finance Holding and Austria's Hypo Investment Bank AG) ended at the applicant's request. The Bulgarian Acquisition Company II owned by the State General Reserve Fund of the Sultanate of Oman was cleared to acquire 30 per cent of the Corporate Commercial Bank AD.

EU credit institutions advising the BNB of intentions to conduct bank transactions in Bulgaria numbered 170. In Varna a branch of Latvia's Regional Investment Bank opened. Proceedings on closing Bank Leumi, Romania branch in Sofia are in progress. Both branches were opened under the single European passport under which no BNB licence is required.

Despite the worsening economic situation banks did not breach any significant regulations; hence, there were no serious supervisory corrective measures. The major efforts were to boost capital coverage of assumed risks. Recommendations in credit risk and concentration risk management were intended to improve internal rules and improve the monitoring of related groups of borrowers.

## VII. The Central Credit Register

The Central Credit Register stores information on customers' debt to banks and financial institutions. Kept by the Bulgarian National Bank, it provides information and summarises it for BNB needs.

Loans disbursed by banks and financial institutions have to be reported to the Register irrespective of size. Loans to government and the BNB are exempt, as are loans with negotiated eligible excess of payments over the residual (overdrafts) of up to BGN 1000 provided they are classified as standard under BNB Ordinance 9 on the Evaluation and Classification of Bank Risk Exposures and the Allocation of Specific Provisions for Credit Risk.

The Register provides banks and financial institutions with online real-time information on customer debt against fees set out in a BNB tariff. Disclosures comprise the state of current loans and any overdue current or repaid loans for five years back.

The Register is regulated by BNB Ordinance 22. The new version of the Ordinance, in force from 1 October 2009, introduced the requirements of Article 56 of the Law on Credit Institutions. Under them, the Register now also covers financial lessors and lenders who do not take deposits or other reimbursables.

Information to banks and non-bank financial institutions now enables more precise borrower assessments, improving credit risk management. This in turn tightened borrower discipline and is a step towards improving credit decisions and boosting asset quality.

During the last year the trend towards a growing number of loans registered in the Register endured, albeit at lower rates. By the end of December 2009 the Register listed 3,209,731 loans against 3,149,843 at the end of 2008, their balance sheet exposure increasing to BGN 52,452 million on BGN 49,716 million as of 31 December 2008. Borrowers totalled 1,787,803 including 1,686,395 individuals, 8710 professionals and self-employed, 90,122 legal entities, and 2576 foreign persons.

In 2009 banks and financial institutions made 3,070,000 Central Credit Register enquiries, including 2,267,000 on individuals and 803,000 on legal entities. This was 1,481,000 fewer than in 2008 (4,551,000). The monthly average number of enquiries in 2009 was some 256,000 or approximately 11,600 a business day.

## VIII. The Fiscal Agent and State Depository Function

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

In pursuing these functions, the Bank continually develops and improves 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.

Revenue from BNB agency function fees and commissions amounted to BGN 1,335,500 over the reporting year. This was a 7 per cent rise on 2008 and included BGN 810,000 from the Ministry of Finance contracts (against BGN 786,000 in 2008). The 3 per cent rise in MF fees and commissions in 2009 was negotiated under Article 43 of the Law on the Bulgarian National Bank due to the volume and nature of services provided by the Bank, including system maintenance and development.

### Information Service

Under the contract the Bank sends the MF statements on budget entities' account movements and balances. All entities down to municipal level are monitored, as are all accounts: extra budgetary, deposit, foreign currency, and letter-of-credit, in levs or foreign currency, at the BNB and elsewhere. IOBFR generates the statements. In addition, the BNB monitors the daily amounts of security pledged by each budget servicing bank for the MF and tallies it with reported balances.

In summary, on 31 December 2009 the balance of budget entities' bank accounts came to BGN 8473.8 million, of which BGN 7515.7 million<sup>38</sup> in fiscal reserve accounts.<sup>39</sup> A year earlier the respective figures were BGN 9486.5 million and BGN 8148.2 million.

In 2009 the MF advised of two new World Bank credit agreements worth EUR 251 million for inclusion into AS ROAD. That system also recorded MF advice on the decrease in global euro and US dollar bonds on world capital markets after buybacks.

The period under review saw 30 regular payments of EUR 214.2 million<sup>40</sup> on foreign financial obligations. This included EUR 61.0 million principal and EUR 153.2 million interest. On 31 December 2009 total obligations in AS ROAD came to EUR 2409.5 million<sup>41</sup> against EUR 2381.0 million a year earlier.

### Servicing Government Securities Trading

GSAS hosted MF-scheduled auctions for three-month, five-year, and ten-year government securities nominally worth BGN 488.7 million. Of them, BGN 288.0 million (58.9 per cent) were in 2006, 2007, and 2009 five-year tap issues. Since more primary dealers' clients wished to acquire government securities from the primary market, the MF increased the proportion of securities available through non-competitive bids. Average annual yields of three-month, five-year, and ten-year issues attained at auction were 4.16 per cent, 5.00 per cent, and 7.29 per cent respectively.

Demand for government securities remained greater than supply in 2009. Of the 64 primary dealers' bids per average auction, 30 were approved. Bids for ten-year government securities were significantly more numerous at 79, with 33 approved, per average auction. Some 73.3 per cent of bids were *via* the GSAS web bid facility using universal electronic

<sup>38</sup> Balances on foreign currency accounts included in the fiscal reserve are shown in levs at the BNB exchange rate for 31 December 2009.

<sup>39</sup> The minimum amount of the fiscal reserve set in the Transitional and Final Provisions of the 2009 Law on the State Budget of the Republic of Bulgaria for 2009 totalled BGN 6800.0 million.

<sup>40</sup> The payments total is shown in euro at the BNB rate on 31 December 2009.

<sup>41</sup> The payments total is shown in euro at the BNB rate for the respective currency on 31 December 2009.

signatures, with the rest *via* SWIFT. During the auctions there were no system disruptions and system availability was 100 per cent.<sup>42</sup>

ESROT registered government securities primary sales and payments of BGN 1177.7 million<sup>43</sup>, a 33.5 per cent increase on 2008. Of this, newly issued securities amounted to BGN 488.7 million (up 63.8 per cent on 2008), and payments to BGN 689 million (BGN 550.3 million principal and BGN 138.7 million interest). By 31 December 2009 ESROT-reported debt on government securities issued on the domestic market totalled BGN 3009.5 million<sup>44</sup>: a 2.1 per cent fall on 2008.

The nominal secondary market in government securities in 2009 was worth BGN 40,293.0 million. Repo agreements had the largest share (63.0 per cent), followed by blocking and unblocking (25.9 per cent), transactions with or between customers (9.2 per cent), and outright purchases and sales (1.9 per cent). The average weighted yield of repo agreements on current accounts ranged from 1.99 per cent for one day transactions to 2.74 per cent for over 30 day transactions. By holder, the structure of government securities issued on the domestic market by 31 December 2009 was: 58 per cent banks; 25 per cent non-bank financial institutions, companies and individuals; 16 per cent insurers and pension funds; and 1 per cent foreign investors. Compared with 2008 the downward trend in insurers and pension funds continued (a 24 per cent decrease), with insignificant change elsewhere.

The review period saw 10,408 government securities transaction notifications and requests: 2385 through SWIFT (to ISO 15022) and 8023 through ESROT. There were no refusals due to insufficient funds in participants' current accounts. In 2009 ESROT offered 99.5 per cent availability. Contingency rules for interaction between BNB systems handled any issues.

Most blocking and unblocking in home market government securities related to funds in budget entities' accounts under § 25 of the Transitional and Final Provisions of the Republic of Bulgaria 2009 State Budget Law.<sup>45</sup> Average daily nominals of blocked government securities were BGN 853.0 million, EUR 118.2 million, and USD 48.0 million: a BGN 1207.9 million, EUR 127.4 million, and USD 58.8 million decline on the prior year. To secure budget accounts, servicing banks also blocked foreign government securities not registered in ESROT (government securities on external debt) by transfer into dedicated BNB accounts. Average daily nominals here were BGN 347.3 million, EUR 79.9 million, and USD 263.3 million.

By the close of 2009, there were 1637 accounts under BNB Ordinance No 31 on Government Securities Settlement. Of them, 42 were for the MF, 642 for participants' portfolios, 563 for participants' customers, and 390 for encumbered securities. Government securities in these accounts totalled BGN 3009.5 million nominal.

## System Development

In 2009 systems development improved service to the MF and banks through new risk controls. Work began on a supplementary module to IOBFR to curtail manual data entry relating to security and consents for security reductions, to expert recommendations. This would collect the entirety of relevant information from diverse systems and go on to assess requests for releasing government securities pledged as security on external debt. Work also began on a new IOBFR configuration environment to improve primary data collection from banks and speed processing.

GSAS expansion, agreed with the MF in 2009, went ahead to cater for the Ministry's additional bid approval criteria and to prepare new statements on primary dealers' participation in auctions.

<sup>42</sup> The proportion of time when the system is operational to all scheduled operating time.

<sup>43</sup> The lev equivalent of payments on foreign currency denominated government securities issues is shown at the BNB rate on the date of payment.

<sup>44</sup> The payments total is shown in euro at the BNB rate for the respective currencies on 31 December 2009.

<sup>45</sup> Under § 25, paras. 2 and 5, funds in all budget entity (including municipality) bank accounts, deposits, and letters-of-credit in levs and foreign currencies are secured in favour of the MF through blocking Bulgarian domestic and external debt government securities, EBRD EUR-denominated debt securities, EIB BGN- or EUR-denominated debt securities, and claims on BNB bank accounts. 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.

To remove Giovannini Barriers to cross-border securities clearing and settlement, ESROT now advises participants of pending principal and interest payments on government securities. Advice is *via* SWIFT, to ISO 15022 – MT564 Corporate Action Notification and MT566 Corporate Action Confirmation. Fully automatic, they rely on mechanisms which identify relevant corporate actions and their parameters. The use of SWIFT in processes related to corporate actions helps information standardisation and automation, restricting risk in Government Securities Depository asset management. The Thomas Murray international rating agency reacted to the new functionality by raising the asset management risk rating to AA- Positive (very low risk) and that of the whole Government Securities Depository to A+ Positive (low risk).

In 2009 the BNB took part in projects for gathering and disclosing depository and settlement information, run by the Association of Global Custodians (AGC), the Committee on Payment and Settlement Systems/International Organization of Securities Commissions (CPSS-IOSCO), and Thomas Murray. Periodic reports on relevant legislation and the major characteristics and parameters of system operation provided the required transparency and improved basis for evaluating risks in registering and settling government securities.

