2006

Annual Report

ENCOURAGEMENT BANK AD

2006
ANNUAL REPORT

ENCOURAGEMENT BANK AD

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STATEMENT OF THE CHAIRMAN OF THE BOARD OF DIRECTORS

Dear Ladies and Gentlemen,
Dear colleagues,

It is a pleasure for me to present to your attention the results of Encouragement Bank AD for the year 2006. Last year was a year marked by intensive economic growth and great expectations for the successful accession of Bulgaria to the European Union.

GDP growth in Bulgaria considerably exceeded the average one for the Euro-zone and the banking system in the country reported significant increase in terms of assets and financial results.

For Encouragement Bank 2006 was successful and beneficial. The Bank has achieved considerable growth of all main indications. Established to support the broad foundation of the economy, the small and medium-sized businesses, Encouragement Bank has extended its presence on the market. Throughout the last year a total amount of BGN 45 mio has been negotiated and consecutively secured for providing financing to SMEs.

It is an indisputable fact that due to the positive outcome of the efforts made by the employees of Encouragement Bank, some leading banks in the country refinanced considerable part of the loans extended by our bank despite having initially refused financing to those projects. In this regard, we consider the role of the Bank as an intermediary between SMEs and our colleagues from the commercial banks, who are a bit less risk-oriented than us, as irrefutable. Last but not least, as a result of the financing provided by Encouragement Bank more than 6000 jobs have been created and consequently preserved.

The long-term project "Bulgarian Development Bank" has achieved positive development. After completing the co-ordination process with the competent institutions, the Government of the Republic of Bulgaria commenced the implementation of the project. During 2007 it is expected that the necessary legislative and regulatory acts will be adopted for the establishment of Bulgarian Development Bank. Thus, our country will join those European countries which have already established banking institutions in support to the creation and development of SMEs, one of the main instruments for the implementation of their state and economic policy.

The analysis of the key segment on the market for our activity, the one of small and medium-sized businesses, allows us to note the fact that the access of the companies to financing has been steadily improving. Offering support for providing collateral on potential loans, the need of guarantees and the timely consultation on the structuring of companies' financing are viewed as considerable factors for the improvement observed.

In view of the above, our main goal for 2007 will be the completion of the project for transformation of the Bank, not only in the context of the project for establishing Bulgarian Development Bank, but also aiming at providing effectively products and services corresponding to the needs of the Bulgarian small and medium-sized businesses.

KEY FIGURES

Key figures	2006 BGN'000	2005 BGN'000
Net Profit	3,023	2,778
Shareholder's Equity	39,241	36,840
Total Assets	110,490	94,172
Credit Lines from IFIs (including under trust management)		
Outstanding	62,735	53,527
Approved	70,349	74,854
Guarantee lines (EIF), in EUR thousand	21,000	21,000
Loans to SMEs		
Outstanding (accumulated)	67,205	69,066
Approved (accumulated)	150,118	141,542
INCOME		
Net Interest Income	8,851	7,851
Net Fees and Commissions Income	272	239
Operating Income before Provisions	6,340	4,754
Interests - subscription to the capital of the European Investment Fund - in EUR thousand	3,000	3,000
RATIOS		
Return on Assets	2.98%	2.95%
Return on Equity	7.70%	7.54%
Working Capital/Total Assets Ratio	35.6%	39.1%
Total Capital Adequacy Ratio	38.93%	41.54%
Employees	81	78
Exchange Rate BGN/EUR (pegged under existing currency board arrangements)	1.96	1.96

ENCOURAGEMENT BANK - GENERAL INFORMATION

Encouragement Bank AD ("EB") was incorporated in 1999 as a fully state-owned institution with the **special purpose of providing in priority medium- and long-term financing to the Bulgarian small and medium-sized enterprises ("SMEs")** and of promoting Bulgarian export. Encouragement Bank ("EB") **is unique on the local bank market being the only Bulgarian bank statutory and legally bound to SME lending** (Chapter IV, Art.16 of the Law on Small and Medium-Sized Enterprises) with primary focus on long-term (up to 10-year) SME financing.

EB functions as a joint-stock company, entirely owned by the Ministry of Finance of the Republic of Bulgaria.

Shareholders' participation is allocated as follows:

- *99,997% of the Bank's capital is owned by the Republic of Bulgaria, represented by the Ministry of Finance;*
- *0,003% is owned by DSK Bank.*

By Ordinance № РД22-566/07.11.2001 of the Governor of the Bulgarian National Bank Encouragement Bank also obtained a license for performing "Transactions pursuant to Art. 54, para 1 of the Law on Public Offering of Securities.

Mission

The establishment of Encouragement Bank AD, as an institution contributing to economic growth, is one of the **measures undertaken by the Bulgarian Government to promote and support the start-up and development of SMEs**. Limited access to debt financing for SMEs is the most serious barrier to entrepreneurship. The mission of Encouragement Bank is therefore to provide a range of financial products and services meeting the credit needs of enterprises, which the private banking system does not cover or covers only in part. As a state-owned institution, **Encouragement Bank AD operates at market terms alongside with other commercial banks in Bulgaria and meets the financing needs of the Bulgarian SME sector**.

Business Development Objectives

Encouragement Bank was organized and is operated as Bulgaria's specialized vehicle for SME financing. The **prime objective of the Bank is to promote business and to create a favorable environment** through the provision of financial services which are competitively priced and delivered in a responsive manner.

The specific business development objectives of the Bank are as follows:

- To provide accessible medium and **long-term investment loans to SMEs**.
- To provide the necessary **pre- and co-financing under the EU Pre-Accession Programs** (PHARE and SAPARD).
- To promote the Bulgarian Export by developing the Bank's trade financing activity and by offering customized **export financing products**.

Funding

In order to provide the necessary financial support for the accomplishment of its business development objectives **EB employs its own capital and the funds raised from international and local financial and non-financial institutions**. The credit, guarantee and other tailored SME facilities secure the Bank's lending capacity and diversify its lending products.

Activity

During 2006 Encouragement Bank AD continued to develop according to its plans, generating growth under all quantitative and qualitative indicators. Special attention was given to the milestone project of transforming the bank into a development bank. In this regard a complete concept, model and plan were developed, based on the best European practices.

The establishment of EB evidenced the determination of the Bulgarian Government to ensure effective and friendly environment for SMEs growth and reinforcement. In this sense, Encouragement Bank functions as the promotional bank for Bulgaria making up for the limited **access to long-term financing for the SME sector**.

During 2006 Encouragement Bank AD has approved loans of a total volume of BGN 42,317 thousand. In comparison during 2005 the volume of newly approved loans was BGN 40,580 thousand.

As an institution providing financial support and stimulating the emergence and development of Bulgarian SMEs, EB has concentrated its resources in the following areas:

- Providing long-term (up to 10 year) financial support to effective economic initiatives and business projects of SMEs. As of 2006, EB's loan portfolio (outstanding) accounts for EUR 34,340 thousand (2.7% decrease versus 2005) and is 100% formed by loans to SMEs. The share of long-term loans (above 5 years) is 50% versus 56% in 2005.
- Promoting the country's export capacities.

Since its establishment EB has been fulfilling its statutory objectives by providing both direct and second floor loans. Almost 98% of the financings granted by the Bank have maturity above 1 year and cover the investment needs of the Bulgarian SME sector - a critical aspect of their development while preparing to join the common European market. The average maturity of the Bank's credit portfolio is 69 months. Encouragement Bank is also directly involved in EU integration initiatives through its support for and contribution to the faster and efficient utilization of the EU Pre-accession Programs allocated to Bulgaria. EB's value added is evidenced also by the more than 6,000 jobs created and preserved.

Since 1999 onwards EB has valuably contributed to the development of the local SME sector by sustainable increase of its investment support to the Bulgarian enterprises. In line with the Bank's statutory priority of providing affordable resources to companies with growth potential, for the period 1999 - 31st December 2006 **396 SME loans totaling EUR 95 mio have been approved**.

Direct Lending

Loans funded with EB's own resources and/or the refinancing provided under the loan agreements with IFIs are provided under 9 programs for investment financing of SMEs and 2 programs for specialized pre-export financing programs.

Second-floor loans

In its on-lending activity Encouragement Bank operates as an agent of the Ministry of Finance, working in partnership with Bulgarian commercial banks, through which it channels its attractively priced long-term resources raised from KfW.

MANAGEMENT BODIES

SUPERVISORY BOARD

Atanas Katzarchev
Chairman

Nina Radeva
Deputy Chairman

Kiril Ananiev
Member

BOARD OF DIRECTORS

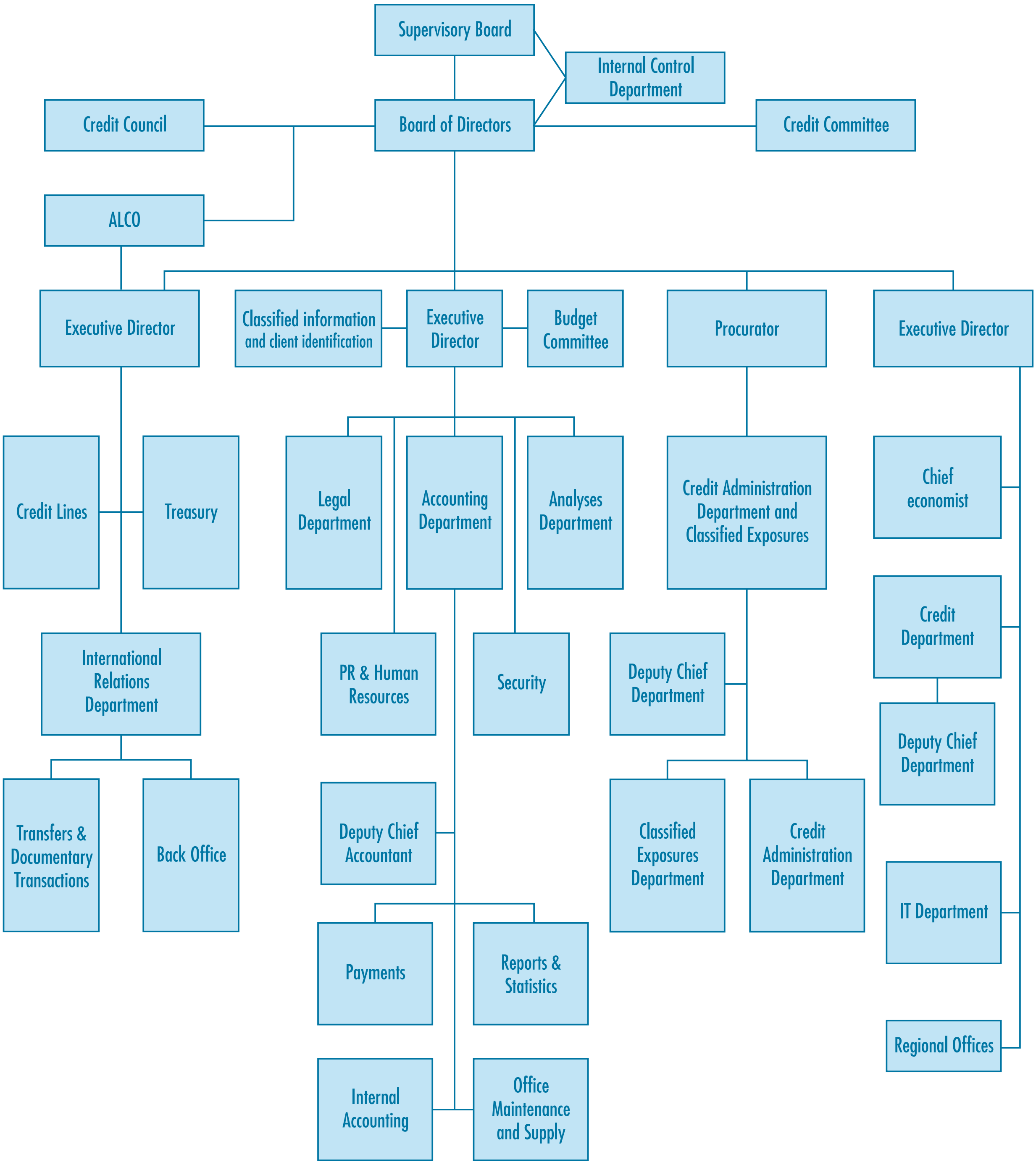
Dimitar Dimitrov
Executive Director
Chairman

Sasho Tchakalski
Executive Director
Member

Angel Gekov
Executive Director
Member

Dimitar Tadarukov
Member

ORGANIZATIONAL CHART



Organizational structure of Encouragement bank as of 18.05.2007.

EXTERNAL ENVIRONMENT - MACROECONOMIC AND BANKING SECTOR REVIEW

THE GENERAL ENVIRONMENT

For a consecutive year the Bulgarian economy has registered a sustainable growth well above the EU average one. The GDP has increased during the first nine months of 2006 by 6.3 % with the forecast being that the annual growth will reach 6.5%.

In absolute value, the largest contributor to the growth of the GDP is the service sector, but in 2006 the rate of its development is visibly decreasing. The value added in the sector for the third quarter of 2006 has increased by 5.8 %, being 6.2 % for the same period of 2005. During the third quarter of 2006 a minimal increase in the added value was registered in the agricultural sector, which is 0.9 % higher than the one for the same period in 2005.

The dynamic growth of the economy in 2006 is mainly due to the industry sector, which value added generated during the first nine months of the year is 9.8 % higher compared to the previous year, when the registered rise was 7.7 %. The acceleration of the rate of growth in the industry sector is due principally to the manufacturing industry, which with a rate of growth of 12 % has surpassed the industry sector growth as a whole. The growth in the construction sector, in contrast to previous years has dropped down to 7.9 %. The mining industry, although experiencing intensive growth, has lost part of its growth rate and during the third quarter of 2006 has been 24.8 %, while in the second quarter it was 34.9 %. To complete the picture the processing industry has also contributed by doubling its rate of development and reaching 13.7 % during the third quarter of 2006, while in the previous year it had registered only 5 % for the same period.

The domestic consumption continues to be a significant factor for the growth, with a contribution to the increase of the GDP for the first nine months of 2006 of about 11 percent points, while there is a 4.6 percent points negative contribution of the external trade.

The consumer-price index for 2006 has conserved its relatively high level from the previous year - 6.5%. The main inflation factors are the already traditional influence from the fuel price, as well as the influence of the administrative costs.

The Bulgarian labor market has evolved very positively, recording an unemployment rate for December of 9.1 %. In line with this positive trend the average salary has increased and for the last quarter of 2006 it was set at BGN 368.

During 2006 the foreign direct investment in Bulgaria reached EUR 4.1 billion which served to cover completely the current account deficit (103% coverage). The pursued high level of fiscal discipline and the membership in the EU will continue to have a positive effect on the process of attracting foreign capital.

The undertaken measures by the BNB for restricting the credit expansion in the country achieved a clear decrease in the rate of offered loans in the private sector and the households. The registered annual rate of alternation is respectively 24.6 % and 30.6%. For comparison during 2005 the same indicators had the following values 32.4 % and 58.4 %. At the end of the year the BNB decided to abolish the administrative restrictions for the rate of credit expansion.

The conditions for the development of business in Bulgaria can be considered as favorable. A restatement to this conclusion can be the results obtained by ESTAT in the examination of the business environment, which show an increased level of business optimism in the economy.

BANKING SECTOR

As of the 31st of December 2006 there are 28 commercial banks and 4 branches of foreign banks operating in Bulgaria. The process of consolidation in the banking sector has continued, with special attention given to the acquisition of 90% of the shares of DZI Bank by Eurobank EFG Group. The bank group is also the owner of Bulgarian Post Bank AD and has declared publicly its intentions to merge the two financial institutions in 2007.

The Hungarian MKB Bank (part of the BayernLB Group) acquired 60% of the capital of Union Bank and renamed it to MKB Union Bank.

For a consecutive year the Bulgarian banking system has experienced an intensive growth rate. The total amount of commercial banks assets increased by 28.4% (31.8% during 2005) at an annual rate and reached BGN 42,195 million.

