INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/199

BULGARIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

July 2017

TECHNICAL NOTE—STOCKTAKING OF PROGRESS ACHIEVED BY THE BULGARIAN NATIONAL BANK IN STRENGTHENING BANKING SUPERVISION

This Technical Note on Stocktaking of Progress Achieved by the Bulgarian National Bank in Strengthening Banking Supervision for Bulgaria was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2017.

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International Monetary Fund
Washington, D.C.

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STOCKTAKING OF PROGRESS ACHIEVED BY THE BULGARIAN NATIONAL BANK IN STRENGTHENING BANKING SUPERVISION

Prepared By
Monetary and Capital Markets Department, and Finance & Markets Global Practice, World Bank

This Technical Note was prepared by IMF and WB staff in the context of the Financial Sector Assessment Program in Bulgaria, led by Michael Moore, IMF and Ilias Skamnelos, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance & Markets Global Practice, World Bank. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx, and www.worldbank.org/fsap.

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Glossary

AC	Advisory Committee to the Deputy Governor (responsible for BSD)
ALM	Asset and Liability Management
AML-CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
BDIF	Bulgaria Deposit Insurance Fund
BNB	Bulgarian National Bank
BSD	Banking Supervision Department
BSPM	Banking Supervision Process Manual
CAEL/CAMELOS	Capital, Assets, Management, Earnings, Liquidity, Other, Sensitivity
CAR	Capital Adequacy Ratio (Own Funds)
CG	Corporate Governance
CPOSA	Commission for Public Oversight of Statutory Auditors
CP	Core Principle
CET1	Core Equity Tier 1
CMG	Crisis Management Group
DG	Deputy Governor
EBA	European Banking Authority
FID	Financial Intelligence Directorate
FSCO	Financial Supervision Commission
FSAP	Financial Sector Assessment Program
GC	Governing Council of the Bulgarian National Bank
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Program
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
KRI	Key risk indicator
LCI	Law on Credit Institutions
MOU	Memorandum of Understanding
NPL	Nonperforming Loan
PMO	Project Management Organization
RAS	Risk Assessment System
RASM	Risk Assessment Manual (including associated CAMELOS rating)
RWA	Risk Weighted Assets
RRL	Recovery and Resolution Law
SNAS	State National Agency for Security (DNAS).
SREP	Supervisory Review and Evaluation Process
SSA SSD	Specific Supervisory Activities, Special Supervisory Directorate
UBO	Ultimate Beneficial Owner
WB	World Bank

EXECUTIVE SUMMARY AND KEY RECOMMENDATIONS[1]

A. Background

This technical note (TN) provides a stocktaking of the current state of the implementation of the key recommendations made by the IMF and the World Bank in their 2015 assessment report on the observance of Basel Core Principles (BCPs) for effective banking supervision in Bulgaria. It provides an overview of the most recent initiatives taken by the Bulgarian National Bank (BNB) to address the shortcomings found in the domestic supervisory regime. It also reflects the regulatory and supervisory framework in place as of the date of the completion of this review.

This note does not provide an exhaustive analysis of each of the 29 BCPs and is not meant to revise the ratings assigned by the BCP assessors in their 2015 report. The focus is on the eight principles that were found to be materially non-compliant in 2015 (Appendix II). In addition, there is analysis of the progress achieved on six principles rated as largely compliant in 2015 that have an important bearing on the effectiveness of supervision and where the BNB is working to enhance its supervisory practice.[2]

The 2015 BCP Assessment report identified weaknesses in a number of areas. Out of a total of 29 principles, the BCP assessors identified 9 principles as compliant, 12 as largely compliant, and 8 as materially non-compliant. No principles were identified as fully non-compliant. Material deficiencies were found in six areas: (1) inadequate governance model of exercising the BNB's supervision functions; (2) weaknesses in the internal organization of the Banking Supervision Department; (3) incompleteness in the regulatory acts, and internal rules and guidelines regulating banking supervision; (4) absence of an institutional framework for crisis management and bank resolution; (5) deficient IT and communication support for the supervisory function; and (6) insufficient coordination and information exchange with other institutions relevant to the supervisory function. Furthermore, there were concerns that the BNB was too resource-constrained to deliver effective minimum levels of supervision.

Progress in responding to the recommendation of the 2015 BCP Assessment is underway. The BNB endorsed a Plan on Reforms and Development of Banking Supervision that is now being implemented and will be followed by a set of actions that will span during the next years. The Plan aims to address the issues identified in the 2015 BCP report by improving the BNB's banking supervisory process and structure. The priority given to the 2016 Asset Quality Review (AQR) and subsequent stress testing has put heavy pressure on the resources of the Banking Supervision Department (BSD), thereby delaying the implementation of some of the BCP recommendations. A

[1] This technical note was prepared by Pierre Laurent-Chatain (World Bank) and Joaquin Gutierrez (IMF). Both authors would like to thank the Deputy Governor, the Directors, and the staff of the BSD for their excellent cooperation and fruitful discussions.

[2] Principle 1 (Responsibilities, objectives and powers); Principle 5 (Licensing), Principle 8 (Supervisory approach); Principle 9 (Supervisory techniques); Principle 15 (Risk management); Principle 18 (Asset quality); and Principle 29 (AML).

set of new policies, manuals, and ordinances are being or will be adopted soon to better achieve the recommendations of the BCP assessors. However, there is still room for further enhancing the governance model, risk assessment practices, and the response to the risk accumulation, notably regarding local risks. Assessing the needs and allocating reasonable incremental resources to the BSD is crucial, including providing tools to support and manage the risk assessment process.

As part of the reforms initiated in October 2015, the BNB has put in place a new governance model to enhance the effectiveness of supervision. The activities of the BSD will be governed by new formal policies adopted by the Governing Council (GC).[3] Through a new quarterly report, the GC is now better informed on banking risks and progress in addressing them. The BSD is also subject to annual internal audit. The decision-making process for supervision is also streamlined with a more active role assigned to the advisory council (AC) in advising the deputy governor in charge of supervision (DGS). Under the new arrangement, the AC provides a collective opinion on supervisory maters, including on enforcement, so that the DGS can take informed decisions. It is noteworthy that the DGS remains by law the sole authority responsible for supervision, except for the authority of the GC to grant and to withdraw licenses and to introduce special supervision measures[4].

The enhancement of the governance model for banking supervision is a crucial endeavor. However, strategic decisions remain to be made by the GC in three key areas. First, is the need to formalize a strategy on how to achieve the BNB's mandate by further detailing a set of prudential policy objectives, including to specify its tolerance to the supervisory risk of failure. Second, there is the need to adopt an explicit framework to enable an assessment of the delivery on the selected policy objectives. Lastly, there is the need to adopt formal policies regarding the conditions under which the GC and the GDS will escalate their response and early intervention measures, including specifying the severity of enforcement actions.

To strengthen the BSD's reliability, the GC should adopt a strategic tool to promote the effectiveness of the risk assessment process and the policy response adopted. First, the process should be put in place to align the risk tolerance of the GC and the response and escalation stance of the BNB. For example, by adopting a method to combine the risk profile and the systemic impact of each institution, this could be achieved. This method may be used to guide the supervisory response and escalation stance expected ex ante from the BSD. In parallel, the combined effectiveness of the GC and the BSD should be assessed ex post by the success of the response

[3] A renewed Banking Supervision Process Manual will be approved in February 2017 to be followed before year-end by a new risk focus onsite inspection manual to adopt the guidelines of EBA/GL/2014/13.

[4] The law gives the Deputy Governor strong powers to act separately and independently; however, the Governing Council has a role and responsibilities over troubled banks in addition to its licensing and regulatory powers. In other words, on-going banking supervision is entrusted exclusively to –and responsibility over ongoing supervision rests exclusively with- the dedicated Deputy Governor assigned to the Banking Supervision Department. However, BNB GC retains full powers and competences in licensing and carries certain responsibilities over troubled banks in limited cases determined in the law on credit institutions.

strategies in containing or resolving the risks that have been assessed (per institution, per risk, or across the industry).

The reinforcement of the organization and the resources of the BSD is also underway. A new Offsite Directorate has been established and segregated from the Onsite Inspection Directorate. Inspection teams have increased from five to six. Two separate divisions have been created within the Special Supervision Directorate, Analysis of Market Behavior and Risk Division and the AML Division, to permit greater focus on AML/CFT issues by the latter one. Cooperation and information sharing with key domestic partners has been improved by signing three new Memoranda of Understanding (MoU). New staff has been recruited, although the desired levels are still to be reached. Very recently, the BNB has launched an external assessment of the adequacy of its IT systems, both for banking supervision and failing bank resolution activities. Moreover, key ordinances await drafting to adopt soon to be published EBA standards, such as the development through regulations of Article 45 on related-party transactions, including the revision of the supervisory processes and their supporting manuals of procedures, which are already being reviewed at present.

However, the BSD's capacity to meet the expectations of the GC and the DGS should be reinforced, considering its engagement model. The intensity of the BSD's activities and its annual operational objectives should be reviewed, considering the changes in the governance model and the objectives endorsed by the GC and the GDS. Once the engagement model and the activities through the supervisory cycle are determined, a reasonable estimation of the workload and of the available skill set and needs (i.e., number of staff and specialists) will be necessary to continue the recruitment plan initiated. In addition, the BSD will need to implement an appropriate curriculum and training program, and adopt an attractive remuneration system. In search of effectiveness and efficiency synergies, the BNB should consider providing modern software tools to the BSD to support a more integrated, efficient, and auditable risk assessment and response process aligned to and consistent with the risk tolerance of the GC, including to simplify extensive reporting.[5]

Besides amending the Banking Supervisory Process Manual (BSPM) to supporting the new governance model, work has already started to update a number of manuals of procedures. The process and procedures for onsite inspection are being reviewed to become supervision based on the risk handbook and better aligned to the EBA's standards. There is nevertheless the need to recalibrate the current risk assessment methodology by developing key benchmark risk indicators and by setting up more granular criteria and control points for consistently guiding the assessment of central functions that are essential to internal governance. There should be means to coordinate the offsite and onsite risk assessments (CAEL and CAMELOS)[6] for the combined rating, leading to an

[5] For example, electronic onsite inspection working papers with upload features to a risk assessment and scoring data base shared with offsite inspection to manage end-to-end in an integrated manner the full SREP.

[6] The BNB system operates two core methods: CAMELOS (used for on-site inspections) and CAEL (used for the ongoing off-site assessment of the bank). The CAMELOS is performed annually, based on findings from on-site inspections, while CAEL is updated quarterly though offsite evaluation. Component ratings for both internal assessment systems (CAMELOS and CAEL) vary from 1 to 5. The composite Risk Assessment System rating of 1

explicit response and escalation policy clearly related to the early intervention, recovery, and resolution planning policies and practice. Moreover, there is a need to formalize a comprehensive Supervisory and Review and Evaluation Process (SREP), which includes an explicit and detailed supervisory Pillar 2 capital requirement, including adequate ways to factor concentration and untreated hidden risks.[7]

The intention of the BSD is to use its 2017 supervisory plan of activities to follow up tightly on the outcomes of the 2016 AQR and the progress reached by the banks in complying with its requirements. The Onsite Inspection Directorate has already adopted a plan of inspections to probe progress with set targets by relevant banks, following what seems a reasonable risk scope, including of concentration and related-party risks. The Offsite Inspection Directorate is also monitoring targets required through more frequent ad hoc reporting requirements. To support the work of these two Directorates, the Policy Directorate is strengthening its tools to profile interconnections and relationships, as well as considering the most feasible alternatives to adopt the suggestions of the stocktaking mission. This may include the possibility of factoring, through a well-calibrated additional Pillar 2 capital requirement, any excess idiosyncratic risks that are not fully captured under Pillar 1.

The sections that follow summarize the views of the stocktaking mission regarding the progress achieved toward complying with the BCP standards and the tasks that remain to be undertaken. Table 1 provides a number of suggestions regarding the priorities foreseen by the stocktaking mission in the following quarters until end-2019.[8] Until late 2019, the mission may not see that the reforms and developments might warrant a formal complete BCP update, which should provide sufficient time to the BSD for effectively implementing in practice the new policies and procedures adopted. The next section discusses the Plan of Development adopted by the BNB and how the plan is addressing the issues reported regarding independence, accountability, resourcing, and legal protection (CP 2). The last section discusses the additional measures planned or that are being carried out by the BSD to address other areas in need of attention, which were assessed in March 2015 as Materially Non-Compliant. Finally, Appendix I provisionally updates the status of the Plan of Development; Appendix II advances a mid-term review of the status of advance in implementing the recommendations of the assessors in 2015; and Appendix III suggests a number of criteria taken from practice regarding the identification of related-party transactions, some of which are already part of the practice accrued by the well-experienced staff of the BSD.

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represents the best performance, very good systems for risk management and requires minimal supervisory attention. Composite rating 5 is the worst score and shows critical performance weak or missing systems for risk management and requires maximum attention from the supervisor.