## IX. International Relations and Participation in the ESCB

The international community's coordinated efforts to overcome the global economic crisis intensified dialogue and relationships between EU Member States. The Bank took an active part in deliberations and policymaking at the ESCB, Ecofin, the Economic and Finance Committee, and other EU Council and European Commission committees and working groups. EU work over the review year addressed the future European supervisory framework, obtaining consensus on a more effective financial regulatory and supervisory architecture acceptable to all Member States, and action to improve financial stability.

Growing expert capacity and experience in technical assistance gave the Bank an advantage. Regional cooperation with central banks broadened and intensified, underpinned by traditionally good relationships and the impact of the global financial crisis in the region. The Bank's 130th Anniversary celebrations also found an international reflection.

### Participation in the ESCB

The BNB Governor is a member of the ECB General Council and sits on its meetings with central bank governors from all 27 EU Member States and the ECB President and Vice-president. BNB representatives sat on 12 ESCB committees, 31 working groups, and the Human Resource Conference. Through representatives on ESCB bodies, committees, and working groups the Bank participated in monetary policy coordination, drafting ECB legal instruments, forming and developing monetary and banking infrastructure, payment and settlement systems, statistical reporting, and deliberations on other issues. In 2009 the ESCB focused on tackling the world financial and economic crisis at the global, European, and national levels, and on a new European supervisory framework.

EU members have undertaken to consult the ECB on relevant legislative moves. The Ministry of Justice consulted the ECB, inter alia, on the Bill to Re-enact the Law on the Administration with Amendments and on amendments to the Law on Prevention and Disclosure of Conflicts of Interest, and the Law on the BNB.

EU members follow an ESCB communication policy and the BNB continued translating and publishing ECB publications, including the 2008 Annual Report and Monthly Bulletins published at a quarterly frequency, posting them on the BNB and ECB websites.

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

The BNB Governor participates in Ecofin informal meetings which bring together EU ministers for economic affairs and finance. At the Ecofin informal meeting in Gothenburg in October 2009 they discussed the economic situation and risks to EU financial stability, the future European Supervisory Framework, and action to improve financial stability, including strategies to complete crisis measures by EU Member States. A consensus was reached on the Roadmap on financial supervision, stability, and regulation, and on an EU framework for policy coordination on financial stability. On 20 October the Ecofin Council adopted conclusions on strengthening EU financial stability.

The Bank's representatives in the Economic and Finance Committee helped formulate EU policy on assessing the economic situation in the Union and broadening and strengthening financial stability at the Community and world levels. They participated in annual assessments preparing Ecofin conclusions on EU Member State stability and convergence programmes.

The Bank contributed to financial sector reform by participating in EU bodies. After the February 2009 de Larosière High-Level Group report and the June 2009 European Commission communication on financial supervision of May 2009, Ecofin and the European Council proposed a European supervisory architecture with a European Systemic Risk Board and a European System of Financial Supervision as its pillars. On 23 September 2009 the European Commission proposed new regulations on the supervisory framework.

The ESRB would watch and assess potential threats to financial stability in the Community at the macro level, issue systemic risk warnings, recommend ways to tackle risk, and



monitor progress. It would be an independent entity with no legal personality and would use ECB administrative, logistical, statistical, and analytical support. The Board would report twice a year to the EU Council and European Parliament.

The ESFS would be a network of three new supervisory bodies: the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority. The network would involve Member State supervisory bodies and the Joint Committee of European Supervisory Authorities. National supervisory bodies would continue supervising national institutions.

The European supervisory authorities, independent bodies with legal personalities, would replace the existing Level 3 Committees: the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors, and the Committee of European Securities Regulators, inherit their powers and gain new ones under the draft regulations.

The BNB worked intensively to harmonise national and European legislation. Bank representatives at the Committee of European Banking Supervisors and its working groups took part in supervisory practice convergence and helped develop new practice, instructions, and forms. BNB representatives participated in EU Council and European Commission working group deliberations on banking regulation and payment systems. The BNB actively formulated national positions on the proposed European supervisory framework and the regulations on the establishment of the European Systemic Risk Board, European Banking Authority, European Insurance and Occupational Pensions Authority, the European Securities and Markets Authority, and the draft Omnibus Directive which amends sectoral directives to make way for the new bodies. The Bank was involved in discussions on amending the Capital Requirements Directive, the Directive on Deposit Guarantee Schemes, the Directive on the Business of Electronic Money Institutions, the Regulation on Cross-border Payments in the Community, and the Regulation on Credit Rating Agencies.

Preparing for reform, the BNB raised banking community awareness of coming legislative changes. In 2009 the National Assembly adopted the Law on Payment Services and Payment Systems and amended the Law on Credit Institutions and the Law on Bank Deposit Guarantee to match relevant European directives. Amendments to BNB Ordinance 27 on Balance of Payments Statistics raised the threshold for statistics on transfers and payments to other countries from BGN 25,000 to BGN 100,000.<sup>46</sup>

The BNB representatives in the Council for European Affairs formulated national positions and policies on payment systems, banking and financial services, supervisory practice convergence, and the new financial architecture.

The Bank raised awareness of its participation in EU policy making by circulating periodical overviews of European policy and regulation in banking and finance to relevant bodies and through seminars for bankers, financiers, and civil servants.

In late 2009 the Bank's Governor invited Bulgaria's European parliamentarians for discussions of the new European supervisory framework and other issues of importance to Bulgaria in the economic and financial crisis.

#### **Relations with International Financial Institutions**

The BNB Governor attended the bimonthly meetings of the Bank for International Settlements (BIS) central bank governors. They are a major forum for cooperation between member central banks and for debate on world economic development and prospects, financial markets, and challenges to central banking from globalised finance. The Governor also took part in the Annual General Meeting of BIS shareholders in late June. There the BIS Board of Governors allocated net profits and paid a dividend of SDR 144.7 million (SDR 265 per share) to participating central banks.

In April 2009 Bulgaria hosted a regular IMF mission under Article IV of the IMF Statute. This assessed current economic developments and prospects for 2009. In its regular report the mission concluded that prudent policies and accumulated fiscal reserves shielded Bulgaria from the crisis. Banking stability also received a positive assessment.

<sup>46</sup> The changed threshold came into force on 1 January 2010 in line with Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payment in the Community.

**Bilateral  
Cooperation  
with Central  
Banks**

In 2009 the Bank expanded cooperation with other central banks, including those from distant regions. The BNB hosted high-level delegations from the People's Bank of China and the State Bank of Vietnam. In June 2009 representatives of the Ministry of Finance of Azerbaijan visited the Bank under the EU's technical assistance for that country's Ministry of Economic Development. Discussions centred on central bank macroeconomic policy and forecasting. Given the impact of the global financial and economic crisis, the Bank intensified dialogue with neighbour countries' central banks, and with the Central Bank Governors' Club of the Black Sea Region.

**Technical  
Assistance  
and  
Exchange**

In 2009 the BNB launched three technical assistance projects funded by the EU.

On 1 April the European Commission chose the BNB to manage a technical assistance project to strengthen the regulatory supervision capacity of financial regulators in Montenegro in consortium with De Nederlandsche Bank and the Bulgarian Financial Supervision Commission. The project began on 30 November 2009. The Bank is the first Bulgarian body to manage a twinning project and one of the few EU central banks involved in such projects. The 18-month project will improve the institutional and regulatory capacities of financial supervisors and achieve more effective supervision over financial markets and bodies in line with EU legislation. It covers four areas: banking supervision and financial stability; securities and pension funds; insurance; and preventing money laundering, terrorist financing and other financial crime. Assistance will help transpose ten EU financial sector directives. The three supervision bodies will begin using best European practice. Their expert capacity will be boosted during 630 training days provided by 76 experts from the BNB, De Nederlandsche Bank, and the Bulgarian Financial Supervision Commission.

In late May 2009 the nine-month technical assistance programme for the National Bank of Serbia, which assessed regulatory and operational framework requirements, ended successfully. It was managed by the ECB and 17 EU central banks. After analysing the legal and institutional framework of consumer protection in banking, the BNB provided expert advice on consumer protection in financial services.

A European Commission-funded three year cooperation programme with the Central Bank of Egypt on bringing banking supervision into line with Basel II principles was launched on 1 January 2009. The ECB manages the programme in cooperation with seven EU central banks. The BNB provides assistance in three strategic areas: own funds, a standardised approach to credit risk, and reporting.

## X. Statistics

The BNB collects, compiles, and disseminates statistics under Article 42 of the Law on the BNB and, as member of the ESCB, Article 5 of the Protocol on the Statute of the ESCB and the ECB.

Over the review year migration continued to the Classification of Economic Activities (NACE-2008, providing for the implementation of NACE Rev. 2). Work on quarterly deposit and loan statistics broken down by business and quantitative categories was completed.

After extension of the Register of Institutions and Assets Database (RIAD) the BNB took part in database testing and began supplying regular lists of investment funds and financial vehicle corporations engaged in securitisation transactions.

Methodology guidelines and reporting forms were developed for 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 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).

As regards interest rate statistics, methodology guideline amendment and new report form development started under 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).

Work continued on statistical coverage of the non-bank financial sector, with the BNB starting to publish quarterly information on Bulgarian lending specialists and insurers, re-insurers, and health insurers.

Meeting a requirement for euro area Member States, the BNB started filing quarterly data on the international investment position by geographical region with the ECB.

In line with Council Regulation (EC) 716/2007 on Community statistics on the structure and activity of foreign affiliates the BNB started collecting data on companies outside the EU controlled by Bulgarian interests.

Preparations ended on extending direct balance of payments and international investment position reporting to the BNB. Reporting forms on service imports and exports were developed and work on a balance of payments register continued. A pilot survey was made of statistical reporting units with the largest shares of current account receipts and payments.

A BNB random sample border survey of Bulgarians and foreigners helped complete work on new evaluation models for balance of payments items such as *travel*, *passenger transport*, *compensation per employee loans*, and *migrants' current transfer loans*.

BNB Ordinance 27 on Balance of Payments Statistics was amended, bringing external sector statistics into line with the latest changes in European institutions' regulations and helping the BNB live up to its statistics duties as a member of the ESCB. The statistical reporting threshold for individuals and companies on foreign transfers and payments rose to BGN 100,000 from BGN 25,000 in line with Regulation (EO) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community. Local entities now have to report to the BNB all commercial credit and transaction claims and liabilities over BGN 50,000 involving non-residents, other than financial loans.