The amount of net loans offered by the non-financial institutions has reached BGN 22,101 million. The registered delay in the growth rate (24.6 %) is a result of the undertaken measures in 2005 by the BNB. These measures were supplemented at the start of 2006 and after achieving the desired positive results regarding the credit expansion rate a decision for their abolishment was made.

Unlike 2005, when the euro loans experienced a higher rate of growth, during 2006 the growth rate of the loans in local currency (30 %) overtook that of the euro loans (25 %). In full conformity, considering the currency structure of the income and the foreign trade, the absolute amount of the loans in other currencies has decreased, with the relative share being insignificant - under 2 %.

The stable economic environment is a strong incentive for attracting more deposits. The banks have offered a larger variety of deposit products and now cover a larger scope of maturities, earnings and currency characteristics. The deposits of the non-financial institutions have reached EUR 27,560 million, registering a growth rate of 35 %, one of the highest for the last years.

MAIN MACROECONOMIC AND FINANCIAL INDICATORS	Notes	2005	2006
REAL SECTOR			
National accounts			
GDP, current prices	mln. BGN	42 797 407	49 090 605
Final consumption	mln. BGN	37 742 097	42 494 959
Gross fixed capital formation	mln. BGN	10 346 504	12 878 326
Exports of goods and services	mln. BGN	25 765 854	31 420 432
Imports of goods and services	mln. BGN	32 692 326	40 740 774
GDP real growth rate, y/y	(%)	6,2	6,1
Final consumption	(%)	5,3	6,5
Gross fixed capital formation	(%)	23,3	17,6
Exports of goods and services	(%)	8,5	9,0
Imports of goods and services	(%)	13,1	15,1
GVA current prices	mln. BGN	35 220 410	39 971 518
Agriculture and forestry	mln. BGN	3 322 232	3 415 443
Industry	mln. BGN	10 343 645	12 565 843
Services	mln. BGN	21 554 533	23 990 232
GVA - volume index, preceding year = 100 %	(%)	5,3	6,0
Agriculture and forestry	(%)	-9,5	-1,9
Industry	(%)	4,7	8,3
Services	(%)	8,3	6,1
Production indices			
Industrial sales real growth rate, 2000=100 *	(%)	53,9	66,5
Industrial production real growth rate, 2000=100 *	(%)	52,3	61,2
Inflation			
Infaltion, end of period	(%)	6,5	6,5
Inflation, annual average	(%)	5,0	7,3
Labour market			
Employed, annual average		3 253 518	3 349 199
Public sector		689 511	678 578
Private sector		2 564 007	2 670 621
Average monthly wage, BGN	BGN	323,8	354,5
Public sector	BGN	400,9	438,8
Private sector	BGN	288,4	317,0

MAIN MACROECONOMIC AND FINANCIAL INDICATORS	Notes	2005	2006
Registered unemployed (end of period)		397 340	337 796
Unemployment rate (till 2002 end of period; since 2003 average for the period)	(%)	9,9	8,4
FISCAL SECTOR			
Consolidated budget revenues (accumulated)	mln. BGN	18 012,2	20 023,4
Consolidated budget expenditures (accumulated)	mln. BGN	16 678,5	18 267,4
Cash balance (accumulated)	mln. BGN	1 333,7	1 756,0
Internal government debt (annual average)	mln. BGN	2 782,4	2 960,4
External government debt (annual average)	mln. BGN	11 232,0	9 537,1
FINANCIAL SECTOR			
Broad money (M3)	thous. BGN	25 259 580	32 061 383
Annual growth rate	(%)	23,9	26,9
Claims on non-government sector	thous. BGN	18 662 582	23 255 949
Annual growth rate	(%)	32,3	24,6
Base interest rate (period average)	(%)		2,7
Exchange rate BGN/USD (period average)		1,6	1,6
Interest spread (between short term credits and time deposits in levs)	(%)	4,9	4,9
EXTERNAL SECTOR			
Current account	mln. EUR	-2 621,9	-3 977,9
Exports	mln. EUR	9 466,3	11 982,6
Imports	mln. EUR	-13 876,1	-17 372,7
Financial account	mln. EUR	3 560,1	5 395,6
Foreign direct investments	mln. EUR	3 103,3	4 104,5
Overall balance	mln. EUR	569,3	1 785,6

* *Percentage changes are derived from the indices, which are arithmetic average of the monthly NSI indices based on 2000=100.*

Source: Agency for economic analysis and forecasting

BANKING SECTOR REVIEW

		2006
EQUITY ANALYSIS		
Capital		
Total shareholders equity	thous. BGN	4 388 784
Subscribed capital	thous. BGN	1 502 447
Total reserves	thous. BGN	1 812 727
Current year profit	thous. BGN	807 590
Capital Adeqacy		
Capital base	thous. BGN	3 813 807
Equity (Tier 1 capital)	thous. BGN	3 115 384
Risk component	(%)	26 297 631
Equity ratio	(%)	11,85%
Total capital adequacy	(%)	14,50%
ASSET ANALYSIS		
Asset Structure/Total Assets	thous. BGN	42 194 864
Cash and balances with the Bulgarian National Bank	thous. BGN	4 559 045
Cash/ Assets	(%)	10,80%
Due from financial institutions	thous. BGN	8 875 530
Due from financial institutions/ Total Assets	(%)	21,03%
Held-for-sale portfolio	thous. BGN	2 242 446
Investment portfoilo	thous. BGN	3 126 778
Investment in securities/ Total Assets	(%)	12,72%
Loans to non-financial institutions	thous. BGN	22 770 569
Loans/ Total Assets	(%)	52,38%
Allowances for loan impairment (non-financial institutions)	thous. BGN	669 950
Allowances for loan impairment/ Loans	(%)	2,94%
Assets for resale	thous. BGN	22 311
Assets for resale/ Total assets	(%)	0,05%
Long-term fixed assets	thous. BGN	924 382
Long-term fixed assets/ Capital	(%)	21,06%
Long-term fixed assets/ Total Assets	(%)	2,19%
Interest bearing assets	thous. BGN	36 345 376
Interest bearing assets / Total Assets	(%)	86,14%
Other Assets		343 744
Other assets/Total Assets		0,81%

BANKING SECTOR REVIEW		2006
Currency Component		
Foreign currency denominated assets/ Total assets	(%)	53,35%
Foreigh currency denominated liabilities/ Total liabilities	(%)	54,78%
Quality of the Loan Portfolio		
Standard exposures	(%)	95,78%
Watch exposures	(%)	2,02%
Substandard exposures	(%)	0,63%
Non-performing exposures	(%)	1,57%
PROFITABILITY		
Return on assets (Net Profit/ Total assets)	(%)	2,17%
Return on interest bearing assets	(%)	2,53%
Return on equity (Net Profit/ Subscriber capital)	(%)	59,25%
Cost of interest bearing liabilities = Interest expenses/Interst bearing liabilities	(%)	2,51%
Cost of interest bearing assets = Interest income/ Interest bearing assets	(%)	7,62%
Interest margin = Cost of interest bearing assets - Cost of interest bearing liabilities	(%)	5,11%
Net interest margin = (Interest income - Interest expenses)/ Interest bearing assets	(%)	4,99%
Interest expenses/ Interste income	(%)	34,54%
Interest income from loans advanced to customers/ Loans advanced to customers	(%)	9,70%
Interest income from securities/ Securities	(%)	2,52%
Interest from dealings in foreign currencies and revaluation/ Interest bearing assets	(%)	0,09%
Non-interest expenses/ Interest bearing assets	(%)	4,04%
Efficiency = Non-interest expences/ Profit		1,60
LIQUIDITY		
Liquid assets	thous. BGN	14 622 669
Attracted funds (deposits)	thous. BGN	37 804 097
Primary liquidity	(%)	13,74%
Liquid assets ratio	(%)	33,48%

* *Percentage changes are derived from the indices, which are arithmetic average of the monthly NSI indices based on 2000=100.*

** *Data for 2006 is preliminary*

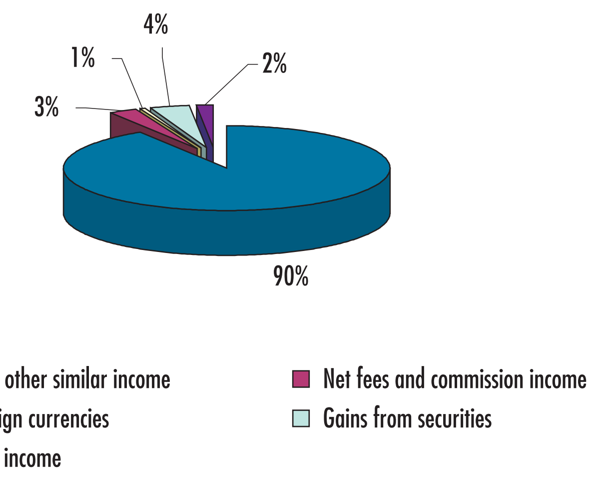
2006 FINANCIAL RESULTS & PERFORMANCE

INCOME STATEMENT

SUMMARY INCOME STATEMENT IN BGN '000	2006	2005
Net interest and other similar income	8 851	7 851
Net fees and commissions income	272	239
Gains from dealing in foreign currencies	61	77
Gains from securities	359	45
Other operating income	175	150
Total revenues	9 718	8 362
Operating expenses	- 3 378	- 3 608
Income before provisions	6 340	4 754

In 2006 Encouragement Bank reported a net profit of BGN 3 023 thousand (up 8.8% year-to-year basis), securing comfortable profitability ratios ROA and ROE of 2.98 and 7.70 respectively, against 2.95% and 7.54% in 2005. The positive results in the generated income are a product of stability in revenues and profitability combined with the ability of Encouragement Bank's management to control financial and operating costs. An additional growth-contributing factor is the implementation of a proper business policy and a sound credit and market risk management. The significant share of income from ongoing operations and the low portion of gains from extraordinary (one - off) transactions further substantiate this conclusion.

Revenue structure



The biggest contribution for this outcome was the net interest income, which reached BGN 8,851 thousand. Despite the high competition in this market and the distinctive pressure for lowering the interest rates, the cited indicator notes an increase of 12.74% compared to 2005, as a result of active operations.

The interest income structure matches the total revenue structure with main share attributable to interest income from loans (90%) up 11% to BGN 9,544 thousand in 2005 (from BGN 8 567 thousand in 2005). In spite of decrease in the securities portfolio, interest income on securities available for sale is up 18% to BGN 624 thousand from BGN 528 thousand in 2005.

Interest expense is dominated by the interest payable on other borrowed funds (up 20% year-to-year) (loans from financial and non-financial institutions) with 99 % of total interest expense. At the end of 2006 the average (weighted) interest rate on the bank's long-term borrowings accounted to 3.00% p.a. (2005: 2.67% p.a.).

Net fees and commissions income increased to BGN 272 thousand (+13.8%) from BGN 239 thousand in 2005 with largest share attributable to fees and commissions on customers' accounts, bank transfers and cash operations. Transaction fees for subprojects under the EU/EIB SME Finance facility and the trust management fees of borrowed funds are other main components in the structure of this indicator.

General administrative expenses dropped in absolute terms to BGN 3 378 thousand from 3 608.

Profit before tax in 2006 increased sharply with 9.2% on a year to year basis and reached BGN 3 573 thousand against BGN 3 273 thousand in 2005, as a result of the increase in net interest and other similar income to BGN 8 851 thousand from BGN 7 851 thousand in 2004.

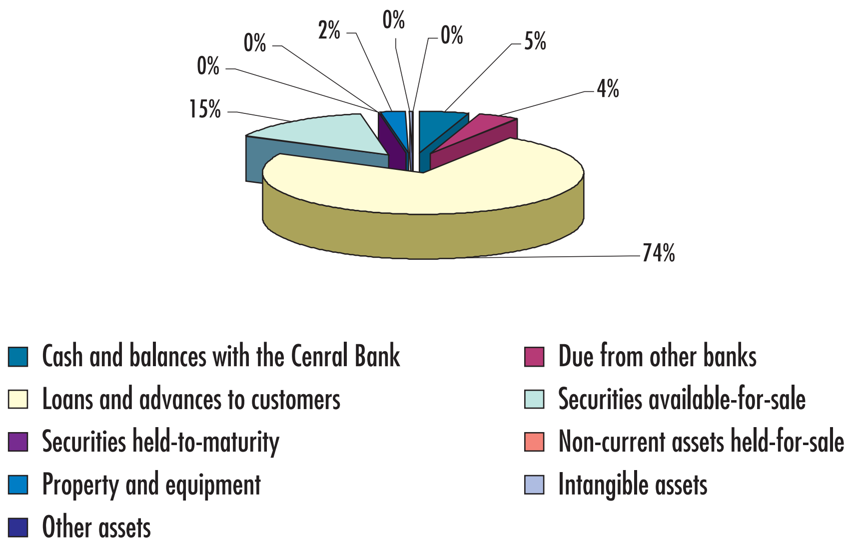
BALANCE SHEET

As of the end of 2006 Encouragement Bank's total assets reached BGN 110,490 thousand - up 17% on an annual basis, after 0.3% reduction in 2005. The increase is mostly due to increasing lending activity and new credit line attracted. The share of interest-bearing assets was over 90% of total assets. Encouragement Bank maintained a comfortable liquidity reserve of BGN 15,863 thousand in liquid assets[1] (14.36% of total assets, against 20.1% in 2005).

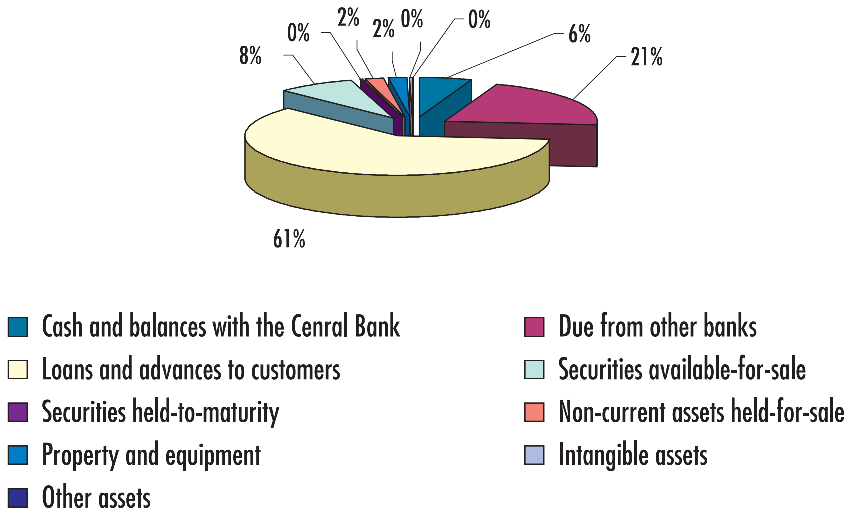
The structure of Encouragement Bank's assets remained relatively unchanged with the main share attributable to loans to SMEs - 61% compared to 73% in 2005. There is a great difference in the portion but amounts are similar - 67 205 thousand in 2006 and 69 066 thousand in 2005. Another interest-bearing component in the Bank's assets accounting for 21% is due from other banks (only 4% in 2005). Investments in securities in 2006 are less than in 2005 - 9 239 (8%) compared to 13 697 (15%).

1 Bulgarian National Bank definition

Assets structure as of 31.12.2005



Assets structure as of 31.12.2006



As in the previous years the main component of Encouragement Bank's assets is the loans to SMEs representing over 61% of total assets. In 2006 new loans and net drawdowns accumulated BGN 67,205 thousand of loans outstanding. The slowdown versus 2005 on a gross (before provisions) basis is 2.7% in new operations with SMEs.

Around 37% of the loans extended by the bank are EUR-denominated and the remaining 63% are BGN-denominated. In comparison in 2005 the proportion was - 51% EUR-denominated and

49% BGN-denominated loans. The currency structure of Encouragement Bank's liabilities is dominated by EUR denominated-component: 58% against 42% for the local currency one. The currency risk is mitigated with the currency-board arrangements effective in Bulgaria where the local currency is pegged to the EUR.

