



Attn:

- Bulgarian National Bank
- Bulgarian Association of Management Companies
- Bulgarian Stock Exchange
- Investment intermediary “Somon FB”
- Investment intermediary “Beta Corp”
- Investment intermediary “STS Finance”;
- Investment intermediary “Elana Trading”

## Consultation Questionnaire

### Working Group 2

WG Coordinator: Ms. Valentina Stefanova (FSC)

Requirements to the activities of investment intermediaries

### Chapter 8

Section III (Risk Mangement), Section IV (Internal Audit)

### Prepared by

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Dear Sir,

The Bulgarian Financial Supervision Commission together with other entities indicated in the box above are participating in an Impact Assessment (IA) training initiative organized by World Bank administered Convergence Program. The purpose of this initiative is to strengthen our ability to use the disciplines of IA in order to improve the way in which we make policy. IA does this by requiring policy makers to use evidence and economic analysis to justify and explain their proposals. Consultation with stakeholders is a key part of the IA process because it promotes public accountability and provides stakeholders with the opportunity to contribute to the evidence base that should underpin the policy making process. The IA training exercise involves us undertaking a retrospective IA on an existing piece of legislation. In this case we are looking at **Ordinance N 38 on the requirements to the activities of investment firms – Chapter 8, Section III (Risk Management) and Section IV (Internal Audit) as if it was on draft stage.** We are writing to you in your capacity as one of the key stakeholders affected by this piece of legislation. We have attached to this letter a questionnaire and we would be most grateful if you could arrange for its completion.

The questionnaire is designed to provide us with evidence relating to:

- a) the nature of the problem that the regulation was seeking to address and
- b) the costs and benefits of the regulation

Once the evidence has been gathered we will complete a final IA report setting out in a clear and transparent fashion what the problem was and why the regulatory response was the best means for addressing the problem. Clearly, since this is a theoretical consultation exercise being undertaken over a shortened period of time, we would not expect you to be able to devote a large amount of resource to this exercise. Nevertheless, we will be following this up with a face-to-face meeting to quality check all stakeholder responses and enhance our understanding of your answers. And, since we do intend to consult with stakeholders in the future, we regard this as a useful exercise for you too, so are looking forward to hearing from you. We very much value your cooperation. If you have any questions regarding this exercise please contact .....

We would appreciate having your written response by December 19<sup>th</sup> 2007 in the morning when we invite you to attend the first round of consultation process as per the agenda that you will receive/have already received from FSC .

Then we are also pleased to invite to a more extensive live consultation meeting scheduled in the morning of December 20<sup>th</sup>.

Yours sincerely,

NAME ....

# ANNEX A: Impact Assessment questionnaire

Section 1: <u>What is the problem?</u>
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In this section we consider what the rationale for a particular regulatory intervention might have been.

We are looking at FSC **Ordinance N 38 Chapter 8, Section III (Risk Management) and Section IV (Internal Audit) on the requirements to the activities of investment firms**

There is asymmetric information between consumers and the investment firms about the quality of the investment process. Especially with respect to the big (with full license) intermediaries, the irregular management of their internal processes and especially the false defining of the operational and market risks could damage their financial status and have a negative impact on market stability and investor confidence.

In our view there is also a regulatory failure related to a level-playing field for investment intermediaries in the EU Common Market. The absence of common rules for investment intermediaries has caused obstacles for the development of the common financial market. The introduction of the MiFid is a prerequisite for the development of a fair, transparent and efficient financial instruments market;

**Question 1: do you agree with us that the problem is as described above?**

Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible. For example, what evidence do you think would demonstrate or in fact does demonstrate that there was significant regulatory failure? Do you agree that if the internal control wouldn't be designed as it is proposed, regulatory failure as described above would remain?

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If no intervention or further intervention would have taken place, we think that the the market would have not corrected the failure by itself in the short term for the following reasons(s):  
In our opinion the Bulgarian capital market is a new one, and this is the reason, that it could not be considered as experienced in the matter of solving disruptive processes, as far as they concern investor protection and market confidence.