Within the ESCB, work continued on the Centralised Securities Database and development of a Bulgarian securities database began.

Data was regularly compiled on government quarterly financial accounts under Regulation (EC) No 501/2004 of the European Parliament and the Council<sup>47</sup>, as well as on government finances (with the National Statistical Institute and the Ministry of Finance).

The Bank and the NSI continued sending the ECB and the Bank for International Settlements macroeconomic indicator information. There were regular updates and metadata certification under the Special Data Dissemination Standard to IMF methodological requirements and a set schedule. Procedures on updating and certifying BNB, NSI, and MF metadata to the Special Data Dissemination Standard changed after an IMF decision.

In 2009 the first stage of the integrated statistical information system project was completed, with work on some of its modules continuing. The system will automate statistical receipt, control, processing, and dissemination.

The order in which data are published on the BNB website, as well as their tabular presentation and press releases was changed. A new statistical database was inserted in website under Statistics. It facilitates searching for data from the statistical data series, including metadata.

The Bank remained focused on boosting the amount of information and improving access to it under the accessibility and clarity principle of the European Statistics Code of Practice. The BNB published for the first time data series on:

- specialised lenders;
- insurers, reinsurers, and health insurers;
- quarterly financial accounts of the general government sector.

<sup>47</sup> Regulation (EC) No 501/2004 of the European Parliament and of the Council of 10 March 2004 on quarterly financial accounts for general government, OJ L 81, 19.03.2004 p.1–5.

## XI. Research

Economic research, analysis of Bulgarian economic processes, and macroeconomic forecasts support the Bank's management in decision making and formulating economic policy. In 2009 research continued to reflect the BNB priority of successful ESCB participation. Worked focused on economic agents' behaviour through microdata, financial sector modelling, and developing macroeconomic forecasting models.

Specialised research under the 2009 to 2010 Research Plan supported BNB operations by analysing individual economic processes and issues and improving forecasting and modelling tools. Over the review year work addressed labour market flexibility, wage and price-setting mechanisms, and inflationary factors. Also tackled were empirical sectoral analyses of Bulgarian exports, Bulgarian competitiveness, interest rate modelling, and the dynamic stochastic general equilibrium model. The reporting period saw testing and honing of the new basic macroeconometric model for improving BNB macroeconomic forecasting. Research results were presented in technical reports and at seminars organized by the BNB for experts from relevant bodies, academia and non-governmental organisations.

In November 2009 the BNB and the IMF organized a joint seminar Forecasting Systems and Economic Policy Analysis Based on Models Related to the Real and Financial Sectors. The event brought together experts from the central banks of Azerbaijan, Albania, Belarus, Georgia, Greece, Lithuania, Macedonia, Morocco, Moldova, Romania, Slovakia, Serbia, Turkey, Ukraine, Hungary and Croatia.

The Guest Researcher Programme supports BNB research and helps establish fruitful cooperation with experts from Bulgaria and abroad on subjects of interest to the BNB. In 2009 two participants worked on developing models of medium to long-term inflation trends in Bulgaria and on systematization and analysis of the Bulgarian economic thought until 1944. BNB representatives took part in the fourth annual conference of the South Eastern Europe Monetary and Financial History Study Network on 27 March in Belgrade.

Through its Discussion Papers research series, the BNB continued encouraging Bulgarian research and practice in macroeconomics, finance, and economic history. 2009 saw the publication of nine working papers: seven in the area of *macroeconomics and finance* and two in the area of *economic history*.

## XII. Information Infrastructure

Several information infrastructure projects were implemented in 2009 under established long-term programmes and to ensure business continuity and system integrity. A uniform project management methodology for information systems is to introduce ECB and Project Management Institute instructions and practices. A methodology was created to monitor and optimise information systems ownership costs.

The following projects were launched in information security and networks: participation in TARGET2; internet voice communication; developing the communication infrastructure including communication within the ESCB; developing communication with financial institutions; drafting a concept paper on BNB systems operation in more than one location; launching server system virtualisation; supplying and implementing a disc data storage system; a new BNB website; replacing SWIFT equipment; launching an application monitoring system; building new structural cabling and power supply for computerised workstations.

Technical infrastructure for BNB participation in TARGET2 was analysed, prepared, and built, the required software installed, and the TARGET2-BNB system component was developed. Technical infrastructure risk attending the link with TARGET2 was evaluated and certified. Dedicated file processing for payments through TARGET2-BNB and associated statements and reports was developed. SOFI and TurboSwift were modified for TARGET2-BNB. Business process models were prepared and functional updates made to the system which manages gross international reserves (Trema FinanceKit).

In data processing, the core banking information system was stabilised and new functionalities were added to the SAP accounting system.

Technical maintenance of the real-time gross settlement system focused on normal function and business continuity, system and software maintenance and administration, hardware, communication links, and SWIFT services. The RINGS version was updated to the requirements and amendments of the SWIFT Standards Release and Message Format Validation Rules 2009. Preparations began to transfer RINGS operational databases to the *Oracle 10g* version to improve system reliability, stability, and promptness and enjoy maintenance by Oracle.

In 2009 the Central Credit Register project developed and implemented a new information system. It meets the requirements of the Law on Credit Institutions, BNB Ordinances 22 and 26 and the need for changes in information scope and volume. The review period saw financial institutions entered into the Central Credit Register as reporting entities under the Law on Credit Institutions Article 3, paragraph 1.

Another project is giving the BNB Cash System new functionalities for straight-through processing of banks' monthly limits on free withdrawals of banknotes of one denomination from the BNB, as well as collection of fees for cash withdrawn over set limits. Operations on internal rules for delivering, accepting, and keeping precious metals and valuables at the BNB Issue Department and their entry into the Cash System are now automated.

The Single Data Depository/Banking Supervision Reports project advanced, with updates related to changes in supervisory reporting taking place over the year. Incoming reports are now electronically signed and paper documents are discontinued.

Technical terms of reference and detailed functional specifications of the Financial Institutions subsystem were developed to the requirements of BNB Ordinance 26.

The ESROT electronic system for registering and servicing government securities trading acquired a new functionality after recommendations following an IT audit.

The project to develop a system to process information by payment system operators, participants, bank card issuers, acquiring banks, and electronic money issuers was completed.

The first stage of the integrated statistical information system for the Statistics Directorate was also finalised.

Over the year, end users enjoyed a Help Desk which accepted reports of incidents and resolved problems. Some 30 per cent of equipment was replaced. All workplaces at the BNB Cash Centre were equipped. Electronic message infrastructure shifted to MS Exchange 2007. Antivirus protection (harmful code and firewall) moved to the overall workstation level. A new BNB website is in gestation. Sundry tasks involved administering the recording and legal information systems, administering and maintaining financial information systems (Reuters, Bloomberg), delivering custom software, launching encrypted USB devices, administering ESCB systems, supporting the 130th anniversary celebrations and attending events.



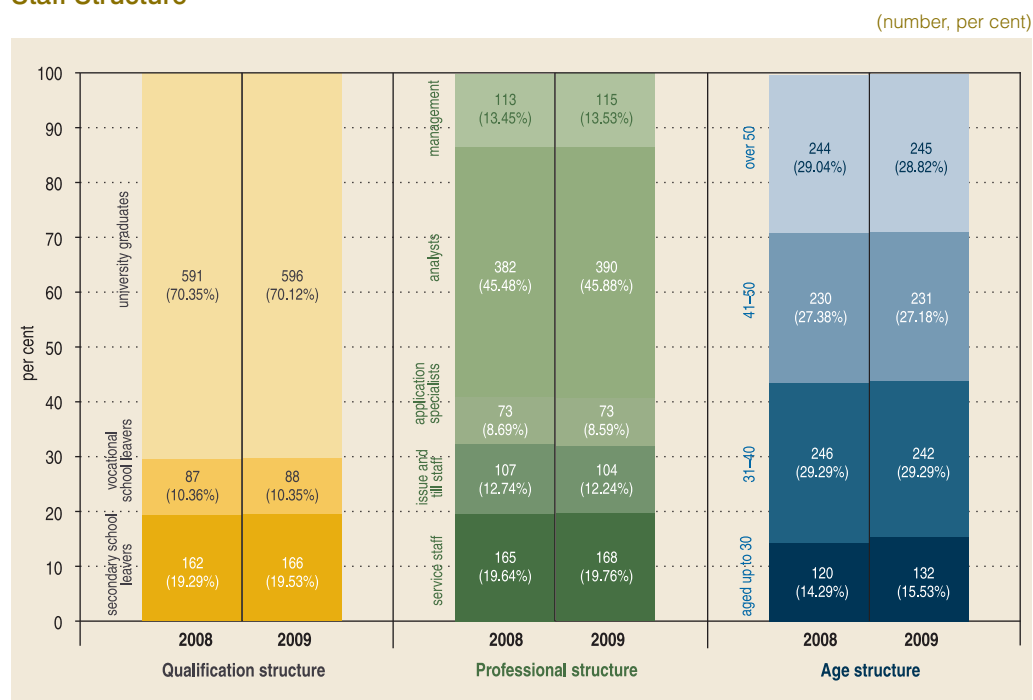
## XIII. Human Resource Management

Following the pursued policy, over the review period human resource management applied mechanisms and improved practice to boost efficiency to European levels. Priorities involved improving recruitment and optimising staff age, professional, and qualification structure, along with training and motivation.

In 2009 the BNB continued to pay according to performance, taking into account each employee's contribution to the Bank's objectives and duties under Article 23 of the Law on the BNB.

Though the BNB's responsibilities, including participation in the ESCB, grew, staff numbers remained unchanged. Over the year 59 people joined the Bank and 53 left, of whom 16 retired. Turnover was lower than in 2008 when 185 left. A reason for the high number of people leaving the Bank in 2008 was the transfer of 64 staff to the Cash Services Company. Falling staff turnover in 2009 also reflected a changed external environment and improved working conditions at the Bank.

### Staff Structure



Source: BNB.

In 2009 the rise of the number of employees aged under 30 continued, their share increasing by 1.24 percentage points and their number from 120 to 132. Of the 59 new entrants, 34 were under 30. The proportions of other age groups declined.

The rise in the number of university graduates also continued, as expected of a professional body dominated by analysts.

Data on BNB staff professional backgrounds in the chart show no changes in the relative shares of personnel by category on 2008.