As in previous years the Bank financed its lending operations mainly through funds raised from international financial institutions and from its own capital. Borrowed funds from international institutions grew to BGN 54 802 thousand against BGN 47 255 thousand in 2005 due to the better utilization of the available resources. Other borrowed funds rose to BGN 9 063 thousand from BGN 6 272 thousand.

Following the last subscription to the capital by the main shareholder of the Bank - the Ministry of Finance which took place back in 2003, the authorized capital remained unchanged at BGN 29,574 thousand. Reserves remained relatively unchanged - BGN 7 275 thousand (BGN 7 266 thousand in 2005).

REGULATIONS AND SOLVENCY RATIOS

In 2006 Encouragement Bank continued to be well capitalized above the regulatory minimum requirements. Although the capital base of the bank went up 6.4%, while bank's risk component rose by 15.7% on a year to year basis. Capital adequacy remained high at 38.93% providing for a large reserve for further expansion of Encouragement Bank's lending activity. Encouragement Bank AD calculates its total capital adequacy ratio as a percentage of its own funds to the risk weighted assets (Regulation No.8 of the Bulgarian National Bank). The own funds include share capital and reserves. The total risk weighted assets include balance sheet and off-balance sheet exposures as reported in the statutory financial statements. The minimum capital adequacy ratio required by the law is 12%.

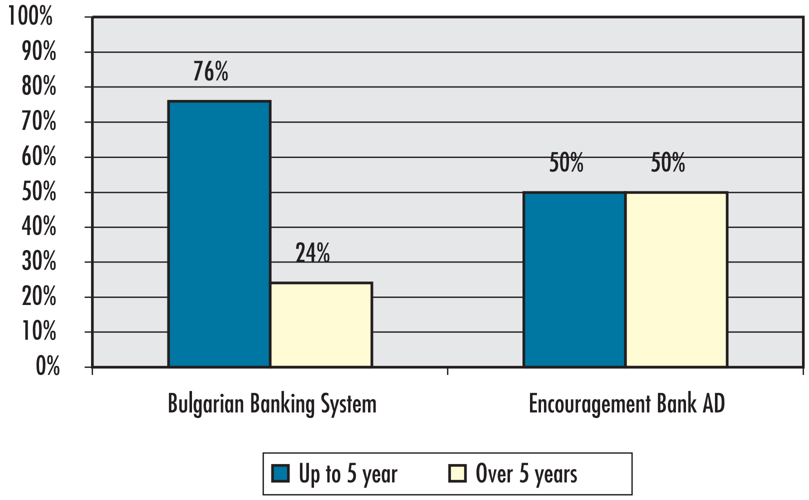
Ratios	**Legal requirements**[2]	**Encouragement Bank AD**	
		2006	2005
Total capital adequacy	Min.12%	38.93%	41.54%
Primary capital adequacy	Min.6%	38.14%	39.88%

2 Bulgarian National Bank Requirements

LENDING

The development of SME lending over the last few years follows the growing trends of the credit expansion on the Bulgarian banking market. Despite the fact that Bulgarian SMEs are starting to be considered by the main banks as a market niche with great potential, long-term SME lending is still inadequate. The reason for this gap on the market is, on the one hand, the mismatch between the maturity structure of banks' funding base (supply side) and the maturity of loans requested by SMEs (demand side). A major part of the deposits of individuals and corporate customers are at sight or have a maturity of not more than one year. Long-term credit lines from abroad are still limited to a medium-term horizon.

Established and operated as Bulgaria's special vehicle for SMEs, providing long-term investment financing and promoting the local export, during 2006 Encouragement Bank AD further expanded its lending activity thereby responding to the sustainable high demand for long-term SME loans. Despite the growth in long-term lending only 24% of BGN and foreign currency denominated credits to non-financial institutions in Bulgaria have a tenor of more than 5 years. This figure should be regarded as including mostly loans to large corporate customers (non SMEs). This obstructs the technological upgrade and improvement of the competitiveness of Bulgarian SMEs. The structure of EB's receivables from SMEs is reversed which evidences the importance of its intervention, filling an existing market gap.



Direct Lending

In 2006 the main priorities in Encouragement Bank's lending activity were the following:

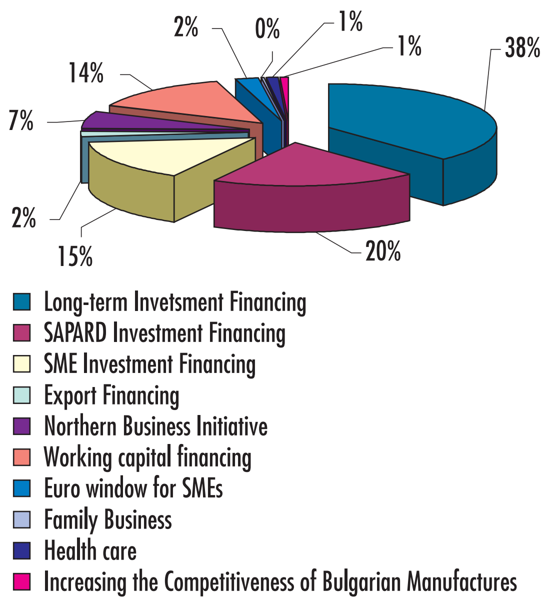
- To provide accessible **medium** and **long-term investment loans to SMEs.**
- To provide the necessary **pre- and co-financing under the EU Pre-Accession Programs** (SAPARD)

- To promote the Bulgarian export by developing the Bank's trade financing activity and by offering customized **export financing products (loans);**

- To provide working capital financing which is an important component some small and medium size businesses require to remain competitive, up-to-date and confident in their marketplace.

In order to meet its targets while responding to the existing market demand Encouragement Bank offered 9 investment and 2 working capital programs, each one focusing on a different aspect of SMEs' financing needs. The scope of financing covers from capital good purchases through intangibles to working capital needs for investment and export purposes. The amount of financing, extended by Encouragement Bank, usually ranges from EUR 25 thousand to EUR 1 mio.

Loan Portfolio Breakdown by Lending Program

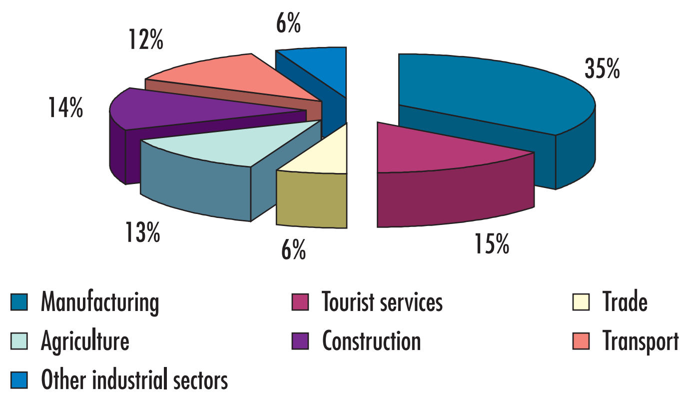


During 2006, 73 loan applications were received of which 55 were approved totaling BGN 42,580 thousand.

Encouragement Bank's loan portfolio as of 31st December 2006 went down by 1% on a year to year basis and reached BGN 74 877 thousand (before provisions) versus BGN 75 744 thousand as of the end of 2005. Provisions totaled BGN 7 672 thousand providing for a coverage ratio of 10.25% versus 2.94% on an average for the banking sector which is due to the specific activity of Encouragement Bank - the long-term lending associated with higher than the average risks.

The breakdown of the Bank's loan portfolio as of 31st December 2006 by economic sectors is as follows:

Loan Portfolio Breakdown by Sector



Despite the fact that Encouragement Bank does not maintain a branch network and is domiciled only in Sofia, the Bank has a balanced coverage of the country corresponding closely to the distribution of companies with a growth and job creation potential throughout Bulgaria. As of 31st December 2006 38% of loans approved have been extended to Sofia and Sofia region companies, 23% - to companies located in the Northern part of Bulgaria and 39% - in the South.

In 2006 a major marketing objective was to promote the name of the Bank, and to strengthen its important place in the field of SMEs' financing, through presentations and on-site campaigns, PR publications and media advertisements. The development of the credit market in Bulgaria set new challenges for the bank on the way to increase its market share.

As a whole in 2006 the biggest clients' interest was in the field of medium and long-term investment loans, and also in working capital financing. In 2007 Encouragement bank will continue to promote its SMEs financing products, and the development of new ones.

On-lending

In its on-lending activity Encouragement Bank operates as an agent of the Ministry of Finance, working in partnership with Bulgarian commercial banks, through which it channels attractively priced long-term resources raised from KfW.

INTERNATIONAL PARTNERS AND ACTIVITIES

In the past year Encouragement Bank AD continued to manage successfully the borrowed funds under the existing credit lines and other types of agreements with International Financial Institutions.

The year of 2006 has been the fifth consecutive year that Encouragement Bank AD acts as an agent of the Ministry of Finance in managing long-term funds granted by KfW and aimed towards financing the SME sector through selected commercial banks. At the end of 2006 the total amount of the funds has increased to EUR 3,949,182.77.

The credit lines with the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB) have been completely disbursed under the program for long-term investment projects of SMEs. The total outstanding amount under these credit facilities accounts for BGN 43,066,862 as at the end of 2006.

In December 2006, Encouragement Bank disbursed a second tranche at the amount of EUR 5,000,000 under the Loan Agreement with Nordic Investment Bank contracted in November 2004. By the end of 2006 the Bank finalized several investment loans refinanced with funds from the Nordic Investment Bank. Thus, the total "Scandinavian" financing provided by Encouragement Bank has surpassed 2.5 million euros.

Having been appointed as the first approved financial intermediary from the acceding and applicant countries under the Multiannual Program of the European Union for enterprises and entrepreneurship, Encouragement Bank was granted a guarantee from the European Investment Fund (EIF) with a volume of EUR 21 million. The issued guarantees under the facility are direct and cover 50% of the newly formed medium and long term loan portfolio of the Bank for a period of 10 years. In 2006 a number of new loans totaling around EUR 5 mio have been approved and covered with an EIF guarantee.

Encouragement Bank remained the sole Bulgarian institution - shareholder in the European Investment Fund possessing 0.15% of its capital. After each Annual General Assembly, Encouragement Bank is entitled to receive dividends in proportion to its participation in the share capital of EIF.

In 2006 Encouragement Bank AD extended its international contacts by concluding two more loan agreements with the Japanese Bank for International Co-operation (JBIC) and the Croatian Bank for Reconstruction and Development (HBOR) respectively.

Aiming at expanding the economic co-operation between Bulgaria and Japan, on 19th July 2006 Encouragement Bank AD and the Japanese Bank for International Co-operation concluded a framework loan agreement for the amount of EUR 10,000,000. The purpose of the agreement is to finance the import of Japanese investment goods. The Government of the Republic of Bulgaria has issued a Letter of Comfort to serve as collateral for the purposes of the loan agreement. The final disbursement period of the Agreement expires on 24 February 2009.

On 19th September 2006, Encouragement Bank AD and the Croatian Bank for Reconstruction and Development signed a Framework Loan Agreement for the amount of EUR 1,000,000 with a two-year disbursement period. The purpose of the Agreement is to finance the import of Croatian investment goods by Bulgarian companies.

Since 2005 Encouragement Bank AD has been a full-fledged member of the European Association of Public Banks (EAPB). Encouragement Bank continued to take an active part in the workshops and seminars organized by EAPB in relation to the elaboration and drafting of the European banking and finance legislation in 2006. At the same time the membership of Encouragement Bank facilitates the exchange of experience and best practices between the Bank and various European public banks.

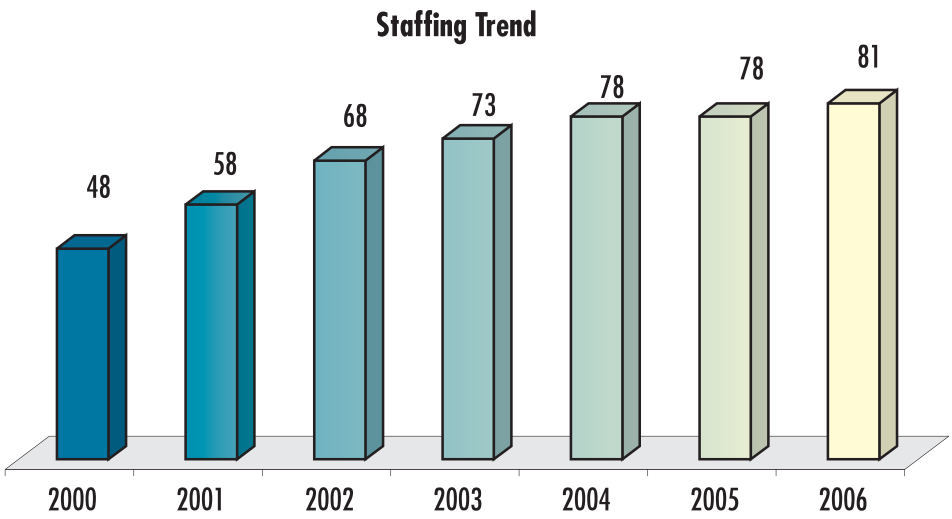
Encouragement Bank AD is an observing member in the Organization of the Institutions in the European Union Specializing in Long-Term Credit (ISLTC Club).

At the end of 2006 Encouragement Bank was formally invited to take part in the regular meetings of the Network of European Financial Institutions (NEFI). NEFI was established in 1999 and currently comprises 11 banks from 11 Member States of the European Union. On the one hand NEFI pursues the improvement of the exchange of information; know-how and experience in providing financing to SMEs among the banks while on the other hand - to maintain a constructive dialogue on SME financing issues with the European Union institutions. It is envisaged that Encouragement Bank AD will become a full-fledged member of the Network of European Financial Institutions during the next year.

The collaboration between Encouragement Bank AD and the Bank for Development of North-Rhine Westfalia continued to develop under the Co-operation Agreement concluded in 2006.

HUMAN RESOURCES

In line with the growing volume of operations since its establishment the number of staff employed by Encouragement Bank has been raising. As at 31 December 2006 the number of permanently employed personnel accounted to 81 against 78 at the end of 2005 (+3.8% on annual basis).



Recognizing the fact that the building up of a well-trained and devoted staff is one of the keys to success, Encouragement Bank has been applying consistent efforts to further develop the skills and professional qualification of its employees. In 2006 the Bank started developing internal quarterly assessment forms for direct evaluation of the performance of its employees which make the remuneration system more flexible and result-oriented. To stimulate its staff and make the working environment a rewarding activity Encouragement Bank AD sponsored a number of external training courses.

PLANNED DEVELOPMENTS AND PRIORITIES

The main goal is to restructure Encouragement Bank AD as an effective and well integrated financial group with the main purpose of encouraging the development of the business activity in the country through offering financing to the SME segment.

Since the first quarter of 2007 the process of reorganizational and functional transformation of Encouragement Bank AD has started. The main goal is to adjust the separate systems of the institution in a state of art corresponding to the ambitions of a development bank. Until the end of 2007 several concrete objectives of the project are planned to be achieved as follows:

- Introducing a new business model in accordance with the structure of the business segments that the Bank will cover;
- Developing a well functioning administrative and analytical capacity necessary for the financing and servicing of the public sector;
- Creating organizational and functional premises for the acquisition of the target activities within the sub-segments of the SME market.
- Organizational reinforcement of the activity through synthesis of products aiming at achieving high level of standardization of the product portfolio by preserving a flexible approach towards the Bank's customers.
- Carrying-out a detailed analysis of the auxiliary functions and activities with a view of their possible differentiation and outsourcing the structure from the Bank.
- Preparing the institutionalization of the guarantee function and the potential activities for financing through providing risk capital on a basis of a detailed analysis of the regulatory requirements with respect to the capital.

During 2007 we foresee a considerable extension of the co-operation with business organizations, employers and the regional structures of Bulgarian Small and Medium Enterprises Promotion Agency. Taking into account the relatively low intensity of the mutual relationships till now, we plan that the potential new relationships be established on a case-by-case basis.

