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Staff Country Reports

**Bulgaria: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Monetary and Financial Policy Transparency,
Banking Supervision, Securities Regulation, Insurance Regulation,
and Payment Systems**

This Financial System Stability Assessment paper on **Bulgaria** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **July 12, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Bulgaria** or the Executive Board of the IMF.

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BULGARIA

Financial System Stability Assessment

Prepared by Monetary and Exchange Affairs Department and European I Department

Approved by Hassanali Mehran and Michael Deppler

July 12, 2002

This Financial System Stability Assessment (FSSA) is based on the work of the joint World Bank (WB)-IMF Financial Sector Assessment Program (FSAP) mission that visited Bulgaria from October 29–November 14, 2001, and an expert visit on payment systems in June 2002. The mission met with the Minister and Deputy Ministers of Finance and their staff, the Governor, and Deputy Governors of the Bulgarian National Bank (BNB) and their staff, members of Parliament, the Head of the Deposit Insurance Fund, and staff of the financial sector regulatory agencies, the Financial Intelligence Unit, EU representatives, aid donors, banks, and auditors.

The assessment team was led by Mr. Albert Martinez (ECA, World Bank) and Mr. Jan Willem van der Vossen (IMF/MAE), and included Mr. Mark De Broeck (EU1), Mr. Boyko Dimitrachkov (LEG), Ms. Yuri Kawakami, Ms. Jia Liu, Research Assistant, Mr. Hemant Shah (all MAE), Mr. Paul O'Brien (Central Bank of Ireland, IMF Expert on Payment Systems), Mr. Peter Allsopp, consultant, formerly of the Bank of England (Expert on Payment Systems), Mr. Arpad Kiraly (Hungarian State Financial Supervision, IMF Expert on Bank Supervision), Mr. Aditya Narain (Reserve Bank of India, IMF Expert of Bank Supervision), Mr. Euan Abernethy, (Consultant, World Bank Expert on Capital Markets), Mr. Luc Cardinal, Mr. Simeon Djankov, Mr. Luc Laeven, Ms. Esperanza Lasagabaster, Mr. Kenneth Mwenda, Ms. Susan Rutledge, and Ms. Maria Kalimerova (Program Assistant) (all World Bank). The mission liaised with Ms. Piritta Sorsa, IMF Resident Representative in Bulgaria, Mr. Oscar de Bruyn Kops, Country Office Manager, and Ms. Lada Stoyanova, Acting Country Office Manager, World Bank Sofia Office.

The development of the financial sector in Bulgaria benefits from intense and successful efforts of the Bulgarian authorities to restore financial stability to the country after the economic crisis of 1996–97. Bulgaria's macroeconomic policies are tied to three anchors: (i) the discipline imposed by the Currency Board Arrangement (CBA); (ii) discipline imposed by the accession procedure to the EU and EMU; and (iii) the conditionalities of Fund and World Bank programs. While real growth has resumed and the fiscal deficits have been contained, the increasing current account deficit is a matter of concern.

These stable macroeconomic policies form a sound basis for the financial sector in Bulgaria. The Bulgarian banking system is generally well supervised, highly capitalized, profitable, and risk-averse. Stress tests performed by the mission suggest that the banking system is very resilient to foreign exchange and interest rate risks, and can also absorb considerable credit risk. Since 1996, the banking sector has gone through a process of consolidation, privatization, and restructuring. Now, with a growing real sector and competitive pressure on margins, banks are beginning to expand their credit portfolios, which will entail new risks and require vigilance from banks and supervisory authorities.

The small nonbank financial sector does not pose short-term systemic risks. However, improper pension reform design and implementation could hinder financial system development and entail future fiscal costs. Also, further development of the financial sector will require improvements in the legal, judicial, and corporate governance areas.

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SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. OVERALL STABILITY ASSESSMENT

1. **The key challenge for the Bulgarian financial system in the coming period is to successfully make the transition from post-crisis caution and consolidation to renewed emphasis on development and carefully managed expansion, without incurring undue levels of risk and new instability.**
2. **The condition of the financial sector in Bulgaria must be assessed against the background of intense and successful efforts of the Bulgarian authorities to restore financial stability to the country after the economic crisis of 1996–97.** Bulgaria's stable macroeconomic policies are reinforced by the discipline required for: (i) the Currency Board Arrangement (CBA); (ii) the criteria for EU and EMU accession; and (iii) the conditionality of Fund and World Bank programs.
3. **These stable macroeconomic policies have borne fruit, as real growth has resumed and fiscal deficits have been contained, although the increasing current account deficit is a matter of concern.** In 2001, gross official reserves covered five months of imports of goods and non-factor services and are projected to average the same level over 2002.
4. **On this macroeconomic basis, a stable, generally well supervised, strongly capitalized, profitable, and risk-averse banking system has developed. However, the nonbank financial sector remains in need of development, but does not pose a systemic risk at this time.** The stability of the system is underscored by the results of the stress tests performed by the mission, which suggest that the banking system is very resilient and can absorb considerable credit risk.
5. **The banking sector is now facing new challenges, after a period of consolidation and retrenchment in the aftermath of the 1996–1997 crisis.** With a growing real sector, expanding credit demand, and competitive pressure on margins on placements, banks are expanding their credit portfolios. This will entail new risks, certainly after entry of more EU based financial institutions into the market, and therefore demand unremitting vigilance of banks and bank supervisors.
6. **The non-bank financial system is still in an early stage of development, and, as with regard to the banking sector, further development will require improvements in the legal, judicial, financial disclosure, and corporate governance areas.** The pension system, if reform is not designed and implemented properly, may hamper sound financial system development and entail fiscal costs in the future. The insurance system is small, compared to other jurisdictions. Neither pose systemic threats, although supervision of these sectors needs to be considerably strengthened, notably of insurance companies and pension funds.

7. **The following short and medium term recommendations on the one hand focus on managing the risks inherent in renewed credit growth and expansion of the financial sector, and on the other hand on the continuation of measures to create a better infrastructure for a safe and balanced development of the financial sector.**

A. Short-Term Vulnerabilities and Recommendations

8. **The Bulgarian National Bank (BNB) should at this time carefully monitor and control the quality of banks' currently expanding credit portfolio, before the expansion of credit leads to lower asset quality.** The BNB must also assess whether banks' credit allocation and risk management systems are capable of dealing with the increase in lending. The increasing risk in the banks' portfolios is exacerbated by deficiencies in legal and judicial systems, corporate governance, and financial disclosure. Additionally, BNB and the Deposit Insurance Fund (DIF) must develop a strategy to monitor the smaller and more vulnerable banks, which are to be faced with expected increased competition and consolidation, especially in the period running up to, and after EU accession.

9. **Connected to control over safe and sound lending policies, as well as over connected lending and safeguard financial system integrity, is the need for BNB to investigate the identity and suitability of direct and indirect shareholders of banks.** Recent amendments in the Law on Banks have given the BNB expanded powers in this area, which it needs to use.

10. **The newly established coordinating committee of financial sector supervisory agencies must be used by the authorities to develop a system-wide perspective of financial sector vulnerabilities, also based on the FSAP results.**

11. **The liquidation of a number of unresolved banks should be speeded up. Passage by Parliament in July 2002, and subsequent implementation, of the draft law on bank bankruptcy will expedite this process.**

12. **As an integral part of maintaining stable macro economic policies and as a necessary backdrop for sound financial sector development, a public debt management strategy needs to be finalized as soon as possible and the draft Public Debt Law enacted.**

13. **The supervisory capacity of the State Insurance Supervision Agency (SISA) and the governance of pension insurance companies and pension funds need strengthening.** The pension legislation would require substantial amendment to address its many weaknesses. In addition, the investment guidelines for insurance companies and pension funds should be reviewed to ensure proper risk diversification.

14. **Although all efforts should be undertaken to ensure the introduction, in the course of 2002, of the RTGS payment system, there is a strong case for the BNB to**

suspend its chosen implementation date, and to set a new date only when it can be certain that all the banks are in every key respect ready for the new system.

B. Medium-Term Vulnerabilities and Recommendations

15. **The authorities must continue ongoing programs to build expertise in supervising IT risk in banks, and to build capacity to assess internal ratings based risk management systems in banks, which will be necessary under the new Basel capital proposals.**

16. **The authorities need to obtain more knowledge on cross-sectoral ownership relationships between institutions in the financial sector, as the relatively scarce information on this point can pose medium term vulnerabilities.**

17. **The legal and judicial framework, corporate governance and financial transparency need to be strengthened in order to promote access to credit and safe bank lending, as well as the development of viable capital markets. Also the legal framework and institutional arrangements covering enforcement of creditor rights and insolvency need to be improved.**

18. **Supervision of the non-bank financial sector needs to be strengthened, in terms of the supporting legislation as well as staff numbers expertise and experience. Cooperation with the other financial sectors through the newly created financial sector supervision coordination committee will also be beneficial in this respect.**

II. MACROECONOMIC BACKGROUND

19. **Stable exchange rates and interest rates, and sound underlying policies are key to the development of stable financial sector and the increase in financial intermediation.** Since the crisis in 1996/1997, Bulgaria has been successful in stabilizing the financial system. These policies need to be continued, and the authorities are firm in their intention to do so. Key to the sustainability of the CBA are continued fiscal discipline, a manageable current account deficit, continued inflow of foreign capital, and in the longer term creation of more competitive conditions for foreign investors, including improvements in the judicial, governance, accounting and disclosure areas.

20. **The CBA, introduced in July 1997, tightly constrains the monetary policy of the Bulgarian National Bank (BNB).** The CBA fixes the Bulgarian Leva to the Euro, and the BNB does not operationally target interest rates. The BNB does not provide credit to the government, invest in government securities, or undertake open market operations. Foreign reserve cover under the CBA currently stands at over 112 percent of domestic liabilities. The BNB sets minimum reserve requirements for commercial banks, which were lowered to 8 percent from 11 percent in July 2000. Further lowering of the reserve requirements to

achieve a closer alignment with levels in the EU would depend on alternative sources of reserve liquidity for banks, for instance through the interbank market.

21. **Following the introduction of the CBA, a conservative fiscal stance has been maintained.** In order to reduce a high public debt burden and to avoid fiscal stimulus that would put pressure on the external position, the authorities adopted consistently prudent deficit targets in the 1998–2001 budgets. Fiscal policy was tightened in response to external shocks in 1999–2001, containing the deficit to around 1 percent of GDP in each year. The fiscal reserve account of more than BGN 2 billion provides a cover for major fiscal contingencies related to the external debt service and shortfalls in projected external financing inflows.

22. **In the medium-term, public debt management in Bulgaria faces several major challenges.** These include further reducing the public debt to GDP ratio, and reducing the external, dollar-denominated, and floating-rate debt component. While fiscal deficits are expected to be modest over the medium-term, high current account deficits are a potential source of vulnerability, which may result in loss of reserves and a need for additional borrowing to support the CBA. Over 2002, the current account deficit is expected to be around 6.5 percent. At end April 2002, exposure of the banking sector to the government is limited, and stands at roughly 12.5 percent of commercial bank assets. The CBA strictly limits the issuance of government paper.

23. **At end April 2002, domestic public debt amounted to 1921.7 million leva (5.8 percent of estimated 2002 GDP), 681.3 million leva of which was denominated in foreign currency, while public external debt was almost 58 percent of GDP.** Only a small fraction of the debt is short-term, and amounts to only 123.6 million leva at the end of April, on a residual maturity basis, which is less than at the end of 2001 (135.5 million leva). At the end of March 2002, the external debt of Bulgaria's private sector stood at US\$1879.8 million (12.8 percent of estimated 2002 GDP). Of this, US\$1130.3 million was short-term (including US\$672.1 million trade credits) (7.8 percent of estimated 2002 GDP). At end 2001 these figures were US\$1966.3 million, US\$1208.2 million and US\$654.5 million (14.5 percent, 4.8 percent, and 8.9 percent of 2001 GDP), respectively.

24. **A debt management strategy remains under discussion and needs to be finalized.** A draft Public Debt Law was submitted to Parliament in January 2002. It envisages debt management functions to be exercised by the Ministry of Finance (MoF). Formulation of a clear and accepted debt strategy is an urgent matter in order to guide the tactical debt issuance decisions. An important element of the strategy would pertain to the size of debt buy-back and refinancing operations, which would determine the volume of aggregate issuance and the sustainable number of benchmark issues.

25. **In 1999–2000, Bulgaria recorded external current account deficits of more than 5 percent of GDP.** Reflecting the global economic slowdown, exports shrank in the middle of 2001, while imports grew at double-digit rates, fueled by private consumption and

investment. The 2001 trade deficit exceeded 10 percent of GDP and the current account deficit was close to 7 percent of GDP. For 2002, a deficit of 6.5 percent is anticipated.

26. **External financing needs in recent years have largely been met by foreign direct investment (FDI) inflows.** In 1999–2000 large privatizations helped cover the current account deficit, and build up international reserves. In 2001, however, the privatization process slowed considerably and Greenfield FDI projects were affected by the unfavorable external environment. Lower FDI inflows, a wider current account deficit and external debt service reduced international reserves to around four months of imports at end 2001. At the end of the first quarter of 2002, reserves covered twice the amount of short-term debt. Bulgaria has felt little impact of pressures in international emerging debt markets, and retains access to these markets to cover its financing needs. Private portfolio investment and equity inflows are negligible, as there are few investment instruments available, and investment in Bulgarian enterprises is still not attractive to most foreigners.

27. Real GDP growth picked up from 3½ percent in 1998 to almost 6 percent in 2000 driven by industrial production and the services sector. Net exports and investment were the main sources of growth in 2000. In 2001, continued strong investment growth and a recovery in private consumption helped cushion the impact of the reduction in export demand due to the global economic slowdown. In 2001, real GDP grew by 4 percent and the same growth is projected for 2002. Inflation amounted to 4.8 percent at the end of 2001, but is expected to increase to more than 7 percent over 2002.

III. BANKING SECTOR

A. Bank Intermediation

28. Bank intermediation remains low, reflecting risk adverse behavior after the 1996 crisis, although BNB data indicate an increase in lending to the private sector by 16 percent in real terms over the 12-month period until April 2002. Nevertheless, credit to the private sector over 2000 of 15.9 percent of GDP was still much lower than in other central European countries. Although deposits in good foreign banks remain an important part of bank assets, in the fourth quarter of 2001 banks' balance sheets for the first time since the crisis, showed loans in excess of placements in foreign banks. However, deposits in foreign banks and lending to the private sector still each account for broadly one third of banks' assets in March 2002.¹

29. **Low bank intermediation is broadly accounted for by supply and demand factors, legal problems, unreliable corporate financial accounts, and weak corporate governance.** SMEs in Bulgaria rely primarily on cash and informal credit sources. In

¹ Most of the deposits are placed in banks, which have received single A or equivalent from international rating agencies.

general, much liquidity, in Leva as well as in dollars—approximately 58 percent of deposits—is still retained outside the banking system. Cash holdings by the population are estimated at US\$0.7–1 billion, and only a third of the population has a bank account.

30. **Bank lending to the domestic sector accounts for roughly a third of total assets.** Two thirds of this lending goes to private enterprises and one third to individuals and households. Commercial banks are increasingly trying to cut into retail market segments such as consumer credit and residential mortgages, which had been dominated by two banks.

31. Over the second half of 2001, there seems to have been a redirection of loans toward mid-size domestic companies and away from blue chip companies. Banking sector claims on private enterprises increased to about BGN 3.4 billion (Q3, 2001). Banks have also increased loans to households—from BGN 600 million (Q1, 2001) to BGN 820 million (Q4, 2001). This shift is explained by the high level of liquidity and stiffer competition.

32. **Average maturities of these deposits are short (a few months) and deposit rates range between 3–5 percent.**² Maturities of both assets and liabilities are very short, and a large proportion of assets and liabilities use floating interest rates, thus limiting interest rate mismatch.

33. **Foreign-currency-denominated assets and liabilities are both steadily increasing.** Foreign exchange denominated deposits from nonfinancial institutions increased from 35 percent of total liabilities at end-1999 to 42 percent in March 2002. Lending in foreign currency increased from 10 percent of total assets to 13 percent assets during the same period. Banks attempt to lower the currency mismatch between foreign exchange liabilities and assets, and are in compliance with the BNB regulations on open foreign exchange positions. Most borrowers prefer loans in Leva, to avoid exchange rate risk. Due to data limitations, it is not possible at this time to establish which part of foreign exchange lending is dollar or Euro denominated. This also limits the ability to establish the real extent of exchange rate risk, as the only major risk lies in the dollar/lev rate. Under the CBA, the Euro/lev rate is fixed.

34. **Nevertheless, the proportion of foreign currency loans to foreign currency deposits is still relatively low (approximately one-third).** Of lending to enterprises, 48 percent is in foreign currency, while foreign currency lending to households stands at 4 percent of total lending to households (March 2002).

² While contractual deposit maturities are short, bankers estimate that 70–75 percent of deposits are stable.

B. Structure and Ownership

35. **The financial sector of Bulgaria is small relative to the size of its economy (assets of 41 percent of GDP in March 2002), and is dominated by the banking sector (93 percent of assets; Table 1).** Although the number of banks seems relatively large, overbanking is not

Table 1. Bulgaria: Structure of Financial Sector as of March 2002

	Number of Institutions	Assets		
		In millions of leva	In percent of Total assets	In percent Of 2002 GDP
Banks	35	12,707	93	39
Foreign-owned banks	25	9,411	69	29
Subsidiaries	18	8,406	62	26
Branches	7	1,005	7	3
Domestic	10	3,296	24	10
Private banks	6	787	6	2
State-owned banks	4	2,509	18	8
Agricultural credit unions	33	23	0	0
Securities firms	69	54	0	0
Finance companies 2/ Collective investment schemes	42	112	1	0
Investment funds	1	7	0	0
General insurance companies	2	4	0	0
Life insurance companies	19	409	3	1
Licensed Pension funds	12	195	1	1
	9	127	1	0
Total financial system	221	13,638	100	41

Sources: Bulgarian National Bank and IMF staff estimates and projections.

an issue in Bulgaria.³ Although information was limited, there was no positive evidence of cross-sectoral ownership of financial institutions. Thus no firm conclusions could be drawn as to potential systemic instability as a result of these cross holdings. This weak information

³ Many banks serve only a limited customer base, usually companies from their home country. The number of banks serving domestic companies and the general population is much smaller than 35. Further bank consolidation is expected as competition increases over the medium term.

base on bank ownership can pose medium term vulnerabilities from an AML/CFT as well as a prudential point of view, as consolidated supervision is not possible without good information on group (beneficial) ownership and financial structures.

36. **Bulgaria has made significant progress in privatizing state-owned banks attracting some strong foreign banks as strategic investors** (Table 2).⁴ The state-owned banks have a market share of only 20 percent of assets and 22 percent of deposits. Foreign branches and subsidiaries hold 74 percent of assets and 73 percent of deposits.

Table 2. Bulgaria: Structure and Ownership of Commercial Banks, March 2002

	Total	Private		State owned	
		(in percent of total)			
		Foreign Subsidiaries	Domestic Branches		
Total number of banks	35	18	7	6	4
Assets	100	66	8	6	20
Of which the three largest banks	46	33			13
Deposits	100	66	7	5	22
Of which the three largest banks	48	34			14
Capital and Reserves	100	75	2	7	16
Of which the three largest banks	49	40			9

Source: Bulgarian National Bank.

37. **Concentration of bank assets measured by the Herfindahl-Hirschman Index (HHI) is moderate.**⁵ In March 2002, the three largest banks accounted for 46 percent of bank assets, 48 percent of deposits, and 49 percent of capital and reserves in March 2002. Further concentration among the smaller banks is likely as competition increases.

⁴ Since the fall of 2001, significant progress has been made in finalizing the privatization program for the banking sector. The government's minority stake in the Central Cooperative Bank was sold to a strategic investor in November 2001. The privatization procedure for Biochim Bank was relaunched in early 2002 following two unsuccessful attempts to sell it in previous years. Finally, a sale strategy for DSK Bank—the former State Savings Bank and Bulgaria's third largest financial institution—was approved in March 2002.

⁵ The HHI for the banking sector was 1,017 as of June 2001 (an HHI below 1000 is considered non-concentrated; between 1000 and 1800 moderately concentrated, and above 1800 highly concentrated).

38. **Insufficient information was available to the mission to assess the quality of the shareholders of a number of banks.** All shareholders can be required to provide information relevant to their suitability as shareholders to the BNB; shareholders of between 3 and 10 percent are obliged to submit information, and shareholders above 10 percent must obtain prior permission of the BNB. In some cases, the BNB itself is insufficiently aware of the identity and suitability of the beneficial owners of the banks, which are sometimes located in offshore centers, in particular Cyprus. Lack of knowledge of the ultimate shareholders raises governance and AML/CFT issues and makes effective monitoring of prudential standards difficult.

C. Banking Sector Performance

39. **The banking sector operates in an environment of fundamentally good rules and regulations adapted to EU standards, good banking supervision, as well as high capital and liquidity levels.** The sound condition of the banking system is also attributable to: (i) risk averse policies of banks; (ii) limited opportunities for relatively risky domestic lending; and (iii) tight prudential regulations and supervision. Asset quality indicators are at an acceptable level. There are no significant short-term vulnerabilities. Macro policies are stable as a result of policies committed to maintenance of the CBA, and meeting Fund, World Bank and EU accession conditionality. Banks conduct a relatively low risk business, with low levels of lending, large proportions of investments in low risk prime bank deposits, and little or no portfolio, foreign exchange or interest rate risk.

40. **However, vulnerabilities could arise when risks increase as a result of higher competition, shrinking margins, continued high overheads and the increase in credit risk from increased lending.** Therefore, commercial banks as well as the Banking Supervision Department of BNB will need to closely monitor asset quality and banks' risk management capability during the coming period. Banks' risk management systems are still relatively basic, which is still adequate, in view of the straightforward nature of most banks' balance sheets. Thusfar, commercial banks have managed credit risk by limiting lending volume, high collateral requirements, high lending rates and short term variable rate lending.

41. **The banking system is highly capitalized.** The average capital adequacy ratio (CAR) for the banking system gradually declined from 43 percent at end-1998 to 29 percent in March 2002. These high CAR levels suggest that banks can still expand their lending considerably, but also that they are not obtaining an optimal return on their invested funds. In March 2002, smaller banks had the highest average capital adequacy ratios (52 percent) followed by the group of the largest banks (36 percent). Subsidiaries of foreign banks' capital adequacy ratios declined from 52 percent at end-1999 to 32 percent at in March 2002, while the CAR of domestic banks hovered at around 23–25 percent during 2000–2002. For long-term profitability, these ratios are too high, but justified for the immediate term, in a post crisis interim situation.

42. The gross nonperforming exposure ratio (defined as loans classified as watch, substandard, doubtful, and loss, including any classified deposits in foreign banks), fell from 14 percent at end-1999 to 6 percent in March 2002. Net of provisioning, the exposure ratio fell from 4 percent to 1 percent during the same period (Table 3). However, the overall gross nonperforming exposure ratio of 6 percent is distorted significantly downwards⁶ by the inclusion of deposits in foreign banks in both the numerator and the denominator of the ratio. Leaving aside such low-risk deposits in strong foreign banks, nonperforming loans as a percentage of total loans would have been 13 percent—double the reported gross nonperforming exposure ratio. The nonperforming loan ratio net of provisions would have been 6 percent in March 2002. It should be noted however, that asset quality differs substantially between different groups of banks,⁷ as shown in Table 3.

Table 3. Bulgaria: Quality of Domestic Loans of Commercial Banks, 1999–March 2002¹
(End of period; in percent of total, unless otherwise indicated)

	1999	2000	2001	2002 Mar.
Nonperforming exposure ratio	14	8	7	6
<i>Of which: provisioned</i>	10	7	5	5
Nonperforming loan ratio 2/	29	17	14	13
<i>Of which: provisioned</i>	21	14	4	7
Nonperforming exposure ratio by group				
Group 1	6	3	3	3
Group 2	32	15	9	7
Group 3	9	10	16	15
Group 4	18	20	18	16
Group 5	12	8	5	4

1/ Nonperforming exposure or nonperforming loan is the total of assets or loans categorized in watch, substandard, doubtful, and loss.

2/ Assumes all claims on financial institutions as standard with no provisioning.

Sources: BNB, and IMF staff estimates.

⁶ There is also an upward distortion of the ratio by the practice of banks to retain written-off assets on their books, which increases the numerator of the ratio.

⁷ Since the beginning of 2001, the BSD has categorized banks into five groups according to asset totals: Group 1: > BGN 800 million (3 banks); Group 2: > 300, <800 million (6 banks); Group 3: > 100, <300 million (6 banks); Group 4: < 100 million. (13 banks); Group 5: all branches of foreign banks (7 banks).