[7] Rendering fully consistent the current practices to comply with the standards promoted by EBA in EBA/GL/2014/13.

[8] These priorities might differ and are not necessarily the same as those actually undertaken by the DGS and the GC. The mission would encourage clear formalization of the official priorities and plan of actions, including a more concrete detailed timetable for implementation toward monitoring

Table 1. Bulgaria: Main Recommendations	
Actions Recommended to Attend Priorities Foreseen by the Stocktaking Mission	Paras.
Short-Term Priorities (suggested targets during 2017)	
• Adopt a multi-year Action Plan, with detailed activities to continue strengthening the BSD.[1/]	12, 52 & 54g
• Implement a comprehensive supervisory strategy for the target banks under the AQR.	57
• Adopt the Banking Supervision Process Manual (including measures to track effectiveness).	15–31b
• Estimate workload; align resources to it; provide further key capacities (credit, ITs, statisticians).	52d & 50a
• Regulate Article 45 of the LCI on related parties, setting criteria to typify circumvention practices.	36–38
• Develop capacity, processes and practice to oversee an effective implementation of IFRS 9.	58 (a) (f).
• Complete the revision of the AML/CFT oversight methodology, reflecting the latest reforms in the European Union.	65
• Adopt the new the risk focus Onsite Inspection Manual being developed (adapt CAMELOS to it).	50c & 52k
• Start developing a range of software tools to support effective and efficient operations of the BSD.[2/]	52i
Medium-Term Priorities (suggested targets during 2018)	
• Enforce remedies to concentration and related-party risks based on the 2017 inspections.	34
• Adopt an internal "response and escalation policy" anchored in the rating (web a light version).	9 & 16
• Adapt current ordinances expanding the EBA's guidelines, for concentration risks, inter-alia.	33d
• Recalibrate CAEL and CAMELOS, with entry scores guided by benchmark key risk indicators.	50 & 52j
• Combine CAMELOS and impact measures to set the risk tolerance of the GC and DGS.	5
• Complete the existing SREP components, adopting a detailed Pillar II capital regime.[3/]	52h
• Use the above to solve residual local risk excesses (i.e., connectedness, relatedness, other relevant).	34–37g
• Adopt a process to assess the effectiveness of supervision (objectives, impact, accountability).	6–8 & 52f
Long-term (suggested targets during 2019)	
• Review progress achieved under the Action Plan and adjust to prepare for a BCP Update.	52–54
• Update the BSD's internal Self-Assessment of Compliance with the BCP.	52–54
• Submit to a formal BCP Update, including all principles.	52–54

1/ The stocktaking mission suggests these actions as targets that could fit into the multi-year (2017–2019) Action Plan, continuing the Institutional Development Program of the BSD understanding that the priorities of Senior Management might change going forward, but could be made time consistent by targeting readiness for a new BCP Update by end-2019.
2/ Given what seem resource intensive reporting practices within the BSD and toward the GC, the mission sees opportunities to simplify the associated work load and the templates in use by providing to BSD a number of software support tools (see para. 53), which should also result into efficiency and security gains.
3/ Fully compatible with the standards promoted by EBA in EBA/GL/2014/13 and other SREP related EBA's guidelines.

THE PLAN OF DEVELOPMENT FOR THE BULGARIAN NATIONAL BANK

A. Governance of Banking Supervision[9]

Background

1. **As observed by BCP assessors and acknowledged clearly in the BNB Plan on Reforms,[10] the *"existing governance model concentrates an extremely broad range of powers and responsibilities in the hands of the Deputy Governor in charge of the banking supervision, without providing for reliable information channels and control mechanisms by the other members of the BNB Governing Council."*** Further, the legal structure of the governance arrangements provides no options for the effective delegation of supervisory powers if the Deputy Governor for Supervision becomes unavailable or incapacitated for whatever reason. To address these fundamental issues, the governance model of the BNB is being revised with the view to increase further participation of the GC in banking supervision matters, as discussed below. This role includes the adoption of a new set of revised rules and procedures. The decision-making process for supervision is also being streamlined, with a more active role assigned to the advisory council to the deputy governor in charge of supervision. The conditions for enforcing prudential laws and regulations are also planned to be revised in the next quarters.

The new BNB governance model and the role of the Governing Council

2. **A set of internal rules and guidelines relating to supervision activities is to be adopted by the BNB's GC**. As part of the BNB's Plan on Reforms, the GC is set to adopt a package of rules and internal guidelines. This package will include not only revised manuals, but also a set of principles that will define *inter alia* the tone of the supervisory approach, including business analysis and risk tolerance for each bank, new criteria for enforcement, working arrangements between the different Deputy Governors (DGs), and between the DGs and the GC.[11] Most, if not all of the supervisory manuals for both onsite and offsite supervision purposes are being revised by the relevant directorates within the Banking Supervision Department. The resources assigned to this

[9] This topic refers primarily to Principle 2 (Independence, Accountability, Resourcing and Legal Protection).

[10] Appendix I provides a summary of the Plan on Reforms and Development of Banking Supervision. Appendix II includes a summary of the status of implementation of the recommendations of the March 2015 assessment of compliance with the Basel Core Principles that were assessed as Materially Non-Compliant.

[11] A consultant from Belgium (deputy chief of supervision) has provided advice to the BNB in the course of 2015 and a fresh perspective from an SSM standpoint.

endeavor are substantive and the review progress to date indicates that targets will be achieved by end-2017.[12]

3. The banking supervisory function will be subject to enhanced internal scrutiny. Another notable feature of the strategy to improve internal governance is to conduct every year an internal audit of the compliance with the supervision rules mentioned above, and fulfillment of the plan on reforms. This audit, which is to be carried out by a team composed of the Head of the Financial Audit Division (lead), the Chief Internal Auditor, and the Head of the Information Systems Audit, has been tasked to conduct a comprehensive review of the adequacy and effectiveness of the internal regulatory framework, regulating the supervisory processes of Banking Supervision, and the Single Data Repository information system developed for the purposes of supervisory activities.[13] The review of the internal regulatory framework shall be structured in accordance with the Plan of Reforms already mentioned, and focus on key areas such as the "Governance Model," "Internal Organization of the Banking Supervision Department," and "Regulatory Framework."

4. It is, however, essential to ensure that the audit's findings lead to concrete measures at the GC level. The mission understood that the audit results would be shared with the DGS and reported to the BNB's GC. Nonetheless, discussion with staff suggests that recommendations from the internal audits have not always resulted in concrete actions. Past audit findings include outdated regulations, insufficient manpower, and unclear allocations of resources, inadequate follow-up of recommendations to banks, and decreased effectiveness of supervisory processes. In that context, the mission recommends a strict follow-up at the GC level of the audit recommendation. This will provide reasonable assurance that the BNB's Plan of Reforms will be completed as agreed and within a reasonable timeframe. The Internal Auditor was apprised of the findings of the 2015 BCP report to ensure maximum impact of its work. The objective of any review should focus on evaluating the effectiveness of supervision rather than solely looking at compliance with internal manuals of procedure and organization.

5. A new type of reporting is now submitted quarterly to the GC on banks' monitoring and prudential responses. Under the previous regime, the GC was provided with one single report on the conditions affecting the banking system as a whole, along with information on individual banks. In addition to this macro-level analysis, the GC is now provided with a second report focusing on supervisory matters, including details on (i) onsite inspections (e.g., number of visits, findings, and issues); (ii) supervisory risk ratings and problems identified (including number and type of infringements) and recommended corrective actions; and (iii) enforcement measures taken or considered against specific institutions and progress achieved to date. Inputs from the offsite

[12] The BSD has assigned substantive resources to this task with two heads of inspection team, two inspectors from the On-site Inspections Directorate and two heads of team from Off-site Directorate full-time dedicated. The drafting work shared with the mission evidences progress and the intention to make the BSD' supervisory procedures fully compliant with the standards of EBA/GL/2014/13 while preserving a risk focus inspection approach as part of the overall BSD' supervisory culture.

[13] Order of the Governor No. BNB-85275/21.09.2016.

department also provide granular details on follow-up measures to address recommendations and adoption of corrective measures by banks. The quarterly reports also contain information on changes in the shareholding structure of banks.[14] The stocktaking mission suggests that a combination of the supervisory rating and the systemic impact of each bank be used for reporting to the council, including to align the latter's risk tolerance to the BSD's response and escalation policies.[15]

6. The enhancement of the governance model of banking supervision is a crucial endeavor that would require additional strategic decisions from the Governing Council in three crucial areas. First, there is the need to formalize a strategy on how to achieve the BNB's mandate by further detailing the set of prudential policy objectives, including to specify the tolerance of the GC to the BNB's risk of failing to effectively contain or to resolve on time an idiosyncratic crisis.[16] Second, there is the need to adopt an explicit framework to enable a reasonable assessment of the delivery on the selected policy objectives. Lastly, there is the need to adopt formal policies to specify the conditions under which the GC and the DGS will respond to defuse, contain, or resolve the accumulation of risks that might lead to failure, including specifying the severity of their enforcement stance.

7. The set of prudential objectives is essential to guide from the top the delivery of supervision as well as to support a reasonable and responsible assessment of its impact and accountability. There are three fundamental types of objectives that may still require explicit formalization within the BNB. The first type objectives are the strategic long-term goals of the GC to further the spirit of the Article 2 of the BNB's Law, which, besides price stability, mandates the BNB to regulate and supervise banks in order to ensure financial stability and to protect depositors. The second type of objectives are the tactical medium-term objectives of the DGS to implement actions for delivering on the GC's strategic goals. Lastly, the third type of objectives are the annual operational targets of each Directorate and Technical Supervision Line Unit in implementing the direction set by the Council's goals and the DGS' objectives, once they are formalized.[17]

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[14] It is noteworthy that these reports will strengthen the level of information of the Board (the GC) regarding supervisory matters in general. They may lead the Board to suggest supervisory actions to the DGS since the latter is, together with the Governor, a full member of the Governing Council. However, the LIC has not been changed and the DGS remains the sole authority to take supervisory measures and "*apply, separately and at his own discretion, the actions and penalties as provided for by law*."

[15] For example, see the risk assessment and response policies of the Australian Prudential Regulatory Authority (APRA combining the supervisory rating (as probability of failure) and the systemic impact (as potential for loss given default).

[16] This refers to the risk that a bank fails without the BNB having previously identified with a reasonable anticipation and precision the bank's ongoing solvency and viability deterioration, including adversely scored the reliability and effectiveness of key elements of its internal governance framework (probably identifying also hidden high level control issues) resulting into the adoption of some form of proportional remedial actions of appropriate severity to counteract the deficiencies observed.

[17] For example, the GC could commit as a strategic goal to enhance stability by a set of measures that improve the overall solvency of the system, such as a reduction of the levels of NPLs and other local risks (say unspecified

8. The framework to assess the impact of supervision and to account for its successes and failures is the alter ego associated intimately to the above objectives, which remains to be articulated.[18] The question posed is challenging—how will the GC and the DGS determine (and report to their stakeholders, if so decided) that they have achieved what they intended, including that their decisions defused, contained, or resolved risk accumulation?[19] In addition to good manuals of procedures, reasonable risks assessments made by BNB supervisors, and a superimposed cycle of internal audit on the latter's work, the assessment of the effectiveness of the supervision delivered by the BNB requires the design of a reasonable impact and accountability framework, with a few relevant indicators to assess the footprint in delivering on the mix of selected policy objectives (the consequences of supervision and its response).

9. Finally, the formalization of the response and intervention policies into specific criteria is of paramount importance to support the previous two strategic elements. These criteria are necessary for specification of the thresholds for implementing supervisory measures and administrative penalties per the LCI (Articles 36, 103, 115, and 152) and the RRL (Articles 13 and 44). In this manner, the decisions taken by the GC and the DGS would timely address risk accumulation in a predictable, proportional, and consistent manner, including as part of an explicit Pillar 2 capital risk regime, when the risks are difficult to approximate or of a hidden nature, such as poor internal governance, possible inside abuse, or a potential negative effect of difficult to clarify related-party transactions.

The decision-making process and the role of the advisory council

10. Even though the decision-making structure for supervision remains unchanged, the new measures above represent a step in the right direction. The BNB's internal governance structure for banking supervision in relation to the distribution of powers and responsibilities regarding banking supervision is the same as those observed by BCP assessors in 2015. While they acknowledged that this was a conscious decision, designed to ensure responsibility and accountability, the assessors were concerned that, in the absence of some form of checks and balances in the decision-making process, the DGS was highly vulnerable to external pressure and influence.

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concentration and related party risks), resulting into an improvement in external ratings of several banks. The DG could commit to support the above strategic goal by requiring banks to adopt plans with multi-year NPLs reduction targets resulting into improved measures of inherent credit risk through calibrated KRIs that cascade into better CAEL-CAMELOS ratings and, say, lower Pillar 2 capital, except for the institutions that do not reach minimum targets.