Internal and external staff mobility continued to be encouraged. Moving between units is common practice, with 21 employees moving in 2009. This boosted staff expertise and intensified the exchange of knowledge and experience within the Bank. External mobility, mostly to the ESCB and EU bodies, has also been lively. Over the review period nine BNB employees took on short-term ECB assignments.

Diverse learning programmes improved staff awareness and professional qualifica-

tions, helping the Bank in its duties and making its participation in the ESCB more effective. In recent years opportunities to train and upgrade professional qualifications have become a leading motivation for BNB employees to join the Bank's corporate culture and build careers.

The annual BNB Staff Educational and Professional Training Programme was the main instrument in this area. The Programme follows BNB Governing Council policy on developing solid administrative capacity through continuous learning. In 2009 the Programme helped ESCB participation through multiple opportunities for staff to raise their educational and professional attainments. All Programme entrants are acquainted with the BNB's major functions and operations. Induction training offers an appropriate opportunity to familiarise new employees with BNB corporate culture, current tasks, and internal rules and administrative procedures common to all units. Training content was amplified compared with the prior year. In 2009 there were four groups of new entrants.

In 2008 and 2009 21 employees boosted their educational attainments without discontinuing work. Of them, nine received university degrees. Compared with the previous year, this number declined slightly. This reflected improved selection and better assessment of whether candidates' educational qualifications match vacancies.

In 2009 36 BNB employees took part in four distant learning programmes.

The BNB cooperates with the central banks of a number of European countries and with international financial institutions which offer specialised courses on various central banking areas. Training focuses on macroeconomics, monetary policy, international reserves and risk management, banking supervision, monetary and banking statistics, accounting, banking and financial law, human resources management, and internal audit.

When the Annual Programme was adopted, participants in foreign courses and seminars were broadly set, allowing precise planning. In 2009 BNB staff took part in 191 foreign courses and seminars. Furthermore, many more BNB employees took part in training related to ESCB membership. In 2009, 23 employees attended 15 ESCB committee and working group seminars.

In 2009 a BNB employee took part in the Bank's first comprehensive four-week programme at the Bank for International Settlements. The more comprehensive programme was directed at central bank staff responsible for reserve management. Again for the first time, a BNB participant took part in a specialised ten-week exchange programme organized by the City of London Corporation.

Foreign language learning to minimum levels of proficiency and specialised language skills is an aspect of the qualification boosting programme. English courses were attended by 110 employees. By the end of 2009 the proportion of employees covering minimum requirements consistent with their job descriptions was 85 per cent against 83 per cent in December 2008.

For the second consecutive year, the BNB participated in the KARIERI 2009 student training and career forum to meet applicants and trainees. In 2009 35 trainees were recruited.

To mark the 130th Anniversary of the BNB, the Governing Council granted five scholarships to postgraduate students. The aim was to direct these students to subjects of importance to the Bank with a view to their possible future appointments. In 2009 the scholarships' scope was expanded to undergraduate students. Two students reading for bachelors' and two students reading for masters' degrees won scholarships. Jointly with their tutors, scholarship students prepared papers on central banking operations, macroeconomics, monetary policy, fiscal policy, world trade, and exchange rates.

## XIV. Facilities Management

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The BNB mainly trades from owned premises and properties. This ensures the level 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 premises.

Facilities management followed the Strategy for BNB Development between 2004 to 2009 approved by the Governing Council. Property spending was mainly on BNB operations, with savings in expenditure on fuels, spare parts for fixed tangible assets, consumables and equipment maintenance, and in the investment programme. Construction of the BNB Cash Centre was completed over the review period. It was granted a Form 16 Commissioning Certificate by a state acceptance commission on 10 November 2009, and Safe Use Permit numbered ST-05-1347 by the National Construction Supervision Office two days later. A Technical Information Pack on the premises was lodged with the Technical Information Pack Register at the Metropolitan Municipality Construction Supervision Office.

## XV. Internal Audit

Under Article 22 of the Law on the Bulgarian National Bank, a Chief Auditor appointed by the BNB Governing Council and approved by the President of the National Audit Office heads internal audit at the Bank. This aims to establish and maintain reliable risk control and mitigation. The Chief Auditor's authority and duties contribute to improving corporate management by assessing internal audit systems and guiding the Bank's management in their further development and in constraining risk.

In 2009 work progressed to an annual audit programme based on assessing risk by audited unit. The BNB Cash Centre project, the storage, processing and destroying of cash, payment system supervision, the BNB financial statement as of 30 June 2009, the SAP (the main Bank information system) and human resource management were audited. The overall purpose of audits was to provide reasonable assurance of adequate and effective risk and corporate management at the Bank. The main recommendations addressed improving internal audit systems in the audited units to mitigate risk and to guarantee adherence to statutory requirements, established policies, and procedures. The Chief Auditor reported directly to the BNB Governing Council.

BNB Functions	Audits under the BNB Internal Audit Programme
Cash circulation	Cash storage, processing, and destruction
	The BNB Cash Centre project
Information and analysis	The BNB financial statement as of 30 June 2009
	SAP (the main Bank information system)
Payment systems	Payment systems supervision
Human resources	Human resource management

Under the ESCB Internal Auditors' Committee programme for 2009, BNB Internal Audit participated in the two audits within the ESCB.

ESCB Functions	Audits under the ESCB Internal Auditors Committee Programme
Information and communication technologies	Information technology management
Statistics	Monetary and financial statistics

During the review period progress towards implementing previous audit recommendations was examined. This included analyses of evidence that recommendations are followed and of changes in practice, assessments of any ensuing risks, and status updates.

In 2009 internal operating rules were revised to BNB Internal Audit recommendations and with a view to harmonise methodologies and procedures for joint audits with the ESCB.

To improve qualifications, auditors in the team received training under the Institute of Internal Auditors (IIA), the Information Systems Audit and the Control Association (ISACA) programmes. They took part in specialist seminars at other central banks and attended specialised courses on annual programme commitments. An internal auditor successfully completed a Certified Internal Auditor (CIA) course.

The Operational Risk Methodology and Consolidation Department was established in 2009 to report to the Chief Auditor. It is to develop the general methodology for operational

risk management, coordinate joint actions by units managing operational risk; summarise information, and compile a consolidated statement of the Bank's operational risk.

The new department coordinated the definition of operational risks attending units' work, adopted control mechanisms, and prepared action plans in line with the Policy of BNB Operational Risk Management and the Guidelines on BNB Operational Risk Management. Risk management comprises four major stages for assessing individual units according to degree of critical importance. The most critical units then go on to identify risks and controls characteristic of their work.

Central Bank of Spain experience was studied to improve operational risk management methodology. The department participated in seminars on operational risk management and the continuity of the processes organised by ESCB central banks.

## XVI. BNB Budget Implementation

The BNB Governing Council adopted the BNB Budget for 2009 by Resolution No 104 of 6 November 2008.

The Report on the Bank's budget comprises two sections, Operating Expenditure and the Investment Programme, pursuant to the BNB Governing Council's Internal Rules on Setting, Implementing, and Reporting the BNB Budget.

### 1. Operating Expenditure

The BNB spent BGN 83,405,000 or 89.5 per cent of its budgeted figure on 2009 operations.

Currency circulation cost BGN 25,688,000 or 91.5 per cent of budget. Banknote and coin printing and minting cost BGN 24,935,000 or 93.4 per cent of projected funds for 2009. This included BGN 18,185,000 or 95.1 of projected funds on banknote printing and BGN 6,750,000 on coin minting, of which BGN 5,965,000 on circulating coins. Commemorative coins cost BGN 785,000, in line with the BNB Governing Council's coin programme.

The design of new banknotes and coins cost BGN 31,000 or 50 per cent of projected funds. Machines servicing cash circulation cost BGN 78,000 or 39 per cent of budget.

Renting premises at the BNB Printing Works, at the State Mint and at the Cash Services Company cost BGN 514,000 or 98.8 per cent of projected funds for 2009.

Consumables, services, and depreciation cost BGN 32,016,000 or 85.2 per cent of the budgeted BGN 37,564,000. Of this, consumables comprised BGN 1,195,000. Major spending in this group comprised, *inter alia*, BGN 459,000 on inventories, BGN 353,000 on office consumables, and BGN 270,000 on fuel and spares for the vehicle fleet.

Expenditure on hired services was BGN 14,633,000 or 73.7 per cent of the annual budget. Significant items concerned software maintenance subscriptions at BGN 3,723,000. Bloomberg, Reuters, internet, and other systems cost BGN 1,503,000. Equipment maintenance cost BGN 1,323,000. Property and refuse levies came to BGN 1,207,000. Power bills were BGN 488,000. The Bank spent BGN 2,508,000 on its security contract with the Ministry of the Interior. Since the start of the year expenses on major building maintenance totalled BGN 1,460,000. Mail, telephone, and telex came to BGN 387,000.

Consultancy services amounted to BGN 202,000 or 23.1 per cent of annual budget. The bank used consultants to apply good practices in information projects, for security systems at the Bank's premises, for elaborating BNB communication in the European media environment, and for publishing monetary and financial history research by the Programme Council for Banking and Finance History.

Depreciation came to BGN 16,188,000 or 100 per cent of 2009 budget.

Payroll, social, and healthcare spending totalled BGN 20,776,000 or 98 per cent of the 2009 budget. In accordance with IAS 19, Income of Hired Persons, the Bank reported BGN 610,000 of expenditure on current retirement obligations and unused paid leave under this item.

Social expenditure amounted to BGN 1,863,000 or 91 per cent of budgeted funds.

Miscellaneous administrative spending was BGN 1,771,000 or 72.9 per cent of annual budget. Inland travel involved mainly cash logistics in regional cash centres and checks there; it cost BGN 57,000.

Foreign travel covered participation in seminars and staff training. Expenditure came to BGN 315,000 or 49.2 per cent of the annual budget.

In 2009 BNB employees enjoyed various forms of qualification upgrades, including new training methods. Staff training totalled BGN 843,000 or 89.3 per cent of budgeted funds.

The Bank's representative and protocol expenses were BGN 527,000, of which BGN 355,000 for 130th Anniversary celebrations.

Spending related to ESCB participation came to BGN 1,291,000. The cost of BNB representatives' participation in ESCB commissions and committees was BGN 553,000. Telecommunication rental came to BGN 463,000 and staff training to BGN 80,000. The annual fee for ESCB membership was BGN 174,000.

## 2. The Investment Programme

Budgeted investment funds for 2009 totalled BGN 68,437,000, of which BGN 51,593,000 or 75.4 per cent were utilised.