43. **Bank profitability in Bulgaria has been generally high compared to banks in other central European countries (see Table 4). Over the period 1998–2000 the return on average equity (ROAE) increased from 6 percent to over 15 percent, while the return on average assets (ROAA) almost tripled from 1 percent in 1998 to close to 3 percent in 2000.**⁸

Table 4. Bulgaria: Earnings of Banks in CEE Countries in 2000

	(In percent)						
	Bulgaria	Czech Republic	Hungary	Poland	Romania	Slovenia	Slovak Republic
Number of banks covered for earnings indicators	20	19	30	36	21	20	16
Earnings							
Return on average assets (ROAA) 1/	2.9	0.5	1.6	1.0	0.9	1.2	1.7
Return on average equity (ROAE) 2/	15.5	6.1	11.7	10.5	5.5	11.7	23.8
Memorandum items:							
Net loans in percent of total assets 3/	23	29	49	48	33	53	43
Net interest margin	5	3	4	4	8	5	3
Cost to income ratio	66	70	73	63	53	58	68

1/ ROAA=net income/total average assets.

2/ ROAE=net income/total equity

3/ Discrepancies with data in Table 3 are attributable to the fewer number of banks, which have higher proportion of assets deposited in foreign banks.

44. **Across the sector, the open foreign currency position is very low relative to the capital base.** The interest rate risk is also low, because of the stable interest rate and short maturity of the mostly floating-rate assets and liabilities. The weighted average maturity of assets was 11 months, while that of the liabilities was 8 months in September 2001.

D. Liquidity Arrangements and Interbank Market

45. **Under the CBA, central bank liquidity support can only be extended under conditions of systemic risk.** As a result, the BNB has placed a high priority on monitoring commercial banks' liquidity management. A minimum reserve requirement (MRR) of 11 percent was reduced to 8 percent (generally 2–3 percent in EU countries) in July 2000 to stimulate lending to the private sector. Banks prefer to keep low stocks of Leva liquidity, depositing most of the surplus liquidity in foreign currencies in foreign banks. Liquidity ratios of banks are generally high, with a stable primary liquidity ratio at around 10 percent. Since the third quarter of 2001, the BNB has started compiling a "marketable assets ratio," to

⁸ Bankscope data. The data are for 20 banks. The ROAE is defined as net income in percent of average equity. The ROAA is defined as net income in percent of average assets.

monitor banks' liquidity. The ratio of marketable assets⁹ to total assets is high at 48 percent in March 2002.

46. **Daily interbank deposit trading volumes range between BGN 30–100 million, and average only around BGN 60 million daily, mostly in the form of three-day placements.** Less creditworthy banks do not enjoy adequate credit lines from other banks. Settlement liquidity of smaller banks will need to be managed very carefully. An adequate repo market has not developed, for a variety of reasons, including the small overall size of the market, underdevelopment of standardized contracts, benchmark interest rates, and collateral arrangements.

47. **Bunching of large payments of corporate and personal income taxes and social security payments around mid-month, have resulted in short term liquidity shortages of the order of BGN 30–50 million, and associated interest rate spikes of between 25 and 35 percent.** The BNB cannot provide liquidity support under the currency board rules, but as of November 1, 2001, is providing same day Lev against Euro to ease these pressures. This bunching of liquidity needs has been exacerbated by the centralization of government accounts in a single treasury account, and the fact that the current payment system infrastructure does not provide the banks information on true real time and complete intra-day balances in reserve accounts at the BNB. The latter issue will be resolved when the RTGS payment system becomes operational later this year.¹⁰

48. **In cases of systemic threat, BNB can extend credit to solvent banks experiencing illiquidity against high grade collateral for a maximum of three months.** Total liquidity advances may not exceed the excess of foreign exchange reserves—currently approximately BGN 1 billion. This facility has never been used.

E. Deposit Insurance

49. **The Deposit Insurance Fund (DIF) currently guarantees, in full, household and corporate, resident and non-resident, foreign exchange as well as domestic currency account holders, to a maximum of BGN 10,000 per depositor per bank.**¹¹ Average

⁹ To take account of Bulgarian banks' significant holding of deposits in foreign banks which can be liquidated without much difficulty, a new category called marketable assets has been developed which includes cash, noninterest-bearing deposits, interest-bearing deposits with banks, Bulgarian treasury bills and bonds, minus all interest-bearing deposits with banks classified as watch or worse and all assets pledged to third parties.

¹⁰ The payment system is discussed in Section IV.

¹¹ Amendments to the Law on bank Deposit Guaranty were passed by Parliament in December 2001, and entered into force on December 22, 2001.

household deposits in Bulgaria were BGN 535, and average corporate deposits BGN 6,534 as of end-2001. The high level of cover is required as an interim step to meet the requirements of the EU rules on deposit insurance. Cover of corporate deposits intends to protect SMEs. Banks are obliged to participate in the deposit insurance system, with the exception of foreign branches covered by the schemes applicable to their head offices. Annual premiums are 0.5 percent of the average deposit base over the previous year, which is high by international standards. The mission raised this issue and the commercial banks have complained about this high level. However, in view of the need to bring cover up to the very high level required by the EU—and accepted by the authorities—lower contributions are not considered feasible by the authorities. In general, in light of the sharply increased ceilings of insurance cover, and the expected increase of the use of the banking system as confidence returns, funding of the DIF will need to be considered carefully in the coming time.

50. **Fund assets were approximately BGN 139 million per end April 2002, and are sufficient to handle simultaneous failure of the 17 smallest banks, or a failure of several of the 6 medium-sized banks at current deposit levels.**¹² The DIF is authorized to borrow from the government to meet liquidity needs, but needs Parliamentary approval to do so. Since December 2001 the DIF is authorized to borrow from banks. The DIF meets high standards of financial policy transparency. The EU deposit guarantee requirement of coverage of EUR 20,000 (roughly seven times 2001 GDP per capita in Bulgaria) is very ambitious, but the Government is committed to meet this level over time in the context of EU accession, also to level the playing field between domestic and EU banks in their competition for deposits.

F. Regulation and Supervision

51. **Banking supervision is exercised by the BNB.** The Law on Banks lays down prudential regulations in the areas of capital, liquidity, loan classification and provisioning, credit concentration, risk exposures, connected lending and investments, and also empowers the BNB to issue further regulations. A risk weighted capital adequacy ratio of 12 percent is prescribed, exceeding the 8 percent minimum ratio in the Basel Capital Accord. BNB also requires banks to maintain a leverage ratio¹³ of 6 percent. Detailed guidelines have also been issued for liquidity management. The system of bank supervision effectively monitors compliance with prudential regulations and takes enforcement action based on a regular schedule of on-site supervision and off-site surveillance. With approximately 75 staff, the Supervision Department of the BNB is sufficiently staffed.

¹² A total of 31 banks participate in the system. For its internal analysis, the DIF classifies banks in three groups, on the basis of amount of insured deposits. Thus, per end April 2002, the group of smallest banks comprised 18 banks, the group of medium sized banks 6 banks, and the group of largest banks 7 banks.

¹³ Capital over total assets.

52. **The banking supervisory system is found to be fully compliant or largely compliant with the near totality of the 25 Basel Core Principles. Principle.** More work can be done on the regulation and supervision of country, market, and operational risk formalizing information sharing arrangements, and strengthening corporate governance in banks. The BNB largely observes good practices with regard to transparency in banking supervision.

G. Bank Resolution

53. **The bank resolution system in Bulgaria has proven effective in the actual closing of insolvent banks, and the protection of small depositors, but, due to the slow process of liquidation, not in the dissolution of the closed banks.** Total assets of the banks currently under liquidation amount to some US\$195 million.¹⁴ Realizable value could be as low as 10 percent of this amount.¹⁵ Bankruptcy and liquidation of banks is currently performed by a Court-appointed trustee, selected by the Court from a list maintained by the BNB. The draft Law on Bank Bankruptcy, currently before Parliament, provides for a more expedient liquidation process, with more effective oversight, to be exercised by the DIF.

H. Stress Tests

54. **Stress tests to analyze the potential impact of changes in the loan quality, foreign exchange, and interest rates on the capital position of banks showed a high degree of resilience of the banking system.**¹⁶

55. **Because of the extremely high degree of capitalization for all groups of banks, under the stress tests the capital adequacy ratio for individual banks remained well above the minimum 12 percent required in Bulgaria with few exceptions.** Table 5 summarizes the assumptions and the results of the various stress tests conducted.

56. **The commercial banks in Bulgaria have limited open foreign exchange positions, and are thus hardly exposed to direct foreign exchange risks.** The BNB has also imposed

¹⁴ This reflects reported balance sheet values, which have not been marked to market. Real values are expected to be lower.

¹⁵ Source: BNB.

¹⁶ To simplify the analysis, each variable was shocked separately, assuming that nothing else changes in the portfolio. While it ignores the potential magnifying effects resulting from the correlation with different types of risks or secondary effects, this approach enables isolating the potential losses from an increase in a given type of risk. Group 5 banks (branches of foreign banks) were excluded from the stress tests.

Table 5. Bulgaria: Summary of Stress Tests Assumptions and Results, March 2002¹
(In percent)

		Total	Group 1	Group 2	Group 3	Group 4	Foreign	Domestic
	CAR ¹⁷ before shock	29	36	21	19	44	32	23
Exchange rate risks								
30 percent lev depreciation 2/	CAR after depreciation	29	35	21	19	43	32	23
	Changes from initial CAR	0	-1	0	0	-1	0	0
Interest rate risks								
An increase in lev rates by 50pp 3/	CAR after 6 months of shock	27	34	17	17	42	31	18
	Changes from initial CAR	-2	-2	-4	-2	0	-1	-5
Credit risks in domestic lending								
A shift in asset composition 4/	CAR after provisioning	26	33	19	17	41	29	21
	Changes from initial CAR	-3	-3	-2	-2	-3	-3	-2
A migration of NPLs 5/	CAR after provisioning	27	34	19	17	41	30	20
	Changes from initial CAR	-2	-2	-2	-2	-3	-2	-3
Worst case scenario								
30 percent lev depreciation, an increase in lev rates by by 100pp, and a further intensification in migration of NPLs 6/	CAR after combined shocks	19	28	7	9	36	28	14
	Changes from initial CAR	-10	-8	-14	-10	-8	-4	-9

Sources: BNB and IMF staff estimates.

1/ Since the beginning of 2001, the BSD has categorized banks into five groups according to asset totals: Group 1: > BGN 800 million (3 banks); Group 2: > 300, < 800 million (6 banks); Group 3: > 100, < 300 million (6 banks); Group 4: < 100 million. (13 banks); Group 5: all branches of foreign banks (7 banks). Data exclude Group 5. Data may differ from those in Table 4 because classification of group in Table 4 was as of December 2000.

2/ Exchange rate shocks applied to net open foreign exchange position excluding Euro position.

3/ Based on the repricing-gap model. Shocks only applied to lev-denominated interest-rate sensitive assets and liabilities.

4/ Main assumptions include: a) all deposits in foreign banks classified as standard with no specific provisioning; b) banks shift 50 percent of their deposits in foreign banks to local loans; c) distribution of quality of domestic loans remain unchanged.

5/ Main assumptions include: a) 10 percent of guarantee and commitment called and classified as loss; b) no shift from deposits to bank lending; c) quality of existing domestic loans deteriorates and all doubtful loans become loss, 50 percent of substandard loans becomes doubtful, 5 percent of watch loans becomes substandard, and 1 percent of standard loans become watch.

6/ The assumption on intensification of migration includes: 10 percent of watch loans become substandard, and 5 percent of standard loans become watch.

¹⁷ Capital adequacy ratio.

strict limits on net open foreign exchange positions.¹⁸ Commercial banks have very little interest rate mismatch. The maturity of bank assets and liabilities is very short, and floating interest rates are widely used.

57. A “worst case scenario” was applied, combining the results of stress tests on credit risks, foreign exchange rate risks, and interest rate risks, in which some of the shocks were made more severe than under the individual scenarios.¹⁹ Under this scenario, the system-wide capital adequacy ratio declined to almost 19 percent, still well above the 12 percent minimum. While, overall, the system would thus remain solvent even in the face of the large combined shocks, a third of the tested banks would require considerable recapitalization to remain in the system.²⁰

I. Banking Sector Vulnerabilities

58. Although overall the system is robust, as shown by the results of the stress tests, the banking system is subject to a number of vulnerabilities. These include: (i) weak company law, intransparent corporate ownership, poor corporate financial disclosure, and weak accounting and auditing rules and practices, all of which undermine the safety and transparency of the credit allocation process; (ii) weak loan enforcement and collateral foreclosure rules, and inefficient judicial procedures, all of which hinder effective loan collection practices; (iii) risk management systems which are in a developmental stage and need to be further upgraded to handle increased lending; and (iv) relatively high cost levels, which makes banks’ current profitability more vulnerable to stronger competition, for instance when Bulgaria joins the single EU banking market. Weak loan enforcement by the courts can create a ripple effect of defaults, as company managers see that other companies successfully delay paying off their debt.

¹⁸ Indirect exchange rate risks resulting from lending in foreign exchange to non-foreign exchange earners are not covered by the stress tests on exchange rate risks but by the stress tests on credit risks.

¹⁹ In the NPL migration scenario for credit risk, the degree of migration from watch to substandard was intensified to 10 percent (up from the previous 5 percent), while that from standard to watch was increased to 5 percent (up from the previous 1 percent). The level of Lev depreciation vis-à-vis the U.S. dollar remained unchanged at 30 percent. The increase in Lev interest rates was assumed at 100 percentage points, up from the previous 50 percentage points.

²⁰ The capital shortfall of the banks that would have become undercapitalized under the worst-case scenario is estimated at less than 1 percent of 2002 GDP.

59. **In reviewing the medium-term vulnerabilities of the banking system, a distinction must be made between foreign owned and controlled institutions, and domestic institutions.** The foreign owned banks have in majority been established as strategic investments, in anticipation of Bulgarians accession to the EU. It is expected that these institutions will support their establishments in Bulgaria. Furthermore, their financial condition is overall more robust than the domestic banks.

60. **The domestic banks need to manage their lending risks prudently, in the face of the circumstances mentioned in the first paragraph of this section, and expected higher competition.** However, domestic banks comprise only around 20 percent of the assets of the banking system, and do not pose a risk to the functioning of the system as a whole. Furthermore, the Deposit Insurance Fund is well funded, and is able to pay out eligible deposits in the totality of the small domestic institutions.

61. **Events in Argentina have cast doubt over the willingness of banks to stand by their branches in times of stress.** However, the stability of Bulgarian policies over the past few years' contrasts sharply with those followed by Argentina. The argument used by foreign banks in Argentina that government policies forced them to refuse payment of their branches' obligations, even through their establishments outside Argentina, therefore does not apply in Bulgaria.

62. **The BNB has shown itself to be effective in addressing potential threats to bank stability.** During the Turkish banking and financial crisis in late 2000, the BNB succeeded in keeping Turkish banks in Sofia open without losses to depositors.

J. Central Bank Issues

63. **The Law on the BNB provides a sound basis for central bank independence.** Provisions relating to appointments of the Governing Board are close to best international practice. The BNB is required by the Law to provide extensive financial disclosure, follow International Accounting Standards (IAS), and has a Chief Auditor reporting directly to the BNB Board.

64. **The restrictions on lending to the government and the banking system eliminate many conflicts between the central bank's roles as the implementer of sound monetary policy, the lender of last resort (LOLR), the banker to the government, and the supervisor of the banking system.**

65. **The BNB is profitable, and has reserves of nearly BGN 1 billion (statutorily required capital: BGN 20 million).**

III. CAPITAL MARKETS AND NONBANK FINANCIAL INSTITUTIONS

A. Capital Markets

66. **The role of the capital markets in intermediating savings and productive investment is extremely limited.** The Bulgarian capital market is in an early stage of development. Its institutions, specifically the Bulgarian National Securities Commission (BNSC) and the Bulgarian Stock Exchange (BSE) are new, and are building experience. Laws and regulations are still largely untested, and enforcement experience is limited. However, much work has been done to create proper conditions for a functioning capital market.

67. **At the present time, the stock market has a low capitalization (5 percent of GDP as of end-October 2001) and is highly illiquid (turnover of 3 percent of capitalization in 2000), one of the lowest in Central and Eastern Europe.** However, with the introduction of the multi-pillar pension reform and the development of the insurance industry, there is potential for greater activity in capital markets over time.

68. **Although the legal and regulatory framework is largely harmonized with EU and IOSCO standards, the Commercial Law and the Law on the Public Offering of Securities (LPOS) still require amendment to enhance investor confidence.** The amendments should address the deficiencies in minority shareholder protection and provide for clear duties of directors to all shareholders, including minority shareholders. Other useful amendments would be to authorize the BNSC to take court action on behalf of disadvantaged shareholders in civil actions to give more power to general shareholder meetings over certain corporate decisions, and to provide new rules for taking companies out of the register of publicly traded companies.

69. **Other vulnerabilities in the rules and regulations include the lack of an obligation to report events that can have a material impact on share values.** Moreover, there is no explicit legal protection of supervisory staff. Staff remuneration needs to be reviewed in order to remain a competitive employer. Furthermore, there are no MoUs with foreign supervisory agencies. The terms of office of Board members of the BNSC should be staggered, which can help avoid suboptimal continuity in governance.

70. **Furthermore, although accounting standards are to be IAS-conform in 2003, the current system, while already broadly based on IAS, still contains deficiencies, most notably the absence of an obligation to report transactions with affiliated companies.**

71. **The Bulgarian Stock Exchange (BSE) has two markets. The official market requires issuance of a prospectus, comprises 29 companies with total capitalization of BGN 203 million (end October 2001), and turnover of BGN 30.8 million in 2000.** The unofficial free market, which does not require issuance of a prospectus, comprises 411 companies with a total capitalization of BGN 927 million (end October 2001), and turnover of BGN 97.7 million in 2000.

72. **The BSE rules are extensive and in general reflect good stock exchange practice.** However, there is little incentive for companies to remain subject to the more stringent requirements imposed by the LPOS and the BSE compared with the requirements of the Commercial Law, which governs other companies.

73. **The BSE provides a good trading system, which is designed to cope with trading volumes many times greater than are experienced at present.** The system is fully electronic and automatic, provides maximum transparency, and enables good information disclosure. However, company information is not supplied to the BSE in a timely way despite the fact that the rules provide that information that may affect the value of the shares need be sent within seven days.

74. **The system for clearing and settlement of transactions is reliable and efficient.** Since all public company shares are dematerialized, settlement and delivery are done through the Central Depository. The settlement period is T+3 and the BSE has a guarantee fund against broker default.

B. Insurance

75. **The insurance industry is well diversified and foreign insurance companies are well represented.** It does not represent a source of instability. At end October 2001, there were 32 licensed insurance companies operating in Bulgaria—12 life insurance companies and 20 non-life insurance companies. Of these 32, 20 are joint stock companies offering non-life insurance, and 8 joint stock companies and 4 mutual companies offering life insurance. Foreign insurance companies accounted for 15 percent of the assets of all the life insurance companies, and 56 percent of the assets of all the non-life companies (December 31, 2000). As of the same date, the 3 largest life insurance companies held 90 percent of the assets of the life insurance industry, while the 3 largest non-life insurance companies owned 57 percent of the assets of their industry. Insurance penetration is increasing with premiums to GDP increasing from 1.08 percent in 1998, to 1.52 percent in 2000, although there is still much scope for growth.

76. **The size of Bulgaria's insurance market is average for the region.** In 1997, insurance industry premiums in the EU ranged from 3.6 percent to 10.7 percent of GDP. Reinsurance premiums ceded amounted to BGN 105.9 million. Total assets for Bulgarian insurance companies at the end of 2000 amounted to 2.4 percent of GDP.

77. **Although profits in relation to annual premiums for life insurance increased from 2.07 percent in 1998 to 14.16 percent in 2000, and for non-life from 1.48 percent in 1998 to 3.52 percent in 2000, insurance sector profitability shows weaknesses.** For life as well as non-life insurance, claims ratios have gone up, for life insurance from 66 percent in 1999, to 84 percent in 2000, and from 58 percent for non-life in 1999 to 61 percent in 2000. The sharp increase in the claims ratio for life insurance is said to be the result of certain accounting rules, as well as legislative changes, influencing the structure of portfolios towards riskier business. Gross rates of return on investments for life insurance in 2000 of

8.11 percent were only just sufficient to compensate for inflation, leaving a real rate of return of around zero. For non-life, the return of 3.42 percent was clearly insufficient to compensate for inflation and implies a loss. Solvency requirements are currently met by all companies, although in 1999 and 2000 one company was not in compliance. About 95 percent of all reinsurance is placed outside Bulgaria.

78. The government is pursuing the privatization of the largest insurance group in the country. The State Insurance Institute (DZI), with 20 percent of the non-life market (premium income) and 47 percent of the life market in 2000, was earmarked for privatization in 1999. An offer made by DZI 2000-TBI, a Bulgarian-Dutch consortium, of \$ 22.5 million was rejected in October 2001. The Privatization Agency intends to start a new procedure before Christmas 2001, for closure in early 2002.

C. Pension Funds

79. Building a more financially sustainable, better diversified and less risky pension system will only be possible if serious shortcomings in the regulatory and supervisory framework for private pension plans are addressed, specifically on issues of structure and governance. The governance structure of pension insurance companies and pension funds is extremely weak. The institutional capacity of SISA is weak and its governance structure contains major deficiencies.

80. The legislation does not establish an adequate fit and proper test for shareholders, members of the board of directors or investment managers. Nor does it require members of the board of directors and investment managers to exert due care in the management of the pension fund, a fundamental principle that should apply to any investment intermediary. In the case of insolvency of a pension fund, the legislation does not hold the board and fund managers accountable in case of improper management nor is the pension insurance company liable.

81. The Law creates a supervisory council with seven members but only two of them are meant to hold relevant technical knowledge, the chairman of SISA and the chairman of the BNSC. The responsibilities of the supervisory council and the chairman of the agency are poorly defined and seem to overlap, and there is no reference in the legislation to their accountability. After the crisis in the mandatory pension system in the 1990s and the weak development of the supplementary pension plans, a multi-pillar reform plan was enacted in 2000. The Government has formed a Commission to review the legal framework for the pension system. Key short, medium and long-term issues for reform are the following.

82. Regulation of private pension funds should be more rigorous, in particular with regard to accounting practices, asset valuation, crediting of accounts and disclosure, in order to foster transparency and comparability of performance of pension funds.

83. The State Insurance Supervisory Agency (SISA), established less than two years ago has limited experience and its institution-strengthening program should receive high priority, especially after the launch of the of the mandatory universal pillar. SISA

should start playing a more active role towards the supervised institutions to enforce good standards in the sector. The financial and operational capacity across funds differs widely, and SISA should prepare for a restructuring and further strengthening of the market.

84. **In the longer term, private pension funds should be better integrated with the rest of Bulgaria's financial system and the EU.** This will imply inter alia the elimination of restrictions of foreign diversification, permission to provide a broader range of pension plans, permission for insurance companies to access the mandatory annuities market.

D. Other Nonbank Financial Institutions

85. **The financial leasing market is small but growing.** It does not represent a vulnerability of the system. As of mid-2001, there were three equipment-leasing companies with assets of around US\$60 million, and around 10 car/truck leasing companies with assets of around US\$90 million. At US\$150 million, total assets of the leasing industry amount to only 3 percent of total banking system assets.²¹ Accounting standards are not in conformity with IAS, in particular with regard to income recognition.

86. **Agricultural credit is provided by the banks, and by agricultural credit unions.** As of June 2001, these credit unions totaled 33 with total assets of BGN 23 million. These credit unions extend loans only to their members on the account of contributions made by them and cooperative funds. Credit unions fall under the Cooperative Law and are not supervised by the BNB.

E. Payments, Clearing, and Settlements

87. **The BNB oversees the payments system.** The institutions principally concerned with payment systems in Bulgaria are the BNB, the commercial banks, BankService, the inter-bank payment processing company) and BORICA (the inter-bank card processing company). The BNB, as banker to the banks and to the Government, holds the banks' settlement accounts, and provides a specialized payment service (the "Express Service") for large-value inter-bank payments, and for payments between the Budget (the Government) and the banks. It also settles the cash side of transactions in the primary and secondary markets in Government securities (the BNB operates the depository for Government securities), and in the secondary market for corporate securities (handled through CDAD). BankService, which is owned by the BNB and the banks, operates the BISERA 3 system, which is in effect an Automated Clearing House for retail payments (mainly credit transfers initiated by the banks' corporate customers), with the inter-bank settlements carried out across the banks' settlement accounts with the BNB. BankService also supplies and operates BANKNET, a communication system for banks and corporates. BORICA, which is owned

²¹ As of end-2000, the assets of the equipment leasing industry in the Czech Republic totaled US\$2.2 billion, US\$1.6 billion in Poland, US\$1.1 billion in Hungary, and US\$0.6 billion in Slovakia. Source: Leaseurope.

by the banks, owns and operates the nation-wide ATM and POS systems, with the inter-bank settlements again taking place across the banks' accounts with the BNB. The Systemically Important Payment Systems (SIPS) at present (but see paragraph 7 below) are the Express Service and BISERA 3. The BNB has the statutory responsibility for the oversight of payment systems in Bulgaria. It has recently been decided that the oversight responsibility will be located in a new function, separate from both the operational side and the division responsible for payment system policy issues.