[18] See the recommendations of the Basel Committee's in its October 2015 Report on the impact and accountability of banking supervision.

[19] For example, when would be the risks accumulating in one bank or banking group, or across the industry at system level be so intense per reference to the risk assessment (the CAMELOS or another reasonable measure) that requires the response of a Directorate, that of the DGS, or the weight of the full GC, so that the most effective measures of the LCI and RRL are adopted.

11. In that respect, the measures introduced by the BNB Plan, some of which are not completed yet, are designed to promote more transparency in reaching supervisory decisions. The Governing Council should be now fully informed and on a regular basis about the individual conditions of banks and detailed supervisory decisions made or envisioned by the deputy governor. In presenting its quarterly report to Board members, the DGS can be challenged on its actions,[20] even though the final decision rests with him. Equally important, the DGS is now assisted by an Internal advisory council that provides, among other things, guidance on supervisory measures. While the effectiveness of this new system remains to be seen, the mission is of the opinion that the new system will allow a more active role by the BNB's Council in supervisory matters, especially once the council has established its risk tolerance.

12. An internal advisory council has been established to provide nonbinding advice to the deputy governor in charge of supervision. This council has been operating for several years now. The intention now is to enhance its advisory role vis-à-vis the DGS and to formalize its internal organization. The council does not bear any legal responsibilities, and it consists of the heads of the six Directorates of the BSD, the advisor of the DGS, as well as the director of the newly established Banking Resolution Directorate. So far, discussions have focused on micro- and macro-supervisory related issues, scope of future onsite inspections, and on the latest developments in the European banking regulations and guidance. Going forward, the AC will discuss the situation of particular banks and measures to be adopted in light of the outcomes of the AQR. The AC meets every Monday, and can also be scheduled upon request of the DGS. The stocktaking mission suggests that the AC design for proposal to the DGS a robust multi-year Action Plan along the lines indicated in this Note, including mechanisms that would allow starting to evaluate and report the effectiveness of the BSD.

13. The AC's internal organization, functioning, and mandate are being now formalized.[21] This work is part of the internal rules and guidelines to be adopted soon by the BNB's GC. It is therefore essential to make sure that this AC plays an active role in strategic thinking by challenging decisions to be made in supervision, including, for example, on enforcement measures by providing unbiased insights and informed guidance to the DGS. In the BNB's views, which the present mission shared, the AC should by no means become a collegial decision-making body in lieu of the DGS. The latter remains, by virtue of the law, the sole authority responsible for supervision. All things considered, if the AC is entrusted with a clear advisory mandate, the stocktaking mission is of the opinion that it can be an important ally in the quest for superior corporate governance within the BNB. Moreover, it can facilitate better interaction between key departments and higher transparency in supervisory decision making. The AC should also provide a forum for higher quality assurance (QA) and focus for response and escalation advisory to the DGS.

[20] An example of this is a verbal recommendation made by a GC member to the DGS to tell a bank to reduce its exposures.

[21] As part of the reviewed Banking Supervision Manual Process being planned for adoption in February 2017.

14. A decision from the BNB's GC has clarified the regime for delegation of powers. In 2015, it was noted that, should the position of deputy governor fall vacant unexpectedly, there was no legal possibility for the enforcement powers to be delegated to another individual. This flaw exposed the BNB to unnecessary uncertainties in its supervisory activities. In the BNB's opinion, the legal framework ensures the necessary guarantees to achieve effective delegation.[22] However, further clarity has been provided to the situation observed during the BCP through a motion presented in July 2015 by the DGS, whereby the GC designates the DG heading the Issues Department to perform the DGS's powers in the absence[23] of the latter. In addition, in case of simultaneous absence of both DGs, the DG in charge of the Banking Department is designated to act on behalf of the DGS. The stocktaking mission was informed that this GC decision is applicable for unlimited numbers of instances.

The new approach for enforcing prudential norms

15. The decision-making process for enforcing the laws and regulations is being improved with the establishment of the advisory council. As discussed above, the BNB is in the process of establishing a permanent advisory body, with representatives of all directorates of the Bank Supervision Department, head of the Restructuring Department, and the DGS's advisor, who will assist the latter in supervisory related matters, including on sanctions and other remedial measures. While the rules are still being considered, the role of the council in enforcement matters will consist of (i) analyzing each case of infringement with banking norms; (ii) discussing various options; and (iii) forming a collective opinion to share with the deputy governor, so that the latter can take an informed decision. The rules of the AC will become part of the Banking Supervision Process Manual (BSPM). Even though the effectiveness of this new regime remains to be tested, the advisory role in enforcement matters of the AC is an important step forward.

16. Internal guidelines are envisaged with the view to assist the DGS in determining the most adequate response in case of breach or violation. This was a key recommendation from BCP assessors in 2015 to achieve higher predictability and transparency in enforcement policies. However, no concrete decisions have been made so far to address this issue, in part because of the AQR process that has mobilized the entire personnel over the past year. The stocktaking mission was informed that the BNB will be holding in-depth discussions to explore different options with the view to provide guidance to the DGS in its enforcement approach, linking supervisory findings to specific remedial actions, and establishing procedures for appropriate exceptions. In that regard, the mission reiterates the importance of adopting a "response and escalation policy" based on the risk profile of each bank, as well as an enforcement policy and criteria for sanctions according to the gravity of the offense. These policies should form part of the BSPM currently being developed by the BNB and to be approved by the GC sometime in 2017.

[22] According to art. 19 of the law on the BNB, "on a motion by a DG, the Governing Council shall designate an alternate deputy governor to exercise his powers when he is absent." This provision is reiterated in the Rules of Procedure of the BNB's GC.

[23] The notion of "absence" is not defined in text, however.

17. Recent decisions against two banks suggest a shift in the BNB's approach to serious offenders, which is welcome. According to the BNB, more forceful actions have been taken against two institutions that breached regulations, pursuant to article 103, paragraph 2, items 3, 4, 10, 11, and 15 of the LCI. Written orders have been issued instructing a bank to cease and eliminate the violations. Other measures include corrective actions to improve the respective banks' financial positions, limit the volume of certain types of activities, capital increase, and changes in the banks' internal rules and procedures. In one case, the bank was instructed to terminate certain operations or to transfer non-transparent credit portfolios managed outside the country borders back into the scope of detailed supervisory surveillance (see discussion under CP 29). This approach is welcome and should become a general practice going forward.

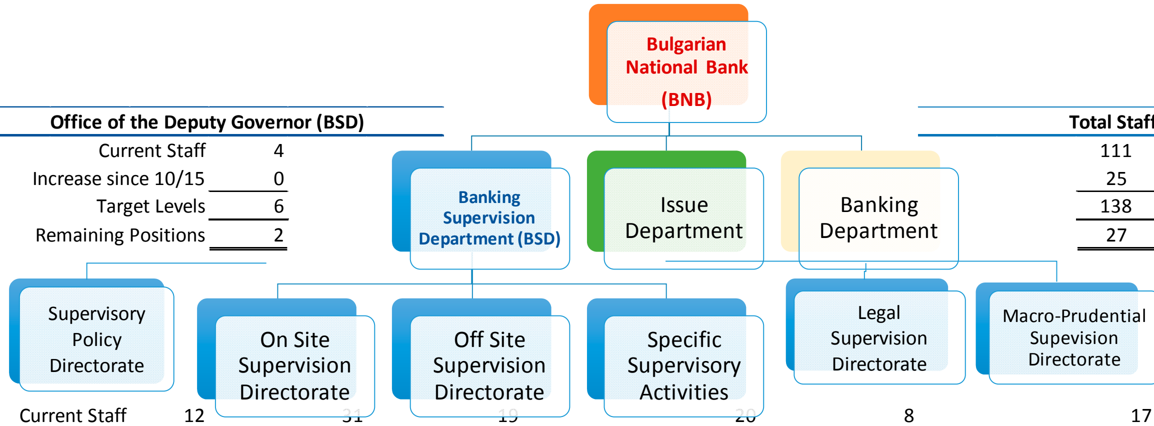
B. Internal Organization of the Banking Supervision

18. Background. As indicated by the BCP assessors in 2015 and acknowledged in the BNB Plan of Reforms, the existing internal organization of the Banking Supervision Department fails to ensure the necessary coordination and quality assurance of prudential oversight activities, including effective internal communication. To overcome these weaknesses, the BNB has taken a series of measures, some of which are structural in nature while others relate more to operational aspects of supervision. The stocktaking mission welcomes these initiatives as a step forward that is likely to improve conformity with several CPs (CP 01, 08, and 29).

19. Offsite and onsite supervision activities have been split into two distinct directorates. The failure of Corporate Commercial Bank AD (KTB) has prompted the authorities to rethink the way supervision should be organized in order to prevent a similar case from happening again. One of the most important responses has been to change the structural approach for supervision by separating onsite from offsite supervision in two directorates within the Banking Supervision Department. The onsite inspections will continue to be conducted by the Onsite Inspection Directorate. It is noteworthy that while the two work streams are separated, working arrangements have been established to ensure cooperation and information exchange between the directorates. The objectives of the reform are to increase efficiency, promote better allocation of resources, and ensure mutual quality control (Figure 2).

20. The organization of onsite supervisory work has been improved. Another lesson drawn from the KTB case was the need to revisit the organization of the work to be done onsite. The BNB has increased the number of inspection teams from five to six to improve both the frequency of visits in the field and the possibility for team rotation, and is now requesting teams to rotate with the view to ensuring a fresh perspective on the bank.

Figure 1. Bulgaria: Banking Supervision Department of Bulgarian National Bank



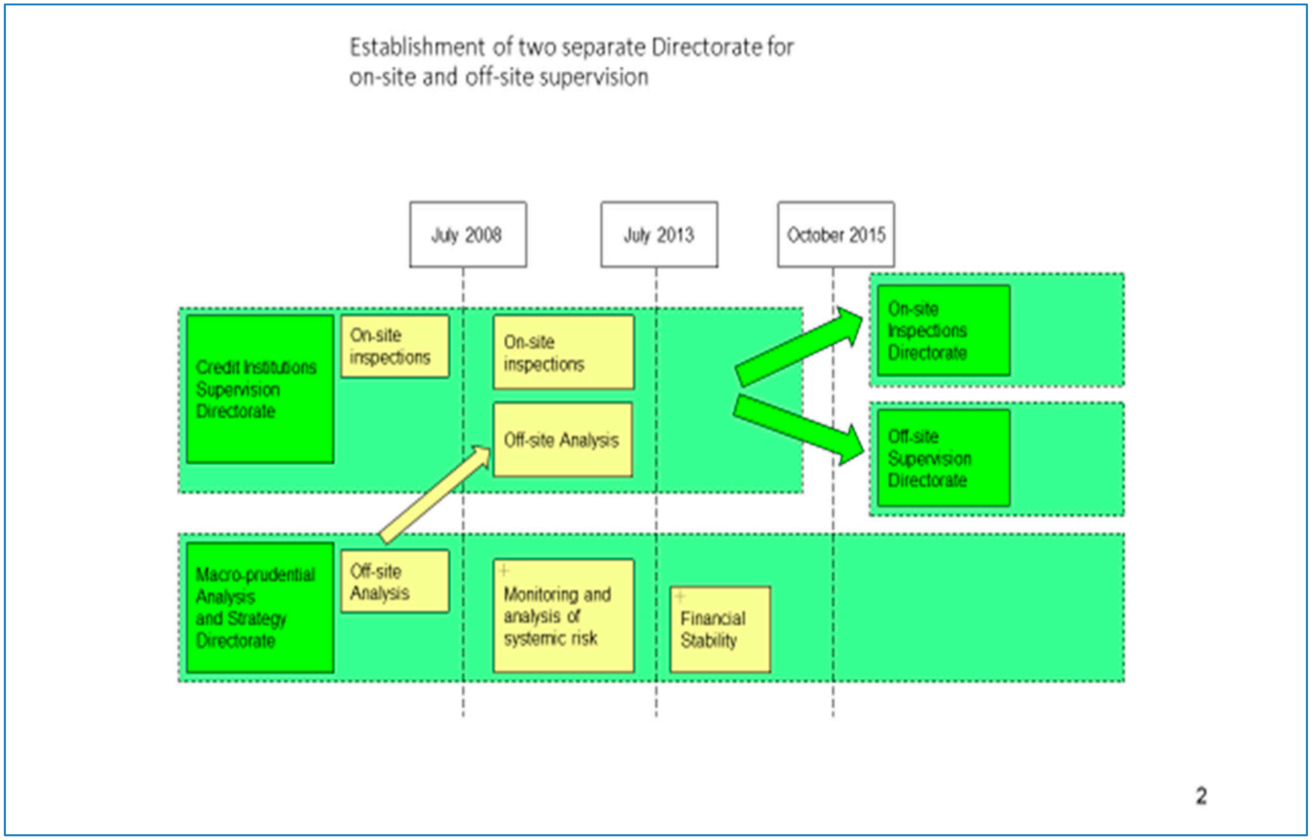
Office of the Deputy Governor (BSD)	
Current Staff	4
Increase since 10/15	0
Target Levels	6
Remaining Positions	2

Total Staff - BSD	
111	Current Staff
25	Increase since 10/15
138	Target Levels
27	Remaining Positions

	Supervisory Policy Directorate	On Site Supervision Directorate	Off Site Supervision Directorate	Specific Supervisory Activities	Legal Supervision Directorate	Macro-Prudential Supevision Directorate	
Current Staff	12	31	19	20	8	17	107
Increase since 10/15	2	8	6	5	2	2	25
Target Levels	18	43	21	22	10	18	132
Remaining Positions	6	12	2	2	2	1	25

Source: BNB, 2016.