In 2009 BGN 32,049,000 was spent on construction, refurbishment, and modernisation. Of this, BGN 25,873,000 went on constructing the BNB Cash Centre, BGN 637,000 on refurbishment and vault door hydraulic actuators, BGN 2,088,000 on physical protection systems, BGN 1,335,000 on video surveillance, and BGN 1,033,000 on alarm systems.

In 2009, BGN 11,024 went on machines and equipment, vehicles, and sundry equipment, of which BGN 9,141,000 on machines and equipment for the BNB Cash Centre, of which BGN 60,000 for special access control systems and BGN 673,000 on furniture for the bank, BNB regional cash centres, and a banknote packaging line.

Computerisation cost BGN 8,399,000 of which BGN 5,121,000 for hardware and BGN 3,278,000 for software. Investment went mostly into information and communications technology development to provide a modern infrastructure.

Hardware costs amounted to BGN 5,121,000 of which BGN 1,208,000 for communications equipment and BGN 3,913,000 on computers, of which BGN 3,422,000 for the BNB and BGN 491,000 for the BNB Cash Centre.

Software costs of BGN 3,278,000 went on licences (BGN 1,848,000), the development of new products, and functionality expansion of existing systems (1,430,000).

Spending on BNB participation in the ESCB came to BGN 89,000 and sundry investment spending to BGN 32,000.

### Implementation of the BNB Budget as of 31 December 2009

Indicators	Report 31 Dec. 2009 (BGN'000)	Budget 2009 (BGN'000)	Implemen- tation (%)
<b>Section I. BNB operational expenditure</b>	<b>83 405</b>	<b>93 226</b>	<b>89.5</b>
Currency circulation expenditure	25 688	28 080	91.5
Materials, services and depreciation expenditure	32 016	37 564	85.2
Salaries and social security expenditure	20 776	21 195	98.0
Social activity expenditure	1 863	2 048	91.0
Other administrative expenditure	1 771	2 430	72.9
BNB expenditure on membership in ESCB	1 291	1 909	67.6
<b>Section II. Investment programme</b>	<b>51 593</b>	<b>68 437</b>	<b>75.4</b>
Expenditure on construction, reconstruction and modernization	32 049	37 080	86.4
Expenditure on machines, equipment, vehicles and sundry equipment	11 024	12 829	85.9
Expenditure on BNB computerization	8 399	15 795	53.2
Investment related to BNB participation in ESCB	89	196	45.4
Other investment	32	2 537	1.3



# **XVII. Bulgarian National Bank Consolidated Financial Statements for the Year Ended 31 December 2009**

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

### **Report on the consolidated financial statements**

We have audited the accompanying consolidated financial statements of the Bulgarian National Bank and its subsidiaries, which comprise the consolidated statement of financial position as at 31 December 2009, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting principles made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## Opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Bulgarian National Bank and its subsidiaries as at 31 December 2009, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

## Report on Other Legal and Regulatory Requirements

### *Annual report of the activities of the Bank according to Article 33 of the Accountancy Law*

As required under the Accountancy Law, we also report that the historical financial information prepared by Management and presented in the annual report of the activities of the Bank, as required under Article 33 of the Accountancy Law, is consistent, in all material aspects with the financial information disclosed in the annual consolidated financial statements of the Bank as at and for the year ended 31 December 2009. Management is responsible for the preparation of the annual report of the activities of the Bank which was approved by the Governing Council of the Bank on 21 April 2010.



KPMG Bulgaria OOD

*Sofia, 22 April 2010*

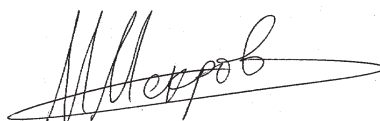
45/A Bulgaria Boulevard  
1404 Sofia  
Bulgaria

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

*The Law on the Bulgarian National Bank requires the Governing Council of the Bulgarian National Bank to prepare financial statements 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 to safeguard the assets of the Bulgarian National Bank and to prevent or detect fraud and other irregularities.*

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

Ivan Iskrov  
Governor of the BNB

## Consolidated Statement of Comprehensive Income for the Year Ended 31 December 2009

(BGN'000)

	Note	31 Dec. 2009	31 Dec. 2008
Interest income	7	644,397	1,045,533
Interest expense	7	(31,216)	(302,689)
<b>Net interest income</b>		<b>613,181</b>	<b>742,844</b>
Fee and commission income		7,783	8,356
Fee and commission expense		(3,897)	(3,831)
<b>Net fee and commission income</b>		<b>3,886</b>	<b>4,525</b>
Net profit/(loss) from financial assets and liabilities at fair value through profit or loss	8	286,059	326,802
Other operating income	9	35,852	34,532
<b>Total income from banking operations</b>		<b>938,978</b>	<b>1,108,703</b>
Administrative expenses	10	(105,095)	(95,326)
<b>Profit for the period</b>		<b>833,883</b>	<b>1,013,377</b>
<b>Other comprehensive income</b>			
Revaluation of real estate		-	36,085
Other comprehensive income		(290)	(3,745)
<b>Other comprehensive income, total</b>		<b>(290)</b>	<b>32,340</b>
<b>Total comprehensive income for the period</b>		<b>833,593</b>	<b>1,045,717</b>
<b>Profit attributable to:</b>			
Majority owners		833,728	1,013,222
Minority interest		155	155
<b>Profit for the period</b>		<b>833,883</b>	<b>1,013,377</b>
<b>Total comprehensive income attributable to:</b>			
Majority owners		833,438	1,045,562
Minority interest		155	155
<b>Total comprehensive income for the period</b>		<b>833,593</b>	<b>1,045,717</b>

The accompanying notes on pages 75 to 99 form an integral part of the consolidated financial statements.

## Consolidated Statement of Financial Position as of 31 December 2009

(BGN'000)

	Note	31 Dec. 2009	31 Dec. 2008
<b>ASSETS</b>			
Cash and deposits in foreign currencies	11	4,144,152	2,655,053
Gold, instruments in gold and other precious metals	12	1,937,132	1,559,116
Financial assets at fair value through profit or loss	13	19,142,156	20,600,510
Financial assets available for sale	14	1,416,503	1,424,016
Tangible assets	15	253,950	207,827
Intangible assets	16	14,302	15,270
Other assets	17	47,742	51,471
<b>Total assets</b>		<b>26,955,937</b>	<b>26,513,263</b>
<b>LIABILITIES</b>			
Banknotes and coins in circulation	18	8,049,100	9,179,414
Due to banks and other financial institutions	19	4,924,976	5,006,486
Liabilities to government institutions and other liabilities	20	7,390,220	7 487 687
Borrowings against Bulgaria's participation in international financial institutions	21	2,594,546	1,302,601
Other liabilities	22	137,145	109,763
<b>Total liabilities</b>		<b>23,095,987</b>	<b>23,085,951</b>
<b>EQUITY</b>			
Capital	23	20,000	20,000
Reserves	23	3,836,247	3,403,764
Minority interest	24	3,703	3,548
<b>Total equity</b>		<b>3,859,950</b>	<b>3,427,312</b>
<b>Total liabilities and equity</b>		<b>26,955,937</b>	<b>26,513,263</b>

The accompanying notes on pages 75 to 99 form an integral part of the consolidated financial statements.

## Consolidated Statement of Cash Flows for the Year Ended 31 December 2009

(BGN'000)

	Note	31 Dec. 2009	31 Dec. 2008
<b>Operating activities</b>			
Net profit		833,883	1,013,377
Adjustments for matching with the net cash flow from operating activities:			
Dividend income		(4,554)	(4,501)
Depreciation	15, 16	23,392	20,994
(Profit)/loss on disposal of tangible assets		415	(21)
Gains on financial assets and liabilities arising from market movements		(283,434)	(324,454)
Profit of associates		(3,350)	(2,581)
Other adjustments		(197)	-
<b>Net cash flow from operating activities before changes in operating assets and liabilities</b>		<b>566,155</b>	<b>702,814</b>
<b>Change in operating assets</b>			
(Increase) in gold, instruments in gold and other precious metals		(3,978)	(4,016)
Decrease/(increase) in financial assets at fair value through profit or loss		1,367,750	(2,041,821)
Decrease/(increase) in other assets		4,720	(6,470)
<b>Change in operating liabilities</b>			
(Decrease)/increase in currency in circulation		(1,130,314)	768,547
(Decrease)/increase in due to banks and other financial institutions		(81,510)	(777,052)
(Decrease)/increase in due to government institutions and other liabilities		(97,467)	733,865
Increase in borrowings from IMF of total allocation of SDR		1,302,808	-
Increase in other liabilities		27,382	57,893
<b>Net cash flow from operating activities</b>		<b>1,955,546</b>	<b>(566,240)</b>
<b>Investing activities</b>			
Purchase of tangible and intangible assets		(69,055)	(41,711)
Dividends received		4,554	4,501
<b>Net cash flow from investing activities</b>		<b>(64,501)</b>	<b>(37,210)</b>
<b>Financing activities</b>			
Payments to the Government		(400,955)	(250,634)
<b>Net cash flow from financing activities</b>		<b>(400,955)</b>	<b>(250,634)</b>
<b>Net decrease in cash and cash equivalents</b>		<b>1,490,090</b>	<b>(854,084)</b>
<b>Cash and cash equivalents at beginning of period</b>		<b>2,682,385</b>	<b>3,536,469</b>
<b>Cash and cash equivalents at end of period</b>	11, 17	<b>4,172,475</b>	<b>2,682,385</b>

The accompanying notes on pages 75 to 99 form an integral part of the consolidated financial statements.