88. **The key institutional constraint on the daily settlement of the payment systems, and in particular of the large-value payment streams, is that the BNB operates a Currency Board regime, under which it is currently unable to provide liquidity to the commercial banks, either intra-day or overnight or longer, to ensure the full settlement of all payments due each day.**²² Banks are permitted to draw down their minimum reserve balances, which are maintained on a monthly average, to finance their payment flows, but there is a penalty, in the form of a penal interest rate, if the reserve balance is drawn to below 50 percent of the required average, even for one day. There is an inter-bank market in BGN, which operates in reasonable depth from same-day out to 7-day deposits, but the availability of funds in that market is variable, with several days each month of potentially quite severe shortages (caused by tax payments). Moreover the access of the smaller banks to funds in the market is limited, even against collateral (the bulk of inter-bank deposits are un-collateralized). The only source of additional intra-day liquidity for the banking sector, to assist in the timely settlement of large-value same-day payments, comes from the legal obligation of the BNB to sell to the banks for same-day value BGN against EUR, where a bank has a sufficient EUR balance on its account with the BNB.

89. **The principal payment instruments in Bulgaria are cash (used extensively by individuals and still, to a substantial extent, by corporate customers), credit transfers and credit cards. The number of POS terminals is growing fast, so that the volume of debit card transactions is expanding.** There is minimal use of checks. Direct debits are used mainly in specialized circumstances (for instance in the settlement of the net debit positions of investment institutions arising from transactions on the Bulgarian Stock Exchange).

90. **The BNB and the banks are in the process of implementing an RTGS system, which is currently planned to go live on September 16, 2002.** The system is being supplied by Montran, while SWIFT is the message communication system. (Three small banks, which were not previously members of SWIFT, have now joined that system.) The

²² The BNB is permitted by law to lend to a bank (against collateral, for up to 3 months) if, and only if, the value of its unsettled payments is such as to threaten major systemic problems. This is defined as a situation where a bank with more than 10 percent of the daily payment traffic is unable to settle its position, or where payments that have been queued unsettled for 3 days amount to 10 percent of the daily traffic.

system will handle all the payments now effected through the Express Service, and all credit transfers of BGN 100,000 or more now made through BISERA 3; it will also handle the net settlements of the remaining payments through the BISERA system (to be re-constructed as BISERA 4), of the card payments through BORICA and of the corporate securities transactions through CDAD.

91. **It should however be emphasized that the implementation schedule for the RTGS system is extremely ambitious, and that in some key respects it is vulnerable to disruption, which will result in the non-compliance with certain Core Principles by the Express Service and BESIRA 3 persisting for longer than is currently anticipated.** Most important, no rigorous steps appear to have been taken to ensure that by 16 September all 36 commercial banks will be ready, with the required software installed and fully tested, and trialled across the entire membership, and with operational staff trained. There is no certainty that the banks' treasurers are properly prepared for the task of managing the flows of their payments and receipts across their accounts with the BNB in real time throughout each day.

92. **In setting this timetable, the BNB appears to have given insufficient weight to one key aspect of every RTGS system around the world—namely the extent to which there is a mutual inter-dependence among every member of the system, including the central bank as well as the commercial banks.** A problem in any one member, because of a system failure, an operator error or for any other reason, can have an immediate impact on the smooth flow of payments throughout the system, and can thus disrupt a range of transactions. There is thus a strong case for the BNB to suspend its chosen implementation date, and to set a new date only when it can be certain that all the banks are in every key respect ready for the new system.

IV. CORPORATE SECTOR

A. Access to Credit

93. **The supply of credit to the corporate sector is limited for a number of reasons: cautious lending behavior by banks and unfamiliarity of small borrowers with normal bank credit approval procedures, ongoing bank restructuring, and upgrading of risk management systems.** Moreover, two large state-owned banks are preparing for privatization (DSK Bank and Biochim), and are limiting credit risk. Finally, banks have been able to charge high lending rates to domestic companies, pay low deposit rates and thus maintain high margins. Margins may be put under pressure, as competition intensifies and banks start to expand credit to domestic companies, as is already developing.

94. **The lack of long-term funding in the Bulgarian financial system makes it difficult for banks to extend investment credit, as banks prefer to avoid a maturity mismatch.** In addition, as bank deposits are pre-dominantly in foreign currency, banks also prefer to avoid a currency mismatch. Another factor is the lack of quality credit information.

There is no centralized credit register for SMEs and many borrowers do not have a credit history available to the lender. Finally, informal credit often crowds out bank credit.

B. Corporate Governance

95. **From a corporate governance perspective, the Commercial Law has a number of important weaknesses that allow asset stripping and share dilution.** The Law provides insufficient protection for minority shareholders, and includes provisions that have been abused in other transition countries: (i) shares may have disproportionate voting rights, rather than one-share one-vote; (ii) shareholders' meetings may be held with a quorum of as few as 5 percent of the capital; (iii) assets may be sold or transferred without approval of either the (supervisory) board or the shareholders' meeting; (iv) new capital can ignore pre-emption rights of existing shareholders; and (v) capital may be increased through in-kind contributions of uncertain value. The above provisions are prohibited under the LPOS, but fewer than 440 companies are required to follow the LPOS. The remainder of the corporate sector, including most banks and all insurance companies and pension insurance corporations are not publicly traded and thus do not fall under the securities legislation. Furthermore, neither the Commercial Law nor the LPOS has a well-defined fiduciary responsibility for members of (supervisory) boards.

96. **Another important weakness is in public disclosure of reliable information on the ownership of corporations.** Companies that are not publicly traded may keep their own share registers and the list of shareholders is not available publicly.

V. LEGAL FRAMEWORK AND INFRASTRUCTURE

A. Creditor Rights

97. **Bulgarian law does not provide creditors, secured and unsecured ones alike, with an effective mechanism for the enforcement of their claims.** The 1996 Law on Secured Pledges establishes a modern system for pledges on movables, receivables, and going concerns. However, the Civil Procedure Code foreclosure provisions are very weak. Described as 'fiercely pro-debtor,' foreclosure procedures can delay the enforcement of a valid claim for years.

98. **Particular attention should be given to replacing the foreclosure section of the Civil Procedure Code with a set of rules, which allow creditors, once a writ of execution has been obtained, to enforce their claims without delay.**

B. Insolvency

99. **Bulgaria's corporate insolvency law (Part IV of the Commercial Law) has not provided an efficient mechanism for the resolution of companies' financial difficulties in a way that does not unduly prejudice creditor rights.** Courts are not sufficiently predictable and expeditious, mostly at the expense of creditors and the estate. causes for the

courts' lack of efficacy include: deficient financial and human resources; lack of adequate professional training and specialization; and outdated systems of case and document management. Trustees' lack of experience, inadequate incentives, and poor monitoring has resulted in performance that is generally perceived as incompetent, corrupt, and unaccountable.

C. Unification of Financial Services Supervision

100. **In Bulgaria, the introduction of a unified agency for the regulation and supervision of all financial services, which had been discussed within the Government, seems premature.** There are arguments for combining non-bank financial supervision agencies, i.e., common skills and techniques, similar responsibilities and economies of scale. Setting up a joint agency at this time would however risk disrupting the development and emerging stature of these agencies.

101. **However, as an interim step, the recent creation by the authorities of a coordination committee of all financial sector supervisory agencies has merit and can start a process of better cooperation, coordination and exchange of information. This forum should be used to develop a system-wide perspective of risks and vulnerabilities, to share experiences, and develop common approaches.** In any case, there are compelling reasons for maintaining the responsibility for banking supervision with BNB.

D. Anti-Money Laundering

102. **Bulgaria is a high-risk jurisdiction. Its location, freedom of capital movements, free convertibility of the domestic currency into Euro, the increasing overall openness of the borders in anticipation of EU accession, and the low-income levels create incentives for illegal economic activities and corruption.** Bulgaria's Anti-Money Laundering (AML) legislative framework consists of the AML Law and associated Regulation, Internal Rules on the Structure of the Financial Investigations Bureau,²³ the Instruction on Cooperation between the Ministries of Finance and Internal Affairs, provisions in the Criminal Code which criminalize AML-related activities (Arts. 253 and 253a), guidance notes on the development of internal AML rules for reporting institutions, and the internal rules issued by individual institutions. The framework is consistent with formulated international AML standards and good practices, including the Strasbourg Convention on Money Laundering, Tracing, Seizure and Confiscation of the Proceeds of Crime.

103. **The Law includes 27 types of service providers under the scope of the law, including banks, insurance and securities companies and also notaries and accountants.** It also allows disclosure to the Bureau without a court order of information on suspicious transactions, customers, and sources that is otherwise subject to bank secrecy. All crimes under the Criminal Code, except tax fraud, are considered predicate offences.

²³ The Bulgarian financial intelligence unit (FIU).

104. **The authorities are taking action to further improve the implementation of effective AML/CTF policies and practices.** The Financial Investigations Bureau has been placed under new management and is being reorganized to enhance its effectiveness. Six additional analysts have been appointed and five vacancies are still to be filled. Computer systems and databases to assist in tracing financial transactions are being upgraded. EU, UK and USAID funded technical assistance has been obtained for institution building and to further develop the FIB's analytical tools. Then budget is very low, at under US\$250.000 per year.

105. **Efforts are undertaken to improve the processing of suspicious transaction reports and remove the backlog of cases.** A steering committee has been created to improve coordination between the Bulgarian agencies involved in the AML/CTF area. A working group has been set up to prepare draft amendments of the legislation, for instance to facilitate confiscation of assets, and to include lawyers and realtors under the scope of the reporting requirements. Draft anti-terrorist finance has been drafted and is ready for submission to the Council of Ministers. Adoption is envisaged for June 2002.

106. **From 1998 to April 2001, the Bureau received 801 reports from service providers and, based on its analyses, forwarded to the Prosecutor's Office 53 requests for further investigation.** In 1999 the Bureau played an active role in uncovering a money-laundering operation that had involved transfers of over USD 300 million and, as a result, 15 individuals were arrested in Bulgaria only.

VI. EU ACCESSION

107. **The working assumption for accession of Bulgaria to the EU is January 1, 2007.** The crux of the negotiations is the EU position that Bulgaria needs to become a "functional market economy and able to cope with competitive pressures." The EU also needs to have confidence that the structures and administrative capacity are in place for effective implementation of the rules. The EU has not set precise criteria for this assessment. In the meantime, negotiations on the 30 "chapters" of the "Acquis Communautaire" continue, and 17 chapters have been provisionally concluded. The negotiations on Chapter 3, on "Freedom to Provide Services," which includes banking, has been provisionally closed in November 2001.

SECTION II—SUMMARY ASSESSMENTS OF STANDARDS AND CODES

I. INTRODUCTION

108. This section reviews the extent to which Bulgaria observes selected internationally recognized codes and standards relevant to the financial system. The assessments were performed in the context of the joint World Bank-IMF Financial Sector Assessment program mission to Bulgaria, from October 29-November 14, 2001. This section contains summaries of the detailed assessments prepared in connection with the FSAP mission by assessor teams from the IMF, World Bank, and cooperating institutions.

109. Bulgaria is moving towards a high degree of observance with the international standards and codes that were assessed, and has achieved most notable results in the areas of banking and transparency. Areas in which policies could be strengthened are also highlighted in this section, and are partially reflected in the Overall Stability Assessment and Key Recommendations in the first section of this report. During the Article IV mission to Bulgaria in May 2002, the Bulgarian authorities have indicated their broad agreement with these assessments, and have provided comments.

110. During the Article IV mission to Bulgaria, in May 2002, the assessments were discussed with the authorities, and their responses and comments obtained. These are reflected in this section.

111. The summaries are based on assessments prepared by:

Basel Core Principles for Effective Banking Supervision	Mr. Aditya Narain, Reserve Bank of India and Mr. Arpad Kiralyi of the Hungarian State Financial Supervision
IAIS Core Principles on Insurance Supervision	Mr. Luc Cardinal, World Bank
IOSCO Objectives and Principles of Securities Regulation	Mr. Euan Abernethy, Consultant, World Bank
CPSS Core Principles for Systemically Important Payment Systems	Mr. Paul O'Brien, Central Bank of Ireland, and Mr. Petere Allsopp, formerly of the Bank of England
Code of Good Practices on Transparency of Monetary Policy	Mr. Hemant Shah, and Mr. Mark De Broeck, IMF
Code of Good Practices on Transparency of Monetary and Financial Policies-Banking Supervision	Mr. Aditya Narain, Reserve Bank of India and Mr. Arpad Kiralyi of the Hungarian State Financial Supervision
Code of Good Practices on Transparency of Monetary and Financial Policies- Deposit Insurance	Mr. Aditya Narain, Reserve Bank of India and Mr. Arpad Kiralyi of the Hungarian State Financial Supervision
Code of Good Practices on Transparency of Monetary and Financial Policies-Securities Market Supervision	Mr. Euan Abernethy, Consultant, World Bank

Code of Good Practices on Transparency of Monetary and Financial Policies-Insurance Supervision	Mr. Luc Cardinal, World Bank
Code of Good Practices on Transparency of Monetary and Financial Policies – Payment System Oversight	Mr. Paul O’Brien, Central Bank of Ireland, and Mr. Peter Allsopp, formerly of the Bank of England

II. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

112. The assessment of the bank supervisory system in Bulgaria was performed on the basis of the Basel Core Principles for Effective Banking Supervision, and the Basel Core Principles Methodology. Extensive discussions were held with the Banking Supervision Department of the BNB, as well as with commercial bankers from different domestic and foreign banks, auditors, and officials of the Financial Intelligence Bureau Agency (FIB) and the Deposit Insurance Fund (DIF). Publications of the different agencies including their accounts, laws and regulations and the inspection manuals of the BSD have also been perused in the course of the assessment. Written responses to questionnaires were received from the BSD prior to the assessment. Together with the previous assessment made by the IMF staff in 1999, these have also been key inputs into the exercise.

B. Institutional and Macroeconomic Setting and Market Structure—Overview

113. Banking supervision is carried out by the Bulgarian National Bank, on the basis of the Law on Banks and the Law on the Bulgarian National Bank. The BNB specifies as the objective of banking supervision “ensuring the financial stability of the banking system and protecting the depositors’ interests.” On the basis of the Law on Banks, more detailed regulations have been issued. The system went through a severe crisis in 1996. Following the closure of a large part of the banking system, there has been an overhaul of the banking and bank supervisory system with a new law on banking and several amendments to the law governing the BNB having been passed since then. A number of important foreign investors have come in to establish operations in Bulgaria, and currently some 75 percent of the assets of the system are held by foreign owned banks. Against the backdrop of the introduction of the currency board, which imposes financial discipline and limits its lender of last resort function, the BNB has put in place a regime of strict prudential regulation and supervision based on international best practice.

114. The post crisis financial system is characterized by a cautious intermediation function with a low loan to deposit ratio, high capital adequacy and high liquidity ratios. The majority of banking sector assets remains in low risk investments and foreign currency placements. In 2000, placements, mostly in foreign banks, had 34 percent of the share of banking assets,

while the share of credit remained within 30 percent.²⁴ Recent developments indicate however a gradual shift towards more lending. In the past 12-month period, loans have increased by some 37 percent. Over the last quarter of 2001, for the first time since the crisis, loans took a larger proportion of banks' balance sheets than placements.

115. The structure of the banking system has changed significantly since the 1996 crisis. Of the 34 banks in Bulgaria, 24 are controlled by foreign entities with 17 subsidiaries and 7 branches of foreign banks. Together, foreign banks own 56.5 percent of the equity and 73.3 percent of the assets. State and municipal ownership is now limited to 17.6 percent and 2.1 percent of assets.²⁵

C. General Preconditions for Effective Banking Supervision

Macro economic policies

116. The Currency Board Arrangement (CBA) introduced in July 1997 tightly constrains the monetary policy of the Bulgarian National Bank (BNB). The CBA fixes the Bulgarian Leva to the Euro, and the BNB does not operationally target interest rates. Following the introduction of the CBA, a conservative fiscal stance has been maintained. In order to reduce a high public debt burden and to avoid fiscal stimulus that would put pressure on the external position, the authorities adopted consistently prudent deficit targets in the 1998–2001 budgets. Fiscal policy was tightened in response to external shocks in 1999–2001, containing the deficit to around 1 percent of GDP in each year. The fiscal reserve account of more than BGN 2 billion provides a cover for major fiscal contingencies. While fiscal deficits are expected to be modest over the medium-term, high current account deficits are a potential source of vulnerability, which may result in loss of reserves and a need for additional borrowing to support the CBA.

117. In 1999–2000, Bulgaria recorded external current account deficits of more than 5 percent of GDP. The 2001 trade deficit exceeded 10 percent of GDP and the current account deficit was close to 7 percent of GDP. Lower FDI inflows, a wider current account deficit and external debt service reduced international reserves to around four months of imports at end 2001. However, Bulgaria has felt little impact of pressures in international emerging debt markets, and retains access to these markets to cover its financing needs. In the medium-term, public debt management in Bulgaria faces several major challenges. These include further reducing public debt to GDP, and reducing the external, dollar-denominated, and floating-rate debt component. Real GDP growth picked up from 3½ percent in 1998 to almost 6 percent in 2000 driven by industrial production and the services sector. Real GDP

²⁴ Source: Annual Report of the BNB, 2000.

²⁵ As at end-2000; Source: Annual Report of the BNB, 2000.

grew by a robust 5 percent in the first half of 2001 and is expected to reach about 4½ percent for the year as a whole. Inflation amounted to 4.8 percent at the end of 2001.

Public infrastructure

118. The legal framework in which banks operate is quite good. However, the judiciary system is not efficient, and banks experience delays in foreclosing on collateral, which can take up to several years. This should be addressed urgently. Financial statements are based on National Accounting Standards, which differ from International Accounting Standards (IAS) in some respects. Banks and financial institutions are to adopt the IAS from January 1, 2003, and other firms from January 1, 2004, though most banks have also been preparing their accounts by IAS for some time now.

Market discipline

119. Markets are not effectively able to exercise discipline over banks, and the responsibility for a sound banking system lies primarily with the authorities. Financial markets in Bulgaria are at an early stage of development. Bank intermediation is low, and other securities and insurance markets are not well developed. There is very little stock market activity. Pension funds are not subject to adequate regulation and supervision. The public has few sources of information on the functioning of the financial markets. The accounting system is still in a process of conversion to IAS, and corporate accounts are unreliable.

Resolution of problem banks

120. The bank resolution system in Bulgaria has proven effective in the actual closing of insolvent banks, and the protection of small depositors, but not in the liquidation and dissolution of the closed banks, due to the slow process of liquidation. Total assets of the banks currently under liquidation amounts to some US\$195 million.²⁶ Realizable value could be as low as 10 percent of this amount.²⁷ Bankruptcy and liquidation of a bank is currently performed by a Court-appointed trustee, selected by the Court from a list maintained by the BNB. The draft Law on Bank Bankruptcy, currently before Parliament, provides for a more expedient liquidation process, with more effective oversight. BNB has been effective in addressing subsequent potential threats to bank stability. During the Turkish banking and financial crisis, which broke out in late 2000, the BNB succeeded in keeping Turkish banks in Sofia open without losses to depositors.

²⁶ This reflects reported balance sheet values, which have not been marked to market. Real values are expected to be lower.

²⁷ Source: BNB.

D. Main Findings

121. BNB has made strong efforts to achieve compliance with international standards and practices and the requirements of the EU. This effort has resulted in the installation of a supervisory and regulatory framework for banks, which is viewed as effective by the market participants. The rules and regulation issued by BNB are comprehensive and compliance is monitored on an ongoing basis. Supervision is becoming increasingly effective and is expected to be able to deal with the developments in the markets as banks offer more complex products in future.

122. The supervisory system is found to be largely in compliance with the Basel Core Principles. The remaining gaps are mainly in the regulation and supervision of country, interest rate and operational risks, allocation of capital for market risk, formalizing information sharing arrangements with other supervisory agencies and strengthening corporate governance in banks. In some of these areas, the authorities are preparing new regulations and guidance or introducing supervisory techniques to enhance compliance.

Objectives, autonomy, powers, and resources (BCP 1)

123. The BNB has clear responsibilities and objectives, as well independence and adequate resources, which are laid out in the law. The Banking Supervisory Department (BSD) located within the BNB and headed by a Deputy Governor, is responsible for supervisory action. The conditions for the appointment and removal of the Deputy Governor are also laid out in law. The BSD has the required budget and ample powers to enforce laws and regulations and address safety and soundness concerns. The BNB is authorized to issue regulations covering a wide range of subjects including prudential regulations. The law also gives ample power to the BSD to obtain information in the form and frequency necessary to fulfill its supervisory tasks.

124. The Law on Banks provides legal protection for banking supervisors provided the action in question was not “ultra vires” nor grossly negligent. However, like other public officials, they can be prosecuted under Section 282 of the Penal Code for abuse of official powers. The legal basis for co-operation between the financial regulatory agencies is in place to some extent and is stated to work in practice. Cooperation and information sharing with other domestic regulators has been strengthened through a recently concluded formal agreement between the financial sector regulators.

Licensing and structure (BCPs 2-5)

125. The activities which a bank may undertake are laid out in the Law on Banks which also prohibits the use of the word ‘bank; or any of its derivatives to those entities not licensed to carry out banking activities. It also stipulates that only those persons who have been granted a bank (foreign bank branch) license by BNB are allowed to carry on ‘bank activity,’ including taking deposits from the public.

126. Applicants are required to submit relevant documents on the organization, management and capital and funding structure of the proposed bank and the BSD is required by law to check the validity of all documents and the financial status of the applicant before ruling on the application. Within six months of the receipt of the application, the central bank must notify the applicant of the decision. The law also lays down the situations in which the BNB may refuse a license. Foreign banks applying for branch licenses are also required to submit details of the parent bank and written consent of the home supervisor. The BNB may refuse a license if the home supervisor is not considered effective.

127. Acquisition of 10 percent or more of the voting shares in an operating bank requires written permission of BNB. Information can be requested by the BNB on all shareholders, and is mandatorily provided for shareholders above 3 percent. If the shares are acquired on the stock exchange or other regulated markets, the owner cannot exercise his voting power over these shares without obtaining the permission of BNB. (If permission is withheld, he must sell these shares.). Further, when the shareholder transfers his voting shares in a domestic bank, and the result of this transfer is that his stake falls below 50, 33, 20, and 10 percent, he is required to notify the BNB within 10 days. Although the criteria for rejection of transfer are not specifically laid down, in practice the BNB applies the same criteria as at the licensing process to refuse the transfer. As part of its portfolio of remedial actions, BNB is also empowered to order the shareholder holding qualified equity in a bank to transfer his shares within 30 days and to prohibit the exercise of voting power. Although the BNB has sufficient authority to refuse transfer of significant ownership, it did not have adequate authority to identify the ultimate beneficial owners in the case of transfer or licensing. Amendments to the Law on Banks, passed in December 2001, have enhanced the BNB's powers in this area.

128. BNB has the authority to establish criteria for reviewing acquisitions or investments by a bank. No bank may acquire equity in a company (other than a bank) the value of which exceeds 15 percent of the bank's own funds, without obtaining written permission from BNB. Further, the total amount of a bank's investment in real estate and other tangible fixed assets is capped at 50 percent of its own funds. However, tangible fixed assets and equity participation in companies other than banks acquired from mortgages, pledges and other collateral for the purpose of preventing losses from its bank operations, are exempted from this rule provided they are transferred within two years following the acquisition. Banks are required to submit the details of investment to the BNB which may refuse to grant a permit for the acquisition for reasons such as breach of prudential regulations, sharp increase in credit risk or doubts on the bank's ability to finance the acquisition.

Prudential regulations and requirements (BCPs 6-15)

129. The Law on Banks and the supporting regulation require all banks to calculate and maintain a minimum capital adequacy ratio for credit risk on the lines of the Basel Accord. The BNB currently prescribes a minimum CAR of 12 percent, which is expected to be sufficient to cover market risks under current conditions. Detailed instructions have been issued for the management of liquidity and foreign exchange risks but interest rate risk and

operational risks have not been given adequate regulatory attention. From July 2001, banks are also required to put in place systems to identify and measure country risk but no specific system for provisioning against country risk has been imposed. Further, the procedures for the supervisory assessment of this risk, both on and off-site, are still being developed.

130. Banks are required to adopt and submit to BNB the policy and rules governing their credit activities. They must also establish a credit committee as a specialized internal body for monitoring, assessment, classification and provisioning of their risk exposures. While asset quality assessment under the CAMELS model includes the loan and investment policies and procedures, the rating on management evaluates banks' ability to oversee the credit and investment process.