Figure 2. Bulgaria: Establishment of Separate Directorates for Onsite and Offsite Supervision



21. A new Analysis of Market Behavior-Related Risk Unit (AMBRU) has been established within the SSD. Following the recommendations made by the BCP assessors in 2015 and pursuant to the BNB's Plan on Reforms, a new unit has been set up within the Special Supervision Directorate (now called Specific Supervisory Activities (SSA) Directorate) to assume all tasks that are not directly related to the BNB supervisory function, but carry legal and reputational risks. AMBRU is responsible for monitoring and analyzing business practices in areas such as consumer and mortgage lending, offering of deposit and other banking products, product transparency and analysis of customer complaints, which are not connected to money laundering and terrorist financing. AMBRU has four permanent staff positions and additional resources are being considered in anticipation of the implementation of the new law on Real Estate Loans for Consumers (LRELC)[24] transposing the requirements of the Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property.

22. The name of the Special Supervisory Directorate (SSD) has been changed to "Specific Supervisory Activities (SSA)" and its staffing has been increased. As recommended by the BCP assessors, the SSD has been renamed to avoid possible confusion with the special supervision regime under the Law on Credit Institutions.[25] Further, the name of the AML/CFT Unit has been changed to "*AML and Other Specific Supervisory Activities*" to emphasize better the tasks assigned to the unit. In addition, the staff of the latter has been increased to nine inspectors dedicated mainly to AML/CFT issues. Even though the SSA still carries a wide range of activities, the distinction now being made between AMBRU, which carries out non-AML related activities, and the AML Unit is an important improvement. Nonetheless, the ability of the SSA Directorate to focus on its core mandate under its new structure remains to be seen. Further, additional staffing for AML purposes is very welcome but should be continued going forward.

23. Staffing has been increased, but not yet to the desired level. As a fulfilment of the Plan of Reforms, the decision has been made to increase resources for supervision purposes. This was also an important recommendation of the BCP assessors, who observed that resources are insufficient for the range and nature of the tasks the BNB must carry out for effective supervision. As a result, the Offsite Supervision Directorate has been established and staffed with 18 inspectors as of August 30, 2016. The total number of employees of the directorate, according to the plan, is 20 inspectors, excluding the head of the directorate. The staff of Specific Supervisory Activities has been increased with five experts. The AML Unit headcount has also been increased by four, resulting in an amount of nine inspectors dedicated mainly to AML/CFT. The staff of the Supervisory Policy Directorate has been increase with one person. The staff of Onsite Supervision Directorate and Legal Supervisory Directorate have been increased with four and two experts respectively. Further, two

[24] The LRELC assigns new responsibilities to the Deputy Governor responsible for Banking Supervision Department including control of the requirements for creditworthiness assessment for consumers (part V of LRELC), remuneration (Article 47 LRELC) and competence of staff (Articles 48 - 49 LRELC) over the credit and financial institutions. The BNB will also act as a contact point for the other competent authority under LRELC in Bulgaria and European Banking Authority.

[25]According to which the BNB may establish a special supervision procedure concerning a bank if it finds that the bank is "*at risk of insolvency*" (art. 115).

additional experts have been assigned to the Macroprudential Supervision and Financial Stability Directorate. These trends are very welcome and should be pursued. As it concerns the total authorized capacity of the BSD, as shown in Figure 1, the target has not been attained yet, and there is still a gap of about 25 percent (31 positions less 6 new onsite inspectors, recently recruited and being trained). The lack of additional office space may delay further reaching the planned headcount.

C. Institutional Framework for Crisis Management[26]

24. The BNB has been designated the banking resolution authority, and a new resolution regime for banks has been established. The KTB's collapse in 2014 revealed a series of major weaknesses in the domestic regime for dealing with problem banks, exacerbated by the lack of certain types of resolution powers. At the time of the BCP assessment, the BNB did not have sufficient options in order to cooperate and collaborate to achieve the orderly resolution of a bank. With the adoption of the Law on Recovery and Resolution of Credit Institutions and Investment Firms, a resolution framework governing such processes has been established. The new Act was published in the State Gazette on August 14, 2015, with most provisions entering into force on set dates, including in 2017 and 2025 respectively.

25. The Act implements the EU Bank Recovery and Resolution Directive 2014/59/EU. In addition to designating the BNB as the resolution authority with appropriate powers, the law requires all institutions to produce a recovery plan (on a group or an individual basis) and update it annually and as needed.[27] The recovery plans of local banks are subject to review by the BSD. Furthermore, the BNB should prepare individual resolution plans for each institution without a parent undertaking in the European Union, setting out the resolution actions that the resolution authority may take and to identify any material impediments to resolution and possible actions to remove them. The BNB also participates in EU resolution colleges and contributes to the development of group resolution plans of local subsidiaries of EU institutions. The BNB is also empowered to intervene early in the operations of an institution, and to impose measures whenever an institution infringes or is imminently likely to infringe, due to a rapidly deteriorating financial condition, the requirements of EU Regulation or applicable Bulgarian legislation.

26. To implement this new regime, the BNB is in the process of establishing relevant organizational structures within the central bank and designing appropriate operational procedures for interaction with the Banking Supervision Department. To that end, and pursuant to the BNB Plan on Reforms, a new Bank Resolution Directorate outside of the Banking Supervision Department has been established and staffed. Draft internal rules—shared with the mission—have been established as well. These rules shall govern the interaction and current exchange of

[26] See the technical note prepared by Mr. Attila Arda on Safety Net and Crisis Management for an exhaustive coverage review of the status of this essential thematic component of the financial safety net.

[27] The discussion and approval on the recovery plans of Bulgarian subsidiaries of international banking groups are carried out as part of the activities of the supervisory colleges. The BSD is responsible to approve the recovery plans of domestic banks.

information between the Resolution of Credit Institutions Directorate (RCI) and other structural units of the Bulgarian National Bank (BNB) during a resolution process, including the BSD, and the Banking and Legal Departments.

27. Work to make the new resolution regime operational is undergoing. The reform addresses the gaps in the resolution and crisis management toolkit. Implementation has started and involves a significant amount of work for both the BNB and the industry. At the resolution level, additional tasks include, inter alia, the completion of operational procedures within the BNB, including the interface between the Directorate for Resolution and the GC, which is the sole resolution authority. Resolvability assessment as well as resolution planning and strategies for each bank are also of paramount importance, especially for banks rated adversely. Banks have also prepared and completed their recovery plans (RP). This process has started, and the mission understands that some of the plans submitted in 2016 4Q remain to be reviewed based on template procedures for analyzing recovery plans already adopted. Three meetings with the industry have also taken place to explain further improvements that are to be made to the RP. The mechanism for cross-border cooperation with the home resolution authorities, mainly the Single Resolution Board (SRB) and the Magyar Nemzeti Bank (The Central Bank of Hungary) has been established. The relevant Multilateral Cooperation and Coordination Agreements for setting up and functioning of resolution colleges have been concluded.

OTHER CORE PRINCIPLES REQUIRING FURTHER ACTION

28. In addition to the actions undertaken to reinforce the governance and the organization of banking supervision, the BNB has continued the implementation of other measures directed to achieve full compliance of the Regulatory Framework with the relevant Basel Core Principles.[28] These actions include three key activities directed to: (1) draft legislative amendments to expand powers for imposing supervisory measures; (2) conduct a full review of ordinances, internal rules, and guidelines regulating supervision activities; and (3) adopt supervisory review and risk assessment procedures in line with the decisions of the European Banking Authority (EBA) on common procedures and methodologies. After the reorganization of the BSD and, once the AQR has been finalized in August 2016, these actions are now being undertaken as discussed in the following sections that focus on the most relevant Basel Core Principles that were assessed as Materially Non-Compliant in March 2015.

[28] Appendix I provides a summary of the status of implementation of the BNB's Plan of Reforms. From the BCP perspective, Appendix II provides a summary update of the status of implementation of the recommendations of the March 2015 assessment of compliance with the Basel Core Principles, which were assessed as Materially Non-Compliant.

A. Banking Risks[29]

Ownership Aspects (Core Principles 5 and 6)

29. Background. The March 2015 BCP assessment provided a number of key recommendations to strengthen licensing and authorization activities. Two key recommendations remain to be implemented. The first recommendation is to include a clear definition of ultimate beneficiary owner (UBO) in the LCI in consonance, with the definition provided in the Anti-Money Laundering Law (AML). The second recommendation is to require in the LCI that banks notify of material negative information regarding the suitability of a major shareholder, including for the BNB to take measures when a material negative event might affect a bank through contagion or reputational impact.

30. The BNB envisages legal amendments to strengthening legal concepts and its powers to furthering compliance with the applicable ownership standards. Once the fourth Anti-Money Laundering Directive (EU 2015/849) has been transposed to the relevant Bulgarian legal framework, the BNB plans to submit amendments to align the definition of UBO and to obtain appropriate powers to address negative information instances following the above recommendations.

31. The BNB has also undertaken, or is planning to undertake, additional actions to enhance its licensing and authorization activities regarding ownership standards. These actions promote more intensive vetting of shareholders' suitability and the propriety of key relevant persons, including to further the transparency of ownership structures. The following three specific actions have been noted:

a. First, per the MoU signed in August 2015 with the State Agency for National Security (SANS), the BNB has reinforced communication and information exchange with the Financial Intelligence Unit (FIU). This MoU has been used recently to expand the investigation of the origin of funds of a number of shareholders of banks and nonbank financial institutions, including active exchange of information with the Prosecutor's Office.[30] This is resulting in further mitigation of risks associated with residual ownership transparency issues.

b. Second, the Banking Supervision Process Manual and other internal rules are being updated with a formal mechanism for the interview of applicants, including the exchange of information with other Directorates of the BSD regarding the process of tracking funds proceeds and sourcing. Through the changes planned in its Risk Assessment Manual (RASM), the BSD intends to enhance the relevant components of its risk assessment system (CAMELOS).

c. Third, the BNB plans to update, as deemed necessary, its Ordinance 20 on the Issuance of Approvals for Members of the Management and Supervisory Boards, following the outcome of

[29] This topic refers primarily to five principles, including: Principles 5 and 6 (on Licensing and Transfer of significant ownership); Principle 19 (Concentration risk and large exposure limits), Principle 20 (Transactions with related parties), and Principle 21 (Country and transfer risks), which were all assessed as Materially Non-Compliant in March 2015, except for Principle 5 on Licensing that was assessed as Largely Compliant.

[30] The 2016 MoU signed between the BNB and the Prosecutor's Office is being updated.

the review of the Joint ESMA and EBA Guidelines on suitability assessments, which are in the process of preparation and with which the BNB intends to fully comply.

Concentration Risks (Core Principle 19)

32. Background. The March 2015 BCP assessment provided three key recommendations to strengthening the supervision of concentration risk and large exposures: (i) conduct horizontal reviews of conformity; (ii) instruct the industry to increase its efforts in understanding customers' ownership structures; and (iii) take forceful measures against banks in order to promote observance.

33. To improve conformity with CP 19, the BNB has initiated a number of important activities. These include the following:

a. ***AQR review.*** The BNB has conducted a system-wide first horizontal review of concentration risks as part of the AQR. The AQR was not designed to perform an in-depth forensic review of interconnections. However, the eighth task of the Work Block 1 of the AQR (Policies, processes, and accounting review) included a high-level review of connected client IDs and countries of ultimate borrower ID policies. In addition, as part of the samples reviewed, the AQR providers were instructed to review groups of connected clients for the cases where flags were identified, including to review other material exposures identified subject to the two largest in a group of connected clients. The AQR providers were to use publicly available sources to challenge the identified groups of connected clients.[31]

b. ***Targeted inspections.*** After the finalization of the AQR, the BSD is to conduct a plan of targeted inspections where the review of connectedness and relatedness is a central theme of the reviews.

c. ***Redrafting manuals and risk assessment.*** The BSD is also starting to re-draft its manuals of onsite inspection and its Risk Assessment Manual (RASM) to develop specific procedures for the review of the banks' internal risk management frameworks, including practices and internal audit function program associated with concentration risks.

d. ***Update of the Guidelines on large exposures.*** The BNB's guidelines on large exposures (based on the respective CEBS' guidelines) will be reviewed and updated as per the new regime being prepared by the EBA, whose proposed guidelines for connected clients were to be available for public consultation since end-October 2016. The enhanced guidelines will be used to provide adequate instructions to the industry, including the experience accrued from the AQR and the

[31] The BSD indicates that the findings of the AQR did not provide indications of significant under-reporting of large exposures (set at the standard 10 percent level of regulatory requirement) and that, in general, there were no material discrepancies identified in the reviews. Notwithstanding, the BSD fully understands that having followed the ECB methodology, the analysis of economic interconnectedness was not the focus of the recently conducted AQR, and further ongoing efforts are advisable.

targeted inspections currently underway. This effort will expand, as necessary, the criteria for establishing connections, including additional indicators beyond formal ownership factors.