The enhanced intensity of the Bank's operations and the sought diversity of the product portfolio will also set new requirements towards the control and reporting systems of the Bank. In this regard:

- A review of the internal rules and procedures will be made within the first quarter of the year aiming at achieving optimization and co-ordination with the strategic objectives of the Bank in its capacity of a development institution;
- Critical areas of the current reporting such as risk management and monitoring of the implementation of the planned objectives shall be supervised with enhanced intensity;
- A management information system shall be established which shall consolidate the necessary information for the Bank and shall create pre-requisites for analysis and evaluation of different scenarios for the development of the institution;
- A three-year strategic plan for the development of the Bank shall be elaborated until the middle of 2007.

SUPERVISORY BOARD:

Chairman:	Atanas Katsarchev
Deputy Chairman:	Nina Radeva
Members:	Kiril Ananiev

MANAGING BOARD:

Chairman:	Dimitar Dimitrov
Deputy Chairman:	Sasho Tchakalski
Members:	Dimitar Tadarukov
	Angel Gekov

AUDITORS:

AFA OOD
38, Oborishte Str.
Sofia 1504, Bulgaria

MAZARS & GUERARD
Le Vinci - 4, Allee de L'Arche
92075 La Defencse Cedex, France

Head Office:

1, Dyakon Ignatiy Str.
Sofia 1000
Bulgaria

INDEPENDENT AUDITOR'S REPORT

TO
THE SHAREHOLDERS
OF ENCOURAGEMENT BANK AD

We have audited the accompanying financial statements of ENCOURAGEMENT BANK AD (the Bank), which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2006, and its financial performance and its cash flows for the year then ended in accordance with the International Financial Reporting Standards.

MAZARS & GUERARD

Max Dongar

Exaltis – 61, rue Henri Regnault
92075 La Defense Cedex, France

AFA OOD
Registered Specialised Audit Firm

Renny Georgieva Iordanova

Valia Iordanova Iordanova

38, Oborishte Street
1504 - Sofia, Bulgaria

28 March 2007

28 March 2007

ANNUAL FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2006

CONTENTS

ENCOURAGEMENT BANK AD
INCOME STATEMENT
for the year ended 31 December 2006

	Notes	2006 *BGN'000*	2005 *BGN'000*
Interest and other similar income		10 515	9 264
Interest and other similar expenses		(1 664)	(1 413)
Net interest and other similar income	*3*	**8 851**	**7 851**
Fee and commission income		290	259
Fee and commission expenses		(18)	(20)
Net fee and commission income	*4*	**272**	**239**
Gains less losses from dealing in foreign currencies	*5*	61	77
Gains less losses from securities available-for-sale	*6*	359	45
Other operating income	*7*	175	150
Total operating income		**9 718**	**8 362**
Loan impairment and uncollectability losses	*8*	(2 767)	(1 482)
General administrative expenses	*9*	(3 378)	(3 608)
Profit before taxes		**3 573**	**3 272**
Income tax expense	*10*	(550)	(494)
Net profit for the year		**3 023**	**2 778**

The accompanying notes on pages 5 to 39 form an integral part of these financial statements.

Dimitar Dimitrov
Executive Director

Sasho Tchakalski
Executive Director

Angel Gekov
Executive Director

Ivan Lichev
Chief Accountant

ENCOURAGEMENT BANK AD
BALANCE SHEET
as at 31 December 2006

	Notes	31 Dec 2006 *BGN'000*	31 Dec 2005 *BGN'000*
Assets			
Cash and balances with the Cenral Bank	*11*	6,138	4,597
Due from other banks	*12*	23,104	4,095
Loans and advances to customers	*13*	67,205	69,066
Securities available-for-sale	*14*	9,239	13,697
Securities held-to-maturity	*15*	197	197
Non-current assets held-for-sale	*16*	2,206	8
Property and equipment	*17*	2,177	2,323
Intangible assets	*18*	74	103
Other assets	*19*	150	86
Total assets		**110,490**	**94,172**
Liabilities			
Due to other banks	*20*	1	273
Due to customers	*21*	6,674	2,960
Borrowed funds from international institutions	*22*	55,011	47,255
Other borrowed funds	*23*	9,063	6,272
Other liabilities	*24*	445	376
Deferred tax liabilities	*25*	55	196
Total liabilities		**71,249**	**57,332**
Shareholders' equity			
Share capital	*26*	29,574	29,574
Reserves	*27*	9,667	7,266
Total shareholders' equity		**39,241**	**36,840**
Total shareholders' equity and liabilities		**110,490**	**94,172**

The accompanying notes on pages 5 to 39 form an integral part of these financial statements.

The financial statements on pages 1 to 39 are approved for issue by the Managing Board of Encouragement Bank AD on 28 March 2007 and signed on its behalf by:

Dimitar Dimitrov
Executive Director

Sasho Tchakalski
Executive Director

Angel Gekov
Executive Director

Ivan Lichev
Chief Accountant

ENCOURAGEMENT BANK AD
CASH FLOW STATMENT
for the year ended 31 December 2006

	Notes	2006	2005
		BGN'000	BGN'000
Cash flows from operating activities			
Profit before taxes		3,573	3,272
Loan impairment and uncollectability losses	8	2,767	1,482
Depreciation/amortisation	9	264	322
Net book value of assets written-off	17,18	9	65
Cash flows from operating activities before changes in working capital		6,613	5,141
Changes in operating assets and liabilities:			
(Increase)/decrease in mandatory reserve deposit at the Cental Bank	11	(1,132)	186
Decrease in amounts due from other banks	12	-	2,000
Increase in loans and advances to customers	13	(3,094)	(6,049)
Decrease in securities available-for-sale	14	3,586	2,934
Increase in non-current assets held-for-sale	16	(47)	-
Decrease in interest and fee receivables		118	14
(Increase)/decrease in other assets	19	(64)	123
Decrease in amounts due to other banks	20	(272)	(1,074)
Increase/(decrease) in amounts due to customers	21	3,712	(890)
Increase in other borrowed funds	23	4,057	3,164
Increase in interest and fee payables		114	-
Increase/(decrease) in other liabilities	24	119	(55)
Net cash from operating activities before income taxes		13,710	5,494
Income taxes paid		(583)	(134)
Net cash from operating activities		13,127	5,360
Cash flows from investing activities			
Purchase of equipment and computer software	17,18	(98)	(278)
Net cash used in investing activities		(98)	(278)
Cash flows from financing activities			
Dividends paid		-	(260)
Proceeds from long-term borrowed funds	22,23	9,779	1,956
Payments on long-term borrowed funds	22,23	(3,401)	(6,440)
Net cash from/(used in) financing activities		6,378	(4,744)
Net increase in cash and cash equivalents		19,407	338
Cash and cash equivalents at the beginning of the year	29	4,180	3,842
Cash and cash equivalents at the end of the year	29	23,587	4,180

The accompanying notes on pages 5 to 39 form an integral part of these financial statements.

Dimitar Dimitrov
Executive Director

Sasho Tchakalski
Executive Director

Angel Gekov
Executive Director

Ivan Lichev
Chief Accountant

ENCOURAGEMENT BANK AD
STATMENT OF CHANGES IN EQUITY
for the year ended 31 December 2006

	Notes	**Share capital** *BGN'000*	**Statutory reserve** *BGN'000*	**Other reserves** *BGN'000*	**Revaluation reserve** *BGN'000*	**Retained earnings** *BGN'000*	**Total** *BGN'000*
Balance at 1 January 2005	*26,27*	**29,574**	**1,067**	**1,484**	**964**	**845**	**33,934**
Allocation of profit for year 2004 for:		-	325	260	-	(845)	(260)
* Reserves		-	325	260	-	(585)	-
* Dividends		-	-	-	-	(260)	(260)
Transfer to 'profit or losses for the year' upon sale of available-for-sale investments		-	-	-	(47)	-	(47)
Net unrealised valuation gains from available-for-sale investments taken to equity		-	-	-	503	-	503
Effect of deferred taxes on items directly taken to equity		-	-	-	(68)	-	(68)
Net profit for the year		-	-	-	-	2,778	2,778
Balance at 31 December 2005	*26,27*	**29,574**	**1,392**	**1,744**	**1,352**	**2,778**	**36,840**
Allocation of profit for year 2005 for:		-	2,778	-	-	(2,778)	-
* Reserves		-	2,778	-	-	(2,778)	-
Transfer to 'profit or losses for the year' upon sale of available-for-sale investments		-	-	-	(452)	-	(452)
Net unrealised valuation gains from available-for-sale investments taken to equity		-	-	-	(328)	-	(328)
Effect of deferred taxes on items directly taken to equity		-	-	-	158	-	158
Net profit for the year		-	-	-	-	3,023	3,023
Balance at 31 December 2006	*26,27*	**29,574**	**4,170**	**1,744**	**730**	**3,023**	**39,241**

The accompanying notes on pages 5 to 39 form an integral part of these financial statements.

Dimitar Dimitrov
Executive Director

Sasho Tchakalski
Executive Director

Angel Gekov
Executive Director

Ivan Lichev
Chief Accountant

NOTES TO THE FINANCIAL STATEMENTS

1. CORPORATE BACKGROUND

1.1. Incorporation

Encouragement Bank AD was incorporated in Bulgaria on 11 March 1999 as a joint-stock company. The registered office of the Bank is at 1, Dyakon Ignatiy Street, Sofia.

1.2. Ownership and management

The issued share capital of the Bank is held by the Republic of Bulgaria, represented by the Ministry of Finance - 99.997% and Bank DSK AD - 0.003%.

By virtue of a Decision of the Supervisory Board 69/27 November 2006, Angel Gekov is elected a member of the Managing Board of the Bank and with Decision 70/29 November 2006 - an Executive Director. These decisions of the Supervisory Board are registered with a Decision No. 23 dated 7 December 2006 of Sofia City Court.

As at 31 December 2006 the members of the Supervisory Board and the Managing Board of the Bank are as follows:

Supervisory Board:

Atanas Katsarchev - Chairman;
Nina Radeva - Deputy Chairman;
Kiril Ananiev - Member.

Managing Board:

Dimitar Dimitrov - Chairman;
Sasho Tchakalski - Deputy Chairman;
Dimitar Tadarukov - Member;
Angel Gekov - Member.

Executive Directors of the Bank at 31 December 2006 are Dimitar Dimitrov - Chairman of the Managing Board, Sasho Tchakalski - Deputy Chairman of the Managing Board, Angel Gekov - Member of the Managing Board. The Bank has an appointed procurator - Krasimirka Velinova - Saeva. The Bank is managed and represented jointly by two Executive Directors or by the Procurator with one of the three Executive Directors.

1.3. Activities

The Bank holds a general banking licence, issued by the Central Bank of Bulgaria (BNB) and is allowed to perform all banking operations permitted by Bulgarian law. Nevertheless, the Articles of Association of the Bank prohibit the following types of operations: accepting deposits from individuals (with an exception of deposits from the employees), transactions with precious metals, issuance and management of bank cards, and provision of safe-deposit boxes. The Bank is also a licensed financial intermediary and a broker.

The Bank was incorporated with the special purpose of supporting the implementation of the economic policies of the State by financing business projects of small- and medium-sized enterprises (SME), including supporting their export abilities.

The principal activities in 2006 are related to the provision of commercial banking services, including the granting of loans to private companies, dealing in government securities, performing REPO deals on the interbank market, and other financial services in Bulgaria.

At 31 December 2006 the Bank has 81 employees (2005: 78).

1.4. Structure of the bank

The bank has no branches and offices opened as at 31 December 2006.

1.5. Main indicators of the economic environment

The main indicators of the economic environment that affect the Bank's activities throughout the period 2004 - 2006, are presented in the table below:

Indicator	**2004**	**2005**	**2006**
GDP in million BGN [1]	38,008	41,948	39,917*
Actual growth of GDP	5.6%	5.5%	6.7%*
GDP per capita in BGN	4,884	5,420	4.448*
Year-end inflation	4%	6.5%	6.4%
Average exchange rate of USD for the year	1.57511	1.57415	1.55010
Exchange rate of the USD at the yearend	1.43589	1.65790	1.48506
Basic interest rate at the year-end	2.37%	2.05%	3.26%
Unemployment rate at the year-end	12.16%	10.73%	9.12%

1 *New denominated leva*

Source: NSI, BNB

* *Data as at 30 September 2006*

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

2.1. Basis for the preparation of the financial statements

The financial statements of Encouragement Bank AD have been prepared in accordance with all International Financial Reporting Standards (IFRS), which comprise Financial Reporting Standards and the International Financial Reporting Interpretations Committee (IFRIC) interpretations, approved by the International Accounting Standards Board (IASB), as well as the International Accounting Standards (IAS) and the Standing Interpretations Committee (SIC) interpretations, approved by the International Accounting Standards Committee (IASC), and which are effectively in force on 1 January 2006.

The Bank's current accounting policies have not necessitated amendments for adapting the application of all new standards and interpretations, issued by IASB and respectively, by IFRIC, and in effect for the current reporting year, beginning on 1 January 2006, since they do not refer to its activities and the usual composition and characteristic features of its assets and liabilities.

At the date these financial standards are approved for issue, the following have been issued but not in force: IFRS 7 "Financial Instruments: Disclosures" and the additional amendment of IAS 1 "Presentation of Financial Statements - Capital Disclosures" (in force as of 1 January 2007). In addition, the following IFRS interpretations have been issued: IFRIC 7 "Applying the Restatement Approach under IAS 29 "Financial Reporting in Hyperinflationary Economies"" (in force for annual periods beginning on or after 1 March 2006); IFRIC 8 "Scope of IFRS 2" (in force for annual periods beginning on or after 1 May 2006); IFRIC 9 "Reassessment of Embedded Derivatives" (in force for annual periods beginning on or after 1 June 2006); IFRIC 10 "Interim Financial Reporting and Impairment" (in force for annual periods beginning on or after 1 November 2006). This standard and interpretations have not been adapted for earlier application by the Bank. The Bank's management anticipates that they would not have a significant impact on its financial statements in the future except for amendments and expansion of disclosures.

The Bank maintains its accounting books in Bulgarian lev (BGN), which is accepted as being its functional currency for reporting and presentation purposes. The data in the financial statements and the notes thereto is presented in thousands of Bulgarian levs (BGN'000).

The presentation of the financial statements in accordance with IFRS requires the management to make best estimates, accruals and reasonable assumptions that affect the reported values of assets and liabilities, the amounts of income and expenses and the disclosure of contingent receivables and payables as at the date of the financial statements. These estimates, accruals and assumptions are based on the information, which is available at the date of the financial statements, and therefore, the future actual results might be different from them. The items presuming a higher level of subjective assessment or complexity or where the assumptions and accounting estimates are material for the financial statements, are disclosed in Note 2.19.

2.2. Comparatives

The Bank presents in its financial statements comparative information for one prior period.

For the purposes of achieving a more reliable presentation of the reporting items and transactions, where necessary, changes are made in their classification and presentation in the individual components of the financial statements and then prior year comparatives are also reclassified to ensure the required comparability with the current period.

2.3. Functional and presentation currency

The functional and presentation currency of the Bank is the Bulgarian Lev. Starting from 1 July 1997 the Bulgarian Lev was pegged to the German Mark at the ratio of BGN 1 : DEM 1. With the introduction of the Euro as an official currency of the European Union, starting from 1 January 1999, the fixed ratio between both currencies is BGN 1.95583 : EUR 1.

The ratio BGN / USD is 1.48506 : 1 as at 31 December 2006 (31 December 2005: 1.6579 : 1).

Upon its initial recognition, a foreign currency transaction is recorded in the functional currency whereas the exchange rate to BGN at the date of the transaction or operation is applied to the foreign currency amount. Cash and cash equivalents, receivables and payables denominated in foreign currency are recorded on daily basis in the functional currency by applying the exchange rate as quoted by the Bulgarian National Bank (BNB) for the last working day of the respective month. At 31 December, these amounts are presented in BGN at the closing exchange rate of BNB.

Foreign exchange gains or losses arising on the settlement or recording of foreign currency transactions at rates different from those, at which they were converted on initial recognition, are recognized in the income statement in the period in which they arise and are treated as income from foreign currency transactions on net basis.