131. Banks are required to periodically assess (at least quarterly) their loans and other risk assets, including off-balance sheet liabilities, and to allocate provisions to cover the risk of losses. The supervisors may require from the bank to enforce a stricter evaluation and classification.

132. Banks are required to report large exposures, which are defined as exposures equal or more than 10 percent of the bank or the banks group, as part of the quarterly reporting system, although there is no separate reporting for sectoral concentrations. The limit on large exposures (the sum of the balance-sheet assets and off-balance-sheet commitments to one person or "related persons") stands at 25 percent of the bank's own funds. "Related persons," are defined by regulation and the supervisor has the discretionary power to include persons into the category of related groups. Banks/bank groups are also required to create and maintain adequate administrative and accounting procedures, as well as effective internal control to identify and record all large exposures and subsequent changes to them as well as to place internal caps on concentration of exposures to an economic sector and/or geographic region.

133. Decisions on connected lending beyond a threshold can only be made by a unanimous decision of the bank's managing body and with the approval of the head of specialized internal control office. The threshold has been kept at the annual remuneration of the connected natural persons including bank supervisors; twice the annual remuneration for employees and at one percent of the paid in capital for loans made to connected legal persons or major shareholders. The total amount of the loans made to connected persons shall not exceed ten percent of the bank's own funds, and unsecured loans provided by the bank to its employees shall not exceed three percent of the bank's own funds.

134. The BNB has issued detailed guidelines for managing liquidity and foreign exchange risks. Further, even though banks are allowed to trade in commodities, in fact no bank actually does so. Thus, equity price risk and commodity price risk are absent. As far as interest rate risk is concerned, although this is evaluated as part of the on-site examination as part of the test of market risk sensitivity (the S component of the CAMELS system), there has not been any specific guidance to banks on this issue.

135. Some banks are in the process of putting in place state of the art risk management systems and are investing in technology for this purpose. There are no capital requirements at present for operational and other risks. Management of these risks is largely in the domain of banks' internal audit systems, which are required to assess the risk management techniques and the technical facilities against breaches of the law, and to make recommendations for improvement.

136. The scope and coverage of the internal control and audit function has also been defined in Regulation, and its efficacy is evaluated as part of the on-site inspection. A new regulation is being developed on a priority basis. The draft sets out detailed requirements not only for internal control but also for the management control over basic banking risks. However, banking laws are not explicit on the responsibilities of the board of directors nor does the commercial code cover them adequately though these do find mention in the on-site inspection manual.

137. In Bulgaria, the Financial Investigations Bureau, under the Ministry of Finance, is the central agency for the implementation of Law on Measures against Money Laundering. The LMML requires banks, among other financial and commercial institutions, to report all suspicious transactions over the amount of BGN 30,000. The LMML requires banks to have internal rules and procedures to prevent money laundering and to train staff. The FIB has circulated models for banks' internal rules. The BNB verifies banks' anti-money laundering (AML) systems and procedures through on-site inspections and sometimes-joint inspections with the FIB. To further enhance the quality of compliance, the FIB should promote an amendment to the LMML to protect individual staff that may report incidents of money laundering and criminal abuse of the banking system. Further, the Bankers' Association is contemplating preparation of a code of conduct for banks, which would promote ethical standards. The BNB should encourage this process.

Methods of ongoing supervision (BCP 16-20)

138. A system of off-site reviews based on quarterly/monthly returns has been introduced which is analyzed to provide updated information on the financial condition of banks and to serve as an input to on-site inspection. Manuals have been prepared for both on-site inspection and off-site monitoring. The BNB is undergoing a program to further build supervisory capacity with the help of international consultants under a technical assistance program. BNB supervisors maintain regular contact with the bank management. The findings of on-site inspection are discussed first by inspection team with the bank's management. The overall CAMELS rating is communicated to the bank management. At the same time, banks are also required to inform the BNB of major events such as changes in capital, insider loans and large exposures; interruptions in activities, change in auditors, change in board of directors, opening and closure of branches and amendments to the Articles of Association. The quality and competence of management is evaluated as part of arriving at the Management (M) rating as part of the CAMELS ratings.

139. A system of off-site reporting is in place, which calls for quarterly reporting on both a solo and consolidated basis. The frequency of the reporting can be increased to monthly in view of enhanced risk to an institution. The reports are used to evaluate the bank on a CAEL rating (Capital, Asset quality, Earnings and Liquidity). An analytical framework has been built for the analysis of the statistical and prudential information.

140. The validation of supervisory information is primarily done through the on-site inspections, which are conducted using in-house examiners. External auditors are not used for this purpose, although the BNB has the authority to do so and in fact does require certain prudential reports to be certified. The planning process, responsibilities of examiners, objective of examination and procedures to be followed are well documented in an on-site manual, which is disclosed to banks.

141. All banks are supervised on a consolidated basis, which includes the operations at foreign locations. As of now there are no complex structures or bank groups or bank holding companies in Bulgaria with the exception of an insurance company, which owns a bank. However, the BNB has put in place the components of a regime of consolidated supervision. The parent bank in a bank group or the bank in a financial holding company is also obliged to submit to the BNB information on the structure, size of participations and the changes made therein. Further, the central bank is authorized to inspect other banks and non-bank enterprises on issues related to the inspection. In the on-site inspection manual, there is a separate chapter on related organizations, the procedures under which require the inspector to evaluate these risks.

142. The BNB has recently entered into a MoU with the other major domestic financial supervision agencies other than the DIF, with which it already had an agreement. The agreement creates a framework for cooperation, coordination and exchange of information. As regards locations abroad: branches of domestic banks require licenses, subsidiaries and joint ventures do not require similar permission. The law provides an exception for the application of consolidated supervision, i.e., for subsidiaries in countries where there is an impediment to the flow of information. This exception should be reconsidered.

Information requirements (BCP 21)

143. Banks are required to have their annual accounts audited by external auditors chosen by them from among a list maintained by the BNB. The format of the audited accounts and the disclosures are laid down by the BNB. Banks are also required to publish half yearly balance sheets and the BNB on its own publishes balance sheet data on a quarterly basis based on off-site data. The law requires banks to use National Accounting Standards (NAS), which are different from the International Accounting Standards (IAS) in some respects. However, most banks have begun preparing accounts by IAS. Banks will move to International Accounting Standards from January 1, 2003. Auditors are obliged to inform the central bank about any circumstances that may put the bank's activity at risk though there is no protection available in the banking law to auditors for such disclosure. Promoting such protection for the auditors should be considered.

Formal powers of supervisors (BCP 22)

144. The BNB can take a range of remedial measures against banks and penalize the banks, its administrators or major shareholders. Triggers of remedial action or the penalty are laid down in law and include actions such as violation of the law or regulations, posing a threat to depositors' interests, money laundering, hindrance of bank supervision, etc. Supervisory actions range from the issue of written instructions and cease and desist orders, to prohibition of dividend payments, dismissal of managers and revocation of license, etc. These BNB has been taking timely action as evidenced by the Quarterly Report on Enforcement and Compliance Action.

Cross border banking (BCPs 23-25)

145. Banks are supervised on a consolidated basis, including the operations of foreign branches. Domestic banks require prior approval of the BNB for opening branches abroad, though no similar permission has been contemplated for subsidiaries. Currently, there are no foreign subsidiaries of Bulgarian banks. BNB may refuse the permit for instance if host country supervision is not considered sufficiently effective or if there are legal or administrative obstacles to supervision exercised over the branch by the BNB. The operations of the overseas branch are reviewed through on-site inspection of the parent bank, which includes an evaluation of management competence to oversee the global operations of the banks.

146. The law authorizes BNB to conclude bilateral agreements with other central banks or foreign supervising agencies on exchange of information on a reciprocal basis and a commitment to keep bank secrecy. Sharing of information with overseas supervisors is on an ad hoc basis, and is in the process of being formalized through MoUs and exchanges of letters, in which BNB has taken a proactive stance.

147. Currently Bulgarian banks have overseas branches only in Cyprus and Albania. The BNB has entered into a Memorandum of Understanding with Cyprus, Austria and the U.S. and is negotiating MoUs with Greece and Albania. Banks are required to obtain BNBs permission before opening a branch abroad. It may refuse the permit if it considers the overseas supervisors to be ineffective or if there is an impediment to supervision.

148. Foreign banks operate in Bulgaria both as branches and as subsidiaries and are subject to the same supervisory and prudential regime as domestic banks, with minor exceptions, which reflect the control of the parent bank and the supervisory regime of the host country, in the case of foreign bank branches.

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 6. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
Principle 1.6 Information sharing	The information sharing arrangements with other domestic supervisors should be formalized through appropriate agreements or structures.
Principle 4. Ownership	BNB should establish a system for identification of all eventual owners including beneficial owners of banks.
Principle 6. Capital Adequacy	BNB should introduce regulatory capital for market risk based on the Basel requirements. (It is understood that this is being contemplated for 2004.)
Principle 11. Country Risk	Guidance should be given to banks on specific provisioning for country risk and supervisory oversight should be developed to assess the country risk management practices of banks.
Principle 12. Market Risks	BNB should develop the supervisory capacity to assess interest rate risk (and market risk in general) and the also test and eventually validate the risk management systems of banks, and the assumptions made by them in this regard, and also to provide necessary guidance to them on the subject. It is understood that a special unit is being contemplated which would be trained for this purpose.
Principle 13. Other Risks	BNB should both issue guidance and develop capacity to assess the risks and controls in banks IT systems (and in the e-banking products being offered)
Principle 14. Internal Control and Audit	The responsibilities of the Boards of banks should be clearly laid out in law or regulation.
Principle 20. Consolidated Supervision	The exemption from consolidated supervision in the exceptions to consolidation laid out in Art. 8 of Regulation 12, subsidiaries situated in countries where there are legal impediments for supplying required information can be exempted from submitting consolidated reports. This exemption should be reconsidered.

Authorities' response

149. The authorities are in agreement with the assessment.

III. ASSESSMENT OF OBSERVANCE OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. General

150. The aim of this assessment was to assess the effectiveness of securities regulation, soundness of market intermediaries, and development prospects for the capital markets, as well as observance of the IOSCO Objectives and Principles of Securities Regulation.

151. The Bulgarian capital market and the Bulgarian Stock Exchange (BSE) are still underdeveloped and do not allow the efficient aggregation of capital for use in productive enterprises. Market capitalization is 5 percent of GDP and liquidity is low. A large number of the companies listed on the Exchange (about 38 percent) had no transactions registered in respect of their shares in the last financial year and a further 108 companies had only one trade in that year.

152. The legislation and regulations, setting up the institutional framework, consisting of the Bulgarian National Securities Commission (BNSC) and the BSE are new. The powers of these agencies are still largely untested. A large number of inspections have been carried out, and sanctions applied in a number of cases.

153. Some state owned enterprises are to be privatized, and, to the extent that this process is carried out through the Stock Exchange or the shares listed, the supply of shares to the market will increase. On the demand side there may be more interest in the future from pension funds to invest in equity markets. The planned strengthening of capital markets legislation should promote confidence of small shareholders.

B. Information and Methodology Used for the Assessment

154. The assessment used the Objectives and Principles of Securities Regulation issued September 1998 by the International Organization of Securities Commissions (IOSCO) and the associated five-volume methodology. The BNSC had prepared a set of self-assessments, which were used as basic reference. The assessment was also based on current ordinances and regulations provided by the BNSC, and rules issued by the Bulgarian Stock Exchange. The assessment benefited from interviews with the BNSC officials and various market representatives: the Bulgarian Stock Exchange, accountants, banks and other leading market participants.

C. General Preconditions for Effective Securities Regulation

155. The regulatory environment for the securities markets in Bulgaria generally conforms to the preconditions to the IOSCO Objectives and Principles. These include the absence of unnecessary barriers to entry and exit to and from markets, and to the development of new products, opening to the widest range of market participants that meet the criteria, the

consideration of impacts of regulatory requirements before introduction, and a level playing field.

156. However, the IOSCO principles also require an appropriate and effective legal, tax and accounting framework within which the securities markets can operate. The accounting and auditing standards in Bulgaria do not fully comply with this requirement. Specifically, there is no requirement to report transactions with affiliated companies, which can lead to major misrepresentations.

157. Although the detailed provisions of the LPOS and the ordinances that are made under that law were carefully drafted to implement international best practice, and specific rules covering collective investment schemes, market intermediaries and secondary markets implement IOSCO Principles, the legal framework still shows deficiencies. It does not, for instance, clearly define the duties of directors and managers to the company and require them to act in the interests of the shareholders and not in their own interests. It is also unacceptable that, in the case of the secondary markets, a delay is allowed to advise the BSE of matters, which may affect share prices. Furthermore, the law does not provide adequate protection for minority shareholders.

158. Supervision is exercised by the BNSC, which is an independent State body. Its functions are to regulate and control the public offering of and trade in securities, securities markets, the Central Depository, investment intermediaries, investment companies and management companies, all with a view of protecting investors and enhancing the development of a transparent and efficient securities market. The BNSC has wide powers of surveillance, investigation and enforcement and it has used these powers to impose fines and other sanctions. In the year 2000, 10 inspections of investment companies were carried out. A number of violations was found and formal corrective action undertaken in two cases. In one case a license was withdrawn.

159. The details of the regulations have been carefully drafted to implement international standards of good securities regulation. However, the law on which these regulations are based is deficient in two major areas: (i) effective provisions for the protection of minority shareholders and (ii) a general obligation of directors to exercise their powers with care, and to act in the interests of shareholders as well as of the company. In general, there is a lack of appreciation by shareholders, managers and directors of their respective rights and duties.

160. The surveillance and enforcement activity of the BNSC is hindered by failures to file required returns or to observe timetables and proper procedures for meetings, increasing capital and like matters. The Exchange has wide powers of investigation and discipline under its rules but may be inhibited by the desire to maintain on the Exchange as many listed companies as possible. Nevertheless, in a number of cases action was taken against failure to submit reports of the filing of accounts and similar breaches of regulations.

161. There is a need for further education by the BNSC of company directors, managers, investment intermediaries and others involved in the securities industry. The BNSC has the

objective to implement an information and education program for all capital market participants. Accompanied by strong enforcement, those changes may help raise the level of confidence of investors. Together with a supply of good quality shares placed through the market, this could help lay the foundation laid for a more active and effective market.

162. The BSE trading system is fully electronic and automatic. It is designed to provide transparent, up to date and reliable information about trading and the companies listed on the Exchange. It is designed to deal with turnover several times larger than at present. BSE plans to de-list companies with no trades or very low levels of activity.

163. Clearing and settlement of all listed securities must take place through the Central Depository, which provides an efficient safe and cost effective system. All listed companies have dematerialized securities. The settlement cycle is T+3 and all settlements are carried out on a gross basis. The Central Depository is owned as to 42 percent by the State or its institutions, and the balance by members.

D. Main Findings—Summary

164. Bulgaria has implemented the majority of the IOSCO objectives and principles, but a number of areas still need to be addressed, also in the LPOS and the company's law. These laws should be amended to address the deficiencies in minority shareholder protection and provide for clear duties of directors to all shareholders, including minority shareholders. Other beneficial amendments would be to authorize the BNSC to take court action on behalf of disadvantaged shareholders in civil actions to give more power to general shareholder meetings over certain corporate decisions, and to provide new rules for taking companies out of the register of publicly traded companies. The law should also provide for explicit legal protection for supervisors, budgetary independence, and cooperation with foreign regulators. Accounting standards should require reporting in the financial statements of transactions with affiliated companies.

165. Other vulnerabilities in the rules and regulations include the lack of an obligation to report events that can have a material impact on share prices. Moreover, there is no explicit legal protection of supervisory staff. Staff remuneration needs to be reviewed to maintain salaries at a competitive level. Furthermore, MoUs should be concluded with foreign securities supervisory agencies. Currently only with Greece has a MoU been concluded. The terms of office of Board members of BNSC should be staggered, which can help prevent problems with regard to continuity of governance.

Regulator (Principles 1–5)

166. The powers of the Bulgarian National Securities Commission (BNSC) are clearly set out in the Law on Public Offering of Securities (LPOS) (see Art. 15). The LPOS also sets out the objectives of the Commission, which are to provide protection of investors and create prerequisites for development of a transparent and efficient capital market. All LPOS based

ordinances are made upon recommendation of the BNSC and are submitted to the Council of Ministers for adoption.

167. The LPOS specifically provides that the BNSC is an independent State body (Art. 8 LPOS). Members are appointed for a term of five years by the Council of Ministers and must have a university education, professional qualifications, experience in the field of securities and must comply with reputational and absence of conflict requirements. The chairman must have a university degree in law or economics, and ten years of working experience (Art. 10 LPOS). Once appointed, members may be removed only on the grounds of gross breach of law, conviction of a premeditated crime, or inability to carry out duties for more than six months (Art. 12 LPOS). The Commission is required to submit an annual report to the Council of Ministers containing information specified in the law (Art. 15 LPOS).

168. There is no requirement to disclose the financial statements of the BNSC in the Annual Report although it does include some summary figures. There is no legal requirement to have the report laid before Parliament but the Annual Report is published in print and on the website of the Commission. There is no explicit protection for the Commission members and staff from liability in the proper exercise of their powers and functions. It would be preferable to have staggered terms of appointment of members to allow some continuity of policy and experience.

169. The BNSC does not have budgetary independence, although it has adequate powers and sufficient qualified staff to carry out the BNSC's mandate. The BNSC is funded through a State Budget account (Art. 9 LPOS), which is credited with fees collected by the Commission, fines, and revenues from publications of the Commission. Remuneration and working conditions should be set at a level to retain experienced and qualified staff. The BNSC employed an average 124 persons in the year ended 2000, mainly economists and lawyers. The LPOS gives specific powers to the BNSC to obtain information in relation to the operation of bodies involved in market activities as well as the right to require documents and written explanations from all persons.

170. The BSE is required to provide documents and information on its operations to the BNSC. The Central Depository is obliged on request to present similar information to the Minister of Finance, the BNB and the Commission. Updated information about the Commission's activities and the securities market in general is provided to the general public by means of the publication of a news bulletin once a month and a Bulletin (Art. 15 LPOS) once every two months.

171. The chairman, members of the Commission and staff must sign an agreement binding them to confidentiality. Also, the Law on the Access to Public Information provides protection of personal information. The chairman, members of the Commission and employees must disclose information about securities held by them as well as those of their spouses and under-age family members, and of their contractual relationships with entities controlled by the Commission. Any person with a personal interest in the outcome of administrative proceedings, is prohibited from taking part in the consideration of the matter.

Self-regulatory organizations (Principles 6–7)

172. There is one self-regulating organization under the jurisdiction of the BNSC, i.e., the Bulgarian Stock Exchange. The LPOS allows for the licensing by the BNSC of other trading bodies if that should be desirable. The Bulgarian Stock Exchange Rules and Regulations authorize the imposition of sanctions by the Board of the Exchange after consultation with the Commission of the Exchange for breach of the law or the Rules and Regulations ranging from a warning to suspension or removal of a member from stock market trading.

173. Creating new SROs, other than the Stock Exchange, is not appropriate given the size and stage of development of the market. The limited experience and expertise for now is more conveniently concentrated in the BNSC.

174. The LPOS standards for licensing a stock exchange include capital and other structural requirements as well as governance and operating systems (Arts. 20–27 LPOS). The Stock Exchange is licensed by the BNSC and its rules must be approved by the BNSC (Art. 28 LPOS). Powers to impose sanctions for non-compliance are laid down in the Stock Exchange Rules and Regulations (Art. 127 LPOS and Arts. 126–128 Rules and Regulations). Sanctions can be imposed by the Board of the Stock Exchange after consultation with the Commission of the Exchange (Art. 129). The Commission comprises representatives of the commercial banks, investment intermediaries, stockbrokers and shareholders of the Exchange (Art. 9 Stock Exchange Rules and Regulations).

Enforcement (Principles 8–10)

175. The Commission has the powers necessary to supervise, investigate and enforce relevant regulations and to obtain data information, documents, statements and records from persons subject to supervision. The Commission receives and files regular reports from companies, investment intermediaries and other regulated bodies.

176. It can also obtain information and carry out inspections of other persons on issues relating to those inspections (Art. 16 LPOS). In cases of crimes in connection with securities such as frauds and misappropriation the Commission instructs the prosecutor's office and the police authorities to take necessary actions. The BSE can impose sanctions under its own powers pursuant to Art. 26 of the LPOS. The Commission carries out inspections of regulated entities by reviews of filed documents and reports. It also carries out other inspections, based on signals from the affected entities and reports periodically filed with the Commission. There are no restrictions on the ability to obtain information or access to documents (see Art. 16 LPOS)—the Commission and its employees carry out these inspections themselves. There is no requirement of suspicion of a breach as a precondition to the exercise of these powers.

177. The Commission conducts periodic routine inspections and carries out inspections for cause as a result of reports filed with the Commission. Inspections of organizations will also be based on an assessment of risk. There is no obligation on the Commission to give advance

notice of inspection. The Commission maintains records of its findings and presents an annual report of its operation to the Council of Ministers each year.

178. There were over 400 inspections relating to documents submitted by public companies about obligations for disclosure of information, 600 inspections of documents about general meetings requirements as a result of which the Commission took administrative action against 35 companies as well as reminder or preventative action letters to other companies. The Commission carries out on-site inspections (118 on investment intermediaries and 10 on investment companies in the year ended 2000). Inspections are carried out by Commission staff, which includes economists and lawyers.

179. The BNSC has the ability to impose a variety of sanctions including corrective measures, suspension of business, removal of persons from management, fines, confiscation in favor of the state of incomes acquired from activities unlawfully carried out and revocation of licenses in appropriate cases. (LPOS Art. 212). The BSE can require a temporary halt to trading (Art. 64 Rules and Regulations of the Bulgarian Stock Exchange).

180. The ability of individuals to bring actions is limited and this is being addressed in amendments to the law now under consideration.

Cooperation (Principles 11–13)

181. Under Art. 15 of the LPOS, the Commission has authority to obtain and share with other domestic regulators information on matters of issuing and revoking licenses, investigation and enforcement, determinations, surveillance, market conditions and client identification. Recently, an agreement has been concluded between the financial sector regulators, including the BNB, on cooperation, coordination and information sharing. The Commission has authority to share information with regulators from other jurisdictions.

182. The Commission has not, except for an MoU with the Greek Capital Market Commission, developed any formal mechanism for cooperation in the detection and deterrence of cross-border misconduct or for cooperation in the issuance of licenses and exercising of supervisory responsibilities. Decisions on the mode of cooperation are made on an “ad hoc” basis. Although the requirement to assist is set out in legislation it would be preferable to have the working criteria in writing between the various authorities. There is no restriction on the ability of the Commission to provide information to foreign regulators.

183. MoUs need to be signed between the BNSC and those foreign regulators where there is regular exchange of information, to clearly define the scope of the cooperation and the procedures to be adopted in the use of any such information.

Issuers (Principles 14–16)

184. The objective of the rules on the conduct of issuers is to ensure investor protection and to promote the development of a transparent and efficient securities market. Mandatory disclosure requirements are set out in the LPOS and associated regulations. The LPOS and

the Ordinance on the Prospectus For Public Offering of Securities And Disclosure By Public Companies and Other Issuers of Securities require full, accurate and timely disclosure of financial results and other material information. However, companies listed on the Stock Exchange are not required to immediately report matters that may have a material effect on the value of the shares. The Commission must approve all prospectuses before issue. In cases of non-approval the securities cannot be offered publicly.

185. Although the offering information required for prospectuses complies with IOSCO Principles, public offerings by the State are exempt from these disclosure requirements. The State offering documents do not include full financial statements or prospective statements as are required by the prospectus requirements.

186. There are no general provisions requiring directors to act in the best interests of all shareholders including minority shareholders and not in their own interests. Although there are some specific and limited provisions contained in the LPOS protecting the interests of minority shareholders in public companies, these cover only some particularly designated actions such as disposal of assets and requirement to issue new shares pro rata. While these rules are intended to protect shareholders, they are too specific to effectively prevent instances of unfair allocation of new shares in favor of majority holders and transfer of company assets by major holders. See Art. 112 and 114 of the LPOS. Persons holding at least 5 percent of the capital may take action in court under the LPOS and other individual action may be possible under Art. 71 and 74 of the Commerce Act.

187. Certified or audited financial statements and half-yearly reports must be filed for all securities issued through a primary public offering or admitted for trading on a regulated market. Accounting standards are not fully compliant with international standards. Notably, there is no requirement to report transactions with affiliated companies, which can lead to major misrepresentations. There will be full compliance with the International Accounting Standards for public companies by 2003. Lack of experience and training of accountants and auditors could initially reduce the effectiveness of the international standards.

Collective investment schemes (Principles 17–20)

188. Investment companies must be licensed by the BNSC. They are required to be joint stock companies and therefore subject to the general provisions of Chapter 14 of the Commerce Act. In addition to those rules, the special provisions of the LPOS apply.