## Consolidated Statement of Changes in Equity for the Year Ended 31 December 2009

(BGN'000)

Source of changes in equity	Capital	Revaluation of non-monetary assets	Special and other reserves	Total	Minority interest	Total equity
<b>Balance as of 1 January 2008</b>	<b>20,000</b>	<b>102,419</b>	<b>2,506,417</b>	<b>2,628,836</b>	<b>3,393</b>	<b>2,632,229</b>
Profit for the period	-	-	1,013,222	1,013,222	155	1,013,377
Other comprehensive income:						
– revaluation of real estate	-	36,085	-	36,085	-	36,085
– other income	-	167	(3,912)	(3,745)	-	(3,745)
Other comprehensive income, total	-	36,252	(3,912)	32,340	-	32,340
Total comprehensive income for the period	-	36,252	1,009,310	1,045,562	155	1,045,717
Contributions by and distributions to owners:						
– contribution to the budget of the Republic of Bulgaria	-	-	(250,634)	(250,634)	-	(250,634)
Transactions with owners, total	-	-	(250,634)	(250,634)	-	(250,634)
<b>Balance as of 31 December 2008</b>	<b>20,000</b>	<b>138,671</b>	<b>3,265,093</b>	<b>3,423,764</b>	<b>3,548</b>	<b>3,427,312</b>
<b>Balance as of 1 January 2009</b>	<b>20,000</b>	<b>138,671</b>	<b>3,265,093</b>	<b>3,423,764</b>	<b>3,548</b>	<b>3,427,312</b>
Profit for the period	-	-	833,728	833,728	155	833,883
Other comprehensive income:						
– other income	-	(290)	-	(290)	-	(290)
Other comprehensive income, total	-	(290)	-	(290)	-	(290)
Total comprehensive income for the period	-	(290)	833,728	833,438	155	833,593
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)
<b>Balance as of 31 December 2009</b>	<b>20,000</b>	<b>138,381</b>	<b>3,697,866</b>	<b>3,856,247</b>	<b>3,703</b>	<b>3,859,950</b>

The accompanying notes on pages 75 to 99 form an integral part of the consolidated financial statements.

## Notes to the Consolidated Financial Statements

### 1. Statute and principal activities

The Bulgarian National Bank (the 'Bank') is 100 per cent owned by the Republic of Bulgaria. The Bank is the central bank of the Republic of Bulgaria. The operation of the Bank is governed by the Law on the Bulgarian National Bank (LBNB), which has been effective from 10 June 1997.

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

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

The Governing Council of the BNB approved the consolidated financial statements set out on pages 67 to 99 on 21 April 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 assumption that affect the reported amounts of assets and liabilities for the following financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under 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 statement of comprehensive income.

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

##### *Associated companies*

Associates are those entities in which the Bank has significant influence, but which are neither subsidiary enterprise nor joint venture. Investments in associates are included in the Bank's consolidated financial statements on an equity accounted basis as an amount corresponding to the Bank's share in the associates' own funds as 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 statement of comprehensive income 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 statement of comprehensive income 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 statement of comprehensive income when the Bank establishes the right to their receipt. Exchange rate gains or losses from available-for-sale investments are recognised in the statement of comprehensive income.

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, gains from revaluation of futures, net gains from revaluation of assets and liabilities denominated in foreign currencies.

##### (b) Financial instruments

###### (i) *Classification*

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

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

abilities 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.

**(ii) 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.

**(iii) 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.

**(iv) 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 positions are measured 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.

**(v) 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.

**(vi) 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.

**(vii) 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 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.

**(viii) Financial assets/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 statement of comprehensive income. All changes in the fair value are recognised as net income from trading operations in the statement of comprehensive income. 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.

**(ix) 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 statement of comprehensive income, 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 statement of comprehensive income.

**(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 BNB, the Bulgarian National Bank may take any necessary action in connection with the acquisition, possession and sale of gross international foreign currency reserves, including monetary gold. Consequently, monetary gold as part of the international foreign currency 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 reported 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 decreasing the revaluation reserve in the own funds, and in case of shortage the difference is recognised as expense in the statement of comprehensive income.

**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 statement of comprehensive income as an expense as incurred.

**2) Depreciation**

Depreciation is provided on a straight-line basis at prescribed rates designed to write down the cost of revalued amount 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 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 statement of comprehensive income. Foreign currency denominated non-monetary assets and liabilities are valued at the exchange rate on the date of acquisition or at latest determination of fair value.

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

The exchange rates of the major foreign currencies as of 31 December 2009 and 31 December 2008 are as follows:

Currency	31 December 2009	31 December 2008
US dollars	1 : BGN 1.36409	1 : BGN 1.38731
Euro	1 : BGN 1.95583	1 : BGN 1.95583
Special drawing rights	1 : BGN 2.13069	1 : BGN 2.14729
Gold	1 troy ounce : BGN 1488.400	1 troy ounce : BGN 1198.280

**(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 with 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 of 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 (IFRIC) adopted by the European Commission not yet effective as of the date of the financial statements**

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 this standard 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 ex-

pect amendments to IAS 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 prospectively 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 Governing Council, it is not possible to determine the effects of application in advance.
- IFRIC 18 Transfers of Assets from Customers is effective prospectively 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 EC:

- 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 foreign currency reserves looks to the high security and liquidity of the assets first, and then to the 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 currency board arrangement and in full compliance 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 foreign currency reserves 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 foreign currency reserves, and if required, the investment limits and benchmarks are updated. The observance of underlying limits, rules, and procedures is monitored on a daily basis. Reports are regularly prepared both for the needs of international foreign currency reserves operating management, and for providing updated information to the Bank's management. All approved financial instruments and asset classes in which the BNB may invest are set out in the Investment Guidelines and Benchmarks for the Management of the Gross International Foreign Currency 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 debt instrument issuers which the BNB may invest in, and a list of foreign financial institutions acting as BNB counterparties.

The international foreign currency 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 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 (time deposits and funds on current accounts) with Group I counterparties, central banks, or supranational financial institutions;
- Deposits in gold (time 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;
    - banks: German covered bonds of the type *Jumbo Pfandbrief* and Irish covered bonds of the type *Irish Asset Covered Securities*;
    - 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 embedded options.
- Purchases and sales of foreign currency:
    - with a value date of up to 2 business days (spot);
  - Futures – interest rate and bond (long and/or short positions are eligible) traded on the international regulated markets.

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

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

Two changes in the credit risk limits came into effect in early 2009: the minimum exposure to countries was raised from 50 to 60 per cent and a minimum exposure to an individual issuer, other than a country amounting to 5 per cent of the reserves, was established. Some of the 2008 additional measures to curb credit risk in managing international reserves were retained, e.g. the prohibition on investment in debt issued by the Irish Republic and in covered bonds (till end-September). Foreign currency operations with some of the counterparties to which the BNB may have a credit exposure were temporarily discontinued, while six institutions completely fell out of the BNB list after their credit ratings dropped.

### (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 being 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 on international markets 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 strives to maintain a balance between the maturity of borrowed funds and that of assets through investments in financial instruments with a range of maturities. Limits are set to ensure minimum liquidity by type of currency. This liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments. 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 of 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
<b>Financial assets</b>							
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
<b>Total financial assets</b>	<b>5,207,329</b>	<b>3,315,986</b>	<b>7,247,056</b>	<b>7,896,911</b>	<b>836,239</b>	<b>2,136,422</b>	<b>26,639,943</b>
<b>Financial liabilities</b>							
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
<b>Total financial liabilities</b>	<b>12,293,604</b>	<b>21,592</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>10,643,646</b>	<b>22,958,842</b>
<b>Asset-liability maturity mismatch</b>	<b>(7,086,275)</b>	<b>3,294,394</b>	<b>7,247,056</b>	<b>7,896,911</b>	<b>836,239</b>	<b>(8,507,224)</b>	<b>3,681,101</b>

(BGN'000)

As of 31 December 2008	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
<b>Financial assets</b>							
Cash and deposits in foreign currencies	2,655,053	-	-	-	-	-	2,655,053
Gold, instruments in gold, and other precious metals	369,057	552,988	-	-	-	637,071	1,559,116
Financial assets at fair value through profit or loss	4,026,423	3,938,690	9,259,585	2,934,965	440,847	-	20,600,510
Financial assets available for sale	71,994	-	-	-	-	1,352,022	1,424,016
<b>Total financial assets</b>	<b>7,122,527</b>	<b>4,491,678</b>	<b>9,259,585</b>	<b>2,934,965</b>	<b>440,847</b>	<b>1,989,093</b>	<b>26,238,695</b>
<b>Financial liabilities</b>							
Banknotes and coins in circulation	-	-	-	-	-	9,179,414	9,179,414
Liabilities to banks and other financial institutions	5,006,486	-	-	-	-	-	5,006,486
Liabilities to government institutions and other borrowings	6,313,608	680,079	494,000	-	-	-	7,487,687
Borrowings against Bulgaria's participation in international financial institutions	-	-	-	-	-	1,302,601	1,302,601
<b>Total financial liabilities</b>	<b>11,320,094</b>	<b>680,079</b>	<b>494,000</b>	<b>-</b>	<b>-</b>	<b>10,482,015</b>	<b>22,976,188</b>
<b>Asset-liability maturity mismatch</b>	<b>(4,197,567)</b>	<b>3,811,599</b>	<b>8,765,585</b>	<b>2,934,965</b>	<b>440,847</b>	<b>(8,492,922)</b>	<b>3,262,507</b>



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
<b>As of 31 December 2009</b>							
Banknotes and coins 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	-	-	-
Borrowings against Bulgaria's participation in international financial institutions	2,594,546	2,594,546	-	-	-	-	2,594,546
	<b>22,958,842</b>	<b>22,958,890</b>	<b>12,293,628</b>	<b>21,616</b>	<b>-</b>	<b>-</b>	<b>10,643,646</b>
<b>As of 31 December 2008</b>							
Banknotes and coins in circulation	9,179,414	9,179,414	-	-	-	-	9,179,414
Due to banks and other financial institutions	5,006,486	5,006,486	5,006,486	-	-	-	-
Liabilities to government institutions and other borrowings	7,487,687	7,493,560	6,314,142	681,963	497,455	-	-
Borrowings against Bulgaria's participation in international financial institutions	1,302,601	1,302,601	-	-	-	-	1,302,601
	<b>22,976,188</b>	<b>22,982,061</b>	<b>11,320,628</b>	<b>681,963</b>	<b>497,455</b>	<b>-</b>	<b>10,482,015</b>

#### (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 for the Management of the Gross International Foreign Currency Reserves.

The table below presents one important measure of market risk, i.e. Value at Risk (VaR). VaR is an indicator of the maximum loss over a certain period of time (holding period) and with a certain probability (confidence level). The VaR used in this report is based on a 95 per cent confidence level and a one-day holding period.

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

- the 95 per cent confidence level means that even within this model there is a 5 per cent probability that losses may exceed the VaR;
- the use of historical data (30 days time series) as the basis of determining the probable exits may not cover all possible scenarios, especially those of unusual nature;
- VaR depends on the Bank's positions and the volatility of market prices. VaR of a position of an unchanged volume decreases when the market prices volatility diminishes, and *vice versa*.

The table below describes VaR of the BNB Issue Department assets.