34. In addition, the BSD is considering a number of possible actions to strengthen the supervisory regime for Concentration Risk and Large Exposures. This may consist of a set of four actions currently under consideration, including: (i) imposing a general capital charge under Pillar 2 capital based on an index for sectorial and individual/unit risk counterparties;[32] (ii) imposing an additional individual capital charge under Pillar 2 to banks suspected of exceeding the large exposure limits, including those with identified material deficiencies in their internal concentration risk management frameworks for investigating and flagging interconnectedness; (iii) expanding the scope of Article 45 of the LCI, both in terms of counterparties as well as in terms of transactions and methodologies; this would include as well communicating to banks the means and control systems required to avoid circumvention of prudential regulations through schemes that obscure ownership and control; and (iv) updating the RASM by devising to identify connectivity between parties; for example, by data-mining the information obtained from the AQR in combination with the monthly corporate data set currently reported by banks.

Related-Party Risks (Core Principle 20)

35. Background. The March 2015 BCP assessment provided three key recommendations to strengthen the supervision of risks from related-party transactions: (i) define in guidelines or in regulations the types of transactions that give rise to related-party exposures; (ii) enhance surveillance of such transactions across the industry through thematic inspections; and (iii) provide recommendations to the industry to be more diligent in identifying their customers' ultimate owners. These recommendations stemmed from the absence of specific provisions in the LCI and the BNB's Ordinances regarding a number of relevant standards.

36. The BNB intends to adopt a number of measures to strengthen compliance with the above recommendations once the AQR has been finalized.[33] The BNB will first evaluate the convenience of amending Article 45 of the LCI to strengthen the definitions of related parties and transactions, and the terms and conditions for their approval. Second, based on its understanding of the situation and on the AQR results, the BNB intends to develop a concrete set of guidelines in order to communicate to banks the diversity of inappropriate practices seen in order to circumvent ownership and other control standards. Third, the BSD will also update its risk assessment procedures in terms of identifying interconnections and relatedness, and will also develop a

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[32] The use of the Herfindahl-Hirschman Index (HHI) is a generally accepted measure of concentration risk discussed with the mission by reference to similar treatment in another SSM country.

[33] Except for a number of transactions flagged by the service providers as "unknown" due to the difficulty in identifying the ultimate beneficial owner of borrower entities located in offshore centers, the BNB indicates that the related-party exposures identified during the AQR would not seem to be relevant to significantly altering the risk profile of the banks, for which the aforementioned officially reported transactions continue to be within prudential limits, notwithstanding the fact that the AQR was not explicitly designed as a forensic exercise. These transactions are currently under investigation through standard supervisory procedures including under the inspections that will conducted under the 2017 plan already adopted.

dedicated examination work program to review related-party transactions and the banks' dedicated risk management frameworks, with the intention of using these during thematic line reviews. Guidelines and examination programs will be subsequently adapted to the incoming revision of the EBA's guidelines on large exposures. The BNB is also evaluating the possibility of imposing additional capital requirements for actual or suspected breach of limits and material control gaps.

37. This plan of measures is welcome and should be implemented as soon as possible to mitigate any residual transparency risks regarding related-party transactions. Among other possible complementary measures, the BNB could consider the following concomitant activities suggested by the stocktaking mission.

a. Adopt a consistent strategy to systematically identify the risks involved with reference also to the volume of suspected transactions, inadequate practices, and unreliable controls and systems that should be subject to in-depth, enhanced investigation by means of dedicated resources.

b. Review its presumptive powers to officially declare suspected transactions as related-party transactions using a set of publicly known criteria for presumption (see Appendix III).

c. Seek the development of legal interpretation, and the necessary litigation practice, for shifting the burden of proof to bank's management subject to an executive rebuttal process.

d. Compile the underlying typology of circumvention practices being observed to create a set of warning signals that enable the implementation of the above suggested criteria.

e. Continue its efforts with service providers to develop profiling tools for data mining existing information, including to enable a database of relatedness and connections, as deemed practical.

f. Specify by ordinance or supervisory guideline, the expected *de minimis* components the BNB wishes to see in operation as part of a 'banking group and related-party' risks management contention program.

g. Develop terms and conditions to require risk exposure reduction plans, including through deduction from capital of material risk concentrations or the imposition of additional Pillar 2 requirements.

38. In parallel, or as an alternative to the above suggestion, the BNB should consider formally regulating the Article 45 of the LCI on related-party transactions. Based on its powers under Article 16.5 of the BNB's Law, the Governing Council may specify binding regulations rather than establishing guidelines. This should include to specifying the meaning of Article 103 of the LCI on Supervisory Measures regarding the unsound and unsafe practices seen in previous cases, where banks have circumvented existing regulations, used fictitious persons to by-pass regulations, or both, therefore setting clear presumption criteria on the lines suggested by the mission in Appendix III.

Country and Transfer Risks (Core Principle 21)

39. Background. The 2015 BCP assessment found a series of flaws in the current regime for country and transfer risks. Even though a regulation on country and transfer risks is still missing, the following aspects in current BNB practice should be underscored.

40. The BNB is paying close attention to the risks associated with cross-border exposures. The adoption by the BNB's internal ICAAP manual identifies the cases under which country and transfer risks must be examined in order to supplement the supervisory view on credit risk. When a bank conducts significant operations in other countries (with a high share of foreign assets), it shall also consider the risks associated with these operations, such as country risk and transfer risk.[34]

41. In addition, the Offsite Supervision Directorate receives written information on a regular basis from the Macroprudential and Financial Stability Directorate regarding country and other risks related to subsidiaries of foreign banks as well as to the parent company. An example of this is the concern that arose from the political and economic situation in Greece, Italy, and Turkey, which led the directorate to inquire for additional data from banks on their exposures to these three countries. The degree of concentration within sovereign exposures to Italy, Greece, and Turkey in proportion to the whole institutions' credit portfolio was assessed. Also, for banks that report loans granted by their foreign branches, the transfer risk linked to cross-border foreign currency lending and the exposure in foreign currencies was found immaterial. The outcomes of these assessments were shared with the BNB's senior management in quarterly reports.

42. Other measures that would improve country and transfer risk surveillance are being considered. A revision of the BNB's internal manual for the SREP is envisaged in order to adapt and harmonize the prescriptions outlined under the EBA guidelines on the SREP, with the applicable practices by the BNB. In that regard, and as a response to the 2015 BCP recommendations, the BNB is envisaging drafting more detailed requirements regarding the management of exposures and instruments that carry sovereign risk. It is also noteworthy that, as part of the macroprudential stress test, banks include sovereign risk in their capital assessment.

B. Bank Governance and Risk Management[35]

Bank Governance (Core Principle 14)[36]

43. Background. Despite the quality of the BNB's policy awareness of corporate governance (CG) in banks, it was observed in the 2015 BCP report that CG practices in the banking sector are still in the process of transitioning toward international good practices and require closer attention and,

[34] The share of loans extended in foreign currencies can also serve as an indication of concentration risk. If this CP 11 share is very large, movements in currency prices could affect the credit quality of clients.

[35] This topic refers primarily to Principle 14 (Corporate governance) and Principle 15 (Risk management) which were assessed Materially Non-Compliant and Largely Compliant, respectively, in March 2015.

[36] See the technical note prepared by Mr. Jean Michel Lobet on Bank Corporate Governance for an exhaustive coverage review of the status of this essential thematic component.

possibly, deepening of the skillset by the BNB. In light of the discussion with the BNB staff and the industry, it appears that limited progress has been achieved so far in this field, and that further efforts are still to be made, including to provide a more structured approach to its assessment and guidance for supervisors to perform this assessment consistently.

44. The revision of the LCI has expanded the BNB's power to require changes in the Board's composition, but questions remain on its scope. It is indeed unclear if, according to the revised Art. 103 paragraph 2 of the LCI, the BNB has the requisite powers to require changes to a Board's composition where an individual or individuals have failed to discharge their responsibilities effectively. The text does not explicitly cover this option.

45. The necessary revisions to the BNB's secondary regulations to foster CG risk management in banks are still pending. The BNB is fully aware of the necessity to refresh Ordinance 10 (on internal control) to elaborate more clearly on the BNB's requirements and expectations in the field of CG. In that regard, the BNB has held meetings with the Association of Internal Auditors to discuss amendments to be made to Ordinance 10. In addition, the BNB issued a note to the industry to remind of the need to comply with the existing EBA guidelines on internal governance. Regarding the specific issue of legal protection for individuals who notify the BNB if there are material issues that would affect the fitness and propriety of the Board member or member of senior management, the BNB is awaiting the publication of the upcoming EBA guidelines on that matter. The same holds true for Ordinance 20 regarding the fit-and-proper requirements for Board members.

46. Onsite monitoring of CG-related risks is still needed, but the AQR exercise will provide good insights on banks' practices. In 2015, the BCP assessors observed that greater frequency of corporate governance assessments was needed and recommended to perform a horizontal review. While the AQR's objective was to focus on credit exposures and necessary capital adjustments, the exercise provides a unique system-wide view on current risk management (RM) practices, not only in relation to credit risks but also to other related issues like corporate governance practices. The mission is of the view that many lessons can be drawn from this exercise to deepen the RAS Manual and ICAAP process. The BNB indicated the Onsite Inspection Directorate is in the process of amending its manual in accordance with the EBA SREP Guidelines, part of which will be a new process, and procedures to assess corporate governance.[37]

47. Closer contacts with banks' Boards have been established during the AQR process, and this good practice should be pursued going forward. The AQR has given the BNB an excellent opportunity to establish an ongoing dialogue with senior management and Board members on a wide range of issues, including the AQR process, findings, and action plan to achieve capital surplus

[37] The mission understands that as part of the review of the Onsite inspection manual to adapt the risk assessment to the EBA's standard (EBA/GL/2014/13), the Management component under CAMELOS is to be transformed into an assessment of Internal Governance and Controls that will differentiate five core elements (board, management and controls, risk management, internal audit, and compliance functions), including that these elements will be individually risk assessed and scored following standards consistent with those set by EBA.

for a few banks. Even though CG-related issues were not the focus of the discussion, the problems identified in relation to accounting and impairment policies and procedures reflect the need to increase Board's surveillance. In that regard, the mission reiterates the need to institute systematic senior level contact between the BNB and the banks' Boards to reinforce priority messages, deepen the overall assessment of the Boards' qualities and capacities, and, as necessary, to challenge the banks.

Risk Management (Core Principle 15)

48. Background. The March 2015 BCP assessment provided four key recommendations to strengthen the supervision of risk management (RM)**:** (i) to review the proportion of resources dedicated to assess risk management in the onsite programs; (ii) to consider horizontal reviews to evaluate the state of risk management in the banking sector; (iii) to revise Ordinance 10 to confirm and enhance supervisory requirements; and (iv) to review the RAS Manual providing to inspectors greater guidance to test the quality of RM within firms and reflect their findings in their overall analysis, ratings, and supervisory actions.

49. To improve conformity with CP 15, the BNB has initiated the following activities:

a. ***Reinforcement of staff*** – After the separation of the Onsite and Offsite activities in 4Q15 into two different Directorates, their respective head-count is being expanded and recruitment has already started.[38] Onsite and offsite assessments combine the review of risk management as per the current risk assessment manual that is being updated in line with EU practice. The teams are reported to be dedicated to risk management issues, especially due to the implementation of the AQR and inspection plan for 2016.

b. ***AQR and 2016 inspection plan*** – The first Work Block 1 "Processes, policies and accounting review" (PPA) of the AQR has performed a simultaneous in-depth assessment of the banks' internal policies, procedures and processes, including internal controls and governing asset impairments. In addition, there are three targeted onsite inspections in progress focusing on a suite of risk management issues (market, operational and related party risks). The 2016 plan of target inspections is expected to cover about half of the banks in the system.

c. ***Risk manual reviews*** – The BSD has set up a team dedicated exclusively to: (i) update the current risk assessment manual and the procedures for onsite inspections; (ii) calibrate the benchmarks and proxies used for scoring risks and management and controls for input in CAEL-

[38] Increase of four staff in the Onsite Directorate from 23 to 27 staff already achieved with an overall target headcount of 43 inspectors organized into six teams. And, increase of 4 staff in the Offsite Directorate from 11 to 15 staff, already achieved, with an overall target headcount of 18 inspectors organized into four teams (Box 1).