189. A licensed investment company must comply with specific criteria as to its capital, technical equipment and facilities, organization and qualification of its directors and staff. All directors and the management company must meet criteria of professional experience, place of residence, lack of criminal convictions or regulatory suspension. These requirements apply also to the directors of fund management companies.

190. The LPOS and associated regulations i.e., the Ordinance on the Requirements for the Activities of Investment Companies, Ordinance on the Prospectuses and Ordinance on the Licenses, set specific standards for managers of an investment company. Responsibility for

compliance rests with the Board of Directors or the Managing Board in the case of a two-tier system of governance, and with the company, which manages the activities of the investment fund and carries out the sale and redemption of shares of an open-ended fund on behalf of the company. Open-ended investment funds must be managed by a company licensed by the BNSC.

191. The LPOS and Ordinances prescribe requirements for minimum capital of investment companies, prohibitions on investment in assets in which managers have an interest, separation of custody of assets, requirements for asset valuation disclosure, control of ownership, liquidity requirements, reports and publicity and other matters.

192. Apart from the information provisions specific to investment companies in the LPOS and the Ordinance, there are conduct of business rules in the Ordinance on the Requirements of Investment Intermediaries Activities and in the Stock Exchange Rules, which govern sales by brokers and other investment intermediaries. Fundamental rules about asset valuation, pricing and redemption of shares are set out in the LPOS and in the Ordinance on the Requirements for the Activities of Investment Companies. The Articles of Association of an investment company must set out the detailed rules and procedures for determination of the net asset value of the shares. Valuation and disclosure for open-ended investment companies must occur at least twice per week at equal intervals.

193. The BNSC has the authority to conduct inspections and impose administrative sanctions. In the year ended 2000 the Commission carried out ten inspections and issued seven statements of administrative violation.

Market intermediaries (Principles 21–24)

194. All market intermediaries are licensed. Licenses are granted by the Bulgarian National Securities Commission except in the case of banks, where licenses are issued by the Bulgarian National Bank. The criteria for licensing covers capital adequacy, qualification of personnel, proper business plan and publicity of information. These requirements are set out in the Law on Public Offering of Securities and the ordinances and regulations made pursuant to that law. Individual brokers and investment advisers must satisfy integrity and competence requirements and pass an examination set by the BNSC.

195. The general standards imposed on investment intermediaries are set out in Art. 70 and following of the LPOS. In addition market intermediaries must have internal organizational rules to supplement those and to require observance of all the requirements by employees. The Ordinance on the Requirements for Investment Intermediaries Activities imposes specific obligations in relations with clients.

196. Art. 56 of the LPOS set out capital and other prudential requirements for investment intermediaries, including the establishment and maintenance of a reserve fund. Specific rules are set out in the Ordinance on the Capital Adequacy and Liquidity of the Investment Intermediaries. Initial capital, which must be maintained is 90000 BGN for intermediaries executing transactions for client accounts only and 250000 BGN for those executing

transactions for both own and client accounts. The intermediary must also establish a reserve fund, which must be at least 10 percent of the capital.

197. Other prudential requirements cover position, currency and other risks. Capital adequacy requirements take into account balance sheet items, off balance sheet transactions and activities of affiliated companies. Monitoring is carried out through on site inspections, monthly reports by the intermediary to the BNSC and by a requirement to advise immediately if prudential standards threaten to be breached.

198. The BNSC can require remedial action against breach of capital or liquidity rules. Actions can range from an agreed financial plan to mandatory instructions by the BNSC. The BNSC has the power to transfer client accounts to another investment company in the case of need, and may suspend the sale or carrying out of transactions in certain securities (Art. 212) and may withdraw a license. The Stock Exchange has established a guarantee fund against broker default.

Secondary market (Principles 25–30)

199. Regulated securities markets must be licensed by the BNSC pursuant to the LPOS. That law sets out some broad criteria for the objectives of an exchange, ownership, capital rules and operating procedures. The BNSC has power to withdraw a stock exchange license in appropriate cases including where systematic offenses are committed or if the exchange ceases to satisfy the requirements of the LPOS or its implementing instruments. Brokers must be investment intermediaries licensed by the BNSC. The rules of an exchange must receive prior approval by the BNSC as must any amendments and supplements to the stock exchange rules (Art. 33 LPOS).

200. There is ongoing supervision of the Exchange and its members through on-site inspections. The Exchange must submit half yearly and annual reports to the BNSC including an accountancy report and other information and documents on request (Art. 34 LPOS). Stock exchange records must be kept for 50 years. (Art. 34 LPOS).

201. The trading system is fully electronic and provides transparency and market information. A stock exchange must ensure to its members and their clients equal access to market information and equal conditions for participation in trading (Art. 20 LPOS). The trading system provides markets users with real time information. There is an on-line connection between the Exchange and the BNSC providing all trading and other information on monitors in the Exchange.

202. The LPOS prohibits insider trading and market manipulation. The BNSC can use its investigation and enforcement powers to monitor these provisions. There are broad definitions of insider trading and market manipulation in the LPOS. The Stock Exchange carries out inspections of members and of trades.

203. All transactions in shares in public companies are dematerialized and must be effected through the Central Depository. The LPOS provides for oversight of the Central

Depository by the BNSC. The Central Depository Board of Directors must include a representative of the Bulgarian National Bank and the Ministry of Finance.

E. Recommended Plan of Action and Authorities' Response to the Assessment

Recommended actions

Table 7. Recommended Actions to Improve Compliance with the IOSCO Objectives and Principles of Securities Regulation

Reference Principles	Recommended Actions
Principles relating to the regulator, (CPs 1–5)	<ul style="list-style-type: none"> • The annual report should contain the audited financial statements of the BNSC. • The LPOS should be amended to provide explicit legal protection for members and staff of the BNSC in the exercise of their functions. • The members should be appointed for staggered terms. • Remuneration and working conditions for staff should be increased and improved to retain experienced and qualified staff. • Create spending autonomy within an agreed budget.
Principles for cooperation in regulation (CPs 11–13)	<ul style="list-style-type: none"> • The BNSC should enter into MoUs with domestic regulators and, where appropriate, foreign regulators.
Principles for issuers (CPs 14–16)	<ul style="list-style-type: none"> • The Government, when it sells paper through public offerings, should do so by way of prospectus. • An obligation should be created to report material matters that can influence share values. • Reporting of transactions with affiliated parties should be required. • Minority shareholder rights should have increased protection through amendments to the Commercial Law and the LPOS. • Assure proper training of accountants and auditors to obtain full benefit of the introduction of IAS. • Include a general fiduciary duty for managers and Board members of issuers.

Authorities' response

204. The authorities are in agreement with the assessment.

IV. ASSESSMENT OF OBSERVANCE OF THE IAIS INSURANCE CORE PRINCIPLES

A. General

205. The assessment of the Bulgarian insurance sector was performed to assess observance with the International Association of Insurance Supervisor (IAIS) Core Principles, and to suggest areas for further development.

B. Information and Methodology Used for Assessment

206. This assessment was based on the Insurance Core Principles Methodology document adopted by the IAIS in October 2000, and associated guidance papers, and involved a review of the following documents (i) the self-assessment prepared by ISA, and (ii) the Insurance Act and associated regulations and instructions.

207. The assessment was also based on discussions with the ISA, market participants, the Association of Bulgarian Insurers, external auditors, actuaries and brokers. The supervisory staff of the ISA cooperated extensively in the assessment, by providing answers to the FSAP questionnaires, preparing a self-assessment of IAIS Core Principles, and making themselves available to meet with mission members whenever required.

208. ISA operates under a strict rule of confidentiality under Art. 23 of the Insurance Act. ISA may provide information to interested parties upon request, and through the Annual Report and the public register. Market participants and the Association of Bulgarian Insurers provided insightful advice on industry matters.

C. Institutional and Macro Prudential Setting—Overview

209. Supervision of the insurance sector in Bulgaria is performed by the Insurance Supervision Agency (ISA) under the responsibility of the Ministry of Finance, and the National Insurance Council (NIC) at the Council of Ministers level. NIC grants, refuses or revokes licenses, approves mergers, split and separation of insurers, and initiates bankruptcy proceedings. ISA performs the ongoing supervision of insurers, reinsures and brokers. Pension funds are supervised by the State Insurance Supervision Agency. Health insurance is supervised by the Special Directorate for Health Insurance Supervision at the Ministry of Health.

210. The insurance industry in Bulgaria is still in an early stage of development, but is properly diversified. Foreign insurance companies are well represented. At end—October 2001, 32 licensed insurance companies were operating in Bulgaria—12 life insurance companies and 20 non-life insurance companies. Of these 32, 20 are joint stock companies offering non-life insurance, and 8 joint stock companies and 4 mutual companies offering life insurance. Foreign insurance companies accounted for 15 percent of the assets of all the life insurance companies, and 56 percent of the assets of all the non-life companies, as at December 31, 2000. At the same date, the three biggest life insurance companies had

90 percent of the assets of the life insurance industry, while the three biggest non-life insurance companies owned 57 percent of the assets of their industry. Insurance penetration is increasing, with premiums/GDP increasing from 1.08 percent in 1998, to 1.52 percent in 2000, although there is still much scope for growth.

211. Total premiums received by Bulgarian insurance companies during year 2000 amounted to BGN 387.6 million (US\$181.8 million), of which BGN 44.2 million (11.4 percent) was for life insurance and BGN 343.4 million for non-life insurance. Bulgaria's insurance markets is average for the region of the Balkans and Turkey, with total 2000 premium income estimated to represent only 1.5 percent of GDP. In 1997, insurance industry premiums in the EU ranged from 3.6 percent to 10.7 percent of GDP. Reinsurance premiums ceded amounted to BGN 105.9 million. Total assets for Bulgarian insurance companies at the end of 2000 amounted to 2.4 percent of GDP.

212. Reinsurance premiums ceded amounted to BGN 105.9 million, while Bulgarian reinsurers received premiums of BGN 5.2 million. Bulgaria has one of the smallest insurance market with total 2000 premium income estimated to represent only 1.5 percent of GDP. Statistics from 1997, showed that the insurance industry in developed market economies of EU states represented 3.6 percent to 10.7 percent (UK) of GDP. Total assets for Bulgarian insurance companies as at the end of 2000 amounted to BGN 615.6 million, representing 2.4 percent of GDP.

213. A state owned group, the State Insurance Institute (DZI), the largest insurance group of the country (20 percent of non-life market, 47 percent of the life market in 2000), has been earmarked for privatization in 1999.

214. Profitability of the insurance sector does not seem strong. For life as well as non-life insurance, claims ratios²⁸ have gone up, for life insurance from 58 percent in 1999 to 84 percent in 2001, and from 58 percent for non-life in 1999 to 61 percent in 2000. Gross rates of return on investments in 2000 at 8.11 percent for life insurance was only just sufficient to compensate for inflation, leaving a real rate of return of around zero. For non-life, the return of 3.42 percent was clearly insufficient to compensate for inflation.

D. General Preconditions for Effective Insurance Supervision

215. The development of the insurance industry is hampered by the same factors that hinder the development of financial intermediation in Bulgaria in general, i.e., weaknesses in corporate governance, financial disclosure, and the judicial system.

216. In insurance sector in Bulgaria (i.e., insurers, reinsurers, brokers and agents) is governed by the Insurance Act (IA) and associated regulations. The ISA argues that the

²⁸ Claims as a percentage of premium income.

Insurance Act is effective in dealing with issues relating to regulatory compliance, such as licensing requirements, but that it is weak in addressing 'risk' prevention. There is an overwhelming view that there are significant weaknesses in the implementation of the law.

E. Main Findings

217. Nevertheless Bulgaria is observant or largely observant of the majority of the 17 IAIS core principles. Considerable work still needs to be done to achieve full compliance with a substantial number of principles, although much work is ongoing to attain this objective.²⁹

Organization of an insurance supervisor (CP 1)

218. Information systems would need to be improved in order to appropriately collect the statistical data for the off-site monitoring and the early warning system. The remuneration of ISA staff would need to be more comparable to the private insurance industry and their training needs to be improved. ISA should be independent with its own budget. Furthermore, the position of director of the agency would need to be for a specific term and dismissal should be based on professional reasons.

219. Supervision is organized on two levels: the National Insurance Council (NIC) and the Insurance Supervision Agency (ISA), as laid down in the Insurance Act, the Regulation on the Structure and Activity of the ISA and the Regulation on the Operation of the NIC.

220. The laws and regulations on the NIC and of the ISA guarantee independence and a certain transparency in supervision and exercising control over insurers. Most of the NIC and ISA staff is inexperienced as most of their experienced colleagues went back to the industry for better remuneration. ISA's staff training and budget is seriously limited by oversight of the Ministry of Finance. Last year, ISA spending was limited to 43 percent of the fees collected from insurers, reinsurers and brokers, the remainder being allocated to the government budget. Legal protection for staff should be clarified.

Licensing and changes in control (CPs 2–3)

221. The Insurance Act would need to be amended to provide legal provisions for ISA to be able to seek information from foreign supervisors (home supervisors) at the time of licensing. Then, ISA would need to work on agreements with foreign supervisors to exchange information. There also should be criteria for the assessment of the changes in control of insurance companies. Given the important share of Bulgarian companies that are owned or controlled by foreign companies, it would also be advisable to obtain agreements for the exchange of information on an ongoing basis for the monitoring of foreign owners.

²⁹ See authorities' response to the assessment.

222. The legislative framework on licensing procedure is established by the provisions of the Insurance Act, the Regulation on the Structure and Activity of the ISA, the Regulation on the Operation of the NIC, the Commercial Law and number of instructions issued by the ISA. The third component of this core principle on the sharing of information with foreign supervisors is non-observed, but this is not considered sufficient ground for a lower grading.

223. Supervision on changes in control of insurance companies is considered in the Insurance Act (Art. 9, par. 3), the Regulation on the Structure and Activity of the IGSA (Art. 13), the Commercial Act and a number of instructions.

224. No person, natural or legal, on its own or through related persons, may hold more than 5 percent of the shares of an insurance company, without the approval of ISA. The legal framework gives sufficient powers to ISA to take any appropriate measures.

Corporate governance (CPs 4–5)

225. The legislative framework has few dispositions concerning corporate governance in the Commercial Law and the Insurance Act, and ISA has no specific authorities in this area. This core principle is not addressed in the law, regulations or instructions. Market participants confirmed that ISA does not include this aspect in its off-site or on-site supervision process. A draft amendment to the Insurance Act, which is currently pending, will address shortcomings in this field.

226. The ISA has no clear authorities with regard to internal controls of insurance companies.

227. IAIS core principles expect that the insurance supervisor would have the authority (by law or regulation) to review the internal controls that the board of directors and management apply, and to require strengthening where necessary.

Prudential rules (CPs 6–10)

228. The legislative framework consists of the Insurance Act (Art. 51) and the Ordinance on the procedures and methods of setting-up insurance reserves (Art. 1–16). According to the Regulation on the Structure and Activity of the ISA (Art. 33), ISA assesses compliance with the standards during on-site supervision. Standards and monitoring are in place, but ISA should more strongly promote sound accounting and actuarial principles. The draft amendments to the Insurance Act include definitions of “insurance group,” “mixed activity holding company,” as well as measures for supervision on a consolidated basis. Implementation of these amendments will address concerns in these areas.

229. The Insurance Act contains some provisions and restrictions on the investment of assets, related to amount of the reserves, as well as separate dispositions on the relationship between assets and capital. ISA requires that insurers maintain appropriate capital and solvency under the Insurance Act and the Ordinance for determining the own resources,

solvency margin and its calculation by insurers. ISA has established standards as to the composition of liabilities.

230. Bulgaria currently has no requirement with respect to the use, disclosure or controls of derivatives and off-balance sheet items. Although ISA states that this is done in practice, there are currently no formal regulations and/or instructions in place to require insurers to have an investment policy, comprehensive risk management policies and risk management systems, internal controls, procedures for the accountability of boards of directors, as well as rigorous audit procedures. Derivatives are not explicitly forbidden.

231. ISA approves reinsurance plans of insurers according to Art. 22, par. 1 of the Insurance Act. Reinsurance contracts can also be reviewed at the time of the on-site inspection as per Art. 33 of the Regulation on the Structure and Activity of the ISA. ISA should introduce requirements with respect to reinsurance contracts or reinsurance companies, addressing the amount of the credit taken for reinsurance ceded and the reliance on foreign reinsurance supervisors. Moreover, it should have more precise authorities on the supervision of reinsurers (e.g., in the Insurance Act, there is no definition of a reinsurer and there is no special requirements for reinsurers' supervision). ISA should have agreements with foreign reinsurers' supervision for the exchange of information.

Market conduct (CP 11)

232. The Insurance Act, regulations, policies, guidelines or procedures contain no provisions with regard to market conduct. Only Art. 10 of the Ordinance for Insurance Brokers and Insurance Agents imposes a few obligations on agents. On-site inspections include the review of complaints, but there is no specific procedure.

233. There should be specific standards of market conduct and procedures to review compliance. Instructions should clearly require insurers to have procedures to deal with conflicts of interest and to deal effectively and fairly with complaints of customers.

Monitoring, inspection, and sanctions (CP 12–14)

234. Audited information on insurers' financial condition and performance is to be provided annually under the Insurance Act. Instruction No 12 of 27 of January 2000 specifies additional reports to be submitted annually to the ISA. Financial information is verified through on-site inspections, under Art. 33 of the Regulation on the Structure and Activity of the ISA.

235. The ISA should also have clear legal powers to force insurers to hire, at their costs, independent auditors or actuaries to audit or review the financial statements, or elements thereof.

236. Under the Insurance Act (Art. 22) and the Regulation on the Structure and Activity of the ISA (Art. 33), ISA has a clear legal mandate to perform on-site inspections of insurance

companies. However, some insurers mentioned that they have had no full inspections in many years. Focused inspections also seem to be sporadic, but nevertheless more frequent.

237. ISA should have more frequent (at least every two years) full-scale inspections for every insurer. When internal controls, actuary reviews and external audits have become better, on-site inspection should be more risk based and should cover more processes than compliance.

238. A range of possible available sanctions exists under Art. 22, 31, 43, 50 and Chapter Thirteen of the Insurance Act. NIC can refuse or revoke a license under Art. 30 and 31 of the Insurance Act. ISA can take remedial action under Art. 50 of the Act and Art. 38 of the Regulation on the Structure and Activity of the ISA. Representatives of the insurance industry believe that the reputation of the industry suffers because some companies are charging premiums that are too low for the risk taken. They believe that these are not supervised closely enough by ISA. ISA should have clear intervention procedures that are well communicated and published. They must be able to take control over the affairs of an insurer and appoint an administrator. It should also improve and reinforce intervention methods and powers, along a graduated scale of responses.

Cross border operations, supervisory coordination and cooperation and confidentiality (CPs 15-17)

239. The Insurance Act should require that international insurers, insurance groups and conglomerates active in Bulgaria be subject to continuing effective prudential supervision in their country of origin—irrespective of any licensing requirement. ISA should have a procedure for licensing foreign insurers and consult the insurance supervisor of the parent insurer. Supervision should be exercised over the company as a whole, including its branch operations in foreign jurisdictions.

240. There are no legal provisions on international cooperation and cooperation, for instance on information sharing and cross border inspections. The licensing and requirement of foreign insurers is required under Chapter 4 of the Insurance Act. ISA should obtain legal rights to share information with other supervisors, and conclude information sharing and cooperation agreements with other supervisors, domestically and abroad.

241. The Insurance Act (Art. 23) regulates the confidentiality of information and the obligations of the staff of the ISA.

242. Recently, an agreement was concluded between the financial sector supervisory agencies in Bulgaria, including the BNB, on closer cooperation, coordination and information sharing between the agencies.

F. Recommended Action Plan and Authorities' Response to the Assessment

Recommended actions

Table 8. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor CP 1	<ul style="list-style-type: none"> • Information systems (hardware and software) need to be improved in order to collect appropriately the statistical data for an off-site monitoring and early warning system. • The remuneration of ISA's staff needs to be closer to the private sector in order to attract qualified and experienced prospects. • A continued training program must be instituted to ensure that the staff maintains its competency. • The agency must be more independent with its budget, staffing and have a director with a specific term of office.
Licensing and Changes in Control CPs 2-3	<ul style="list-style-type: none"> • The Insurance Act would need to be amended to provide legal provisions for ISA to be able to seek information from foreign supervisors (home supervisors) at the time of licensing and on an ongoing basis. • ISA should have clear criteria for the assessment of changes in control of an insurance company.
Corporate Governance and Internal Controls CPs 4-5	<ul style="list-style-type: none"> • Provisions on minimum corporate governance and internal controls need to be added to the Insurance Act. • Compliance review procedures also need to be developed.
Prudential Rules CPs 6-10	<ul style="list-style-type: none"> • Sound accounting and actuarial principles should be implemented. • Controls must be introduced on the capital requirements of insurance groups, to prevent double/multiple gearing or other techniques. • Instructions should be issued with respect to the use, controls and disclosure of derivatives and other off-balance sheet items. • ISA should introduce specific requirements with respect to reinsurance contracts or reinsurance companies, and • Have agreements with foreign reinsurers' supervision for the exchange of information.

Reference Principle	Recommended Action
Market Conduct CP 11	<ul style="list-style-type: none"> • Specific standards of market conduct need to be introduced as well as procedures to review compliance. • Instructions should be issued to require insurers to <i>introduce policies and procedures on fair treatment of customers, and delaying with complaints.</i>
Monitoring, Inspection, and Sanctions CPs 12–14	<ul style="list-style-type: none"> • ISA should have clear legal power to force insurers to hire, at their costs, independent auditors or actuaries to audit or review the financial statements, when there is doubt as to their accuracy. • On-site inspections should be more frequent and should be risk-based. • ISA must be able take control over the affairs of an insurers and name an administrator. • It should also improve and reinforce properly graduated intervention methods.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality CPs 15–17	<ul style="list-style-type: none"> • The Insurance Act should provide that international insurers, insurance groups and conglomerates active in Bulgaria be subject to continuing effective prudential supervision—irrespective of any licensing requirement. • ISA should first obtain legal rights to share information with other supervisors, then conclude information sharing agreements with other supervisors abroad.

Authorities' response

243. The authorities are in agreement with the assessment, but have the following comments:

- There is an on-going project for establishing complex information systems. First stage has been accomplished. The possibilities of the established software product are to process the statistical information from the Annual Accounts of the insurers and from other sources as well as to calculate the necessary indices and figures.
- The prepared Draft law amending the Insurance Act is in the Parliament following the undergoing procedures. After the adoption of the amendments new by-laws shall be developed. These will include broad regulation of the on-site and off-site intervention procedures. (The present Regulation on the Structure and Activity of the ISA comprises the regulation of the on-site inspections but it shall be widened and improved).

- A project of introducing a composite supervision over the financial market is in a process of development. The scope of its responsibilities is planned to be very wide. It is planned that the supervisor will oversee the insurers, the pension funds, the health assurance and the securities market. The composite supervision will be more independent, possibly with its budget, staffing and a head with a specific term of office.
- There are provisions in the Draft law which give new possibilities of ISA to control and monitor - the changes in control where the criteria have been set more clear and transparent; the insurance groups and non insurance groups owing insurance companies; the market conduct. All new provisions are connected with relevant sanctions and also the sanction mechanism has been improved as a whole.
- Most of the other recommendations and the respective objectives will be achieved upon accession of Republic of Bulgaria in EU by means of adoption of the new legislative framework.

V. OBSERVANCE OF CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

A. General

244. The assessment of the SIPS in Bulgaria against the CPSS Core Principles, June 2002, supplemented the assessment, undertaken during the FSAP mission. The assessment involved discussions with a Director and senior officials from several departments of the Bulgarian National Bank (BNB), with officials of BankService (the inter-bank payment processing company), of BORICA (the inter-bank card processing company), and of Central Depository AD (CDAD—the depository for corporate securities), and also with a director and senior officials of two large commercial banks.

245. Since the aim of the review was to clarify and to substantiate some of the conclusions and assessments of the previous mission, the approach adopted was to work through a detailed questionnaire, on specific issues raised by those conclusions and assessments, which had been sent to the BNB in early June. Use was also made of the responses of the BNB to the questionnaires prepared by the previous assessment mission; in addition the description of the Bulgarian payment systems, in a publication of the European Central Bank, proved a helpful source of information. The BNB supplied a copy (in English) of a draft regulation currently being drawn up.

246. All the officials met during the assessment mission were open and co-operative. They were unable, in the time available, to answer all the detailed questions put to them, but the points at issue were not material. The BNB officials were unable to provide important statistics relating to a particular category of large-value payments, since the program to extract that data had still not been supplied by the IT Department, despite earlier requests.