2.4. Interest income and expenses

Interest income and expenses are recognised in the income statement on accrual basis for all interest-bearing instruments using the effective yield method based on the actual purchase price or the applicable floating rate. Interest income and expenses include the amortisation of any discount or premium or other differences between the initial carrying amount of an interest-bearing instrument and its amount at maturity calculated on an effective interest rate basis.

Interest income includes coupons earned on available-for-sale government bonds, interest on deposits with other banks, interest on loans and advances to customers, and fees and commissions on loans and advances to customers, which are an integral part of the effective yield of the financial instrument.

Interest expense is recognized on accrual basis and includes the interest accrued on the deposits of customers and banks as well as on the other borrowed funds.

2.5. Fee and commission income and expenses

Fees and commissions on bank guarantees and performance bonds are recognised on a systematic basis over the period of the exposure to match the cost of providing the service.

Trust management fees are recognized on accrual basis throughout the period of providing the service.

Fee and commission expenses related to servicing nostro accounts with other banks are recognized at the time of provision of the underlying service.

2.6. Loans and advances

Loans and advances with fixed and determinable payments, which are not quoted in an active market, are recorded and presented at amortised cost.

Loans and advances that have initially originated in the Bank are recognised when cash is advanced to borrowers and are initially measured at the provided funds value.

Acquired loans and advances are recognised when a significant part of benefits and risks incidental to ownership are received by the Bank and are initially measured at the value of the amount paid or at the determined fair value of the transferred asset.

2.7. Allowances for loan impairment and uncollectability

At each balance sheet date, the Bank assesses whether objective evidence is available that certain individual loans or a group of loans of similar characteristics is impaired. A loan or a group of loans is impaired when there is an objective evidence of impairment as a result of one or more events (a 'loss event') that occurred after the initial recognition of the asset(s) and that the loss event(s) has an impact on the estimated future cash flows of the asset(s) and this impact can be reliably estimated. The criteria used by the Bank to determine that there is objective evidence of an impairment loss include: delinquency in contractual payments of principal and interest; cash flow difficulties experienced by the borrower; breach of key covenants and ratios (indicators) of the loan agreement; deterioration of the borrower's financial, market and competitive condition; deterioration in the state and quality of collateral; initiation of liquidation and/or bankruptcy proceedings and other similar indicators.

Allowances for loan impairment are accrued in a special allowance account if there is objective evidence that the Bank will not be able to collect all amounts due by borrowers (debtors).

The Bank first assesses whether objective evidence of impairment exists at individual level regarding specific loan exposures that are individually significant. Subsequently, the loans for which no impairment is identified at individual level (whether individually significant or not) are included in groups with similar characteristics and are collectively assessed for impairment.

A particular loan is classified in the relevant risk group and is assessed as non-performing depending on the above criteria, mainly the occurrence of delay in contractual payments of principal and/or interest and on the basis of analysis of the financial position of the borrower and the sources for settlement of its debts to the Bank.

The amount of the specific allowances for loan impairment is the difference between the carrying amount and the recoverable amount, being the present value of expected cash flows, including amounts recoverable from guarantees and collateral, discounted on the basis of the agreed-upon effective interest rate.

If there are indications of probable losses in the loan portfolio that have not been specifically identified and crystallized, allowances for coverage of the general credit risk are also provided for on a portfolio basis. They are determined based of historical experience, statistical data and techniques and the judgment of the management on the grounds of its experience and knowledge.

Allowances are also made for other components of the loan portfolio at the balance sheet date, estimated based on historical patterns of losses in each component, current economic conditions in which the borrowers operate and other relevant factors affecting the loan portfolio.

The amounts of impairment are calculated on the basis of internal rules and techniques developed by the Bank in accordance with the requirements of IAS 39.

It is an accepted policy of the Bank that all impaired loans are reviewed and analyzed on monthly basis. Any subsequent changes in the amounts and timing of the expected future cash flows compared to the prior estimates would result in a change in the allowances for loan impairment losses and be charged or credited to loan impairment and uncollectability losses in the income statement.

An allowance for impairment and uncollectability is reversed only when the quality of the loan has improved so that reasonable assurance exists as to the timely collection of principal and interest in accordance with the original contractual terms of the loan agreement.

Subsequent recoveries or decreases in the allowances due to an event occurring after the write-down are credited to the loan impairment and uncollectability losses in the income statement.

When a loan is uncollectable, it is written-off against the related allowance for impairment losses. Such loans are written-off after all necessary legal procedures have been completed and the amount of the final loss has been determined.

2.8. Securities held-to-maturity

The Bank classifies its securities portfolio into the category 'held-to-maturity' when the securities represent financial assets with fixed or determinable payments and fixed maturity, for which the Bank has the positive intent and ability to hold until maturity. The Bank's management determines the appropriate classification of its investments at the time of the purchase.

Securities held-to-maturity are initially recognised at cost, being the fair value of the consideration given including acquisition costs associated with the investment. They are subsequently re-measured at amortised cost using the effective interest method and are subject to review for impairment. Held-to-maturity financial assets are impaired if the carrying amount is greater than the estimated recoverable amount. The recoverable amount of a debt instrument is the present value of expected future cash flows, discounted at the current market interest rate for a similar financial asset.

Interest earned whilst possessing held-to-maturity securities is reported as interest income in the income statement.

Any purchase and sale of held-to-maturity securities is recognised on the date of trading, which is the date when the Bank undertakes the commitment to purchase or sell the asset.

2.9. Securities available-for-sale

The Bank classifies its portfolio of government securities and the investments in shares of other entities into the category 'available-for-sale'.

Securities available-for-sale are intended to be held for an indefinite period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. The Bank's management determines the appropriate classification of its investments at the time of the purchase..

Securities are initially recognised at cost, being the fair value of the consideration given including acquisition costs associated with the investment. They are subsequently re-measured at fair value based on quoted bid prices or amounts derived from cash flow models.

Unrealised gains and losses arising from changes in the fair value of securities classified as available-for-sale are recognised directly in a separate component of equity through the statement for changes in equity until the financial asset is sold, collected or otherwise disposed of or until it is impaired, at which time the accumulated gains or losses recognised in prior periods in the equity, are recognised in the income statement for the reporting period.

Available-for-sale financial assets are impaired if the carrying amount is greater than the estimated recoverable amount. The amount of the recognised impairment loss is equal to the difference between the acquisition cost, net of principal repayments and current fair value (for equity instruments) or recoverable amount (for debt instruments). The recoverable amount of a debt instrument is the present value of expected future cash flows, discounted at the current market interest rate for a similar financial asset.

Interest earned whilst holding debt securities available-for-sale is reported as interest income.

Dividend income earned whilst holding capital securities available-for-sale is reported as other income.

Any purchase or sale of securities available-for-sale is recognized on the date of trading, which is the date when the Bank undertakes the commitment to purchase or sell the asset.

2.10. Sale and repurchase agreements (REPO deals)

Securities purchased subject to sale and repurchase agreements are not recognised in the balance sheet but are recorded and presented as 'due from banks' or 'loans and advances to customers' secured with bonds, as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the period of the REPO agreement using the effective interest method.

2.11. Property and equipment

Property and equipment (tangible fixed assets) are presented in the financial statements at historical cost of acquisition (cost) less the accumulated depreciation and any impairment losses in value.

Initial measurement

Upon their initial acquisition, property and equipment are valued at cost, which comprises the purchase price, including customs charges and any directly attributable costs of bringing the asset to working condition for its intended use. The directly attributable costs include the cost of site preparation, initial delivery and handling costs, installation costs, professional fees for people related to the project, non-refundable taxes etc.

The Bank has set a value threshold of BGN 150, below which any asset acquired, regardless of its nature of a fixed asset, is treated as current expense at the acquisition date.

Subsequent measurement

The approach chosen by the Bank for subsequent measurement of property and equipment, is the cost model under IAS 16, i.e. cost less any accumulated depreciation and any accumulated impairment losses in value.

Depreciation methods

The Bank applies the straight-line depreciation method for property and equipment. The useful life per group of assets has been determined considering: physical wear, the characteristic features of the equipment, the intentions for future use and the expected obsolescence, and is as follows:

- Buildings - 50 years;
- Bank equipment and computers - 5 years;
- Motor vehicles - 5 years;
- Furniture and fixtures - 6.7 years.

The useful life, set for any equipment, is reviewed at each year-end and it is adjusted prospectively in case that any material deviations from future expectations concerning the terms of use are determined.

Subsequent costs

Repair and maintenance costs are recognized as current expenses as incurred. Subsequent expenses incurred in relation to property and equipment having the nature of replacement of certain significant parts or improvements and restructuring, are capitalized in the carrying amount of the respective asset whereas its residual useful life is reviewed at the date of capitalisation. At the same time, the non-depreciated part of the replaced components is derecognised from the carrying amount of the assets and is recognised in the current expenses for the period of restructure.

Impairment of assets

The carrying amounts of property and equipment are reviewed for impairment when events or changes in circumstances indicate that they might significantly differ from their recoverable amount. If any indications exist that the estimated recoverable amount of an asset is lower than its carrying amount, the latter is adjusted to the recoverable amount of the asset. The recoverable amount of property and equipment is the higher of the fair value less costs to sell or the value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market conditions and assessments of the time value of money and the risks, specific to the particular asset. Impairment losses are recognised in the income statement.

2.12. Intangible assets

Intangible assets are stated in the financial statements at acquisition cost (cost) less accumulated amortization and any impairment losses in value. They include software and license for their use.

The Bank applies the straight-line amortization method for the intangible assets with determined useful life of 5 years.

The carrying amount of the intangible assets is subject to review for impairment when events or changes in the circumstances indicate the carrying amount might exceed their recoverable amount. Impairment losses are included in the income statement.

2.13. Provisions and contingent liabilities

Provisions are recognized when the Bank has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources will be required to settle (repay) the obligation. The measurement of provisions is based on the best estimate, made by the management at the balance sheet date, concerning the expenses that will be incurred for the settlement of the particular obligation. The estimate is discounted if the obligation is long-term.

Contingent liabilities are obligations arising from past events, the existence of which can be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not entirely within the control of the Bank, or it is not probable that an outflow of resources will be required to settle the obligation. They are not recognized in the balance sheet but are disclosed. (Note 28).

2.14. Pensions and other payables to personnel under the social security and labour legislation

The employment and social security relations with the employees of the Bank are based on the provisions of the Labour Code and the effective social security legislation.

The employer's major duty is to meet its statutory obligation to State Social Security bodies concerning pension benefits, health and unemployment insurance.

Social security contributions are defined under the Law on the Budget of State Social Security for the respective year. The contributions are apportioned between the employer and the employee at a ratio, which is changed annually and is provided for in the Social Security Code. The total contribution rate for the statutory state social security, unemployment and health insurance schemes in 2006 is 36.6% while the employer: employee ratio is 65:35 for the individuals working under the terms of third category of employment to which the employees of the Bank belong.

In 2007, the contribution rate is not changed - 36.6% and the employer: employee ratio is 65:35.

There is no established and functioning private voluntary social security scheme at the Bank.

The social security and pension schemes, applied by the Bank in its capacity of an employer, are based on the Bulgarian legislation and contributions plans are defined.

In accordance with the provisions of the Labour Code, the employer is obliged, upon termination of the employment contracts, to pay indemnities as follows:

- for non-observed preliminary notice: one gross monthly salary;
- due to closing down of the enterprise or part of it, staff cuts, reduction of the volume of work and work stoppage for more than 15 days, etc.: at amount not exceeding one gross monthly salary;
- upon termination of the employment contract due to illness: at the amount of the gross remuneration of the employee for two months if the individual has at least 5 years of service and has not received an indemnity payment on the same grounds during the last 5 years;
- upon retirement: two to six gross monthly salaries depending on the length of service with the Bank;
- for unused annual paid leave: for the respective years of the time recognized as service period.

Except for payment of the above indemnities, no further liabilities to employees arise for the employer.

Short-term employee benefits in the form of remunerations, bonuses and social payments and benefits (payable within 12 months after the end of the period when the employees have rendered the service or has met the required terms and requirements) are recognized as an expense in the income statement in the period when the service thereon has been rendered or the requirements for their receipt have been met and as a current liability (less any amounts already paid and deductions due) at their undiscounted amount. The Bank's payables for social security and health insurance are recognized as a current expense and liability at their undiscounted amount together with the respective benefits they relate to and within the period of their accrual.

At each balance sheet date the Bank measures the expected costs on the accumulating compensated absences, which amount is expected to be paid as a result of the unused entitlement. The measurement includes the estimated expenses on the employee's remunerations and the statutory social security contributions due by the employer thereon.

In accordance with the requirements of the Labour Code, the employer is obliged to pay to its personnel upon retirement an indemnity, which depending on the length of service with the Bank varies between two and six gross monthly salaries as at the termination date of the employment. In their nature these are defined benefit plans.

The calculation of the amount of these liabilities necessitates the participation of qualified actuaries in order to determine their present value at the date of the financial statements, which to be included in the balance sheet, while the change in their value is to be included in the income statement, respectively.

At each balance sheet date, the management uses actuarial-type of calculations regarding long-term obligations to personnel as indemnity upon retirement.

2.15. Income taxes

Current income taxes

Current income taxes are determined in accordance with the requirements of the Bulgarian tax legislation - the Corporate Income Taxation Act (CITA). The nominal income tax rate for year 2006 is 15% (2005: 15%).

Deferred income taxes

Deferred income taxes are determined using the liability method on all temporary differences, existing at the balance sheet date, between the carrying amounts of the assets and liabilities and their tax bases.

Deferred tax liabilities are recognised for all taxable temporary differences.

Deferred tax assets are recognised for all deductible temporary differences and the carry-forward of unused tax losses, to the extent that it is probable they will reverse and a taxable profit will be available or taxable temporary differences might occur, against which these deductible temporary differences can be utilized, with the exception of the differences arising from the initial recognition of an asset or liability, which has affected neither the accounting nor taxable profit (loss) as at the date of the transaction.

The carrying amount of all deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is probable that they will reverse and sufficient taxable profit will be generated or taxable temporary differences will occur in the same period, from which they can be deducted.

Deferred taxes, related to items directly credited or charged to equity or other balance sheet items, are also reported directly in the respective equity component or balance sheet item.

Deferred tax assets and liabilities are measured at the tax rates that are expected to be applied in the period when the asset will be realised or the liability will be settled (paid), based on the tax laws that are enacted or to a great degree of probability will be enacted. As at 31 December 2006, the deferred income taxes are computed at a tax rate of 10% (31 December 2005: 15%).

2.16. Donations

The non-refundable donations related to the purchase of depreciable assets (computer hardware), are deferred and recognized as income in a period and at a proportion identical to the depreciation expense of these assets.

2.17. Cash and cash equivalents

For the purposes of the cash flow statement cash equivalents comprise cash on hand, cash at current accounts with other banks, demand deposits and placements with other banks with original maturity up to 3 months, including repo deals with original maturity up to 3 months, as well as unrestricted (not blocked) balances with the Central Bank of Bulgaria (BNB).

2.18. Share capital and reserves

Being a joint-stock company, the Bank is obliged to register in the Commercial Register a certain amount of ***share capital***, which should serve as a security for the receivables of the Bank's creditors. The shareholders are liable for the obligations of the Bank only up to the amount of the share capital held by them and may claim refunding of this participation only in liquidation or bankruptcy proceedings.

The share capital represents the non-distributable capital of the Bank and is presented at the nominal value of the issued shares.

Following the requirements of the Commercial Act and the Law on Banks (as from 1 January 2007, under the requirements of the Law on Credit Institutions and the Commercial Act), the Bank is obliged to set aside a ***Statutory Reserve*** from allocation of profit (Note 27).

2.19. Critical accounting judgments on applying the accounting policies. Key estimates and assumptions of high uncertainty.