CAMELOS;[39] and (iii) align the manuals of offsite and onsite inspection to changes in the above.[40] This work is to proceed in close coordination with the update of the Supervisory Review and Evaluation Process (SREP) of BSD, including of its Pillar 2 approach.[41]

50. The stocktaking mission welcomes this plan of measures, which should continue to be implemented with a view to advancing full compliance in the following quarters. Among other possible complementary measures, the BNB could consider the following concomitant activities as essential aid:

a. Completing the staff recruitment plan as a priority that needs to focus on creating a minimum body of risk specialists in key banking disciplines such as IT, statistical experts to support the team responsible for the review of internal models, and key risk control disciplines.

b. Advancing training of new and existing staff in risk management, which needs effort to acquire a suite of training tools using all possible means, such as class lectures, professional books and publications, field work assisted target onsite reviews, and online certified program acquisition.

c. Design the changes to the risk assessment manual and CAMELOS, so as to guide supervisors through a well-structured risk assessment program that properly visualizes for each risk its drivers, the intermediary and proxy indicators to approximate their quantity, and the target risk management, and control elements that focus on assessing their quality (reliability, effectiveness, integrity).

d. Set up as soon as possible the basic policies and procedures to implement the Pillar 2 procedures and its outcome in intimate relation with a formal response and escalation policy.

C. Supervisory Activities[42]

51. Background. The March 2015 BCP assessment provided 10 key recommendations to strengthen the supervisory approach and its techniques and tools. The two CPs dedicated to supervision activities were rated Largely Compliant by the assessors, who noted the overall reliance on onsite inspections as the key tool for supervision, notwithstanding the lack of sufficient resources to conduct a fully effective supervisory program, especially regarding IT examination capacity. The

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[39] The calibration of the benchmarks and proxies used for scoring risks and management and controls for input in the risk assessment is planned to start soon as a joint project of the four key Directorates of BSD (Offsite, Policy, Macro Prudential, and Onsite Inspection). Preparatory work shared with the mission included the initial expanded set of indicators under discussion.

[40] The stocktaking mission sees this as an essential activity to refining the integrity and reliability of CAMELOS as a forward-looking indicator of banking problems and the essential input for escalation and response, including Pillar 2 approach.

[41] Drafts are being planned for finalization during 1Q17 and were not available for review by this mission.

[42] The discussion of principles in some instances includes those assessed in March 2015 as largely compliant due to their centrality for the overall effectiveness of banking supervision (e.g., Principle 8 (Supervisory Approach) and Principle 9 (Supervisory Techniques and Tools).

BSD now reports ongoing progress across the board regarding the said recommendations, noting the structural changes accomplished in the organizational structure of the department. After the finalization of the time-pressing AQR, the BSD expects that progress in implementing the dedicated measures within its Plan on Reforms and Development will flow at a more fluid pace in the following quarters (Table 2).

Table 2. Status of Recommendations—Supervisory Approach, Techniques and Tools (CPs 8 and 9)

Summary Recommendation	Summary Status Reported
Complete resolution assessments after transposing BRRD.	Foreign banks in draft form (local to be started)
Refresh the internal crisis management framework.	Supervisory Process Manuals being updated.
Improve information sharing across directorates of BSD.	Cross communication directory ("ALL DIR") established.
Initiate communication with banks' boards.	Key Directorates started a contact program.
Ensure that inspection teams do not remain static.	Rotation practices have been adopted.
Introduce quality assurance procedures (QAP).	A three level QAP in place, and credit card test.
Carry on horizontal reviews and communicate findings to banks.	System wide AQR performed in 2016.
Consider the use of external experts to support supervision.	Permitted through LCI Art. 80 ¶3.4 amendment
Upgrade systems and enable their integration for querying data.	Public procurement IT review being launched.
Set a committee to review supervisory processes and practices.	To be performed by the AC to de DGS.
Require banks ex ante notification of substantive changes.	Practice being achieved by Offsite Directorate.
Source: March 2015 BCP assessment.	Source: BSD's briefing as October 2016.

52. The stocktaking mission sees additional opportunities to ensure that the measures being implemented allow time to achieve full compliance with the relevant standards. Achieving such purpose is an ongoing process where the adoption of a detailed multi-year action plan will help to lead and monitor the progress in the overall targets of the BNB's plan of reforms.[43] To achieve the overall objective, the stocktaking mission believes that the BSD could consider a number of concomitant measures to rationalize the numerous demands from management and the staff, including from associated memberships to the European forums, as well as from the internal and external public pressure to deliver change. The stocktaking mission sees the role of the weekly

[43] The Table of Key Measures of the Plan could be made more granular by using a more detailed template that could be anchored in the detailed recommendations of the March 2015 BCP assessment in a manner that imitates Table 2, with adequate Project Management Organization (PMO) tools (activities, timing, responsibilities, output, etc.).

Advisory Committee (AC) to the DG as the central locus to lead strategic change, as well as to set reasonable time-bound targets for monitoring progress, including by considering the following suggestions that could be factored into the multi-year action plan suggested:

a. Formalize the role and objectives of the AC, bifurcating operational from strategic issues;

b. Dedicate one session of the AC periodically (say, one per month) exclusively to strategic issues;

c. Select the agenda of key strategic themes to move forward (see paragraph 57);

d. Reasonably estimate the needs from the work load associated to the supervisory approach;

e. Develop a human resource management plan, including curriculum and remuneration policies;

f. Adopt a method to communicate supervisory risks to the GC based on risk ratings;[44]

g. Adopt a process to assess how supervisory responses mitigate, contain, or resolve identified risks;

h. Adopt an objective Pillar 2 capital risk regime, considering progress per the above;

i. Develop a number of software tools to support and integrate the supervisory process;[45]

j. Review current key risk indicators for assessing risk quantities and the regime for their use;[46] and

k. Update supervisory manuals to the decisions on the above strategic themes, *inter-alia*.[47]

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[44] For example, using a tool to combine the risk profile (CAMELOS) and the possible systemic impact of each institution in order to: (a) inform the risk tolerance of the GC/DGS, (b) administer the response and escalation stance of the BNB; as well as, (c) guide the internal allocation of supervisory resources and the selection of activities per the indicated engagement model.

[45] For example: (a) an electronic package of onsite inspection working papers with upload and persistence features for continued use during multiple ongoing examinations, (b) a tool to manage the risk assessment and scoring process to administer efficiently the SREP—which could contain a number of user-designed features, such as the overall score and its components, allowing for continued refreshing along the cycle while controlling for the dates of the update, the type of supervisory activities per the selected engagement model, as well as triggers and warnings regarding updates for completion, inter-alia, and (c) technical interface capability for onsite inspectors to be able to access the BNB's server while engaged in onsite inspections for them to be able to consult the BNB's relevant databases and supervisory information offsite.

[46] Develop benchmarks for the key risk indicators (KRIs) to provide an entry note for each risk, including stress ratios and proxy forward-looking indicators, setting a regime for "modulating" the initial risk score (up or down) based on substantive judgment, and centralizing the responsibility and quality assurance for the risk rating, among other key related aspects.

[47] The stocktaking mission believes that the BSD would like to avoid a dual rating process based on different frequency methods (a quarterly offsite CAEL and annual onsite CAMELOS). There should be only one rating that is refreshed periodically through a combination of supervisory activities, whether conducted onsite or offsite, rather than competing risk assessments and ratings, especially given the reliance of CAEL on backward bank reported information rather than using forward-looking indicators or risk accumulation, such as those qualitative early warning signals provided by management and control gaps.

53. The formalization of sampling policies and tools can result in efficiency gains in onsite inspections. Loan coverage during inspection is high in general, given the concentrations in the loan portfolio and sampling has not been actively used. The mission foresees opportunities in formalizing sampling policies including for: (a) relating portfolio coverage to the scores assigned to the reliability and effectiveness of management, controls and MIS in the area; (b) using attribute sampling to specify levels of supervisory tolerance to failures in the controls operating in a concrete area or bank activity, and (c) supporting the resource allocation decisions by resorting to third party reviews paid by the banks for selected areas, under terms of reference and control of the BSD, when the level of errors identified exceed the policy thresholds adopted by policy.

54. The mission sees a number of additional strategic themes where the orientation of the supervisory approach could warrant further consideration. The strategic direction adopted would be a necessary *ex ante* input to realign the supervisory process and its implementing methodologies and manuals, for example, to internalize in Bulgaria the EBA's SREP guidelines (EBA/GL/2014/13) in a manner adapted to the risk profile of the financial system and the resources available to the BNB.[48] A number of relevant strategic themes foreseen by the stocktaking mission would include the following:

a. The possibility of bifurcating the supervisory model for local subsidiaries of well-rated EU banking groups (presumably, with better corporate group systems and control functions, including overall reliability of internal governance), which probably could be less dependent on intensive onsite activities (only if current risk assessments warrant this change);

b. The possibility of risk focusing the onsite inspection supervision model for local banking groups of relatively different reliability in internal risk governance and other key essential control functions, in order to require improvements that are 'costed' via their profit and loss account;[49]

c. The adoption of means and processes to formalize supervisory strategies for each type of bank and industry segment, including template reports and follow-up procedures, with sufficient resources to allow in-depth monitoring onsite of the effectiveness of internal governance measures that are adopted;

d. Means to accommodate incremental work-load to the development of tools in progress, such as the use of service providers for ad hoc specialized reviews or assisted inspections;

[48] Given that the intensity of the activities of the supervisory model chosen determines the need for resources, including of specialized skills and tools, as well as the continued professional development of the staff and other retention policies.

[49] Additional budget invested in risk management, internal audit, compliance, and (financial) controls, including external auditing, which would 'reveal' the lack of viability of their business model, including to 'save' the BNB from the need for overly frequent and intrusive onsite inspections to make up for the lack of reliable internal controls and governance.

e. Formalization of an internal supervisory escalation policy and response regime;

f. Improvements needed in the risk-assessment process and guidance to ensure a granular view of the qualitative reliability and integrity of key building blocks of internal governance[50]; and

g. Tracking progress in continuing the institutional development of the BSD, for example through a number of selected targets built around the suggested multi-year Action Plan, including to keep a reasonable update of the BSD's internal self-assessment of compliance with the BCP, to select the best possible moment to submit for a formal update, including all of the Basel Core Principles.

D. Asset Classification and Provisioning[51]

55. The March 2015 BCP assessment provided two key recommendations to strengthen the framework governing problem asset and provisioning.[52] These included to: (i) assess and be ready to operationalize the Pillar 2 for banks demonstrating weaknesses in respect of problem exposures; and (ii) consider the use of horizontal reviews of the state of NPL management. While a Pillar 2 policy and approach remain to be developed, the comprehensive AQR, recently finalized, largely assists in fulfilling the two recommendations and provides also the basis for completing the designing of a compliant Pillar 2 approach, as well as to better comply with the CP standards through active and effective implementation.

56. The 2016 AQR has resulted in a quantification of asset provisioning deficits due to a number of IAS 39 implementation issues (Box 1) when applying IFRS. Following the ECB policy, the BNB has decided to allocate a number of provisions and adjustments via impairments through the Profit and Loss Account, basically, when they arise from issues unrelated to discretional parameters or supervisory decisions. Part of the adjustments have been generally allocated as Pillar 2 additional capital requirements and will be dealt with as part of the incoming SREP update.

57. The BSD has adopted bank-specific measures following the AQR as per the risk profiles identified. Seven banks with minor asset quality issues have been recommended to enhance their credit risk management procedures, recalibrate their collective provisioning methodologies, and asked to review their business models. In turn, the three banks that experienced higher impact adjustments are implementing a plan of remedial actions under formal orders issued by the BSD. These orders include an extended set of actions, targets for explicit loan work out,

[50] For example, the stocktaking mission would think that the risk assessment methodology for the "management" component under CAMELOS would need to be further detailed by differentiating the multiplicity of elements now captured, into a number of key components such as the Board, management and controls, internal audit, risk management, and compliance.

[51] This topic refers to Principle 18 (Problem Assets, Provisions and Reserves) assessed as Largely Compliant in March 2015.

[52] As a result of the adoption of the CRR, the BNB repealed in 2014 its Ordinance 9 on loan classification and provisioning, and the banks follow now the relevant accounting and supervisory standards as per the EU legislation (IAS 39 for loan impairments and FINREP for prudential reporting, *inter-alia*, including the EBA' ITS on forbearance).

provisioning, and capital conservation measures. The mission welcomes these measures and encourages close follow-up of the risk-mitigation activities that should be verified through the already adopted 2017 inspection plans. In conjunction with a comprehensive strategy, the BNB should be ready to escalate its supervisory intervention stance.