B. Institutional and Market Structure

247. The institutions principally concerned with payment systems in Bulgaria are the BNB, the commercial banks, BankService and BORICA. The BNB, as banker to the banks and to the Government, holds the banks' settlement accounts, and provides a specialized payment service (the "Express Service") for large-value inter-bank payments, and for payments between the Budget (the Government) and the banks. It also settles the cash side of transactions in the primary and secondary markets in Government securities (the BNB operates the depository for Government securities), and in the secondary market for corporate securities (handled through CDAD). BankService, which is owned by the BNB and the banks, operates the BISERA 3 system, which is in effect an Automated Clearing House for retail payments (mainly credit transfers initiated by the banks' corporate customers), with the inter-bank settlements carried out across the banks' settlement accounts with the BNB. BankService also supplies and operates BANKNET, a communication system for banks and corporates. BORICA, which is owned by the banks, owns and operates the nation-wide ATM and POS systems, with the inter-bank settlements again taking place across the banks' accounts with the BNB. The Systemically Important Payment Systems (SIPS) at present (but see paragraph 7 below) are the Express Service and BISERA 3. The BNB has the statutory responsibility for the oversight of payment systems in Bulgaria. It has recently been decided that the oversight responsibility will be located in a new function, separate from both the operational side and the division responsible for payment system policy issues.

248. The principal payment instruments in Bulgaria are cash (used extensively by individuals and still, to a substantial extent, by corporate customers), credit transfers and credit cards. The number of POS terminals is growing fast, so that the volume of debit card transactions is expanding. There is minimal use of checks. Direct debits are used mainly in specialized circumstances (for instance in the settlement of the net debit positions of investment institutions arising from transactions on the Bulgarian Stock Exchange).

249. The key institutional constraint on the daily settlement of the payment systems, and in particular of the large-value payment streams, is that the BNB operates a Currency Board regime, under which it is currently unable to provide liquidity to the commercial banks, either intra-day or overnight or longer, to ensure the full settlement of all payments due each day.³⁰ Banks are permitted to draw down their minimum reserve balances, which are maintained on a monthly average, to finance their payment flows, but there is a penalty, in the form of a penal interest rate, if the reserve balance is drawn to below 50 percent of the required average, even for one day. There is an inter-bank market in BGN, which operates in

³⁰ The BNB is permitted by law to lend to a bank (against collateral, for up to three months) if, and only if, the value of its unsettled payments is such as to threaten major systemic problems. This is defined as a situation where a bank with more than 10 percent of the daily payment traffic is unable to settle its position, or where payments that have been queued unsettled for three days amount to 10 percent of the daily traffic.

reasonable depth from same-day out to seven-day deposits, but the availability of funds in that market is variable, with several days each month of potentially quite severe shortages (caused by tax payments). Moreover the access of the smaller banks to funds in the market is limited, even against collateral (the bulk of inter-bank deposits are un-collateralized). The only source of additional intra-day liquidity for the banking sector, to assist in the timely settlement of large-value same-day payments, comes from the legal obligation of the BNB to sell to the banks for same-day value BGN against EUR, where a bank has a sufficient EUR balance on its account with the BNB.

250. The BNB and the banks are in the process of implementing an RTGS system, which is currently planned to go live on September 16, 2002. The system is being supplied by Montran, while SWIFT is the message communication system. (Three small banks, which were not previously members of SWIFT, have now joined that system.) The system will handle all the payments now effected through the Express Service, and all credit transfers of BGN 100,000 or more now made through BISERA 3; it will also handle the net settlements of the remaining payments through the BISERA system (to be re-constructed as BISERA 4), of the card payments through BORICA and of the corporate securities transactions through CDAD.

251. The banking system appears to be stable, with the surviving banks having got over the problems of 1996. Technical skills and payment system expertise have been brought into the country by some major banks, either through their branches or subsidiaries or as substantial shareholders in domestic banks. The banks' loan books are said to be expanding, but the banking system as a whole remains very liquid, mitigating the institutional intra-day liquidity constraint referred to in paragraph 6 above. However as the loan books further expand, that constraint is likely to become more important.

C. Main Findings—Summary

252. As described below, a number of issues still need to be addressed before full compliance is achieved with the CPSS Core Principles. In contrast to the approach adopted during the FSAP mission, the Express Service and BISERA 3 have in this report been assessed separately, treating each system as an SIPS. The Express Service is reportedly used for the settlement of most large-value payments in the financial markets (no statistics are currently available in the BNB), and fully meets the SIPS definition; BISERA 3 carries most corporate non-cash payments, including some of large value, and its inability to settle could have a widespread impact across the economy.

253. Each of these systems fails to comply with certain important CPSS Core Principles. In certain respects however this failure to comply is academic, since some key deficiencies will be addressed in full by the planned implementation of the new RTGS system and the replacement of BISERA 3 by BISERA 4. The Recommended Actions (see below) therefore relate to the situation as it is expected to be following the implementation of these new systems. The Actions relate only to the RTGS system, since it is unlikely that BISERA 4 will then be regarded as an SIPS.

254. It should however be emphasized that the implementation schedule for the RTGS system is extremely ambitious, and that in some key respects it is vulnerable to disruption, which will result in the non-compliance with certain Core Principles by the Express Service and BISERA 3 persisting for longer than is currently anticipated. Most important, no rigorous steps appear to have been taken to ensure that by September 16 all 36 commercial banks will be ready, with the required software installed and fully tested, and trialled across the entire membership, and with operational staff trained. There is no certainty that the banks' treasurers are properly prepared for the task of managing the flows of their payments and receipts across their accounts with the BNB in real time throughout each day; indeed statistics are not yet available of the number, and value, of the payments of BGN 100,000 or more that are currently made through BISERA 3, but will in the future have to be made through the RTGS system. The regulations and the rules and procedures for the RTGS system have only just been drawn up, and the arrangements to ensure that BISERA 4, BORICA and the CDAD transactions will be able to settle on a net basis through the RTGS system ("the Credit Reserve Fund") are only now being drafted. The BNB has not as yet developed a contingency plan in case one or more of the banks is not ready by September 16; nor has it fully considered the implications of its decision to implement the new system through a "big bang," as opposed to a progressive cutover.

255. In setting this timetable, the BNB appears to have given insufficient weight to one key aspect of every RTGS system around the world—namely the extent to which there is a mutual inter-dependence among every member of the system, including the central bank as well as the commercial banks. A problem in any one member, because of a system failure, an operator error or for any other reason, can have an immediate impact on the smooth flow of payments throughout the system, and can thus disrupt a range of transactions. This is particularly important where, as will be the case in Bulgaria, the RTGS system is the vehicle for the settlement in DvP mode of transactions in Government securities and in corporate securities. There is thus a strong case for the BNB to suspend its chosen implementation date, and to set a new date only when it can be certain that all the banks are in every key respect ready for the new system. Moreover the BNB should introduce the new system progressively, so as to enable the banks to becoming used to handling and settling an initially small number of real-time payments, before they take on the full daily load.

Express Service

Legal foundation (CP 1)

256. The Electronic Signature and Documentation Law has been enacted, validating the use of authenticated SWIFT messages to pass instructions from banks to the BNB, for payments to be made through the Express Service. There are however continuing questions on insolvency law and creditors' rights, including in respect of unsecured inter-bank loans (of the continuing delay in enacting the proposed Bank Insolvency Law). Moreover there appears to have been no effort to investigate any potential conflicts of insolvency and other laws with the home country legislation of 8 foreign bank branches in Bulgaria.

257. Some legal risks will be eliminated when the EU Settlement Finality Directive is implemented in Bulgarian law. (This is intended to be at the same time as the RTGS system goes live, but no decision has yet been taken on the precise form of its implementation.)

Understanding and management of risks (CPs II-III)

258. Even though banks are in a position to understand the potentially substantial credit risks and liquidity risks that they incur in the Express Service, they are not in a position to manage those risks, since they receive from the BNB no information during the value day about credits to their accounts (or about the non-receipt of anticipated credits); the first information they receive is shortly before the opening of business on the following business day.

259. The ability of banks to manage their liquidity is also reduced by the absence of intra-day, or longer, liquidity facilities with the BNB; by the penalties on drawing down by more than 50 percent their required average minimum reserves; and by the uncertainty about the ability of any small bank to cover its position in the money market, especially on a day of general shortages in the market.

260. To the extent, however, that payments between banks through the Express Service result from original deposits being made in the inter-bank market, or from repayments of maturing deposits, and have therefore been approved under bilateral credit limits, the credit and liquidity risks in the Express Service are somewhat mitigated.

Settlement (CPs IV-VI)

261. The payments that are made through the Service are final and irrevocable from the moment that they are credited to the account of the receiving bank, and they are (by definition) made in central bank money.

Security and operational reliability, and contingency arrangements (CP VII)

262. Although authenticated and encrypted SWIFT messages are used to transmit the payments, it is not clear that the BNB takes sufficiently strong and regular measures to ensure the security and integrity of the banks' internal systems and processes for handling these large-value payments (at present it merely makes recommendations to banks on this topic).

Efficiency and practicality of the system (CP VIII)

263. The lack of any intra-day information to banks about credits to their accounts with the BNB (or about the non-receipt of anticipated credits) means that they are unable to manage their payment flows efficiently: the outcome may be a closing balance that is unexpectedly high, with no opportunity to invest it overnight, or unexpectedly low, so possibly incurring a penalty under the minimum reserve scheme.

Criteria for participation (CP IX)

264. Participation in the scheme is obligatory for every licensed bank.

Governance of the payment system (CP X)

265. It is not clear how far the BNB regularly consults with the licensed banks (the members) about the rules and procedures of the scheme.

Central bank responsibilities in applying the CPs

266. The BNB does not comply in full with its responsibilities for applying the Core Principles to the Express Service. This is demonstrated by the fact that the scheme complies in full with less than half of the applicable Principles. Moreover the BNB has initiated bilateral discussions about the safety and efficiency of the scheme with only one central bank, out of the four central banks, which have commercial bank branches in Bulgaria.

BISERA 3

Legal foundation (CP I)

267. The Electronic Signature and Documentation Law has been enacted, validating the use of authenticated BANKNET messages to pass instructions from banks to BankService, for customer and other payments to be made through BISERA 3. There are however continuing questions on insolvency law and creditors' rights, which may impact on some payments made through the scheme. Moreover there appears to have been no effort to investigate any potential conflicts of insolvency and other laws with the home country legislation of 8 foreign bank branches in Bulgaria.

Understanding and management of risks (CPs II-III)

268. Although the banks are in a position to understand their liquidity risks in the scheme, they are unable fully to manage those risks, since the overnight processing cycle means that they have no opportunity to cover any liquidity shortfall in time to permit all the valid payments that they have submitted to BankService to be made on the value date instructed by the originators.

269. The ability of banks to manage their liquidity is also reduced by the penalties on drawing down by more than 50 percent their required minimum reserves.

Settlement (CPs IV-VI)

270. The payments that are made through the scheme are final and irrevocable from the opening of business on the value date, and they are (by definition) made in central bank money.

Security and operational reliability, and contingency arrangements (CP VII)

271. Although the scheme uses BANKNET (supplied and operated by BankService) as the message transmission system, with an electronic signature and encryption system based on dynamic key management, it continues to rely on diskettes for fallback communication between each bank and the BankService processing centers.

Efficiency and practicality of the system (CP VIII)

272. Despite the apparent efficiency of the BankService processing function, and of the BANKNET communication system, the lack of any intra-day information to banks about credits to their accounts with the BNB (or about the non-receipt of anticipated credits) means that they are unable to manage their liquidity, so as to ensure the settlement in full of their daily submissions to BISERA 3: they are therefore unable to handle their customers' payment orders with certainty on the due date.

Criteria for participation (CP IX)

273. Participation in the scheme is obligatory for every licensed bank.

Governance of the payment system (CP X)

274. It is not clear how effective a voice the smaller banks have in the decision-making process in BankService (despite the duty of the BNB Deputy Governor, who is chairman of BankService, to ensure fairness).

Central bank responsibilities in applying the CPs

275. The BNB does not comply in full with its responsibilities for applying the Core Principles to BISERA 3. This is demonstrated by the fact that the scheme complies in full with less than half of the applicable Principles. Moreover the BNB has initiated bilateral discussions about the safety and efficiency of the scheme with only one central bank, out of the four central banks, which have commercial bank branches in Bulgaria.

**Recommended Actions to Improve Observance of CPSS Core Principles
and Central Bank Responsibilities in Applying the CPs,
in respect of the Proposed RTGS System**

<i>Reference principle</i>	<i>Recommended action</i>
<p>Legal foundation</p> <p><i>CP I—The system should have a well-founded legal basis under all relevant jurisdictions.</i></p>	<p>The Settlement Finality Directive and the Bank Insolvency Law should be implemented as soon as possible.</p> <p>Potential conflicts of law with the home country legislation of the foreign bank branches in Bulgaria should be identified, and steps should then be taken to seek to control and minimize the impact of such conflicts.</p>
<p>Understanding and management of risks</p> <p><i>CP III – The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and control those risks.</i></p>	<p>The BNB should establish the Credit Reserve Fund with a clear mandate to assist the timely and complete daily settlement through the RTGS system of transactions in BISERA 4, BORICA and the CDAD.</p> <p>The BNB should monitor the banks' use of their minimum reserve balances as sources of intra-day liquidity, and should if necessary consider relaxing the penalties on banks falling below 50 percent of their required reserves on a few days during each maintenance period.</p>
<p>Security and operational reliability, and contingency arrangements</p> <p><i>CP VII—The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.</i></p>	<p>The BNB should regularly inspect and verify the security and integrity of each bank's internal systems for processing and releasing large-value payments.</p>

<i>Reference principle</i>	<i>Recommended action</i>
<p>Efficiency and practicality of the system</p> <p><i>CP VIII – The system should provide a means of making payments, which is practical for its users and efficient for the economy.</i></p>	<p>The BNB should establish with the banks agreed, equitable and transparent bases for their contributions to the ongoing and the replacement costs of the RTGS system.</p> <p>The BNB should ensure that banks receiving customer payments through the RTGS system are obliged to give the beneficiary customers value the same day.</p>
<p>Governance of the payment system</p> <p><i>CP X – The system’s governance arrangements should be effective, accountable and transparent</i></p>	<p>The BNB should establish an on-going governance structure for the RTGS system which will promote stability and efficiency, and at the same time will protect the interests of the smaller banks.</p>
<p>Central Bank Responsibilities in applying the CPs</p> <p><i>Responsibility B – The central bank should ensure that the systems it operates comply with the Core Principles</i></p> <p><i>Responsibility D – The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.</i></p>	<p>The BNB should establish an on-going oversight structure for the RTGS system that is within the BNB, but independent from both the supervision and the operational areas.</p> <p>The BNB should establish detailed contacts with the central banks, and the banking supervisors, in Greece, the Netherlands, Turkey and the USA, with a view to exchanging information in respect of the commercial banks from their countries in the RTGS system.</p>

Authorities’ response

276. The authorities are in broad agreement with the assessment.

VI. OBSERVANCE OF THE IMF CODE OF GOOD PRACTICES ON TRANSPARENCY OF MONETARY AND FINANCIAL POLICIES

A. Transparency of Monetary Policy

General

277. The objective of this assessment is to review the degree of transparency and public disclosure of the monetary policy operations of the Bulgarian monetary authorities. Under the currency board arrangement (CBA), the BNB has a limited role in monetary policy operations. The Currency Board Arrangement (CBA) principles, incorporated in Arts. 20, 29, and 45 of the Law on the BNB, limit the BNB's ability to use new monetary instruments. The Law prevents extension of credit to State or State agencies, and limits credit to the banking system to very narrowly defined lender of last resort situations involving systemic risks. BNB maintains full foreign exchange cover for its monetary liabilities. The Law on the BNB and the associated regulations clearly delineate the BNB's role in monetary policy actions.

Information and methodology used for the assessment

278. This assessment is based on extensive interviews with BNB officials and staff, as well as study of the Law on the BNB, other financial sector legislation and regulation, as well as review of the BNB website and other documentary sources. Discussions were also held with commercial banks and other market participants.

Main findings

279. While some improvements are possible and recommended, BNB maintains a very high standard of disclosure and transparency in its conduct of monetary policy operations.

Clarity of roles, responsibilities, and objectives of the Bulgarian National Bank

280. The ultimate objective of monetary policy is clearly defined in Art. 2 of the Law on the BNB, which states that "the main task of the BNB shall be to contribute to the maintenance of the stability of the national currency through implementation of the monetary and credit policy." The objectives of the BNB are clearly defined in the Law on the BNB, in force since July 1, 1997, which, *inter alia*, provides that (i) that the BGN will be fixed against the Euro, (ii) the BNB will maintain full foreign exchange cover for its monetary liabilities, (iii) the BNB will be independent of from the Council of Ministers and other state bodies and will not extend any credits to the State or State agencies, and (iv) the roles, responsibilities, and limited objectives of monetary policy are clearly specified in the Law on the BNB as well as the BNB's regulations. These are published in the Official Gazette. The BNB also maintains an excellent website (www.bnb.bg) which provides, in Bulgarian and English, all relevant laws and regulations; weekly, monthly, quarterly, semi-annual and annual balance sheets, income statements, as well as BNB research.

281. Art. 49 requires the BNB to publish weekly the balance sheet of the Issue Department, showing the BNB's foreign exchange reserves and its monetary liabilities. It also requires the BNB to publish monthly in the State Gazette the balance sheets of the Issue and Banking Departments. Art. 50 and 51 require the BNB to submit to Parliament Annual and Semi-Annual Reports, which also cover a review and assessment of the BNB's activities during the previous period. All of these reports are also available on the BNB's website.

282. Procedures for appointment, terms of office, and removal of member of the BNB governing bodies are publicly disclosed in Art. 10-14 of the Law on the BNB. The BNB's Managing Board consists of seven members including the Governor, the three Deputy Governors, and three other members. Art. 11 requires that all must be Bulgarian citizens, and must possess the highest integrity and prominent qualifications in economics, finance or banking. They must not have been adjudicated insolvent, or have been the principal owner or manager of an insolvent business. The Governor and the Deputy Governors may not engage in any other remunerative activity, other than teaching, or be members of the bodies in companies where the BNB participates or in international organizations related to the BNB activities. The other three members of the Managing Board may not engage in any other activity at the BNB, or work for banks or in the executive.

283. The mandate of any member of the Managing Board is terminated before the set term only on any of the following grounds: resignation; practical inability to perform his functions for more than six months; enforcement of an imprisonment sentence for a premeditated crime; adjudication in insolvency in a capacity as a sole proprietor or general partner in a commercial company; and previous membership of a managing or controlling body of a company or cooperative, which has been dissolved by insolvency.

284. All the amounts and terms of credits to the government (in so far as the Law allows), and the amounts and terms of deposits of the government with the BNB are publicly disclosed through publication of Annual and Semi-Annual Reports submitted to the Parliament, and the Monthly Bulletin of the BNB. Art. 43 of the Law on the BNB provides that the BNB will act as the agent for public debts under terms agreed with the MoF. The activities concerning public debt registry, settlement, and debt service are reported in the Annual and Semi-Annual Reports of the BNB submitted to the Parliament.

285. The agency roles performed by the BNB are clearly defined in the Law on the BNB (Art. 43), the Annual Budget Law (Transitional and Final Provisions, para. 17), the Organic Budget Law (Art. 29), Regulation 5 on the Terms and Procedure for Issuance, Acquisition and Redemption of Book-entry Government Securities (Art. 2), and in the contract between MoF and the BNB. This contract specifies the agency functions of the BNB (concerning mainly the monitoring and servicing of the domestic and foreign public debt). This contract is not yet publicly disclosed. The activities concerning public debt registry, settlement, and debt service are reported in the Annual and Semi-Annual Reports of the BNB submitted to the Parliament.

286. The provisions relating to the BNB's own capital and its profit are disclosed in Chapter two of the Law on the BNB—Statutory Fund and Reserves (Art. 7–9 and 36). The statutory fund (capital) of the BNB is BGL 20 billion (equivalent to BGN 20 million after currency conversion). To cover uncollectable and doubtful receivables, the BNB allocates provisions in the amount specified by the Managing Board, which is item of expense and an adjustment for the balance sheet assets. Of the annual profit of the BNB, 25 percent is allocated to a reserve fund, which is used for covering the BNB's losses. From the remainder of the profits, necessary amounts may be allocated to special funds set up under the decisions of the Managing Board.

287. According to Art. 29 of the Organic Budget Law, the cash performance of the state budget is organized and performed by the BNB in accordance with the provisions of the Law on the BNB. Paragraph 17 of the transitional and final provisions of the Annual Budget Law 2001 specifies the agency functions of the BNB. According to Art. 2 of Regulation 5, the BNB organizes the activities in relation to the sale of government securities on behalf and for the account of the government according to a contract signed with the MoF. The BNB is the government securities depository.

288. The BNB acts as a manager of the foreign exchange reserves as disclosed in Art. 20, 28 and 31 of the Law on the BNB.

289. The responsibility of the BNB as a banker to the government is specified in the Law on the BNB (Art. 43), Organic Budget Law (Art. 29), Annual Budget Law (transitional and final provisions, para. 17).

290. Under Art. 3 of the Law on the BNB, the BNB and the Council of Ministers shall inform each other of their intentions and actions in the formulation of the general outlines of the monetary and credit policy. Experts from the BNB participate in discussions and in preparation of written statements concerning the government's economic program, the credit rating of the country and programs for financial support from international financial institutions. These activities are not stated in any legal act and are not publicly disclosed. The BNB reports to the public on overall economic developments through publication of its annual and semi-annual reports.

Open process for formulating and reporting of financial policies

291. In keeping with the Currency Board nature of the BNB, and as disclosed in the Law on the BNB, the BNB has a very limited number of monetary policy instruments. In particular, the Law forbids credit to the State or the State agencies, open market operations, and restricts lending to the banking system. The BNB does not attempt to manage interest rates. The BNB's limited and somewhat indirect instruments with monetary policy consequences are the minimum reserve requirements and a Lender of Last Resort (LOLR) facility. The relevant law and regulations are fully disclosed.

292. As disclosed in Art. 41 of the Law, the BNB sets the minimum reserve requirements and the method of their calculation and compliance. While variation in reserve requirements cannot be, and the BNB does not use it as, an active monetary policy tool within a CBA, Regulation 21 on the Minimum Required Reserves, provides the banks with some flexibility in meeting their normal liquidity fluctuations within a monthly cycle.

293. As disclosed in Art. 33 of the Law, the BNB provides a strictly limited Lender of Last Resort (LOLR) credit to solvent banks against high quality collateral for a period of no more than three months, in the event of systemic liquidity risks. The operation rules for such credit are defined in Regulation 6.

294. More generally, the BNB can contribute to greater financial market transparency by providing more comprehensive information on the financial status of individual banks than the summary information currently published. It could also make a greater disclosure of its LOLR assistance to distressed banks ex-post, and after a suitable “cooling off” period. And the BNB could provide more qualitative information concerning the banking system and the economy more generally.

Public availability of information on monetary policy

295. As stated, the BNB has a very limited role in monetary policy in keeping with the currency board nature of the BNB. Nevertheless, full information concerning such decisions is widely disseminated.

296. Art. 46 of the Law on the BNB provides that the BNB must maintain its accounts in compliance with the Law on the Accountancy and in connection with the International Accounting Standards.

297. The weekly and monthly balance sheets of Banking and Issue Departments, and semi-annual and annual reports are all publicly disclosed through publication in the State Gazette, Monthly Bulletin, and the BNB’s website. Art. 50 of the Law requires that the BNB must provide a Semi-annual and Annual Report to the National Assembly concerning its operations, which includes its financial statements. The annual financial statement of the BNB must be certified by an independent auditor and shall be published together with the auditor’s report in accordance with the requirements of the international accounting standards. The Annual Report also contains a report of the Chamber of Auditors on the budget of the BNB.

298. The BNB publishes a weekly balance sheet of the Issue Department showing aggregate foreign exchange reserves. Data for the external sector (in particular foreign exchange reserves and other balance of payments indicators) is published monthly together with short notes in a press release. Monthly and weekly dissemination is in hardcopy and website format, which facilitates further analysis and comparison over time.

299. Aggregate information on emergency financial support is contained in the aggregate items of the balance sheets of Issue and Banking departments. Detailed information on emergency financial support by the BNB is not publicly disclosed.

300. The Protocol and Press Office Division of the BNB is responsible for the public relations of the BNB.

301. The BNB maintains a broad range of public information services as follows:

- Publication of Annual Report, Semi-Annual Report, Quarterly Bulletin Commercial Banks in Bulgaria”, Monthly Bulletin; Monthly Bulletin “Government Debt Management”(issued jointly by the MoF and the BNB), Monthly Bulletin “Secondary Market of Government Securities”, balance sheets of Issue and Banking Departments, research publications (discussion papers) and information brochures; Maintenance of a website of the BNB which is accessible free of charge;
- Interviews given by senior the BNB officials on TV and radio programs; and
- Press releases of the BNB’s Press Office.