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continuously evaluated and are based on the Bank's historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

a) Impairment losses on loans and advances

At each balance sheet date, the Bank reviews its loan portfolios to assess the presence of impairment losses and to calculate their amount. In determining whether an impairment loss should be recorded in the income statement, the management of the Bank makes judgments as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows of a portfolio of loans before the decrease can be identified for an individual loan in that portfolio. An evidence for this may include observable data indicating that there has been an adverse change in the payment status of a group of borrowers or of a concrete borrower, or the availability of national, economic or other conditions that relate to a certain risk for a specific group of borrowers /type of loans. The analysis of the impairment and uncollectability loss risk includes classification of loans into risk groups by applying three main criteria: financial position, problems in servicing, including interest and matured principal in arrears and provided collateral in terms of type and possibility for realisation. For loans, approved for guarantee from the EIF, impairment loss is recognised after deduction of the portion covered by the Fund (Note 30).

In determining the future cash flows pattern, the management uses estimates, judgments and assumptions based on its historical loss experience for assets with similar credit risk characteristics, as well as on objective evidence for impairment of the portfolio from non-crystallised loss in a particular component thereof. Analogous approach is used also for assessments at individual loan level taking into account the quality of collateral as well. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly so as to minimize the discrepancies between loss estimates and actual loss experience (Notes 8 and 13).

b) Measurement of financial instruments available-for-sale

The Bank classifies as financial assets "available-for-sale" its investments in the form of share participation in other companies/entities (below 20% of their capital) that have been acquired with the aim of establishing and development of important for the Bank business relations. The management has judged and accepted that they should be measured at cost because sufficiently reliable sources and methods to determine their fair values are not available at present due to the specific closed manner of their trading. Analysis and assessment is performed at each balance sheet date as to whether indicators for impairment of Bank's investments are present. The significant and continuous decrease in the equity, including below the level of the registered share capital of the company/entity, subject to the investment, is regarded as a main indicator. In such cases impairment is determined with the assistance of a certified actuary but at least at the level of the difference between the acquisition cost (cost) and the assessment of participation under the equity method including with additional adjustments of the net assets, if necessary (Note 14).

c) Actuarial calculations

For assessing the present value of the long-term retirement benefit obligation the Bank uses actuarial methods and calculations based on assumptions for mortality rate, staff turnover rate, future level of salaries and a discount factor considered by the management as reasonable and relevant to the Bank (Note 24).

3. NET INTEREST AND OTHER SIMILAR INCOME

	2006 BGN'000	2005 BGN'000
Interest income and other similar income		
Loans and advances to customers	9 544	8 567
Securities available-for-sale and held-to-maturity	624	528
Placements with other banks	347	169
	10 515	9 264
Interest expenses and other similar expenses		
Borrowed funds from international institutions	1 501	1 256
Other borrowed funds	147	117
Customer deposits	14	35
Deposits from other banks	2	5
	1 664	1 413
Net interest and other similar income	**8 851**	**7 851**

4. NET FEE AND COMMISSION INCOME

	2006 BGN'000	2005 BGN'000
Fee and commission income		
Customers' accounts, bank transfers, cash operations	190	160
Trust management of borrowed funds	77	75
Guarantees and letters of credit	23	24
	290	259
Fee and commission expenses		
Bank transfers and cash operations with other banks	11	12
Current accounts due from other banks	7	8
	18	20
Net fee and commission income	**272**	**239**

5. GAINS LESS LOSSES FROM DEALING IN FOREIGN CURRENCIES

	2006	2005
	BGN'000	BGN'000
Net gain from dealing in foreign currencies	62	79
Net foreign currency translation (loss)/gain	(1)	(2)
	61	77

6. GAINS LESS LOSSES FROM SECURITIES AVAILABLE-FOR-SALE

	2006	2005
	BGN'000	BGN'000
Net gain on transactions in securities available-for-sale, incl. realised revaluation reserve	359	45
	359	45

7. OTHER OPERATING INCOME

	2006	2005
	BGN'000	BGN'000
Legal expenses recovered	101	61
Rentals	35	38
Dividends	50	32
Other (losses)/income	(11)	19
	175	150

8. LOAN IMPAIRMENT AND UNCOLLECTABILITY LOSSES

	2006	2005
	BGN'000	BGN'000
Specific allowances for loan impairment	2 704	1 429
General allowances for loan impairment on portfolio basis	63	53
	2 767	1 482

9. GENERAL ADMINISTRATIVE EXPENSES

	2006 BGN'000	2005 BGN'000
Personnel costs	1 532	1 703
Remuneration of the members of the Management Board and the Supervisory Board	328	333
Depreciation and amortisation	264	322
Communications and IT services	263	251
Taxes and governmental charges	251	275
Office and office equipment maintenanc	234	386
Legal and consulting services	219	79
Advertising and entertainment costs	134	111
Hired services	72	51
Business trips	47	52
Rentals	17	23
Contribution to the Statutory Fund for Guaranteeing Deposit	17	22
	3 378	3 608
Personnel costs comprise:		
Salaries	1 077	1 154
Social security contributions	231	306
Social benefits	216	235
Employee benefits upon retirement	8	8
	1 532	1 703

Personnel costs include Executive Directors' remuneration amounting to BGN 87 thousand (2005: BGN 96 thousand).

Taxes include: unrecoverable input VAT, one-off taxes, local taxes and fees, governmental and legal charges.

10. INCOME TAX EXPENSE

	2006	2005
	BGN'000	BGN'000
Current income tax expense	533	501
Deferred income tax expense related to:		
- temporary differences	4	(7)
- tax rate decrease - 5% (2005: none)	13	-
Income tax expense	**550**	**494**

Reconciliation of income tax expense

Accounting profit for the year	3 554	3 272
Tax calculated at the standard rate of 15% (2005: 15%)	536	491
Tax effects from:		
- expenses not deductible for tax purposes	1	3
- tax rate decrease - 5% (2005: none)	13	-
Income tax expense	**550**	**494**

11. CASH AND BALANCES WITH THE CENTRAL BANK

	2006	2005
	BGN'000	BGN'000
Cash on hand	415	81
Balances with the Central Bank:		
Current account in BGN	79	4
Mandatory reserve deposit in BGN	5 642	4 511
Security fund in BGN	2	1
	5 723	4 516
Total cash and balances with the Central Bank	**6 138**	**4 597**

The deposits with the Central Bank are not interest-bearing.

12. DUE FROM OTHER BANKS

	2006	2005
	BGN'000	BGN'000
Current accounts and demand deposits		
Local banks		
BGN	130	357
Foreign currency	120	152
Foreign banks		
Foreign currency	290	201
	540	710
Term deposits within one month		
Local banks		
Foreign currency	19 761	3 385
BGN	2 803	-
	22 564	3 385
	23 104	**4 095**

The term deposit in BGN in local banks is with original maturity of 15 days and is secured with government securities of nominal value BGN 2,543 thousand (repo deal).

Effective interest rates on amounts due from other banks

The average interest rates applied to the current accounts are:

	2006		2005	
	from	to	from	to
USD	0.20%	3.75%	0.20%	3.75%
EUR	0.20%	2.00%	0.20%	2.00%
BGN	0.75%	1.00%	0.75%	1.00%

The average interest rates applied to the term deposits are:

	2006 from	2006 to	2005 from	2005 to
BGN	2.15%	3.58%	1.85%	3.50%
EUR	2.18%	3.70%	1.90%	2.38%
USD	5.20%	5.23%	-	-

13. LOANS AND ADVANCES TO CUSTOMERS

	2006	2005
	BGN'000	BGN'000
Loans	74 877	75 745
Allowances for loan impairment and uncollectability	(7 672)	(6 679)
	67 205	**69 066**
A. Analysis of loans by type of customers		
Companies and sole traders		
BGN	47 153	37 108
Foreign currency	27 297	38 386
Individuals		
BGN	74 450	75 494
	427	251
	74 877	**75 745**
B. Analysis of loans by sector of economy		
Manufacturing	26 348	28 530
Tourist services	11 041	15 588
Trade	4 354	15 565
Agriculture	9 543	8 180
Construction	10 244	4 168
Transport	8 913	-
Other industrial sectors	4 434	3 714
	74 877	**75 745**

The Bank provides funding mainly to small- and medium-sized businesses.

	2006	2005
	BGN'000	BGN'000
C. Maturity of loans		
Up to 1 month	991	461
From 1 month to 3 months	3 924	2 156
From 3 months to 1 year	23 939	7 982
From 1 year to 3 years	24 316	17 297
From 3 years to 5 years	12 403	14 422
Over 5 years	9 304	33 427
	74 877	**75 745**

The loans denominated in BGN are with floating interest rates, calculated by applying the basic interest rate quoted by the Central Bank or the basic interest rate of the Bank itself. The latter is determined periodically on the grounds of market changes plus a margin set individually for each customer. The agreed-upon margins for loans with the basic interest rate quoted by the Central Bank range from 4.9% to 12% annually (2005: from 5.5% to 12%). The agreed-upon margins for loans with the basic interest rate of the Bank itself range from 0.5% to 3% (2005: from 2% to 3%). The Bank's basic interest rate for the period varies from 7.45% to 8.36% (2005: 7.45%).

The loans denominated in foreign currency (EUR) are with interest, calculated by applying the basis interest rate of the Bank itself determined on the grounds of the cost of funds and a margin set individually for each customer. The Bank has the right to reconsider the basic interest rate in accordance with change in the cost of funds. At 31 December 2006 the effective rates vary from 5.58% to 16% p.a. (2005: from 6.55% to 16%).

D. Movement in the allowances for loan impairment and uncollecatbility

	Specific allowances BGN'000	General allowances BGN'000	Total BGN'000
Balance at 31 December 2004	3 841	1 488	5 329
Allowance for loan impairment for the year	1 429	53	1 482
Write-offs	(132)	-	(132)
Balance at 31 December 2005	**5 138**	**1 541**	**6 679**
Allowance for loan impairment for the year	2 704	63	2 767
Write-offs	(1 774)	-	(1 774)
Balance at 31 December 2006	**6 068**	**1 604**	**7 672**

14. SECURITIES AVAILABLE-FOR-SALE

	2006 BGN'000	2005 BGN'000
Government bonds in BGN	386	4 334
Government bonds in EUR (ZUNK bonds)	7 035	7 545
Unquoted equity shares	1 818	1 818
	9 239	**13 697**

14. SECURITIES AVAILABLE-FOR-SALE (continued)

	2006 BGN'000	2005 BGN'000
Movement in securities available-for-sale		
At 1 January	13 697	16 238
Additions (purchases)	-	12
Disposals (sale and/or redemption)	(4 006)	(2 941)
Net (loss)/gain on remeasurement of securities available-for-sale at fair value	(452)	388
At 31 December	**9 239**	**13 697**

Fair value of government bonds

	Par value BGN'000	Fair value BGN'000	Accrued interest (coupon) as at 31 Dec BGN'000	Interest rate (coupon)	Maturity
2006					
Medium-term government bonds in BGN	-	-	-		
Long-term government bonds in BGN	350	374	12	7.50%	2009
Government bonds in EUR (ZUNK bonds)	7 017	6 933	102	6-month EURIBOR	2019
	7 367	**7 307**	**114**		
2005					
Medium-term government bonds in BGN	1 500	1 562	46	6.50%-7%	2006-2007
Long-term government bonds in BGN	2 320	2 649	77	7%-7.50%	2009-2013
Government bonds in EUR (ZUNK bonds)	7 557	7 463	82	6-month EURIBOR	2019
	11 377	**11 674**	**205**		

As at 31 December 2006, securities of fair value BGN 7,421 thousand are blocked as a collateral for borrowed funds from the State Budget in the special account of the Ministry of Finance (2005: BGN 5,858 thousand).

Fair value of unquoted equity shares

	Shares	Par value BGN'000	Percentage in share capital	Capital paid BGN'000	Fair value BGN'000
Shares denominated in EUR	3	5 867	0.15%	1 173	1 765
Shares denominated in BGN	1 926	19	0.25%	19	41
Shares denominated in BGN	3	3	0.12%	3	12

The Bank owns shares in EUR in the European Investment Fund (EIF). The not paid-in portion of the nominal value of the acquired shares of EIF is due after decision of the General Meeting of Shareholders.

The shares denominated in BGN are shares of the capital of two companies licensed as payment system operators under the Bulgarian law -Bankservice AD and BORICA AD. BORICA AD is the abbreviation of the Bank Organization for Bank Card Payments. It can have only banks as its shareholders. Bankservice AD is a Bulgarian company, which develops and maintains the National Intra-bank Settlement System BISERA, the System for Electronic Budget Settlements SEBRA and the System for Prompt Cash Transfers EXPRESS M. It can have only banks as its shareholders and they acquire their shares in a special way whereas the value per share is determined using a formula stated in the company's statute.

The shares are presented at cost (acquisition price) due to their specific closed way of trading.

15. SECURITIES HELD-TO-MATURITY

	Number of bonds	Par value EUR	Amortized cost BGN'000	Fair value BGN'000
Bonds denominated in EUR	100	1,000	197	197

In 2004 the Bank purchased 100 non-cash, interest-bearing, unsecured bonds from the first issue of Doverie United Holding AD, denominated in EUR. The amount of the debenture loan is EUR 1,360 thousand. The par value of the bonds is EUR 1,000. The loan maturity is after 60 months. Principal is paid in three equal portions on: 30 November 2007, 30 November 2008 and 30 November 2009. The bonds are with fixed interest rate of 6.75% p.a. The six-month interest coupons are payable in May and November. The bonds are presented at amortized cost.

16. NON-CURRENT ASSETS HELD-FOR-SALE

	2006 BGN'000	2005 BGN'000
Land and buildings	1 611	8
Machinery and equipment	596	-
	2 206	**8**

The non-current assets held-for-sale include property, plant and equipment acquired by the Bank as a way of settling obligations on loans granted thereby. The assets are currently not used and the Bank does not intend to use them in its future operating activities. The managment actively seeks buyers for selling them until April 2007.

17. PROPERTY AND EQUIPMENT

	Buildings BGN'000	Bank equipment and computers BGN'000	Furniture and fittings BGN'000	Motor vehicles BGN'000	Total BGN'000
Book value (cost)					
At 1 January 2005	1 869	679	182	290	3 020
Additions	-	120	16	80	216
Disposals	-	-	-	-	-
At 31 December 2005	1 869	799	198	370	3 236
Additions	-	64	26	-	90
Disposals	-	(123)	(10)	-	(133)
At 31 December 2006	1 869	740	214	370	3 193
Accumulated depreciation					
At 1 January 2005	133	401	75	60	669
Charge for the year	38	112	27	67	244
Disposals	-	-	-	-	-
At 31 December 2005	171	513	102	127	913
Charge for the year	38	103	27	65	233
Disposals	-	(123)	(7)	-	(310)
At 31 December 2006	209	493	122	192	1 016
Net book value					
At 31 December 2006	**1 660**	**247**	**92**	**178**	**2 177**
At 31 December 2005	**1 698**	**286**	**96**	**243**	**2 323**

18. INTANGIBLE ASSETS

	License BGN'000	Software BGN'000	Total BGN'000
Book value (cost)			
At 1 January 2005	38	379	417
Additions	-	62	62
Disposals	-	(196)	(196)
At 31 December 2005	38	245	283
Additions	-	8	8
Disposals	-	(33)	(33)
At 31 December 2006	38	220	258
Accumulated depreciation			
At 1 January 2005	14	219	233
Charge for the year	8	69	77
Disposals	-	(130)	(130)
At 31 December 2005	22	158	180
Charge for the year	4	27	31
Disposals	-	(27)	(27)
At 31 December 2006	26	158	184
Net book value			
At 31 December 2006	**12**	**62**	**74**
At 31 December 2005	**16**	**87**	**103**

The license represents the right for identification and participation in the SWIFT system.

19. OTHER ASSETS

	2006 BGN'000	2005 BGN'000
Prepayments and advances	76	76
VAT receivable	65	-
Other receivables	9	10
	150	**86**

20. DUE TO OTHER BANKS

The amounts due represent balances of local banks current accounts denominated in BGN.