(BGN'000)

	As of 31 December	Average	Maximum	Minimum
<b>2009</b>				
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)
<b>Total:</b>	<b>(31,558)</b>	<b>(34,876)</b>	<b>(64,272)</b>	<b>(4,630)</b>
<b>2008</b>				
Currency risk	(28,169)	(26,572)	(40,126)	(11,862)
Interest rate risk	(3,654)	(2,898)	(6,120)	1,214
Correlation	(0.22)	0.11	0.52	(0.40)
<b>Total:</b>	<b>(17,450)</b>	<b>(23,393)</b>	<b>(38,355)</b>	<b>(6,616)</b>

### 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 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 of 31 December 2009	Effective rate (%)	Total	Floating rate instruments	Fixed rate instruments		
				Up to 1 month	From 1 to 3 months	Over 3 months
<b>Interest-earning assets</b>						
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
<b>Total</b>		<b>24,088,636</b>	<b>1,846,537</b>	<b>3,616,068</b>	<b>3,296,541</b>	<b>15,329,490</b>
<b>Interest-earning liabilities</b>						
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	-	-	-
<b>Total</b>		<b>10,992,874</b>	<b>1,301,587</b>	<b>9,669,773</b>	<b>21,514</b>	<b>-</b>
<b>Asset/liability gap</b>		<b>13,095,762</b>	<b>544,950</b>	<b>(6,053,705)</b>	<b>3,275,027</b>	<b>15,329,490</b>

(BGN'000)

As of 31 December 2008	Effective rate (%)	Total	Floating rate instruments	Fixed rate instruments		
				Up to 1 month	From 1 to 3 months	Over 3 months
<b>Interest-earning assets</b>						
Cash and deposits in foreign currencies	2.1	2,570,471	15,498	2,554,973	-	-
Gold, instruments in gold and other precious metals	0.55	921,234	-	369,045	-	552,189
Financial assets at fair value through profit or loss	2.48	20,194,593	49,963	3,924,901	3,865,219	12,354,510
Financial assets available for sale		71,994	-	71,994	-	-
Other interest-earning assets		27,332	3,644	-	-	23,688
<b>Total</b>		<b>23,785,624</b>	<b>69,105</b>	<b>6,920,913</b>	<b>3,865,219</b>	<b>12,930,387</b>
<b>Interest-earning liabilities</b>						
Due to banks and other financial institutions		5,006,486	-	5,006,486	-	-
Liabilities to government institutions and other borrowings	1.13	6,701,059	146,687	5,380,858	679,514	494,000
<b>Total</b>		<b>11,707,545</b>	<b>146,687</b>	<b>10,387,344</b>	<b>679,514</b>	<b>494,000</b>
<b>Asset/liability gap</b>		<b>12,078,079</b>	<b>(77,582)</b>	<b>(3,466,431)</b>	<b>3,185,705</b>	<b>12,436,387</b>

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 of 31 December 2009	(174,002)	174,002	223,790	171,197
As of 31 December 2008	(154,460)	154,460	644,649	555,912

### Currency risk

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

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

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

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
<b>Assets</b>		
Bulgarian lev and euro area currencies	22,152,103	23,303,953
US dollar	204,416	264,595
Japanese yen	81	72
Pound sterling	76	66
SDR	2,687,877	1,405,595
Gold	1,908,991	1,536,815
Other	2,393	2,167
	<b>26,955,937</b>	<b>26,513,263</b>
<b>Liabilities</b>		
Bulgarian lev and euro area currencies	24,154,135	24,870,085
US dollar	205,507	264,211
Japanese yen	-	72
Pound sterling	-	81
SDR	2,594,172	1,376,652
Other	2,123	2,162
	<b>26,955,937</b>	<b>26,513,263</b>
<b>Net position</b>		
Bulgarian lev and euro area currencies	(2,002,032)	(1,566,132)
US dollar	(1,091)	384
Japanese yen	81	-
Pound sterling	76	(15)
SDR	93,705	28,943
Gold	1,908,991	1,536,815
Other	270	5

#### (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, international foreign currency 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
<b>31 December 2009</b>			
Cash and deposits in foreign currency	4,144,152	-	4,144,152
Gold, instruments in gold and other precious metals	1,937,132	-	1,937,132
Financial assets at fair value through profit or loss	18,943,370	198,786	19,142,156
<b>Total</b>	<b>25,024,654</b>	<b>198,786</b>	<b>25,223,440</b>

## 7. Interest income and expense

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
<b>Interest income</b>		
- on securities	623,228	912,310
- on deposits	20,562	132,696
- on other	607	527
	<u>644,397</u>	<u>1,045,533</u>
<b>Interest expense</b>		
- on deposits	23,009	252,821
- on other	8,207	49,868
	<u>31,216</u>	<u>302,689</u>

Interest expense paid on government deposits in levs as of 31 December 2009 are BGN 17,602 thousand and BGN 3252 thousand in foreign currency. Interest expense paid on deposits in levs of other government organisations as of 31 December 2009 are BGN 374 thousand and BGN 461 thousand in foreign currency. Interest expense as of 31 December 2008 include BGN 37 568 thousand amortisation of securities premium.

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

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Net gains/(losses) from operations in securities	(205,274)	13,615
Net gains from operations in foreign currency	2,902	179
Net revaluation gains/(losses) on futures	1,238	(3,402)
Net revaluation losses on securities	113,432	191 807
Net revaluation gains/(losses) on foreign currency assets and liabilities	(277)	2,169
Net revaluation gains on gold	374,038	122,434
	<u>286,059</u>	<u>326,802</u>

## 9. Other operating revenue

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Turnover of subsidiaries	26,007	24,914
Income from associated companies	3,350	2,581
Income from sale of coins	1,370	1,585
Dividend income	4,554	4,501
Other income, net	571	951
	<u>35,852</u>	<u>34,532</u>

## 10. Total administrative expenses

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Personnel costs	30,538	28,187
Administrative expenses	47,103	42,930
Depreciation	23,392	20,994
Other expenses	4,062	3,214
	<u>105,095</u>	<u>95,326</u>

Personnel costs include salaries, social and health insurance costs charged under the local legislation provisions as of 31 December 2009, respectively for the BNB: BGN 20,776 thousand, for the BNB Printing Works AD: BGN 5492 thousand, and for the Bulgarian Mint EOOD: BGN 2408 thousand. The number of employees of the Bank and its subsidiaries is 1217 in 2009 (2008 – 1207), including the BNB staff of 850 in 2009 (2008 – 840).

Based on actuarial calculations, the Bank has accrued its compensation liabilities to the personnel on retirement and for unused paid annual leave at BGN 610 thousand (30 December 2008 – BGN 359 thousand). The retirement and unused paid annual leave compensation for the Bank's subsidiaries as of 31 December 2009 is BGN 481 thousand (31 December 2008: BGN 434 thousand).

Administrative expenses include also the BNB's currency circulation expenses of BGN 25,688 thousand as of 31 December 2009 (31 December 2008: BGN 22,872 thousand).

## 11. Cash and deposits in foreign currencies

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Foreign currency cash	140,501	84,397
Current accounts in other banks	1,306,928	13,932
Foreign currency deposits	2,696,723	2,556,724
	<u>4,144,152</u>	<u>2,655,053</u>

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

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
<b>Euro area residents</b>		
In EUR	1,620,893	2,539,839
In other currencies	115,982	953
	<u>1,736,875</u>	<u>2,540,792</u>
<b>Non-euro area residents</b>		
In EUR	1,021,109	95,950
In other currencies	1,386,168	18,311
	<u>2,407,277</u>	<u>114,261</u>
	<u>4,144,152</u>	<u>2,655,053</u>

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

	31 Dec. 2009		31 Dec. 2008	
	'000 troy ounces	BGN'000	'000 troy ounces	BGN'000
Gold bullion in standard form	513	763,613	513	614,769
Gold deposits in standard form	769	1 145,378	768	922,046
Gold in other form	17	24,571	17	20,036
Other precious metals	-	3,570	-	2,265
		<u>1,937,132</u>		<u>1,559,116</u>

Gold in standard form includes gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 1.00 per cent per annum. Gold in other form includes commemorative gold coins of BGN 20,837 thousand. Other precious metals include silver commemorative coins of BGN 350 thousand and platinum commemorative coins of BGN 3220 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	31 Dec. 2009	31 Dec. 2008
Foreign treasury bills, notes and bonds	19,142,156	20,600,510
	<u>19,142,156</u>	<u>20,600,510</u>

Securities comprise both coupon and discount securities denominated in euro. The coupon interest of the EUR-denominated securities reached 3.77 per cent in 2009 (31 December 2008 – 3.85 per cent).

The value of securities pledged as collateral on futures transactions amounts to BGN 29,496 thousand as of 31 December 2009 (31 December 2008: BGN 19,469 thousand).

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

(BGN'000)

	Issuer's credit rating	31 Dec. 2009	31 Dec. 2008
Investment graded securities	AAA	10,740,711	13,324,715
	AA+	2,186,051	2,365,381
	AA	30,560	10,121
	AA-	4,736,947	4,242,979
	A+	1,447,887	657,314
		<u>19,142,156</u>	<u>20,600,510</u>

#### 14. Financial assets available for sale

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Republic of Bulgaria's quota in the IMF	1,364,444	1,372,575
Equity investments in international financial institutions	28,193	30,926
Investments in Associates	23,866	20,515
	<u>1,416,503</u>	<u>1,424,016</u>

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 71,835 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 an interest bearing reserve tranche position, at an average rate of 0.42 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. As of 31 December 2009 the current value of 10,000,000 shares in SDR amounts to BGN 26,593 thousand while as of 31 December 2008 it was BGN 23,950 thousand (see 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 central 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 3562 thousand or BGN 6966 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
<i>Associated companies</i>		
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 for 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 BORIKA AD associated companies initiated merger activities due to their close functions and operations.