302. The website of the BNB has two independent addresses: www.theBNB.bg and www.theBNBank.org. It contains official publications, statistical information, legislative framework of the banking system (Laws and Regulations), texts of speeches of senior the BNB officials discussion papers (research materials), organizational structure of the BNB, information about EU integration issues concerning the BNB, information and links to websites of the commercial banks, daily information about exchange rates of foreign currencies against Bulgarian Lev, fixed exchange rates of Euro and the EMU legacy currencies against Bulgarian Lev, etc.

303. Senior BNB officials explain the BNB’s objectives of the BNB through the following means: public appearances before the Parliament, speeches made at public meetings, media interviews (TV and radio programs), written statements published in the main daily newspapers and specialized magazines, publications (of speeches) at the web-site of the BNB, and publications of discussion papers. The latter are not published on a regular basis.

Accountability and assurance of integrity by the central bank

304. Most provisions in respect of accountability and assurance of integrity of the BNB are exemplary. Provisions relating to the appointment of the BNB’s Governing Board, independence from the State, accountability to parliament and the public, observance and disclosure of observance of the currency board rules, use of IAS in presentation of the BNB’s accounts, requirements under the Law for the appointment of the Chief Auditor and external auditor, and the frequency of financial reporting are generally excellent and are disclosed to the public.

305. According to Art. 49, para. 3 of the Law on the BNB, the annual financial statement of the BNB is certified by an independent auditor and is published together with the auditor's report in accordance with the requirements of the international accounting standards. Under Art. 49, para. 4 of the Law on the BNB, the Managing Board shall elect the independent auditor for a term of three years on the basis of a public tender procedure.

306. The Law on the BNB requires it to appoint a Chief Auditor, reporting directly to the Managing Board of the BNB, to perform the following functions:

- Evaluate the quality of the internal controls systems, test the operation of these systems, their reliability and completeness of information;
- Examine the adequacy of the existing systems for protection of the BNB's assets and, where necessary, take stock of the said assets;
- Examine the compliance of conduct of the BNB's operations with law and other legislative acts and with the regulations issued by the BNB's managing bodies;
- Assess whether the BNB's funds are properly used and, where necessary, make recommendations to the Managing Board;
- Perform inspections concerning different risks in the BNB's activity; and
- Coordinate his activities with the external auditor of the BNB.

307. The BNB's Managing Board adopts internal rules and guidelines for internal control over the financial activities of the BNB, which are not publicly disclosed.

308. The reports on the budget outlays of the BNB are examined by the National Audit Chamber, which prepares a special report on the results of the examination. The report on the budget expenses of the BNB is submitted to the Parliament simultaneously with its Annual Report, but it is not published.

309. At inauguration, and at the end of each year, any member of the Managing Board has to declare to the Board his and his family members' property status and other business interests. The declarations are kept in a special register at the BNB and are not disclosed to the public.

310. According to Art. 17, para. 4 of the Law on the BNB, members of the Managing Board shall not participate in the deliberation and shall abstain from decision-making on issues in which they or members of their families may have interest. They must notify the Managing Board in advance of any such interests.

311. According to Art. 23 of the Law on the BNB, the employees of the BNB when taking office sign a declaration taking an oath of allegiance and observance of law, of performing

the functions entrusted in connection with the BNB activities, and of keeping bank and commercial secrecy.

312. While satisfactory requirements exist for personal financial disclosure by members of the Governing Board, it would be appropriate to extend similar requirements to the top managers, i.e., Directors of Directorates or equivalent (about 30).

313. Art. 28 of the Penal Code envisages criminal prosecution of the BNB officials who act beyond their authority. The wording of Law on Banks is evidently not sufficient to prevent lawsuits against supervisory staff. The BNB also does not have policy to provide legal assistance, or financial means to do so, for their official actions. In practice, the BNB takes over any lawsuits brought against its staff with regard to civil and criminal liability arising from their official actions. However, such staff protection is not adequately formalized in the BNB's internal policy manuals or employment contracts. It is recommended that the BNB fully establish and document an adequate policy for providing the staff with legal assistance and protection in case of lawsuits arising from of their official responsibilities.

Table 9. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code—Monetary Policy

Subject	Recommended Action
Clarity of roles, responsibilities and objectives of financial supervisory agency	<ul style="list-style-type: none"> • The MoF and BNB should publicly disclose the agency contract between the MoF and the BNB pertaining to domestic securities registration, issuance, and settlement.
Open process for formulating and reporting of financial policies	<ul style="list-style-type: none"> • The BNB should make a greater disclosure of the BNB's LOLR assistance to distressed banks ex-post, and after a suitable "cooling off" period; and • provide more qualitative information concerning the banking system and the economy more generally.
Accountability and assurance of integrity by financial supervisory agency	<ul style="list-style-type: none"> • The BNB should publish the agenda and minutes of the Governing Board meetings; • Disclose personal financial information by senior managers; • Report daily foreign exchange reserves, separate funds under investment management from the BNB's balance sheet (and thus from

Subject	Recommended Action
	the foreign exchange reserves); and <ul style="list-style-type: none"> • Value daily at market prices securities comprising foreign exchange reserve assets.

B. Transparency of Banking Supervision

General

314. The objective of this assessment was to review the degree of transparency of banking supervision policies and practices in Bulgaria and to identify opportunities for development. For the purposes of this assessment, detailed discussions were held with the Banking Supervision Department (BSD) of the Bulgarian National Bank (BNB), commercial bankers from different domestic and foreign banks and bank auditors. Publications of the different agencies including their accounts, laws and regulations and the inspection manuals of the BSD have also been perused in the course of the assessment. Written responses to questionnaires were received from the BSD prior to the assessment. Together with the previous assessment made by IMF staff, these have also been key inputs into the exercise.

Main findings

315. There is a high degree of transparency in the functioning of banking supervision. The laws clearly lay out the objectives of banking supervision and the role and responsibilities of supervisors, providing them with effective instruments to exercise supervision. The regulatory process includes consultations with the banks, although generally not with the general public. The BSD also plays a proactive role in the education and training of bankers. Data and analysis on an aggregated basis is put out in the public domain at frequent intervals. Individual institution data is available less frequently and without analytical content, because of the perceived impact on relatively weak institutions.

Clarity of roles responsibilities and objectives of the banking supervisory agency

316. The roles, responsibilities and objectives of bank supervision are well laid out in law. Both the Law on Bulgarian National Bank (LBNB) and the Law on Banks deal with the role of the BNB as the sole supervisor of the banking system. Certain other supervisory responsibilities are also laid out in the Law on Public Offering of Securities, the Banks Deposit Insurance Law, the Law on Measures against Money Laundering and the Foreign Exchange Law. The LBNB specifies as the objective of banking supervision “ensuring the financial stability of the banking system and protecting the depositors’ interests.” It also specifies that within the BNB, a Banking Supervision Department (BSD) shall be responsible for this function.

317. The structure and management of the BNB is laid out Chapter III of the LBNB. The Managing Board of BNB is responsible to the National Assembly and is required to submit half-yearly reports on the functioning of the Bank. The law clearly lays out the scope of supervision, the role of the supervisors in the licensing process, circumstances under which licenses can be refused or revoked, the prudential regulations to which banks are to be subject (which are detailed in the regulations issued under the law), the role of the supervisors in the closure and liquidation of a bank and the legal protection available to them in the discharge of their duties.

318. Laws also specify the relationships between the BNB and other financial agencies: the Bulgarian national Securities Commission, the Deposit Insurance Fund, the Ministry of Finance and the Central Depository. In addition, the Law on Banks requires all government authorities to cooperate with the BSD in the performance of its functions. The BNB has a formal MoU with the DIF, the objectives of which (and not the contents) have been publicly disclosed. Recently an agreement was concluded between the BNB and the financial sector supervisory agencies on cooperation, coordination and exchange of information. The BSD does not have any supervisory responsibility for self-regulatory organizations.

Open process for formulating and reporting of financial policies

319. The laws and regulations are available in the public domain, both on the BNBs website and in a compendium which is disclosed to the public. BSD also issues operating instructions and guidance to the banks. The operating procedures for off- and on-site examinations are laid down in manuals, which have been circulated to banks, but not to the general public. Increased interaction with bank executives is a continuous source of feedback, and the BSD has also been educating bankers on its methodologies through focused seminars, for instance on the CAMELS system and other issues of common interest. The BNB also uses the facilities of the International Banking Institute, in which it is a shareholder, for courses on supervisory topics for bankers and has input into the course content of the Institute.

320. Formulation of and reporting on bank supervisory policies is increasingly based on a process of consultation with the banks, although there is no legal requirement for this. Before finalizing major regulations, the formal comments of the Association of Commercial Bankers and the informal comments of a sample of banks are sought and their recommendations taken into account. This consultative process has now been extended to cover major changes in reporting requirements. All laws and regulations are published in the State Gazette, Annual Reports, and on the BNB's excellent web site. Major changes in policies and regulations are explained in press conferences by the BNB management. The BNB issues and regularly updates a compendium on all the banking laws and regulations.

Public availability of information on banking supervision

321. The BNB has made much progress in disclosing to the public information relating to supervision and the supervised institutions. Twice a year, the BNB submits a report to the

National Assembly, which reviews and assesses banking sector activity. BNB also submits an Annual Report to Parliament, which contains BNB's annual financial statement and auditors report. Under Art. 49 of the LBNB, the central bank is required to publish its annual financial statements and its profit and loss account in the State Gazette.

322. The annual report of the BNB contains a review of the developments in the financial markets including the government securities market, forex market, equity and corporate debt market etc. Developments in banks and progress in Supervision and Regulation are also reviewed in these reports. The BSD publishes aggregated and individual bank data on a monthly and quarterly basis respectively. The BNB's Banking Department also collects statistical data from banks and publishes information periodically on market developments. BNB's Research Department publishes occasional papers, analyzing economic aspects of developments in the banking system.

323. Disclosure on individual institutions is limited to publishing of quarterly financial data and ownership structure in the Commercial Banking Bulletin. Analysis of the financial condition and ratings of banks are not yet disclosed, in view of the potential adverse impact on a system which has still to fully recover from the last banking crisis. However, independent analysts do occasionally rate the individual institutions using the information put out by the BNB.

324. Liquidity support to individual institutions is not disclosed, as it is the opinion of the BNB that such disclosures would be harmful to depositor confidence and not in the interests of financial stability at present.

325. The BSD, being a department of the BNB, does not have a separate information channel from that of the BNB. The BNB does issue press releases and the senior officials of BNB appear before the media on occasion. Laws and regulations, as well as information on, and press releases of, the BNB are available to the public on its excellent website.

Accountability and assurances of integrity by financial agencies

326. Officials of the BNB take part in discussions held in the National Assembly when an issue is discussed which is pertinent to the Bank. Officials of the BNB also appear before the Working Groups and Committees of the National Assembly. However, there is no presumption that the BNB will necessarily be consulted by the Government or Legislature on issues, which may have a bearing on supervision of the different segments of the Financial Sector. It would be useful to create such a procedure.

327. The BNB presents an audited financial statement and an auditors report on its operations once a year, which is to be submitted to Parliament no later than April 30th of the following year. The statements do not show a separate account for the BSD. The annual financial statements of the BNB are to be certified by an independent auditor, to be appointed by the Managing Board of the BNB for a three year period on the basis of a publicly called tender. The BSD, being a Department of the BNB, does not have separate financial

statements. Internal control over its financial activities is exercised by a Chief Auditor, who is required by law to examine the compliance of the conduct of the BNB's operations with laws and regulations, and to assess whether the Bank's funds are properly used. The BSD, as a department of the BNB, is subject to the internal audit process of the Chief Auditor.

328. The budget of the BSD is not separate from the overall budget of the BNB, which in turn is approved by the National Assembly. Details of the supervisory budget are not disclosed separately. The BNB is required to report in the performance of the budget to the National Assembly twice a year. The National Audit office examines the expenses under the budget and reports on the examination.

329. The Governor and Deputy Governors must swear an oath to abide by the law, to contribute to the functions entrusted to the BNB and to abide by bank and commercial secrecy. They are also required to swear an oath to the National Assembly. The members of the Managing Board are required to disclose their properties, business interests and those of their family members at the time of assuming office. These declarations are kept on record in the BNB, but are not available to the public. The staff of the BSD, like the other employees of the BNB, is required to sign a declaration taking an oath of allegiance and observance of law and secrecy. In addition, the BSD has also adopted a code of conduct to be followed by the supervisors, which is not publicly disclosed. Further, the LOB places restrictions on the loans, which banks can give to supervisors, and the instructions of the BNB require the banks to report all such loans.

330. Art. 62(4) of the Law on Banks lays down that the BNB and the persons authorized by it may not be held liable for the damages caused while exercising their supervisory powers unless they acted with intent to cause damage, or "ultra vires."

C. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 10. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code—Banking Supervision

Reference Practice	Recommended Action
VI. Open Process for Formulating and Reporting of Financial Policies	
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	Formal procedures for information sharing and consultation between domestic supervisors have been put in place, as well as with some overseas supervisors; the contents of the arrangements with foreign supervisors could be disclosed. If the contents of the agreements are subject to confidentiality requirements, then their objectives can be disclosed.
VII. Public Availability of Information on Financial	

Reference Practice	Recommended Action
Policies	
7.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.	The periodic data put out on the banking sector could be supplemented by analysis, and the research department of BNB could also expand its scope to cover banking sector issues, and to disclose the results.
7.3.1 Consistent with confidentiality and privacy of information on individual firms, aggregate information on emergency financial support by financial agencies should be publicly disclosed through an appropriate statement when such disclosure will not be disruptive to financial stability.	Disclosure of liquidity support should be considered in due course, when in the BNBs opinion the markets have strengthened and mature enough to absorb such information.
VIII. Accountability and Assurance of Integrity by Financial Agencies	
8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	The code of conduct for supervisors is a laudable effort and could be disclosed to further enhance assurances of integrity and accountability.

Authorities' response

331. The authorities are in agreement with the assessment.

D. Transparency of Deposit Insurance

General

332. This assessment was performed to assess the degree of transparency of deposit insurance policies and practices in Bulgaria. The current system of deposit insurance was set up with the assistance of foreign advisors in early 1999, after the banking crisis. The Deposit Insurance Fund (DIF) is an independent financial agency regulated by the Law on Bank Deposit Guaranty (LBDG). Its accumulated reserves were sufficient to pay out the insured deposits of two small failed banks in 1999 and 2000. The coverage is targeted to be 5 percent of the total amount of insured deposits compared to the present 1.5 percent. A draft law on bank bankruptcy is under consideration, which seeks to assign the DIF new oversight over bank liquidations.

333. The relevant laws clearly lay out the objectives. The DIF is a well-regulated and managed agency. The internal assessments of the DIF showed that under the initial coverage ceilings under the law, the Fund could have covered deposits in the case of a simultaneous bankruptcy of 17 smaller banks and some combinations of smaller and medium size banks. Now that a much higher ceiling of BGN 10.000 has been introduced to meet EU standards, these figures have decreased.

334. The LBDG does not allow the DIF to provide any financial support to ailing banks.

Information and methodology used for the assessment

335. For the purpose of this assessment, detailed discussions were held with the Deposit Insurance Fund (DIF) and the Banking Supervision Department of the Bulgarian National Bank. Publications of different agencies including their accounts, laws and regulations were perused. Draft legislation and recent amendments to the legislation were also taken into account. Written responses to questionnaires were received from DIF prior to the FSAP mission and these, together with the previous assessment made by IMF staff, have also been essential inputs in the course of preparation the report.

Main findings

336. There is a high degree of transparency in the functioning of deposit insurance in Bulgaria.

Clarity of roles, responsibilities, and objectives of financial agencies responsible for financial policies

337. The roles, responsibilities and objectives of deposit insurance are disclosed in the Law on Bank Deposit Guarantee (LBDG) which deals with the role of the Deposit Insurance Fund (DIF) as the agency responsible for paying out the guaranteed amounts of bank deposits. The LBDG is supported by BNB Regulation 23 on the Terms and Procedure for Payment of Insured Amounts on Deposits with Banks with Revoked Licenses. Certain other responsibilities are also laid out in the Law on Banks. According to this the DIF has some control over the assignee in bank bankruptcy and may table proposals to the BNB and the Court. Under the draft Bank Bankruptcy Law, the DIF will be given substantial oversight responsibilities over the bank bankruptcy process.

338. The LBDG clearly lays out the scope of deposit insurance, the role of the DIF in the financial system, and the circumstances under which the DIF may use its resources. It discloses the objectives of deposit insurance, i.e., to (i) determine and collect entry and annual premiums from banks; (ii) invest its assets; and (iii) pay out the guaranteed amount of deposits. The DIF's broad objectives derive from the LBDG, but are not directly defined in the legislation. These have been defined in the mission statement of the DIF, adopted by the DIF's Management Board, i.e. to promote financial stability, to protect the depositors' interests and to enhance public confidence and trust in the banking system.

339. As laid out in the law, the Management Board of DIF is responsible to the Council of Ministers, to the Bulgarian National Bank (BNB) and the National Audit Chamber. The annual budget for the DIF's administrative expenses together with a report on its performance is presented for approval to the BNB Managing Board; the approved budget and report are presented to the National Audit Chamber.

340. The procedures for appointment, terms of office, and general criteria for removal of the heads and members of the governing body of DIF are disclosed in the LBDG. The chairperson of the Management Board is appointed by the Council of Ministers, and the Deputy Chairperson is appointed by the BNB. One Board member is appointed by the Association of Commercial Banks. The Board members are appointed for four years and can be re-elected without any restriction. The terms of office and the reasons for which they may be dismissed from office are laid out in the law.

341. The relationship between the DIF and the BNB is laid down in law. The DIF presents its annual report to the BNB; its annual budget together with a report on its performance is subject to approval by the BNB Managing Board; the DIF Management Board prepares draft regulations for the implementation of the LBDG and presents them to the BNB for discussion and approval; the Deputy Chairperson of DIF is appointed by the BNB. The LBDG requires the BNB to provide data to the DIF. The DIF has a formal MoU with the BNB, the objectives (not the content) of which have been disclosed.

342. The Association of Commercial Bankers plays a consultative and coordinating role in the interaction between banks and the DIF but does not have any supervisory or regulatory role.

Open process for formulating and reporting of financial policies

343. The conduct of policies by the DIF is defined in the legislation and regulations. It is compatible with confidentiality considerations. The regulatory framework of the DIF and its operating procedures governing the conduct of financial policies are defined in legislation and regulations.

344. Regulation 23 sets the terms and procedures for reimbursement of guaranteed deposits. The DIF levies premiums from banks. The premium structure has been disclosed in the LBDG. Information on: annual premium contributions, the deposit base, and the size of insured amounts, reimbursement of insured deposit amounts is publicly disclosed.

345. The LBDG authorizes the DIF to invest in short-term deposits with commercial banks that are authorized dealers of government securities. The "DIF Investment Policy", adopted by the DIF's Management Board, requires that deposit accounts with commercial banks be fully secured by government securities. The annual reports of the DIF portray the type of investments made by the DIF but not the specific institutions with which the DIF maintains relations. Data on the investment activity of the DIF is published on the DIF web site.

346. The DIF is allowed to exercise certain control over the bank liquidation activities of liquidation trustees (Art. 89a of the Law on Banks). The Draft Law on Bank Bankruptcy clarifies the roles and responsibilities of the DIF and the Court in controlling the activities of the trustees.

347. The agency has formal procedures for sharing information with other domestic financial agencies, especially the BNB. These have been established in the LBDG and Regulation 23, and have been disclosed in written reports to the legislature and the State Gazette, in the agency's annual reports. The Memorandum of Understanding, signed between the BNB and the DIF, has facilitated the regular exchange of information. The objectives of the Memorandum of Understanding have also been publicly disclosed to the media. The full text of the memorandum has not been publicly released. Under the memorandum, the BNB provides the DIF with banks' financial statements on a monthly basis, and, on a quarterly basis, with detailed analysis reports. Information on distribution of deposits by size for each bank is provided twice a year. Additional data (such as ad hoc reports, sanctions imposed on banks, results from on-site inspections, conclusions regarding deposit base calculation, and premiums' determination) are also received.

348. The Letter of Cooperation, signed between the Association of Commercial Banks (ACB) and the DIF establishes the framework to facilitate the information sharing and cooperation on matters of mutual interest to the two institutions. This was announced through the media immediately after signing the agreement between the ACB and the DIF. The full text of the Letter of Cooperation has not however been publicly released.

349. Significant changes in financial policies are publicly announced immediately after the decision to change policy, and explained in written reports submitted to the legislature, in official government publications (such as the State Gazette), in published reports (i.e., the DIF's annual reports), and through the media (i.e., press releases, interviews and articles). Changes in financial policies will also be announced on the DIF web site, which has become operational recently.

350. There is the presumption in favor of public consultations when substantial changes to the structure of financial regulations are proposed. However, the length of the consultation period depends on the changes proposed. Consultations can be organized in the form of public discussions.

Public availability of information on financial policies

351. The DIF issues annual reports, which are submitted to national authorities and are also available to the public in hard copy or on the web site of DIF. Detailed information— data and analysis of deposit distribution, premium contributions of banks, and reimbursement of insured deposit amounts—are published in the DIF's annual report, which is widely distributed. Detailed analysis of developments in the banking sector is also presented in the annual report. In addition, information is provided on a regular basis to the media and reports

are published in specialized publications. Information and data on developments of deposit insurance is provided on the DIF web site.

352. The DIF's Management Board may publish information on the DIF's activities, with the exception of confidential data (banking or commercial). Consistent with confidentiality requirements, aggregate data related to DIFs responsibilities is disclosed in reports, in the State Gazette, and through the media. Data on premiums, contributions paid by commercial banks, reimbursement of insured deposit amounts with failed banks, and the DIF's investment activities is also published on the DIF web site.

353. The annual balance sheet of the DIF is published in the State Gazette by March 31, as laid down in the LBDG, and in the DIFs Annual Report. Although the LBDG does not require it, the DIF Management Board has adopted a formal policy to have an independent audit of its financial statements.

354. The DIF maintains different channels for public information. Since its establishment the agency has had a public affairs office. To encourage public support for the DIF the Management Board adopted Public Relations Rules in January 2000. The functions performed by the public information service include: to disseminate policy decisions and announcements; to disseminate information on the operating framework, targets and objectives; to disseminate data; to maintain contact with media representatives; to disseminate texts of speeches by senior officials. Public information services include a publications program—annual report; Q&A Brochure on deposit insurance; publications about the nature and form of deposit protection, the operating procedures of the scheme, the performance of the protection arrangement; press releases. Information about repayment of insured deposit amounts with failed banks is distributed on a regular basis through the media. The DIF has opened a telephone hot line in order to provide additional information on deposit reimbursement and other issues associated with the Bulgarian deposit insurance system.

355. To enhance transparency, senior officials stand ready to explain the DIF's objectives and performance to the public in speeches made at public and private meetings, and media interviews. The timing of statements by senior DIF officials depends on the frequency of changes and developments in the deposit guaranty environment. Thus, statements are made on an irregular basis, but in practice have occurred at least once a month. The release of the texts of speeches of senior officials is the task of the public relations unit.

356. Effective legal and regulatory provisions on deposit insurance are disclosed in the State Gazette. New legal acts are published also in specialized economic publications. The LBDG, Regulation 23 and the Law on Banks (Art. 89a) are also published on the DIF web site.

357. The DIF has no function in overseeing consumer protection arrangements.

Accountability and assurances of integrity by financial agencies

358. The LBDG requires the DIF to present the annual report on its activities also to the National Audit Chamber. The annual report includes information on the conduct of financial polices, the policy objectives of the institution, description of the agency performance in pursuing its objectives, description of developments of deposit insurance in Bulgaria, as well as in the banking system. The annual budget for the DIF's administrative expenses together with a report on its performance is presented for approval to the BNB Managing Board; the approved budget and report on its performance are presented to the National Audit Chamber. Operating expenses of the DIF are made in compliance with a budget approved by the BNB. The report on the budget performance is presented to the BNB and the National Audit Chamber annually. Along with the DIF's annual report, the report on budget expenses is submitted to the BNB and the National Audit Chamber. Aggregate data on expenses and revenues is published in the annual report. Data on resources accumulated is presented on regular basis to the media.

359. Although it is not required by the LBDG, the DIF's Management Board has adopted a formal policy to have an independent audit of the DIF's financial statements. For a third consecutive year, the DIF has engaged an independent financial auditor for this purpose. The DIF's internal governance procedures for insuring integrity of its operations are not currently publicly disclosed. However the DIF is presently discussing disclosure of certain internal corporate governance procedures. The DIF has no internal audit function. However, the setting up of an independent internal audit arrangement has been suggested by the National Audit Chamber, and DIF is actively considering instituting such an office.