Box 1. Asset Quality Review (AQR)

As part of the Bulgarian Comprehensive Assessment (CA), the BNB conducted during 2016 an AQR and a stress test (ST) exercise of critical value, both for public communication and as a supervisory tool. The final results of the CA were made public in August 2016. The methodology used in the AQR has been communicated through a number of public BNB Circulars and follows largely the one promoted by the ECB, with a number of minor deviations. Some of the most relevant features of the AQR include:

- Larger than usual coverage due to target sampling, including of possible related-party transactions;
- Possibly more discretional collateral valuation to account for local market characteristics;
- Relatively lower disclosure compared to the ECB (e.g., less detailed breakdowns of adjustments);
- A well-crafted PMO and QA process with ultimate oversight on behalf of the BNB's CMPO by Deloitte & Touch.
- Participation by representatives of the EU's DG Commission and EBA as members of the steering committee.
- Rich, well organized, auditable working papers documentation, as per the mission's cursory review; and
- A final long report of the service providers for each of the banks reviewed, including follow-up suggestions.

The AQR resulted in aggregate adjustments, as per IFRS accounting policies, of BGN 665 million to be reflected in the banks' financial statements as of December 31, 2016, after taking into consideration events after December 31, 2015. The BNB has requested recovery plans for three banks whose CET1 was ikely to fall below the minimum buffers, aimed at restoring minimum capital buffers by June 30, 2017 at the latest. One of the banks has already restored the coverage of its buffers by raising the needed capital, and two others are subject to capital raising plans.

The AQR has largely achieved its purpose and it is now being followed up with remediation orders addressed to specific banks monitored through *ad hoc* offsite reports as well as through a broad program of inspections for 2017.

Besides monitoring the recovery plans presented, including refining the details of the concrete actions by the banks in terms of recovery measures, a major task now being undertaken by the BNB is to calibrate its Pillar II policies, processes, and capital buffers. This is expected to take into account the results of the projection of findings and ST results regarding sustainability of business models, as well as the degree of conservatism of collective provisioning and collateral valuation in gone-concern nonperforming corporate loans.

58. Besides its relevance to inform the SREP and feed into the respective Pillar capital requirement, the AQR also provides rich information regarding the current industry practices in implementing IAS 39.[53] While a systematic compilation of such practices and gaps was not readily available for the review of the stocktaking mission, it is clear that the BNB's intention is to use the information acquired to enhance the supervisory process. As an example of possible activities, the following stand as needed:

a. Expanding the scope of guidance (internal/external) and dialogue on implementing impairment accounting principles in practice, notably to prepare for the introduction of IFRS 9;

b. Using findings from the AQR to build the above guidance; e.g., collective provisioning, enrich the corporate database;

c. Enhancing NPL reporting on interest performance (accruals vs. cash interest) for FINREP 19, including through the use of the corporate database);

d. Once adopted, using the SREP more actively to set supervisory target thresholds for provisioning;

e. Providing supervisory guidance for write-downs and to start up market price discovery; and

f. Further training the BSD's staff for IFRS 9 and starting a systematic dialogue with banks and auditors.

E. Other Relevant Core Principles[54]

Financial Reporting and External Audit (Core Principle 27)

59. Background. The March 2015 BCP assessment provided three key recommendations to strengthen the framework of external auditing, including overall understanding of IFRS: (i) ensure the BNB's ability to change and rotate auditors, as well as to gain access to their working papers; (ii) establish a framework for regular dialogue with the audit professionals, including on implementing IFRS 9; and (iii) perform a skills mapping and needs assessment for BNB staff in respect of understanding the IFRS.

60. A series of actions are envisaged to achieve compliance in this domain. First, when approved, the draft Statutory Law on Audit before the parliament will require compulsory rotation of the audit firm every seven years and reduce the term of rotation of the audit partner from seven to

[53] For further guidance on these suggestions, see the technical note on "Nonperforming Loans Reduction Strategy," prepared by Gerald Edwards Jr.

[54] This topic refers primarily to Principle 27 (Financial Reporting – External Audit) and Principle 29 (Abuse of Financial Services), which were assessed Materially Non-Compliant and Largely Compliant, respectively, in March 2015.

four years.[55] In addition, the BNB told the team that it has banned a major audit firm and objected recently to an auditor's nomination.[56] However, the BNB is still lacking explicit powers to gain access to the audit documentation and working papers. Second, the BNB intends to comply by March 31, 2017, with the upcoming Guidelines of EBA on communication between competent authorities and auditors. Finally, and in connection with the AQR, the Supervisory Policy Directorate has developed a series of IFRS memos for the staff on key topics, including addressing a number of issues presented by the AQR service providers and banks.[57]

61. The actions undertaken are valuable steps to meet the objectives of this relevant core principle and to assist the BNB to achieve effective implementation of its conditions. To further the implementation of the EBA's Communication Guidelines, the stocktaking mission foresees a number of practical implementation activities that could enhance the "value" of external auditing for prudential supervisory purposes, including to:

a. Provide further relevance to the 'external audit function' by singling out the assessment of its reliability and effectiveness, considering it as part of an identified component within the risk assessment.

b. Ensure that banks' supervisory Boards and Audit Committees properly understand the relevance of the audit function for systemic stability purposes, and systematically grant access to the BNB's supervisors to the audit engagement and work plan, ex ante, as well as to management's letters and working papers, ex post, for risk assessment purposes.

c. Select a number of proxy indicators to approximate a measure of the intensity and effectiveness of the audit programs in order to support their risk assessment.[58]

d. Conduct every year a formal meeting with the audit firm of each bank to discuss issues of supervisory relevance and the auditor's views regarding how the audit contract and plan cover the relevant respective considerations.

e. Host an annual meeting with the audit professionals to discuss key ongoing and nascent topics (e.g., IFRS 9 implementation) and to provide overall guidance indication of supervisory policy regarding asset valuation and revenue recognitions issues.

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[55] A major contentious point is the political pressure to maintain a dual auditor construe as a reaction to the failure of KPMG to warn of the internal control issues in the case of the failed bank KTB.

[56] Using its authority under the LCI Article 76, paragraphs 4 and 6.

[57] A series of notes (copies available in Bulgarian) have been developed as a practice cheat sheet cards including a number of key topics regarding the implementation of IAS 39 ranging from impairment triggers, cash flow determination, as well as collective provisioning practices. These memo notes are currently only available in Bulgarian and will be followed in the future with other essential IFRS topics to provide detailed practical guidance to the staff.

[58] For example, *inter-alia*, overall non-audit consulting billing; overall cost of the audit engagement; total hours of audit staff billed (junior vs. senior); overall reliance on bank controls and internal audit, and scope of substantive testing; and adequacy of the opinion captured in the working papers regarding the effectiveness of controls.

f. Review the structure of the long report format being used to focus on key areas, for example, on the detailed opinion on the internal controls captured in the working papers, the results of attribute testing to confirm their reliability of the former, the scope of IT issues, and operational risk aspects.

Abuse of Financial Services (Core Principle 29)

62. **Background**. In 2015, BCP assessors identified several areas where further progress was deemed necessary. The then Special Supervision Directorate (SSD)[59] originally set up for AML/CFT oversight had been assigned too many activities that were not related to supervision, including transparency of banking products. In the assessors' opinion, this did not ensure proper allocations of resources and distracted the SSD from its core mandate. There was also limited cooperation and information exchange between the Supervision of Credit Institutions Directorate and the SSD. AML/CFT issues were not integrated into the overall supervisory review and evaluation process. No sanctions had been applied by the BNB for AML matters and very few by the FID. Banks' practices to establish the true identity of their customers, especially for legal entities located overseas with undisclosed UBO, were also found to be questionable. In the wake of the BCP mission, several initiatives have been taken by the BNB in order to address these issues, while other aspects remain to be resolved as discussed below[60].

63. **Changes in the structure of the Special Supervision Directorate allow a greater focus on AML/CFT supervision**. With the creation of AMBRU, there is now a clear segregation within the same department between consumer protection-related work on the one hand and AML/CFT oversight on the other. The name of the unit was also changed to "AML and Other Specific Supervisory Activities" to emphasize the tasks entrusted to the AML/CFT Unit. In addition, the name of the SSD was changed to "Specific Supervisory Activities" (SSA) to avoid any confusion with the special supervision regime under the Law on Credit Institutions, as recommended by BCP assessors.

64. **The SSA's manpower has also been increased to ensure adequate administrative capacity for the AML/CFT supervision**. AMBRU has been staffed with four specialists, including two staff who previously exercised AML duties, and an increase in the staff number to six is being considered to cope with additional workload on increasing the transparency of banking products. Concomitantly, in order to ensure adequate capacity for integrity-related activities, the headcount for the AML/CFT Unit has been almost doubled from five[61] to nine, mostly via external recruitments.[62] By assigning non-AML related activities to a specific unit (AMBRU) and increasing the manpower, the BNB allows the SSA to better exercise its core AML mandate.

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[59] This directorate has been renamed Specific Supervisory Activities (SSA).

[60] According to the authorities, the BNB managed to obtain all necessary information in relation to these companies and that they are no longer worried about transparency in these banks.

[61] Seven people were assigned to AML in 2015, but two of them were remapped to AMBRU in 2016.

[62] One staff has an academic background, while the other three possess AML experience in banks.

65. In terms of AML/CFT internal processes, other improvements are being made; however, at a slower pace. An important reform in this regard concerns the newly established advisory council to the deputy governor for supervision, which consists of all the heads of the directorates, including the one in charge of AML. The meetings are an opportunity to discuss in a collegial manner integrity concerns, changes in shareholders' structure, outcomes of AML inspections, and corrective measures. The SSA is also in the process of revising the AML/CFT oversight methodology to reflect latest changes in the EBA guidelines and in the fourth EU directive on AML/CFT (adopted in May 2015), which will lead to a revision of the Bulgarian AML law. One of the most prominent features will be a definition of the UBO that is consistent with the EU directive, which is still imperfect in the current law.

66. A few issues remain to be addressed, in particular in the area of onsite and offsite work. As observed during the BCP assessment, the onsite inspection for AML/CFT purposes is still being performed together with the monitoring of business practices in the area of consumer lending. Even though the two teams may intervene in different locations and not interfere with each other, the outcomes of the two work streams are consolidated into a single inspection report, which is quite unusual as observed in 2015. The BSD indicates that the findings of AML inspection are communicated to both the Onsite and the Offsite Directorates and therefore reflected in the CAMELOS rating.[63]

67. The identification of the UBO is still a challenge for banks. To start a relationship, banks request their customers to provide a number of documents (Article 6 of the AML Act) which, for a legal entity, include the certificate of incorporation and a list of the registered shareholders. The BSD indicates that, as a last-resort procedure, once all other alternative means have been exhausted, the banks can request the applicant to complete a simple declaration. Then, the bank compares the information provided with the trade registry. The latter, however, only provides limited information like names of the companies, address, activity, and Board composition. There are no details on shareholders for joint-stock companies with more than one shareholder. Therefore, banks would appear to continue having problems identifying who is truly behind a legal entity.[64]

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[63] The inspection report is not shared outside the AML/CFT unit of the SSA because information on Suspicious Transaction Reports are confidential. As a result, SSA staff are prohibited by law to share this information even within the BSD.

[64] The mission would advise reinforcing this practice, inter-alia, by requiring an affidavit before a notary from an appropriate senior officer of the legal entity, including a declaration of UBO and related parties, as well as committing to provide to the bank all necessary information to comply with the AML provisions at any time. Perjury, falsehood, and lack of collaboration resulting from the affidavit declaration should be typified as a crime under the AML Law, including other possible actions to curtail unsound practices contrary to the spirit of the Act, including typifying the use of third interposed parties to circumvent the Act.

68. The enactment of the Offshore Law is an important step forward, but concerns remain with regard to transparency in ownership. The recent so-called "Offshore Law"[65] obliges offshore companies that participate (or intend to participate) directly or indirectly in a restricted entity[66] to register with the Bulgarian Commercial Register and to disclose their beneficial owners. In addition, these offshore companies are requested to provide the Commercial Register with information about all companies under their control that also participate in a restricted entity. While this law is welcome, the team is of the opinion that the current regime is more stringent on foreign entities and companies in terms of transparency obligations than on Bulgarian companies. In addition, other aspects remain a concern, such as the existence of bearer shares and the use of SVPs to obscure ownership.[67]

[65] Act for Economic and Financial Relations with Companies Registered in Jurisdictions with Preferential Tax Regime, their Related Parties and Beneficial Owners, July 2016.

[66] Restricted entities are companies operating in key economic areas where public funds are allocated, including in credit institutions, insurance companies, pension insurance companies, and telecom operators.

[67] The BSD indicates that the number of companies with bearer shares is very low, about 1,800 entities—a number that is seen as immaterial compared to the total number of registered companies.