## 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 of 1 January 2009	146,960	76,990	19,904	5,137	5,369	25,100	279,460
Additions	124	14,420	158	56	-	48,492	63,250
Disposals	-	(601)	(1,854)	(103)	(20)	(147)	(2,725)
Transfers	35,485	20,489	9,303	3,811	921	(70,009)	-
As of 31 December 2009	182,569	111,298	27,511	8,901	6,270	3,436	339,985
<b>Depreciation and Impairment loss</b>							
As of 1 January 2009	(7,108)	(43,498)	(14,200)	(3,038)	(3,789)	-	(71,633)
Charge for the period	(4,495)	(7,107)	(4,276)	(568)	(431)	-	(16,877)
On disposals	-	516	1,852	88	19	-	2,475
As of 31 December 2009	(11,603)	(50,089)	(16,624)	(3,518)	(4,201)	-	(86,035)
<b>Net book value as of 31 December 2009</b>	<b>170,966</b>	<b>61,209</b>	<b>10,887</b>	<b>5,383</b>	<b>2,069</b>	<b>3,436</b>	<b>253,950</b>
<b>Net book value as of 31 December 2008</b>	<b>139,852</b>	<b>33,492</b>	<b>5,704</b>	<b>2,099</b>	<b>1,580</b>	<b>25,100</b>	<b>207,827</b>

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 of 1 January 2009	31,433	45	309	31,787
Additions	909	-	4,896	5,805
Disposals	(531)	(4)	(245)	(780)
Transfers	4,614	-	(4,614)	-
As of 31 December 2009	36,425	41	346	36,812
<b>Depreciation and Impairment loss</b>				
As of 1 January 2009	(16,479)	(38)	-	(16,517)
Charge for the period	(6,512)	(3)	-	(6,515)
On disposals	518	4	-	522
As of 31 December 2009	(22,473)	(37)	-	(22,510)
<b>Net book value as of 31 December 2009</b>	<b>13,952</b>	<b>4</b>	<b>346</b>	<b>14,302</b>
<b>Net book value as of 31 December 2008</b>	<b>14,954</b>	<b>7</b>	<b>309</b>	<b>15,270</b>

Software includes, as of 31 December 2009, all licenses purchased by the BNB to the total amount of BGN 1848 thousand (31 December 2008: BGN 10,936 thousand), and software products to the amount of BGN 1430 thousand (31 December 2008: BGN 19,916 thousand).

**17. Other assets**

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Balances of subsidiaries held with local banks	28,323	27,332
Commemorative coins for sale	390	264
Inventories	14,038	14,209
Accounts receivable	2,477	6,935
Deferred expenses	2,300	1,449
Other receivables	214	1,282
	<u>47,742</u>	<u>51,471</u>

**18. Currency in circulation**

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Banknotes in circulation	7,892,082	9,032,131
Coins in circulation	157,018	147,283
	<u>8,049,100</u>	<u>9,179,414</u>

**19. Due to banks and other financial institutions**

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Demand deposits from banks and other financial institutions		
- in BGN	2,233,442	2,625,265
- in foreign currency	2,691,534	2,381,221
	<u>4,924,976</u>	<u>5,006,486</u>

The Bank does not pay interest on demand deposits from banks and other financial institutions. Demand deposits include BGN 4896 million representing the obligatory reserves, which all local banks are required to maintain on accounts with the BNB (31 December 2008: BGN 5003 million).

**20. Liabilities to government institutions and other borrowings**

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
Current accounts		
- in BGN	2,006,422	533,793
- in foreign currency	617,487	419,036
Time deposit accounts		
- in BGN	3,186,000	5,099,000
- in foreign currency	1,580,311	1,435,858
	<u>7,390,220</u>	<u>7,487,687</u>

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in euro and in leva earn interest between 0 per cent and 1.4 per cent.

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

The borrowings against Bulgaria's participation in the IMF as of 31 December 2009 amount to BGN 1,334,801 thousand: SDR 604,863 thousand (as of 31 December 2008: BGN 1,236,559 thousand: SDR 605,072 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 in levs amounting to BGN 3582 thousand (as of 31 December 2008: BGN 3336 thousand).

On 28 August 2009 and on 9 September 2009 the Bank received SDR 474,586,534 and SDR 136,289,102 respectively from the general SDR allocation made by the IMF. The funds shall be returned to the IMF on demand.

## 22. Other liabilities

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
European Commission funds	117,750	97,403
Salaries and social security payable	1,340	2,153
Deferred income	276	1,806
Other liabilities	17,779	8,401
	<u>137,145</u>	<u>109,763</u>

As from 1 January 2007 the Republic of Bulgaria, in its capacity as EU Member State, participates in the funding of EU budget. Pursuant to Article 9 of 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-monetary asset revaluation reserves comprise the net change in fair values of property, equity investments and other non-monetary assets.

Pursuant to Article 36 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.

The 2009 profit distribution in accordance with the profit distribution policy disclosed in note 5 (h) is as follows:

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
<b>Profit for the period</b>	<b>833,883</b>	<b>1,013,377</b>
Allocation to special reserve under Article 36 of the Law on the BNB:		
Unrealised (gains) from gold revaluation	(374,038)	(122,434)
Unrealised (gains)/loss on revaluation of financial assets at fair value through profit or loss	21,730	(191,807)
Unrealised foreign currency revaluation (gains)/losses	277	(2,169)
Other unrealised (gains)	(1,238)	3,402
<b>Result after allocation to special reserve, including:</b>	<b>480,614</b>	<b>700,369</b>
<i>Allocation to other reserves and minority interest</i>	<i>125,904</i>	<i>180,414</i>
<i>Allocation to the special-purpose fund</i>	<i>-</i>	<i>119,000</i>
<i>Planned contribution to the state budget</i>	<i>354,710</i>	<i>400,955</i>

The planned contribution to the state budget results after the allocation of the profit for the period to *reserves* and *special reserves* upon a decision of the BNB Governing Council.

## 24. Minority interest

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

## 25. Monetary liabilities and gross international foreign currency reserves

(BGN'000)

	31 Dec. 2009	31 Dec. 2008
<b>Gross international foreign currency reserves</b>		
Cash and deposits in foreign currencies	4,144,152	2,655,053
Monetary gold and other instruments in gold	1,908,991	1,536,814
Security investments	19,142,156	20,600,510
Equity investments and quota in the IMF	71,835	71,994
	<u>25,267,134</u>	<u>24,864,371</u>
<b>Monetary liabilities</b>		
Currency in circulation	8,049,100	9,179,414
Due to banks and other financial institutions	4,897,212	5,006,376
Liabilities to government institutions	7,150,724	7,294,721
Other liabilities	385,010	290,479
	<u>20,482,046</u>	<u>21,770,990</u>
Surplus of gross international foreign currency reserves over monetary liabilities	<u>4,785,088</u>	<u>3,093,381</u>

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 31 December 2009 the Republic of Bulgaria has not received funds under IMF borrowing 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 31 December 2009 the par value of the government securities held in custody was BGN 3009 million (31 December 2008: BGN 3064 million).

## 27. Subsidiaries

(%)

Ownership interest	31 Dec. 2009	31 Dec. 2008
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 784 thousand from the State Mint EOOD (31 December 2008: BGN 986 thousand) and BGN 3533 thousand from the BNB Printing Works AD (31 December 2008: BGN 3529 thousand).

## 28. Commitments and contingencies

### 1) *Participation in the Bank for International Settlements*

The Bank holds 8000 shares of the capital of BIS, Basle, each amounting to SDR 5000. Twenty-five per cent of the equity investment in BIS, Basle is paid up. The capital subscribed but not paid in is with an option to be paid in within three months following a decision of the BIS Board of Governors. The contingent amount as of 31 December 2009 is BGN 63,921 thousand (31 December 2008: BGN 64,422 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 1,334,801 thousand.

### 3) *Capital commitments*

As of 31 December 2009 the Bank has committed to BGN 1349 thousand to purchase tangible and non-tangible assets (31 December 2008: BGN 25,702 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

15 January	As of 23 February 2009 the Bulgarian National Bank put into circulation a copper commemorative coin '110 Years since Dechko Uzunov's Birth' with a nominal value of BGN 2.
27 January	As of 18 May 2009 the Bulgarian National Bank put into circulation a silver commemorative coin with a silica enamelled fragment '130 Years Bulgarian National Bank' with a nominal value of BGN 10.
26 February	Ordinance on Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk was adopted.  Ordinance on Amendments to BNB Ordinance No. 8 on the Capital Adequacy of Credit Institutions of 2006 was adopted.
26 March	The report on the Implementation of the BNB Budget as of 31 December 2008 was approved.
23 April	The BNB Annual Report for 2008 was approved.  Ordinance No. 20 on the Issuance of Approvals under Article 11, Paragraph 3 of the Law on Credit Institutions was adopted.  Ordinance on Amendments to Ordinance No. 2 on the Licenses, Approvals and Permissions Granted by the Bulgarian National Bank according to the Law on Credit Institutions was adopted.  BNB Ordinance No. 26 on Financial Institutions was adopted.  As of 1 June 2009 the BNB put into circulation as legal tender a banknote of BGN 5 nominal value.
16 July	Ordinance on Amendments to Ordinance No. 23 of 1999 on the Terms and Procedure for Payment of Insured Amounts on Deposits with Banks with Revoked Licenses was adopted.  Ordinance No. 3 on the Terms and Procedure for the Execution of Payment Transactions and Use of Payment Instruments was adopted.  Ordinance No. 16 on Payment Institutions and Payment System Operators Licensing was adopted.  Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes was adopted.  Ordinance No. 22 on the Central Credit Register was adopted.  As of 14 September 2009 the Bulgarian National Bank put into circulation a coloured silver commemorative coin 'Pottery' of the 'Bulgarian Handicrafts' series, with a nominal value of BGN 5.  As of 20 October 2009 the Bulgarian National Bank put into circulation a gold commemorative coin 'St Dimitar Thaumaturge' of the 'Bulgarian Iconography' series with a nominal value of BGN 100.
10 September	The report on the Implementation of the BNB Budget as of 30 June 2009 was approved.
15 October	A new Tariff of Fees Charged by the Central Credit Register was adopted, coming in effect as of 1 November 2009. It repeals the Tariff of the fees which the Bulgarian National Bank collects in connection with the operation of the Central Credit Register in force as of October 2006.  Amendments to the RINGS tariff in effect as of 1 November 2009 were adopted.  Decided on awarding two scholarships to students pursuing a master's degree, and one scholarship to a student pursuing a Ph.D. degree in 2010.
17 November	The BNB Budget for 2010 was approved.  The BNB Report for January – June 2009 was approved.



- 10 December** Ordinance on Amendments to BNB Ordinance No 16 on Payment Institutions and Payment System Operators Licensing was adopted.
- Ordinance on Amendments to BNB Ordinance No. 27 on the Balance of Payments Statistics was adopted.
- 22 December** The following scholarships for 2010 were awarded:
- for pursuing a master's degree to Ivan Ivanov (University of Economics – Varna);
  - for pursuing a PH.D. degree to Tsvetelina Marinova (University of National and World Economy, Sofia).