21. DUE TO CUSTOMERS

A. Analysis by type of customer

	2006 BGN'000	2005 BGN'000
Individuals		
BGN	159	191
Foreign currency	65	55
	224	**246**
Companies and sole traders		
BGN	4 935	2 396
Foreign currency	1 515	318
	6 450	**2 714**
	6 674	**2 960**

The amounts due to individuals represent deposits of the Bank's employees.

B. Maturity of deposits

	2006 BGN'000	2005 BGN'000
Demand deposits		
BGN	2 990	2 163
Foreign currency	1 522	300
	4 512	**2 463**
Term deposits		
Up to 1 month:		
BGN	2 076	398
Foreign currency	56	72
	2 132	**470**
From 1 month to 1 year:		
BGN	28	26
Foreign currency	2	1
	30	**27**
	6 674	2 960

The demand deposits include customer blocked accounts at the amount of BGN 448 thousand (2005: BGN 629 thousand).

C. Interest rates

The interest rates applied to the customers' accounts in 2006 are:

	USD	EUR	BGN	GBP
Current accounts:	0.20%	0.10%	0.20%	0.00%
Term deposits:				
up to 1 month	2.10%	1.75%	1.75%	1.50%
up to 3 months	2.15%	1.85%	2.00%	1.70%
up to 6 months	2.20%	1.90%	2.10%	2.00%
up to 1 year	2.25%	1.95%	2.50%	2.50%

The interest rates applied to the customers' accounts in 2005 are:

Current accounts:	0.20%	0.10%	0.20%	0.00%
Term deposits:				
up to 1 month	2.10%	1.75%	1.75%	1.50%
up to 3 months	2.15%	1.85%	2.00%	1.70%
up to 6 months	2.20%	1.90%	2.10%	2.00%
up to 1 year	2.25%	1.95%	2.50%	2.50%

22. BORROWED FUNDS FROM INTERNATIONAL INSTITUTIONS

	2006 BGN'000	2005 BGN'000
Long-term Global Loan from the European Investment Bank	13 754	15 885
Long-term Framework Loan Agreements with the Council of Europe Development Bank	29 523	29 458
Long-term loan from the Nordic Investment Bank	11 734	1 912
	55 011	**47 255**

European Investment Bank

The Bank has signed a financial agreement (Global Loan Bulgaria - Encouragement Bank AD) with the European Investment Bank for EUR 10,000 thousand to be used for funding of small and medium-sized businesses. This contract is based on a framework agreement signed on 14 July 1997 between the European Investment Bank and the Republic of Bulgaria. The loan has been entirely utilised in tranches. As at 31 December 2006 the outstanding balance is EUR 7,020 thousand (2005: EUR 8,112 thousand). Interest is payable quarterly. The interest rate is determined at the beginning of each interest period on a quarterly EURIBOR basis. The effective interest rate as at 31 December 2006 is 3.77% (2005: 2.56%). The loan will be repaid in 22 semi-annual instalments starting on 15 December 2003 until 15 June 2014. It is guaranteed by the Republic of Bulgaria.

Council of Europe Development Bank (CEB)

Framework Loan Agreements for EUR 10,000 thousand and EUR 5,000 thousand were signed on 2 January 2003 between the Council of Europe Development Bank (CEB), the Republic of Bulgaria represented by the Minister of Finance and Encouragement Bank AD. The loans have been drawn in tranches and as at 31 December 2006 the whole amount of EUR 15,000 thousand has been entirely utilised. Interest is payable on a quarterly basis. The inerest rate is determined at the beginning of each interest period on the basis of quarterly EURIBOR plus 0.29% - 0.34%. At 31 December 2006 the effective interest rates are 3.809% -3.946% (2005: 2.477% -2.781%). The maturity of the loans is 10 years from the date of utilisation of the respective tranche. The principal amount is due bullet, at maturity. The loan agreement for the amount of EUR 10,000 thousand is guaranteed by the Republic of Bulgaria.

Nordic Investment Bank

On 16 November 2004 the Bank signed a Loan Agreement with the Nordic Investment Bank for a loan amounting to EUR 10,000 thousand. The repayment term for the loan is 10 years for each of the tranches utilised and a grace period of up to 2 years. The loan can be utilised in maximum 5 tranches each of them being for not less than EUR 1,000 thousand and not more than EUR 5,000 thousand. The deadline for utilising the loan is 15 December 2007. The purpose of the loan is the financing up to 50% of the expenses on investment projects of small-and medium-sized enterprises in Bulgaria for projects of mutual interest for Bulgaria and the NIB member countries. The Government of the Republic of Bulgaria has issued a Letter of Comfort accepted as a collateral for the credit line. As at 31 December 2006, the Bank has utilised one tranche of EUR 1,000 thousand with a repayment schedule from July 2007 till July 2015 at 17 equal installments and a second tranche of EUR 5,000 thousand with a repayment schedule from July 2008 till July 2016 at 17 equal installments. The interest is payable on a semiannual basis.The inerest rate is determined at the beginning of each interest period on the basis of six-month EURIBOR. The effective interest rate as at 31 December 2006 is 4.054% and 4.371% respectively (2005: 3.176%).

Japanese Bank for International Cooperation (JBIC)

A Loan Agreement for EUR 10,000 thousand was signed on 19 July 2006 between the Bank and the Japanese Bank for International Cooperation. The purpose of the loan is financing of the import of Japanese investment goods and part of the local expenses of Bulgarian companies. The Government of the Republic of Bulgaria has issued a Letter of Comfort accepted as a collateral for the credit line. The agreement is structured as a framework agreement and should be utilised until February 2009. For 60% of the amount of a drawn tranche the interest rate is determined on the basis of a fixed interest rate CIRR + margin and for the remaining 40% of the amount -on the basis of a floating six-month EURIBOR + 0.65%. No financial commitments arise for Encouragement Bank from the signing of the agreement. As at 31 December 2006 no tranches have been drawn.

Croatian Bank for Reconstruction and Development (CBRD)

A Framework Loan Agreement for EUR 1,000 thousand for a two-year term was signed on 19 September 2006 between the Bank and the Croatian Bank for Reconstruction and Development. The purpose of the loan is financing of the import of Croatian investement goods by Bulgarian companies. On indetifying a suitable project the two banks sign a separate agreement with the specific loan terms. No collateral is required for signing the agreement. As at 31 December 2006 no amounts have been drawn.

23. OTHER BORROWED FUNDS

	2006	2005
	BGN'000	BGN'000
Long-term refunding agreement with the State Fund Agriculture	1 339	2 607
KfW funds provided by the Ministry of Finance for trust management	7 724	3 665
	9 063	**6 272**

KfW funds provided by the Ministry of Finance for trust management

The Bank has concluded an agreement with the Ministry of Finance (MF) for management of funds granted to the Ministry by Kreditanstalt fur Wiederaufbau pursuant to an agreement between the Governments of Bulgaria and Germany. These funds are advanced to other partner-banks intermediaries, for the purpose of financing small and medium-sized businesses. The Ministry retains the risk for the advances provided to the partner-banks.

The main responsibilities of the Bank in respect of the funds management include the following: selection of the banks - intermediaries, jointly with the Ministry of Finance, and transferring the funds to those approved; gathering of information and performance of periodic reviews regarding the funds utilization, establishing of a pledge on government securities on the part of the borrowers, monitoring of the timely payments of the interest and principal due and their repayment to the special account of the Ministry of Finance. At 31 December 2006 no funds have been transferred to partner-banks (2005: BGN 3,912 thousand).

The Bank receives a management fee of 1% per annum. The calculation of the management fee is based on the total of funds advanced to the partner-banks plus the balance on the current account of the Fund with the Bank. The balance bears quarterly interest of 2% per annum.

Long-term refunding agreement with the State Fund Agriculture

Under a Contract, signed in 2002, with the State Fund Agriculture for re-financing special-purpose loans provided to farmers, the Fund has refinanced the Bank with its own funds for granting such loans in relation to investment projects and disclosed investment programs. The interest due by the Bank on the borrowed funds is 2% p.a. The loans granted by the Bank to the farmers are at 9% annual interest rate. The re-financing amount received from the Fund is BGN 14 thousand as at 31 December 2006 (2005: BGN 72 thousand).

In 2003, the Bank signed a contract and annexes thereto with State Fund Agriculture for re-financing loans granted by the Bank for the execution of approved projects under SAPARD program, for which agreements have been concluded for grant-based aid under the terms and conditions of the Special pre-accession program of EC for the development of agriculture and the rural areas in Bulgaria. The interest on the borrowed funds due by the Bank is 2% p.a. The Bank grants loans to farmers under the SAPARD program at 9% annual interest rate. The re-financing amount obtained from the Fund as at 31 December 2006 is BGN 1,323 thousand (2005: 2,531 thousand). In accordance with the annexes signed with the State Fund Agriculture for the execution of projects under SAPARD program, the period for inclusion of new projects under this contract expires on 31 December 2006.

24. OTHER LIABILITIES

	2006	2005
	BGN'000	BGN'000
Payables to personnel and for social security	244	180
Taxes payable	71	131
Accruals	63	57
Payables to EIF	63	-
Unamortised grant for the purchase of computer equipment	-	3
Other creditors	4	5
	445	**376**

The payables to EIF represent amounts due to the Fund for its coverage of losses on secured loans, which losses have later been recovered through payments from the borrowers. (Note 31).

The *payables to personnel* include current salaries for December, accruals on compensated leaves and social security contributions thereon as well as the present value of the Bank's liability due on retirement benefit obligations as at 31 December 2006. Under the Labour Code each employee is entitled to indemnity at the amount of two gross monthly salaries upon retirement while if the service period with the Bank exceeds 10 years, the indemnity shall amount to six gross monthly salaries.

An actuarial valuation was carried out by the Bank using the services of a certified actuary in order to determine the amount of these liabilities. On the basis of the actuarial report, a liability was included in the balance sheet as at 31 December 2006 at the amount of BGN 64 thousand (2005: BGN 56 thousand).

	2006	**2005**
	BGN'000	**BGN'000**
Present value of the liability at 1 January	61	51
Unrecognized actuarial loss at 1 January	(5)	(3)
Liability recognized in the balance sheet at 1 January	**56**	**48**
Expenses for the period	8	8
Liability recognized in the balance sheet at 31 December	**64**	**56**
Unrecognized actuarial loss at 31 December	(5)	(5)
Present value of the liability at 31 December	69	61

The following actuarial assumptions were used on determination of the value as at 31 December 2006:

- mortality rate - in accordance with the table issued by the National Statistics Institute for the total mortality rate of the population in Bulgaria for the period 1998 - 2001;
- staff turnover rate - from 0% to 10% for the four age groups formed with the Bank;
- effective annual interest rate i = 7%;
- the assumption for the future level of the salaries is based on the information provided by the Bank's management and amounts to 10% annual growth for 2007 against 2006 and 5% for each subsequent year compared to the prior reporting period.

The assumptions have not changed from the ones used in 2005.

25. DEFERRED TAX LIABILITIES

	2006		2005	
		BGN'000		BGN'000
	Temporary difference	Tax	Temporary difference	Tax
Deferred tax assets				
Property and equipment	60	6	91	14
Other payables	197	20	195	29
Total deferred tax assets	**257**	**26**	**286**	**43**
Deferred tax liabilities				
Unrealised gains from remeasurement of available-for-sale securities	811	81	1 590	239
Total deferred tax liabilities	**811**	**81**	**1 590**	**239**
Net deferred tax liabilities	**554**	**55**	**1 304**	**196**

26. SHARE CAPITAL

	2006	2005
	BGN'000	BGN'000
Share capital		
295,735 ordinary registered voting shares of BGN 100 nominal value each	27 964	27 964
Issue of ordinary shares for cash fully paid	1 610	1 610
Issue of ordinary shares - contribution-in-kind (Bank's building)	29 574	29 574

The Bank did not issue new shares in 2006.

27. RESERVES

In accordance with the special requirements of the Law on Banks in force until 31 December 2006, the Articles of Association of the Bank prescribe that at least one fifth of the profit after taxes should be allocated to the Statutory Reserve until this fund reaches 1.25% of the total amount of the assets and the off-balance sheet commitments, in order to be able to distribute dividends.

The Bank can use the money from the Statutory Reserve to cover its current or prior period losses, but can not use it for distribution of dividends without permission of the Bulgarian National Bank. In 2005, on allocating the profit for 2004, the Bank fulfilled the requirement regarding the formation of the Satutory Reserve.

Following decision of the General Meeting of Shareholders of 23 May 2006, the whole 2005 profit is allocated as an increase to the Statutory Reserve.

The new Law on Credit Institutions in force from 1 January 2007 does not prescribe special rules as regards the formation of Statutory Reserve. Therefore, the Bank will follow the common order of the Commercial Act, namely: at least one tenth of the after tax profit, funds paid above the nominal amount on issuance of capital, the sum of the additional payments made against priviliges granted on the acquired shares, other sources specified in the Articles of Association or designated by the General Meeting of Shareholders until the Fund reserves reach up to 1/10th of the share capital determined by Articles of Association except when the Articles of Association stipulates more strigent requirements. In addition, under the above mentioned law the banks cannot distribute dividends before reaching the minimum reserves required by law or Articles of Association, or in case the distribution of dividends results in violating the regulatory capital adequacy ratios.

28. CONTINGENT LIABILITIES AND COMMITMENTS

	Contract amount 2006 BGN'000	**Contract amount 2005 BGN'000**
Contingent liabilities		
Bank guarantees and letters of credit	1 282	1 085
Irrevocable commitments		
Undrawn loans	14 799	7 937
Uncalled nominal portion of EIF shares (Note 14)	4 694	4 694
	19 493	12 631
	20 775	**13 716**

28. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

Nature of instruments and credit risk

These commitments and contingent liabilities bear an off-balance sheet credit risk because only fees are recognised in the financial statements until the commitments are fulfilled or expire. The amounts reflected in the above table for guarantees represent the maximum accounting loss that would be recognised at the balance sheet date if counterparties failed completely to perform as contracted. Many of the contingent liabilities and commitments will expire without being advanced fully or partially. Therefore, the amounts do not represent expected future cash flows. The collateral coverage ratio for guarantees is over 100% and represents deposits blocked at the Bank, mortgages of real estate and insurance policies issued in favour of the Bank.

29. CASH AND CASH EQUIVALENTS

	2006	2005
	BGN'000	BGN'000
Cash and cash equivalents include:		
Cash on hand	415	81
Current account with the Central Bank	79	4
Amounts due from other banks, with less than 90 days maturity	23 093	4 095
	23 587	**4 180**

30. BANK REGULATORS IN ACCORDANCE WITH THE BULGARIAN LEGISLATION

According to the requiremenrts of the banking legislation effective in Bulgaria and the instructions of the Bulgarian National Bank (BNB) in its capacity of a Central Bank, Encouragement Bank AD shall observe ceratin restrictions related to the following ratios:

Total capital adequacy ratio

The Bank calculates its total capital adequacy ratio as a percentage of its net capital base to the total risk weighted assets. The capital base includes the registered share capital, the Statutory Reserve and the other reserves up to a particular amount. The total risk weighted assets include the balance sheet and off-balance sheet exposures (items) as reported, weighted in accordance with their risk. The reported capital adequacy ratio level at 31 December 2006 is 38.93% (2005: 41.54%). The minimum capital adequacy ratio required by law is 12%.

Minimum share capital

As at 31 December 2006, the Bank's share capital is BGN 29,574 thousand (2005: BGN 29,574 thousand) and it has met the Central Bank (BNB) requirements for a minimum share capital of BGN 10,000 thousand.

Other regulatory ratios

Capital base to open foreign currency positions -the maximum ratio is up to 30% for all foreign currency positions and respectively, up to 15% for each foreign currency position with the exception of those in EUR; Capital base to large risk exposures -the total amount of all large loans cannot exceed 8 times the Bank's capital base. The exposure to a borrower or related parties cannot exceed 25% of the Bank's capital base; Liquid assets to net cash flows -the Central Bank (BNB) monitors the amount and composition of the Banks' liquid assets and when necessary, determines minimal liquidity ratio for each bank, which shall be reached within a defined term as a percentage of the liquid assets to the funds attracted; Capital base to the amount of property, equipment and shares in non-financial institutions -the investments cannot exceed the Bank's capital base while only those in property and equipment can amount up to 50% of the capital base.