360. Disclosure of conflict of interest and the obligation to confidentiality are defined in the LBDG, in the DIF Management Board's Rules of Procedure and other internal documents. According to the LBDG any member of the DIF's Management Board and its administrative staff is bound to disclose in writing to the Management Board any trading, financial or other business interest, which impairs the DIF's interests.

361. In addition, in the middle of 2000, the DIF's Management Board adopted "Internal Rules for Ethical Behavior," setting the general criteria and standards for employees' ethical behavior in fulfilling their duties. Under these rules the DIF has designated an ethics code officer and all employees sign an entry declaration and annual declaration. Thus, requirements to prevent exploitation of conflict of interest are publicly disclosed in official government publications (i.e., in the State Gazette), in published reports (i.e., the DIF's annual reports) and to the media. The full text of the Internal Rules for Ethical Behavior has not been publicly released.

362. DIF management and staff are not legally protected in exercising their duties under the LBDG.

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 11. Recommended Action Plan to Improve Observance of the IMF' MFP Transparency Code—Deposit Insurance

Reference Practice	Recommended Action
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	The formal procedures for information sharing between the Fund and the banking supervisor are laid down in a Memorandum of Understanding, the content of which, if it is not subject to confidentiality requirements, can be disclosed.
7.7 Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.	DIF could consider setting up a system to deal with consumer complaints. Depositors with complaints about the payout of deposits have recourse under the law, which is disclosed.
8.2.2 Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.	DIF should disclose its internal governance procedures, which ensure the integrity of operations.
8.3 Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.	Operating expenses are disclosed in an aggregated form. However, the majority of the expenses were in the category of 'Other financial expenses', the contents of which are not obvious.
8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	The main rules are in the law. Besides that the DIF Management Board has approved internal rules, however these are not publicly available. The publication of internal rules on ethical behavior would foster the increase of public confidence in the DIF.

Authorities' response

363. The authorities were in broad agreement with the assessment, but provided comments of a technical and factual nature.

F. Transparency of Securities Supervision

General

364. The Bulgarian capital market is still at an early stage, is still very small and not very active at this time. The objective of this assessment was to assess the degree of transparency of securities markets supervision policies and practices. This assessment was based on pre-FSAP self-assessments performed by the Bulgarian authorities, extensive interviews with staff of the BSE the BNSC and market participants, as well as study of the rules and regulations.

Main findings

365. Bulgaria is observant or broadly observant of the great majority of the transparency practices with regard to capital markets supervision policies and practices.

Clarity of roles, responsibilities and objectives of financial agencies

366. The institutional framework and the objectives of the Bulgarian National Securities Commission (BNSC) are defined by the Law on Public Offering of Securities (LPOS), in effect as of January 31, 2000, and the Rules for the Organization and Operation of the Bulgarian National Securities Commission, in effect as of May 5, 2000. The objectives are providing protection to investors and creating prerequisites for the development of a transparent and efficient capital market. The LPOS and the Rules are public documents.

367. The BNSC's responsibilities are disclosed in Art. 8 and 15 of the LPOS, which is a public document. As these are set out in legislation, changes to the BNSC's responsibilities can be made through the adoption of amendments to the law. The LPOS requires the BNSC to submit an annual report to the Council of Ministers.

368. The BNSC informs the public through the publication of a monthly bulletin, press releases, conferences and investor awareness meetings. According to Art. 15 (6) of the LPOS, the BNSC is obliged to submit to the Council of Ministers an annual report on its activities by March 31 of the following year. The report contains information on the situation on and the prospects of the securities market, the adequacy of the regulations related to the securities market, the ordinances issued and the proposals made by the BNSC for amendments to the regulatory framework. Furthermore, it contains information on administrative actions, cooperation with domestic and international bodies, and the organizational, financial and human resources policies of the Commission. The annual report of the BNSC is published and disseminated via its Web site (<http://www.ssec.bg>).

369. The criteria for appointment and dismissal of members of the BNSC are set out in the LPOS. The BNSC is composed of a chairman and six members who are appointed for a term of five years and discharged by the Council of Ministers on a proposal from the Minister of Finance.

370. The BNSC's relationship with the other financial agencies has been publicly disclosed in legislation, publications in Bulletins, the media, the web site, and in particular, in the LPOS and the Rules for the Organization and Operation of the BNSC. According to Art. 15(1) 5 of the LPOS, the BNSC is empowered to exchange information indispensable for its activities with the Bulgarian National Bank, other state institutions and bodies, bodies of local self-governance and administration, as well as with non-governmental organizations related to the securities market. The provisions about supervision of the Central Depository are set out in the LPOS.

371. The relationship between the BNSC and the Bulgarian Stock Exchange (BSE) is set out in the LPOS. Operational information is disclosed publicly through the monthly Bulletin of the BNSC, press releases, the web site, and in the BNSC Annual Report. The BSE has adopted a set of policies on transparency of its activities, which are set out in the BSE Rule Book. The Rule Book is a publicly available document.

372. BSE discloses information to the public through its Official Bulletin and its web site.

Open process for formulating and reporting of financial policies

373. The conduct of the BNSC's policies is transparent to the public as information on the conduct of its policies is published in the monthly Bulletin of the BNSC, the web site and the annual report.

374. The LPOS and the Rules for the Organization and Operation of the BNSC were promulgated in the State Gazette, and published in the monthly Bulletin of the Commission. They are also available on the web site of the BNSC. These measures ensure publicity of the regulatory framework and the operating procedures governing the conduct of the BNSC. They are also publicly disclosed and explained through press releases and conferences, round tables and seminars, meetings with shareholders and issuers, letters in response to shareholders' or other bodies' inquiries relating to the BNSC's activities.

375. Securities market participants—issuers, investment intermediaries, including when acting as underwriters, investment companies, and management companies—are under a statutory obligation to submit financial reports to the BNSC on a regular basis. The LPOS and the regulations on its implementation provide for this obligation. Both the primary and the secondary legislation relating to financial reporting are promulgated in the State Gazette and published in the BNSC Bulletin. They are also available on the web site of the BNSC. Further explanation is given via letters addressed to the market participants where amendments or instructions to these regulations have been adopted.

376. The LPOS and the regulations on its implementation provide for the mode of operation of the organized financial markets in Bulgaria. Both the primary and the secondary legislation relating to the operation of organized financial markets are promulgated in the State Gazette and published in the BNSC Bulletin. They are also available on the web site of

the BNSC. Further explanation is given via letters addressed to the market participants where amendments or instructions to these regulations have been adopted.

377. The disclosure of the fee-structure is through publication of the Tariff in the State Gazette and the BNSC Bulletin, as well as through its availability on the web site of the Commission.

378. Recently, an agreement has been concluded between the BNB and other financial sector supervisory agencies on cooperation, coordination and exchange of information. The content of this agreement has been disclosed, but not the full text. There are no formal procedures for sharing information with foreign financial agencies. Instead, official letters from the Commission are commonly used for this purpose. The LPOS (Art. 15(5)) authorizes the BNSC to exchange information with the BNB, other state institutions and bodies, bodies of local self-governance and administration and with non-governmental organizations.

379. Significant changes in financial policies are publicly disclosed and explained immediately after the decision is taken through official publications (such as the State Gazette, the BNSC Bulletin and Annual Report), the media, and the web site. Announcements appear as needed and are not made according to a set schedule.

380. There is a presumption in favor of public consultations for proposed substantive changes to the structure of financial regulations. This is required by the Law on Statutory Acts and Ordinances as all Ordinances must be adopted by the Council of Ministers. Changes in legislation, such as those that were adopted in 2000—new securities law and regulations thereon—are subject of broad public discussion. The latter take place through online comments and discussions via the web site of the Commission, at conferences and workshops, through letters addressed to the Commission.

381. There is a legislative requirement requiring public consultation and it is observed in practice.

Public availability of information on financial policies

382. The BNSC is under a statutory obligation to prepare and submit an annual report to the Council of Ministers. According to Art. 15 (6) of the LPOS, the report shall contain information on:

- The situation on and the prospects of the securities market;
- The adequacy of the regulations related to the securities market, the ordinances issued and the proposals made by the Commission for amendments to the regulatory framework;
- The licenses, confirmations and approvals given, and the refusals to grant approval, registrations performed, and acts of the Commission appealed against and confirmed by the court;

- The effects of the control exercised over the securities market participants;
- The information policy, local and international co-operation;
- The organizational, financial and human resources policy of the Commission; and
- Any other information determined by the Council of Ministers.

383. In its Annual Report 2000 the Commission made an analysis of the condition of the Bulgarian capital market and proposed measures for the promotion of its development.

384. The BNSC provides information consistent with its jurisdictional responsibilities on a monthly and annual basis. According to Art. 16 (7) of the LPOS, all data and documents for offences under the LPOS, which may result in disclosing the identity of the person who has provided them, shall only be submitted by the Commission to third parties with the consent of that person, unless otherwise provided in the law.

385. The BNSC does not release its balance sheet on a pre-announced schedule. Data on market transactions are provided by the BSE. Financial data submitted by the BNSC to the Ministry of Finance are reported to the National Audit Office, which is required by law to audit these data. The law does not require the BNSC to publicly release its financial statements on a pre announced schedule. However, the ability of a securities regulator to carry out its functions depends amongst other things on its funding and the way in which it is applied. When the regulator levies fines or other monetary sanctions there should be public accountability for those functions. Mandatory public disclosure of the audited financial statements should help raise the level of confidence in the activities of the regulator and raise the level of confidence in investors.

386. The General Administration directorate of the BNSC is responsible, inter alia, for the maintenance of public information services.

387. Senior officials are ready to explain the BNSC's objectives and performance to the public. The text of the public statements is released in the Bulletin and other publications, the media, the web site, and through participation in seminars, discussions, and conferences. The frequency of appearances by senior BNSC officials depends on the frequency of changes and developments in the securities markets' legal framework.

388. Consumer complaints dealing with securities markets which are addressed to the BNSC are considered and responded to after either making the necessary inquiry into the problems or forwarding the complaint to the relevant institution for its consideration. There are no investor protection guarantees.

Accountability and assurances of integrity by financial agencies

389. Under the 1991 Constitution, officials of every state body and official or public organization, and citizens are required to submit data and documents that relate to their work

to parliamentary committees. Senior BNSC officials participate in sessions of the Parliamentary Economic Standing Committee in connection with the discussions that relate to changing the securities legislation. They also appear before Parliament to explain policy objectives and describe the BNSC's progress toward achieving them. Officials appear before the Parliament not according to a set schedule but as needed.

390. The financial statements after audit should form part of the annual report and be submitted on a defined program to Parliament to allow debate if necessary on the activities of the BNSC including its financial performance and the resources necessary to properly carry out its functions.

391. Financial statements submitted by the BNSC to the MoF are reported to the National Audit Office (NAO), which by law is required to audit them. Aggregated data on the BNSC's expenses and operating revenues are published after the statements have been audited by the NAO.

392. Internal governance procedures ensuring the integrity of operation, including internal audit arrangements, are contained in the Rules for the organization and operation of the BNSC. The Rules are publicly available through their publication in the State Gazette, the BNSC's Bulletin and web site. Information, if not the very documents, relating to internal governance is published in the BNSC's Bulletin.

393. Aggregate data on the expenses and revenues in operating the BNSC are publicly disclosed in the Annual Report 2000 of the Commission. The information includes the total amount of revenues and expenses and their basic components in percentage—types of income, salaries, premises and office expenses.

394. Standards governing the conduct of the BNSC's public officials and staff are set up by law, and are publicly disclosed in the State Gazette, the Bulletin, through the media and the web site. The Chairman, the members of the Commission and the staff are obliged to disclose information about securities held by them, their spouses and minors, or their contractual relations, including those of their spouses and minors, with companies controlled by the Commission.

395. The names of BNSC's staff involved in particular inspection are written in the order from the Chairman to perform inspections so that the recipients are aware of the purpose of the inspection, the names of the persons who will perform it, and the authorization to perform it.

396. There is no specific legislative protection to officials and staff when exercising their functions. It would be preferable to have specific protection for officials and staff in carrying out their functions bona fide and with reasonable care and for this protection to be disclosed.

G. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 12. Recommended Action Plan to Improve Observance of the IMF's MFP Transparency Code—Securities Supervision

Reference Practice	Recommended Action
Public Availability of Information on Financial Policies Accountability and Assurances of Integrity by Financial Agencies	<ul style="list-style-type: none"> • The BNSC should include its audited financial statements as part of its Annual Report. • Financial statements of the BNSC should be made public on a pre-announced schedule.

Authorities' response

397. The authorities are in agreement with the assessment.

H. Transparency of Insurance Supervision

General

398. The objective of this assessment was to assess the degree of transparency of insurance supervision policies and practices in Bulgaria. This assessment was performed using the IMF Code of Good Practices on Transparency in Monetary and Financial Policies, and the associated Supporting Document. The assessment was based on a review of: (i) the self-assessment prepared by ISA, (ii) the Insurance Act, the regulations and instructions, and (iii) discussions with the ISA, market participants, the Association of Bulgarian Insurers, external auditors, actuaries and brokers. The supervisory staff of the ISA cooperated extensively in the assessment, by providing answers to the FSAP questionnaires, preparing a self-assessment of IAIS Core Principles, and making themselves available to meet with mission members when needed.

399. ISA operates under a strict rule of confidentiality under Art. 23 of the Insurance Act. In cases not covered by the Law, ISA provides information to interested parties upon request, as well as through the Annual Report and the public register. Market participants and the Association of Bulgarian Insurers provided insightful advice on industry matters.

Main findings

400. Bulgaria observes the great majority of the practices of the Transparency Code on insurance supervision.

Clarity of roles, responsibilities, and objectives of the insurance supervisory agency

401. The relevant legislation defining the institutional framework, responsibilities and objectives of the Insurance Supervision Agency (ISA) includes the Insurance Act (IA), the Regulation on the Structure and Activity of the ISA (RSAISA) and the Regulation on the Operation of the National Insurance Council (RONIC).

402. The objectives of insurance supervision are disclosed in the Act and in the Regulations, which have been published in the State Gazette. The objectives are explained in various publications issued both by the ISA and by other bodies (including the ISA Annual Report). Furthermore, the objectives have been a subject of theoretical explanation in recent legal studies.

403. The modalities of accountability for ISA have also been publicly disclosed in the relevant legislation. Pursuant to the Art. 19, par. 1 of the IA the head of ISA shall be appointed and dismissed by the Prime Minister on recommendation of the National Insurance Council.

404. The general criteria for the appointment of the Director are specified and disclosed in the Art. 4, par. 2 of the RSAISA: Bulgarian citizenship; high professional and moral profile; university degree; at least 5 years of professional experience. There is no fixed term of office or are there clear criteria for removal.

405. The relationship between ISA, NIC, the Ministry of Finance and other governmental bodies is disclosed in the IA, the Regulation on the Structure and Activity of the ISA (RSAISA) and the Regulation on the Operation of the National Insurance Council (RONIC).

406. Pursuant to the Art. 5, par. 2, point 12 of the RSAISA the Agency shall pass information for breaches of laws, acts and other regulations to the other supervisory authorities or to the procurator. There are no self-regulatory organizations in the insurance sector in Bulgaria.

Open process for formulating and reporting of insurance supervision policies

407. Policies are broadly specified in the above-mentioned IA and regulations. Furthermore, the IA contains confidentiality provisions to protect insurers against leaks of vital information by ISA. The regulatory framework and the operating procedures are specified in the above mentioned IA, RSAISA and the RONIC, and in the Ordinance for Insurance Broker and Insurance Agents, the Ordinance regulating the procedures and

methods of setting up an insurance reserve and the Ordinance for determining the own resources, solvency margin and its calculation by insurers.

408. All regulations in force, including the ones on financial reporting by insurers are mandatorily published in the State Gazette. The fee-structure is disclosed in the Tariff of the fees charged by ISA regulation. ISA should publish financial statements to the fee-paying entities, in order for them to understand how the funds are spent to protect the market.

409. Art. 68 of the IA states that ISA should maintains relations with financial agencies, domestic and international, but there is no specific procedures for sharing information with foreign supervisors at this point. Recently an agreement has been concluded between the BNB and the other financial sector supervisory agencies on cooperation, coordination and exchange of information. Formal procedures for information sharing and consultation with foreign financial agencies (including central banks), should be introduced and publicly disclosed.

410. The ISA does not announce and explain changes in the financial policies, because it is not a political body. It enforces the changes adopted by the Parliament and the Government after a formal amendment of the Acts and the Regulations. A brief explanation of the legal framework and especially of the newly adopted amendments is being published in the Annual Report. When substantive changes to the structure of financial regulations are proposed, public consultations are envisaged, according to general legislative procedures. There is no special procedure for emergency situations. ISA should be authorized to hold public consultations on its own initiative to discuss technical changes to the structure of financial regulations.

Public availability of information on insurance supervision

411. An annual report shall be submitted by ISA to the Minister of Finance upon completion of the year that is subject of reporting. The ISA also issues a Yearbook pursuant to Art. 67 of the RSAISA. The Yearbook consists of two parts—one summarizing the ISA's activities and the other presenting aggregate figures on the insurance market. The Yearbook shall not be confused with the Annual Report—the latter is submitted to the Minister of Finance and the former is intended for general public use. ISA intends to report more frequently on its activities.

412. The annual report includes data on the number of the administrative sanctions that were imposed. Furthermore, it contains aggregated data about changes in insurance legislation, information on the fulfillment of the responsibilities of ISA (e.g., a review of the orders and instructions issued by the Agency, number of licenses granted, number of licenses withdrawn, activities concerning mergers and splits of insurers, activities concerning liquidation and bankruptcy procedures, number of current checks carried out in the insurers' offices, number of rehabilitation programs that were approved, number of complaints against insurers, addressed to ISA, and information concerning participation in lawsuits).

413. The ISA submits its annual balance sheet to the Minister of Finance (MoF). Quarterly, it submits a report on budget realization to the MoF. Through the MoF the balance sheet is transferred to the State Audit Board (SAB) and to the Statistics Institute. The SAB and the State Finance Control Agency are authorized to carry out inspections in the offices of ISA.

414. ISA maintains an International Cooperation and Public Relations Sector (ICPR) within its general administration. ICPR transfers information on ISA activities to the Press Center of the Council of Ministers and of the MoF on a regular basis. In addition to the Annual Report, subject to the confidentiality rules, press releases are issued mainly through the specialized monthly "The Insurer."

415. The Director of ISA is authorized to respond to media requests for information, subject to confidentiality constraints. The Director of the ISA is obliged under Art. 80 of the Constitution of the Republic of Bulgaria to respond to requests to appear before Parliamentary commissions and to submit data and documents.

416. Pursuant to the Art. 22, par. 4 and to Art. 90, par. 3 of the IA the texts of the generally applicable directives and regulations issued by the Agency are published in the State Gazette.

417. A Temporary Security Fund for Protection of the Interests of the Insured Persons Under Life Policies has been set up at ISA, and operates an account at the Bulgarian National Bank. The IA modalities of this scheme are laid down in the IA. The ISA is not allowed to grant emergency financial support to ailing insurance companies.

418. Pursuant to Art. 40 of the RSAISA, ISA oversees compliance with the laws on underwriting and execution of the insurance contracts. Aggregate figures of the number of complaints against every insurer are disclosed in ISA's Annual Report.

Accountability and assurances of integrity

419. ISA submits its balance sheet to the Minister of Finance. It submits a quarterly report on budget realization to the MoF. ISA's Annual Report summarizes information on the expenses and salaries of the Agency. ISA should publicly disclose audited financial statements of their operations, as well as full information on the operating expenses and revenues. The Chief Accountant of ISA is responsible for internal governance and integrity procedures including internal audit arrangements. He/she is bound by the Rules of Accountancy Policy approved by the director of ISA and by the state auditing body—the State Audit Agency.

420. Pursuant to the Art. 29 of the Civil Servant Act every official and member of the staff of the IGSA shall declare his/hers property status upon appointment to service and annually later on by March 31 every year. Pursuant to the Art. 4, par. 2, point 3 of RSAISA connections between the director of ISA and supervised entities are prohibited. Pursuant to Art. 23 of the IA the officials and the staff shall not disclose classified information to third parties without special request or order by the court. Any willful unauthorized disclosure of

classified information is punishable under Art. 284 of the Criminal Code. All these legislation and regulations are publicly disclosed.

421. There are no explicit provisions on legal protection for the staff of ISA.

I. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 13. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code—Insurance Supervision

Reference Practice	Recommended Action
VI. Open Process for Formulating and Reporting of Financial Policies	<ul style="list-style-type: none"> • On-site, off-site and intervention procedures should be published in regulations. • Formal procedures for information sharing and consultation with international financial agencies (including central banks) should be introduced and publicly disclosed. • ISA should have the ability to hold public consultations itself to discuss technical changes to the structure of financial regulations.
VII. Public Availability of Information on Financial Policies	
	ISA should publicly disclose its balance sheet.
VIII. Accountability and Assurance of Integrity by Financial Agencies	<ul style="list-style-type: none"> • ISA should publicly disclose audited financial statements of their operations. • The information on the operating expenses and revenues should be publicly disclosed annually. • Legal protection should be provided to ISA's staff and publicly disclosed.

Authorities' response

422. The authorities agree with the assessment, but have the following comments:

- “The on-site inspection’s procedures are disclosed in the newly adopted regulation on the Organization and Structure of the Insurance Supervision Agency (ROSISA) particularly in articles 33–36 thereof;
- Formal procedures for information-sharing were introduced by means of the establishment of The Financial Supervision Advisory Council including the national financial sector supervisors; and
- The other objectives (the competence of holding public consultations; the disclosure of the balance sheet and of the financial statements; as well as the legal protection of the supervisor’s staff) will be achieved upon accession of Republic of Bulgaria in EU by means of adoption of the new legislative framework concerning the insurance market and the insurance supervision.”

J. Transparency of Payment System Oversight

General

423. The assessment of the SIPS in Bulgaria against the MFP Transparency Code took the form of a review of the previous assessment, which had been undertaken in late 2001. The assessment mission, over a period of three days from 19 to 21 June 2002, involved discussions with a Director and senior officials from several departments of the Bulgarian National Bank (BNB), with officials of BankService (the inter-bank payment processing company), and with a director and senior officials of two large commercial banks.

424. Since the aim of the review was to clarify and to substantiate some of the conclusions and assessments of the previous mission, the approach adopted was to work through a detailed questionnaire, on specific issues raised by those conclusions and assessments, which had been sent to the BNB in early June. Use was also made of the responses of the BNB to the questionnaires prepared by the previous assessment mission. All the officials met during the assessment mission were open and co-operative.

Main findings—summary

425. In all but 2 particulars, the oversight regime operated by the BNB in respect of the payment systems in Bulgaria appears to comply with the MFP Transparency Code, at least in so far as concerns its relationship with the commercial banks—the members of the payment systems—and with the two inter-bank payment service companies. There was no opportunity during the mission to assess how far, in practice, bank customers in Bulgaria, whether individuals or corporates, are aware of or indeed interested in the subject.

Clarity of roles, responsibilities and objectives of financial agencies

426. The roles, responsibilities and objectives of the BNB in this respect are clearly laid down in the Law on the Bulgarian National Bank, and in 4 specific regulations made under that Law.

Open process for formulating and reporting of financial policies

427. The process of formulating and reporting of financial policies appears to be generally open and transparent. The single visible exception is that the BNB does not disclose the basis on which it has begun to discuss with the central bank of another country issues raised by the participation in the Bulgarian payment systems of branches of two commercial banks incorporated in that country; nor has it disclosed whether, and if so on what basis, it will enter into similar discussions with the central banks, and the banking supervisors, of three other countries whose commercial banks have branched into Bulgaria.

Public availability of information on financial policies

428. The BNB publishes regular reports on its policies, including in respect of payment systems; these are also available on its website. In addition, senior officials regularly speak on payment system policy issues at conferences and seminars.

Accountability and assurances of integrity by financial agencies

429. The BNB publishes regular statements of its operations. It does not, however, publish to the banks the operating expenses and revenues of the payment systems that it operates (currently only the Express Service, but prospectively the RTGS system from later in 2002). It makes no charge to banks for Express Service payments, but will make a *per item* charge to the banks for RTGS payments, with a view to covering the capital cost, and the operating costs, of the system. The scale of RTGS charges has not yet been advised to the banks, nor the basis on which they will be calculated.

K. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 14: Recommended Actions to Improve Observance of IMF's Monetary and Financial Policies Transparency Code Practices—Payment System Oversight

<i>Reference practice</i>	<i>Recommended action</i>
VI. Open process for formulating and reporting of payment system oversight policies	
<i>6.1.5 – Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed</i>	The BNB should publicly disclose the basis on which it will consult and share information with the home country central banks and banking supervisors of the foreign commercial bank branches that are members of the RTGS system.
VIII. Accountability and assurance of integrity by payment system oversight agencies	
<i>8.3 – Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually</i>	The BNB should publicly disclose the operating expenses and revenues relating to its provision of the RTGS system.

Authorities' response

430. The authorities are in broad agreement with the assessment.