Appendix I. BNB Supervisory Development Plan

Plan Reforms and Development of BSD	CP	BNB Status	Target	Themes and Focus	Mission Status
1 Governance Model	***Extreme broad concentration of powers and responsibilities in the DG-BSD***				
1.1 - Council's decision on rules & guidelines	CP2	Underway	1Q2017	Supervisory process, manuals and rating	To be approved [1/]
1.2 - Annual internal audit	CP2	Underway	Annual	The first annual audit has started in 10/16	On-going
1.3 - Quarterly report to Governing Council	CP2	Implemented	Quart.	Two quarterly reports already delivered	On going
2 BSD's Internal Organization	***Failed coordination and QA of controlling activities; lack effective communication***				
2.1 – New Offsite Directorate	CP2	Implemented	10/15	Directorate fully functional	Achieved
2.2 – Advisory council (AC) to Deputy Director	CP2	Underway	10/15	AC's mandate, role and functions pending	To be formalized
2.3 – Increase to "6" inspection teams	CP2	Underway	12/15	Teams formed but complete staffing pending	In progress
2.4 – Set Market Conduct Risk Division	CP2	Implemented	12/15	AML inspection segregated and operational	Achieved
3 Regulatory Framework	***Support Organization with improvement regulations for RBS***				
3.1 – Drafting legislative amendments	Several	Underway	03/16	Some amendments made, others pending	In progress[2/]
3.2 – Conduct full review of Ordinances	Several	Underway	2017[1/]	Reviews pending publication of EBA Guidelines	In progress[2/]
3.3 – Adopt BS SREP Manual aligned to EBA	CP8-9	Implemented	4Q17[1/]	SREP being drafted - Pillar 2 to be designed	In progress
4 CMG Framework	***Strengthen prevention and regulate failure resolution***				
4.1 – Set a Bank Resolution Directorate	CP1-11	Underway	2016[1/]	Directorate established but processes pending	In progress
4.2 – Specify framework of RRPs	CP1-11	Underway	3Q17 [1/]	Guidance and RRPs being developed and tested	In progress
4.3 – Set up rules for early intervention	CP11	Underway	4Q17[1/]	Response/escalation policies to be adopted	Pending

Plan Reforms and Development of BSD	CP	BNB Status	Target	Themes and Focus	Mission Status
5 IT and Communication Support (ITC)	***Significant improvement needed***				
5.1 – Select independent consultant	CP9	Underway	4Q16[1/]	Public procurement has been initiated	In progress
5.2 – Prepare independent ITC assessment	CP9	Underway	2Q17[1/]	To be performed once consultant is selected	Pending
6 Coordination & Information Exchange	***Among BDIF, SANS, MoF, FSCO, CPOSA***				
6.1 – Signing MOU with relevant agencies	CP3	Implemented	12/15	MoUs being implemented in concrete cases	Achieved

1/ Tentative list of amendments of LCI and Ordinances pending, including target dates for completion provided as indicative during the mission.

Note: The decision by the GC to approve key policies and procedures was adopted in 2015. The approval by the GC of the new Banking Supervision Process Manual is expected in February 2017. The approval of further policies and procedures will follow during 2017 as per the plans of the BSD, including new Onsite Inspection Procedures adopting most of the elements of the EU SREP process indicated in EBA/GL/2014/13.

Appendix II. Progress in Implementing Key Recommendations of the March 2015 BCP Assessment[1]

Recommendations of Assessors	Progress to Date and Observations	March 2015
CP 01 – Responsibilities, objectives and powers		**LC**
(1) Refocus the activities of the SSD	High- Achieved through the Plan on Reforms (PoR)	
(2) Empower BNB to request changes in organization/officers	High- Achieved through amendments to the LIC (art. 103)	
CP 02 - Independence, accountability, resourcing and legal protection		**MNC**
(1) Revise the internal governance design of BNB-BSD	High -- Achieved through the PoR (full effectiveness to be monitored)	
(2) Ensure Council is timely informed to take decisions	High – Achieved through new quarterly report (same as above)	
(3) Increase resource allocation, skill set and IT toolkit	Medium – Additional staffing in progress and IT review starting	
(4) Map skills and adopt a strategy to address any gaps	Low – Skills mapping pending and workload to be estimated	
(5) Ensure that BNB will cover legal costs of staff if needed	Low – BNB disagrees with the recommendation	
CP 05 - Transfer of significant ownership		**MNC**
(1) Empower BNB to address unsuitable shareholders	High- Achieved through amendments to the LIC (art. 103)	
(2) Require banks to notify material negative events	Low- Pending amendments of LCI	
CP 11 - Corrective and sanctioning powers of supervisors		**MNC**
(1) Set internal guidelines to assist decisions of the DG	Low – Enforcement policies to be drafted	
(2) Apply gradual response for lack of compliance	Pending – Based on recent examples as per AQR results	
(3) Take more forceful actions against persistent offenders	Pending – To be confirmed through further case practice	
(4) Broaden the grounds to initiate Special Supervision	High- Through the adoption of the RRL law (Response policy pending)	
CP 14 – Corporate governance		**MNC**
(1) Empower BNB to require changes of board members	Medium – Through amendments of the LCI but not yet used	
(2) Require notification of F&P issues (set protection means)	Low – To be confirmed (new wording article to be article)	
(3) Refresh Ordinance 10 with requirements and expectations	Low – Amendments pending to revision of EBA guidelines	
(4) Conduct more frequent assessments (horizontal reviews)	Low – AQR provides first insights to add-single thematic elements	
(5) Expand guidance in the RAS manual for assessments	Low – SREP and manual pending to adapt to EBA	

Recommendations of Assessors	Progress to Date and Observations	March 2015
CP 14 – Corporate governance		**MNC**
(1) Empower BNB to require changes of board members	Medium – Through amendments of the LCI but not yet used	
(2) Require notification of F&P issues (set protection means)	Low – To be confirmed (new wording article to be article)	
(3) Refresh Ordinance 10 with requirements and expectations	Low – Amendments pending to revision of EBA guidelines	
(4) Conduct more frequent assessments (horizontal reviews)	Low – AQR provides first insights to add-single thematic elements	
(6) Expand guidance in the RAS manual for assessments	Low – SREP and manual pending to adapt to EBA	
CP 19 Concentration risk and large exposures		**MNC**
(1) Conduct horizontal reviews	Medium - AQR conducted cross-findings to be communicated	
(2) Instruct the industry to set-up clarifying efforts	Low - Ordinance 7 to be updated to incoming EBA's guidelines	
(3) Take forceful measures for inobservance	Not Applicable - No cases detected have been indicated by BNB	
CP 20 – Transactions with related parties (RPTs)		**MNC**
(1) Define the types of transactions resulting into RPTs	Low – Article 45 of the LCI to be amended and further regulated.	
(2) Enhance surveillance across the industry	Medium – Design of AQR not meant as a forensic exercise	
(3) Recommend diligent identification up to UBO	Low – New definition of the UBO in the LCI pending	
CP 21 – Country and transfer risks		**MNC**
(1) Adopt regulation and include in stress testing	Medium – But definitive new attention being paid to sovereign risks	
(2) Implement EBA's guidelines into SREP	Low - SREP not yet revised including a detailed Pillar II regime	
CP 27 - Financial Reporting and External Audit		**MNC**
(1) Allow BNB to change auditor, rotate, access papers	Medium - Pending explicit powers to access key audit documentation	
(2) Enable framework for dialogue with profession	Low - No framework for annual meetings yet in operation	
(3) Map IFRS (9) skills and understanding in BNB	Low -Mapping, seminars and course documentation pending	

Appendix III. Proposed Official Presumption Criteria

The presumption criteria should rely on characteristics based on: (i) the nature of the relationships; and (ii) the features of the transactions. This, in addition to other red flags, may be formalized based on the broad experience accumulated by the BSD on the type of stratagems used by bank management and shareholders to circumvent prudential regulation, which should be added to this list as seen appropriate.

There are several attributes of the nature of relationships between counterparties, which, taken separately or in conjunction, lead to presuming that the participants in a transaction are related parties of the bank and are not interacting in an independent way on an arm´s-length basis. These attributes are as follows.

By nature of relationships

1. *Exclusivity*

1.1. No other financial institutions that are not related to the bank are lending to the party, and the amount and types of loans do not justify it from an economic point of view (e.g., not a mortgage for an individual to buy a house or consumer credit).

1.2. No credit history with other financial institutions that are not related to the bank (including but not limited to new companies).

2. *Economic dependence*

2.1. The party performs its business activities in an economic sector where the bank or its related parties play a very significant role (including ancillary activities).

2.2. The party gets all or most of its revenues from the bank or its related parties (including, but not limited to managers and employees of the bank and its related parties).

2.3. The party has no significant economic activity or revenues (including, but not limited to, offshore and shell companies, and figureheads).

2.4. The party is so interconnected to the bank or its related parties that economic failure of one or more of these would very likely imply its economic failure.

2.5. The party acts as a nominee mostly for the bank or its related parties.

3. *Common infrastructure*

3.1. The party has common or very close business addresses and locations (physical or virtual) with the bank or its related parties.

3.2. The party has common operational structural elements, such as IT systems and accounting, with the bank or its related parties (including outsourcing).

3.3. The party has common managers or staff with the bank or its related parties.

3.4. The party has common legal advisors with or powers of attorney conferred to or by the bank or its related parties.

3.5. The party has common suppliers, services providers, or customers with the bank or its related parties.

3.6. The loan officer of the bank for the party is also the loan officer for other related parties.

4. *Lack of transparency*

4.1. The ownership structure of the party is not transparent and/or its ultimate beneficiary owner (UBO) is not known or disclosed.

4.2. The ownership structure of the party is unnecessarily complex.

4.3. The party is not cooperative with the BNB in terms of clarifying if its relationship with the bank and its related parties goes beyond the single fact of being a borrower.

4.4. The country where the party is incorporated is not the same as where its main activity is located (including offshore companies) without economic or financial reasons for it.

By Nature of transactions

1. *Purpose of the transaction and use of funds*

1.1. The purpose of the transaction or the use of the funds does not correspond to the typical economic activity of the party (stated business).

1.2. The funds are not used for the stated formal purpose.

1.3. The funds are used, directly or indirectly, by related parties of the bank or on its interest (including but not limited to repayment of loans in other financial institutions, assets, purchases, and payments of services).

1.4. The use of the funds is not known or properly controlled.

2. *Documentation*

2.1. Essential elements of the general documentation of the transaction are missing or not available (including lack of documentation).

2.2. The available documentation does not reflect the real characteristics of the transaction.

2.3. The available documentation does not fit the specific needs of the transaction.

3. ***Underwriting Standards***

3.1. The transaction would not have been made in those terms by a diligent third-party bank (good banking practices), including, but not limited to the following situations:

3.1.1. Some underwriting standards are not present or are defined in an incomplete way.

3.1.2. The amount of the loan extended does not correspond to the scope of the debtor's activity.

3.1.3. There is a material disproportion between proceeds, tenor, terms, and conditions.

3.2. Transactions, the legal form whereof differs from their economic essence.

3.3. Parties have a contractual relationship involving the right to refuse their commitments to the bank (performance of determined conditions) and/or debt transfer to the bank's related party.

3.4. Establishment of individual terms and conditions of debt repayment for the debtor/counterparty, which differ from the current market conditions.

4. ***Indebtedness and Creditworthiness***

4.1. The loans cannot be expected to be repaid in time and form, given the party creditworthiness and its available repayment sources (e.g., loan amortization compared to regular income for individuals and to average EBITDA for corporate).

4.2. It cannot be expected that the loans will be repaid in time and form from the proceeds of the investment of the funds lent.

4.3. The credit rating (or the investment quality) of transactions is below the minimum considered acceptable by the bank.

5. ***Internal Controls***

5.1. The transaction was approved through a procedure different from the procedure specified by the bank for similar counterparties.

5.2. There is no well-grounded opinion of the Risk Department, or it is a negative opinion.

5.3. The amount of the loans granted and the guarantees provided by the bank significantly exceed the internal limit fixed for that kind of counterparties, without any sensible economic reason for it.

5.4. The assets sold or the services provided to the bank by the party cannot be identified, or there is no evidence they even existed at the time of the transaction.

5.5. The collateral received by the bank has not been appraised or registered in accordance with the internal procedures for similar transactions with third parties.

5.6. Loans granted to the party are not classified as problematic when they should be (including loans that are purely formal restructurings) or loan-loss provisions are not properly calculated.

5.7. Bank's undue delay and postponement of implementation of the procedure for loan debt collection and collateral foreclosure.

6. *Interest Rates, Fees, and Price*

6.1. *Loans and other lending*: Interest rates and fees to be paid to the bank are substantially lower than those of clients with similar economic and financial characteristics.

6.2. *Deposits and other borrowings*: Interest rates and other amounts to be paid by the bank are substantially higher than those of clients with similar economic and financial characteristics.

6.3. The prices used to sell assets and/or provide services by the bank to the party are significantly different from those prevailing in the market.

6.4. The prices used to buy assets and/or receive services by the bank from the party are significantly different to those prevailing in the market.

7. *Collateral and Guarantees*

7.1. Collateral or guarantees are provided by the bank or any its related parties to the party or the bank, or to any of its related parties, to get collateral or guarantees from the party.

7.2. Provided collateral and guarantees are less or lower than those required for similar transactions (including not requiring collateral or guarantees at all).