As at 31 December 2006 the Bank has complied with all regulatory requirements of the Central Bank and Bulgarian legislation.

31. RISK MANAGEMENT

In the ordinary course of business, the Bank is exposed to a variety of risks the most important of which are credit risk, market risk and liquidity risk. These risks are identified, measured and monitored through various control mechanisms in order to price bank services and products on a risk-adjusted basis and to prevent undue risk concentrations.

Credit risk

Credit risk is the risk that customers will fail to repay to the Bank the amounts due in full and within the set term.

The management of specific credit risk is performed by the Credit Committee of the Bank and is supervised by both the Management and the Supervisory Boards. The credit risk management function ensures that appropriate policies are established and its compliance with the related credit monitoring procedures and controls. Exposure to credit portfolio risk is managed through regular analysis of the ability of borrowers to meet interest and capital repayment obligations and by establishing lending limits as appropriate. Exposure to credit risk is also reduced in part by obtaining different types of collateral. In addition, on the basis of a guarantee letter from year 2003 and the subsequent annexes signed between the Bank and the European Investment Fund (EIF), the Bank participates in the EU SME Guarantee Facility under conditions determined by the long-term EU program on SMEs. EIF on its part is committed to provide a guarantee covering 50% of the loss on the principal and interest of each loan, included in the sub-portfolio of the Bank, formed on the basis of the conditions of the agreement, but not exceeding EUR 2,520 thousand. The maximum amount of the loans granted, which will be covered by the EIF guarantee, is EUR 42,000 thousand. The deadline for utilising the guarantee facility is 30 June 2007 determined in annex signed on 31 December 2005. The guarantee is limited and covers 50% of the Bank's newly allowed investment credit portfolio with a period over 36 months formed within the term for utilising the facility. The payment obligation on the part of EIF amounts to 12% of the guarantee determined on the basis of the total secured portfolio formed as at 30 June 2007. The Bank has committed itself to use not so strict requirements in accepting collateral for the EIF-guaranteed portfolio of loans.

The Bank is exposed to risk due to the concentration in small-and medium-sized businesses and in loans with maturity of mainly 3 to 10 years.

The primary purpose of the instruments in the form of guarantees and letters of credit is to ensure that funds are available to a customer as required. Guarantees and letters of credit, which represent irrevocable commitments that the Bank will make payments in the event that a customer cannot meet its obligations to third parties, carry the same credit risk as loans. Documentary and commercial letters of credit, which are written undertakings by the Bank on behalf of a customer authorising a third party to draw drafts on the Bank up to a stipulated amount under specific terms and conditions. They are collateralised by the underlying shipments of goods to which they relate and therefore carry less risk than a direct borrowing.

Commitments to extend credit represent undrawn portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to extend credit the Bank is potentially exposed to loss in an amount equal to the total undrawn commitments. However, the likely amount of loss is less than the total unused commitment since most commitments to extend credits are contingent upon customers maintaining specific credit standards. The Bank monitors on a current basis the utilization periods of credit commitments because longer-term commitments generally have a greater degree of credit risk than the shorter-term commitments.

Market risk

Market risk is the risk of adverse movements in the level of interest rates, in the rate of exchange between currencies and the market price of securities and other financial instruments. Accordingly, these movements may affect the Bank's profitability.

The Bank is always exposed to the effects of fluctuations in the prevailing levels of market interest rates which impacts its financial position and cash flows. Interest margins may increase as a result of such changes but may reduce or create losses in the event that unexpected movements arise.

Interest rates on assets and liabilities denominated in BGN are based on the movements of the basic interest rate as determined by the Central Bank (BNB) and the fluctuations are to a certain extent relatively predictable. The Bank monitors constantly interest rate movements in foreign currencies, the mismatch in interest rate levels and in the maturity structure of its assets and liabilities. It also monitors the price changes and the yields of the traded government securities. Market risk is actively monitored by the Analysis Department to ensure compliance with market risk limits. The Bank's market risk exposure is monitored on a current basis by its Assets and Liabilities Committee.

The table below summarises the Bank's exposure to interest rate risks. Information on the Bank's assets and liabilities at their carrying amounts and as categorised by maturity dates and their sensitivity to the interest rate fluctuations has been provided in the table below.

Interest rate risk analysis

		Fixed interest rate instruments					
As at 31 December 2006	**Floating interest rate instruments**	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
Assets							
Interest bearing assets							
Due from other banks	540	22 564	-	-	-	-	23 104
Loans and advances to customers	57 775	-	9 430	-	-	-	67 205
Securities available-for-sale	7 035	-	-	-	386	-	7 421
Securities held-to-maturity	-	-	-	-	197	-	197
	65 350	**22 564**	**9 430**	**-**	**583**	**-**	**97 927**
Non-interest bearing assets							12 563
Total assets	**65 350**	**22 564**	**9 430**	**-**	**583**	**-**	**110 490**
Liabilities							
Interest bearing liabilities							
Due to other banks	-	1	-	-	-	-	1
Due to customers	-	5 787	11	24	-	-	5 822
Borrowed funds from international institutions	-	11 734	43 277	-	-	-	55 011
Other borrowed funds	-	-	-	-	1 339	7 724	9 063
	-	17 522	43 288	24	1 339	7 724	69 897
Non-interest bearing liabilities							1 352
Total liabilities	**-**	**17 522**	**43 288**	**24**	**1 339**	**7 724**	**71 249**
Interest sensitivity gap	**65 350**	**5 042**	**(33 858)**	**(24)**	**(756)**	**(7 724)**	

Interest rate risk analysis (contiued)

As at 31 December 2005	Floating interest rate instruments	Fixed interest rate instruments					Total
		Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	
Assets							
Interest bearing	59 199	3 385	18 122	-	3 900	631	85 237
Non-interest bearing							8 935
	59 199	**3 385**	**18 122**	**-**	**3 900**	**631**	**94 172**
Liabilities							
Interest bearing	-	4 774	45 354	12	2 610	3 665	56 415
Non-interest bearing							917
	-	**4 774**	**45 354**	**12**	**2 610**	**3 665**	**57 332**
Interest sensitivity gap	**59 199**	**(1 389)**	**(27 232)**	**(12)**	**1 290**	**(3 034)**	

Currency risk

The currency risk is the risk of adverse impact of fluctuations in the prevailing foreign currency exchange rates on the Bank's financial position and cash flows. The net position in any currency is monitored on a continuous basis by the Assets and Liabilities (Liquidity) Committee. The major part of the Bank's assets and liabilities are denominated in EUR and since the BGN is fixed to the EUR there is no significant exchange rate risk related thereto. The table below summarizes the Bank's exposure to foreign currency exchange rate risk. Included in the table are the Bank's assets and liabilities at carrying amount, categorized by currency.

Foreign currency position analysis

At 31 December 2006	In USD	In EUR	In other foreign currency	In BGN	Total
	BGN '000	BGN '000	BGN '000	BGN '000	BGN '000
Assets					
Cash and balances with the Central Bank	20	34	-	6 084	6 138
Due from other banks	75	20 077	19	2 933	23 104
Loans and advances to customers	-	25 036	-	42 169	67 205
Securities available-for-sale	-	8 800	-	439	9 239
Securities held-to-maturity	-	197	-	-	197
Property and equipment	-	-	-	2 177	2 177
Intangible assets	-	-	-	74	74
Non-current assets held-for-sale	-	-	-	2 206	2 206
Other assets	-	-	-	150	150
Total assets	**95**	**54 144**	**19**	**56 232**	**110 490**

Liabilities					
Due to other banks	-	-	-	1	1
Due to customers	75	1 504	1	5 094	6 674
Funds borrowed from international institutions	-	55 011	-	-	55 011
Other borrowed funds	-	7 724	-	1 339	9 063
Other liabilities	-	92	-	353	445
Deferred tax liabilities	-	-	-	55	55
Total liabilities	**75**	**64 331**	**1**	**6 842**	**71 249**
Net balance sheet currency position	**20**	**(10 187)**	**18**	**49 390**	**39 241**
Contingent liabilities and commitments	**43**	**8 160**	**-**	**12 572**	**20 775**
As at 31 December 2005					
Total assets	71	48 012	109	45 980	94 053
Total liabilities	64	51 234	22	6 012	64 816
Net balance sheet currency position	**7**	**(3 222)**	**87**	**39 968**	**29 237**
Contingent liabilities and commitments	**-**	**7 150**	**-**	**6 566**	**13 716**

Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its current and potential payment obligations as and when they fall due without unacceptable losses.

The Bank's business requires a stable flow of funds both to replace existing deposits as they mature and to satisfy demands of customers for additional borrowing. Undrawn borrowing facility commitments and the level of outstanding contingent obligations are taken into consideration in monitoring the Bank's liquidity position.

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of the Bank. It is unusual for banks ever to be completely matched. An unmatched position potentially enhances profitability, but also increases the risk of losses. The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature are important factors in assessing the liquidity of the Bank and its exposure to changes in interest rates and exchange rates. To manage this risk, the Bank maintains at all times highly liquid assets in different currencies. The overall liquidity control and monitoring are performed by the Asset and Liability (Liquidity) Committee.

The table below analyses assets and liabilities of the Bank into relevant maturity groupings based on the remaining period at balance sheet date to the remaining maturity.

31. RISK MANAGEMENT (continued)

Maturity analysis

As at 31 December 2006	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Undefined maturity	Total
Assets							
Cash and balances with the Central Bank	6 138	-	-	-	-	-	6 138
Due from other banks	23 104	-	-	-	-	-	23 104
Loans and advances to customers	890	3 522	21 486	32 957	8 350	-	67 205
Securities available-for-sale	654	-	-	2 503	4 264	1 818	9 239
Securities held-to-maturity	-	-	66	131	-	-	197
Property and equipment	-	-	-	-	-	2 177	2 177
Intangible assets	-	-	-	-	-	74	74
Non-current assets held-for-sale	-	-	-	-	-	2 206	2 206
Other assets	35	12	100	3	-	-	150
Total assets	**30 821**	**3 534**	**21 652**	**35 594**	**12 614**	**6 275**	**110 490**
Liabilities							
Due to other banks	1	-	-	-	-	-	1
Due to customers	6 644	5	25	-	-	-	6 674
Funds borrowed from international institutions	197	53	2 247	13 229	39 285	-	55 011
Other borrowed funds	114	2 135	5 753	837	224	-	9 063
Other liabilities	131	138	93	83	-	-	445
Deferred tax liabilities	-	-	-	55	-	-	55
Total liabilities	**7 087**	**2 331**	**8 118**	**14 204**	**39 509**	**-**	**71 249**
Net liquidity gap	**23 734**	**1 203**	**13 534**	**21 390**	**(26 895)**	**6 275**	**39 241**
Contingent liabilities and commitments	**281**	**935**	**11 621**	**3 244**	**-**	**4 694**	**20 775**

Liquidity requirements to support calls under guarantees and letters of credit are considerably less than the amount of the commitment because the Bank does not generally expect the third party to draw funds under these agreements.

As at 31 December 2005							
Total assets	10 456	2 701	19 218	39 942	17 611	4 244	94 172
Total liabilities	3 256	255	6 569	10 874	36 378	-	57 332
Net liquidity gap	**7 200**	**2 446**	**12 649**	**29 068**	**(18 767)**	**4 244**	**36 840**
Contingent liabilities and commitments	**2 336**	**2 220**	**2 208**	**2 257**	**1**	**4 694**	**13 716**

32. FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

Fair value is generally the amount for which an asset could be exchanged or a liability settled in an arm's length transaction. The policy of the Bank is to disclose in its financial statements the fair value of the financial assets and liabilities for which quoted market prices are available.

The concept of fair value assumes realisation of financial instruments through sale. However, in the majority of cases, particularly in respect of loans and deposits, the Bank expects to realise assets through their collection (repayment) in full over time.

Many assets and liabilities are either short-term in nature or are carried at their market value (placements, deposits from banks, investments in securities) to the balance sheet and therefore, their fair value is equal to their carrying amount.

Sufficiently developed market, with stability and liquidity for specific purchases and sales of some financial assets and liabilities is still not in place in the country and published market price quotations for these assets and liabilities are not readily available.

The management of the Bank is of the opinion that the amounts of the financial assets and liabilities reported in the balance sheet are as reliable, adequate and valid for the purposes of financial reporting as possible under the circumstances.

33. RELATED PARTY TRANSACTIONS AND COMPANIES UNDER COMMON CONTROL BY THE STATE

1. Related parties

in 2006

company/person	***type of relation***
Ministry of Finance	Major shareholder of the Bank representing the State
Pirinplast AD	Controlled by key management personnel
Eco-Electric OOD	Controlled by key management personnel

in 2005

company/person	***type of relation***
Ministry of Finance	Major shareholder of the Bank representing the State
Pirinplast AD	Controlled by key management personnel
Eco-Electric OOD	Controlled by key management personnel

2. Companies under common control by the State

in 2006

Bulgarian State Railways EAD

33. RELATED PARTY TRANSACTIONS AND COMPANIES UNDER COMMON STATE CONTROL (continued)

3. The balances with related parties include:

as at 31 December 2006			2006 BGN'000
Assets	Type of balance	Note	
Pirinplast AD	Loans and advances to customers	13	1 121
Eco-Electric OOD	Loans and advances to customers	13	1 595
Liabilities			
Ministry of Finance	Other borrowed funds (current account of KFW)	23	7 724
Pirinplast AD	Due to customers	21	1
Eco-Electric OOD	Due to customers	21	3

as at 31 December 2005			2005 BGN'000
Assets Note Pirinplast AD	Loans and advances to customers	13	1 151
Eco-Electric OOD	Loans and advances to customers	13	1 257
Liabilities			
Ministry of Finance	Other borrowed funds (current account of KFW)	23	3 665
Pirinplast AD	Due to customers	21	4
Eco-Electric OOD	Due to customers	21	1

4. Transactions with related parties include:

in 2006	Type of income/expense	Note	2006 BGN'000
Ministry of Finance	Fee and commission income	4	77
	Interest expenses	3	(108)
Pirinplast AD	Interest income	3	159
Eco-Electric OOD	Interest income	3	165

in 2005		Note	2005 BGN'000
Ministry of Finance	Fee and commission income	4	75
	Interest expenses	3	(14)
Pirinplast AD	Interest income	3	93
Eco-Electric OOD	Interest income	3	81

5. Balances and transactions with companies under common state control include:

as at 31 December 2006			**2006**
			BGN'000
Bulgarian State Railways EAD	Loans and advances to customers (Cession)	13	8 019
Bulgarian State Railways EAD	Interest income	3	6

6. Relations with key management personnel:

The individuals that are members of the key management personnel are disclosed in Note 1.2.

	2006	**2005**
	BGN'000	**BGN'000**
Key management personnel costs (Note 9)	415	429
Interest expenses (Note 3)	3	1
	418	**430**

	2006	**2005**
	BGN'000	**BGN'000**
Payables to key management personnel (Note 24)	56	64
Due to customers on attracted deposits (Note 21)	97	106
	153	**170**

34. POST BALANCE SHEET EVENTS

Changes in the bank legislation

The Law on Credit Institutions is enforced as from 1 January 2007 and revokes the Law on Banks effective so far. The Bank is obligated to make the necessary changes in its Articles of Association in accordance with the new law within three months of its enforcement (until 31 March 2007) and to file an application with BNB for update of its bank license.

Special-purpose General Meeting of Shareholders

On 26 March 2007 a Special-purpose General Meeting of Shareholders was conducted with the following decisions taken:

1) Amendment of the section of the Articles of Association regarding the types of transactions - change in the definition and scope of the transactions performed by the Bank in conformity with the new Law on Credit Institutions;

2) Issuance of bonds with nominal value of BGN 5,000 thousand or 5,000 bonds with par value of BGN 1,000 each and issue value of BGN 1,000 each. The debenture loan is with a two-year term, with the pricipal paid bullet at maturity and the interest rate set at 4.75% annually, paid on a quarterly basis.

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