Section 3: Cost-Benefit Analysis

**I- Analysis of impacts (Users)**

<b>Benefits &amp; Costs</b>	<b>Qualitative description</b>	<b>Quantitative description (e.g. major, minor)</b>
<p><b>1. Costs to consumers</b></p>	<p>In our point of view, if firms pass on higher costs of applying internal audit and risk management mechanisms, there would be a risk of increasing of charges for the clients.</p> <p><b>Question a):</b> Do you agree with the analysis above? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	<p><b>Question b):</b> If you agree with a), please estimate the extend to which the costs to consumers would be reflected (major, minor)</p>
<p><b>2. Benefits</b></p>	<p>We think that more investors and retail clients will purchase investment services as their trust in the investment intermediaries will rise.</p> <p><b>Question a):</b> Do you agree with the analysis above? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p> <p>-</p>	<p><b>Question b):</b> If you agree with question a), please estimate the benefits for consumers (major, minor)</p>

## II - Analysis of impacts (Regulated firms)<sup>1</sup>

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<b>3. Direct costs</b>	<p>Cost items:</p> <ul style="list-style-type: none"> <li>- examining/considering these rules by the regulator, discussing with the association (salary for employees within the regulator, fixed overheads per person)</li> <li>- developing a manual for ongoing and periodical supervision by the regulator (salary for employees, fixed overheads per person)</li> <li>- costs for compliance inspection (salary for employees, fixed overheads per person, costs for business trip if the investment intermediary has seat out of the capital)</li> <li>- costs for enforcement, investigation, sanction, administrative procedures (salary for employees, fixed overheads per person)</li> </ul>	
<b>4. Compliance costs</b>	<p><b>Question a)</b> – Do you agree with the cost categories for investment firms we have identified here below?</p> <p>Please also state other kinds of costs, which you think will arise to investment firms due to the regulations on internal control.</p> <p>Rules on risk management:</p> <ol style="list-style-type: none"> <li>1. Costs for analyses on how to implement the rules on risk management, e.g. development of policy and procedures under Art. 82 and creating the internal rules (one-off costs, staff-time/salaries, salaries should always include fixed overhead costs)</li> <li>2. Costs for setting up a new risk management department (if applicable):</li> </ol>	<p><b>Question b)</b> – With regard to Question a), please provide an estimate of the costs previously qualified: (Please enter cost items, currency and time horizon and other required figures)</p> <ol style="list-style-type: none"> <li>1) first full year</li> <li>2) over 5- year horizon</li> </ol>

<sup>1</sup> The table above is drawn from the UK Financial Services Authority

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p>a) hiring staff with appropriate experience and knowledge (one-off cost for the hiring process)</p> <p>b) the firm has to provide training for the employees on the new rules (one-off costs),</p> <p>c) cost for buying and introducing a new electronic system and other office equipment (one-off costs)</p> <p>3. Ongoing costs of the risk management department:</p> <p>a) salary for employees (ongoing costs)</p> <p>b) other ongoing costs for the operation of the department (e.g. software licences, office material, ...),</p> <p>4. Operational cost for management:</p> <p>-Costs for reviewing and assessing the rules for risk management by management body on a quarterly basis (salary for management body, ongoing costs)</p> <p>Rules on internal audit:</p> <p>5. Costs for analyses on how to implement the rules on internal audit (developing the mechanisms, creating the internal rules)</p> <p>6. Costs for setting up a new internal audit department (if applicable):</p> <p>a) hiring staff with appropriate experience and knowledge (one-off cost for the hiring process)</p> <p>b) the firm has to provide training for the employees on the new rules (one-off costs),</p> <p>c) cost for buying and introducing a new electronic system and other office equipment (one-off costs)</p> <p>7. Ongoing costs of the internal audit department:</p> <p>a) salary for employees (ongoing costs)</p> <p>b) other ongoing costs for the operation of the department (e.g. software licences, office material, ...)</p> <p>8. Operational cost for management:</p> <p>-Costs for reviewing and assessing the rules for internal audit by management body on an annual</p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p>basis (salary for management body, ongoing costs)</p> <p>General:</p> <ul style="list-style-type: none"> <li>- The costs described above depend on the nature, scale and complexity of the business of the investment intermediaries. We will ask in section 7. about the potential impact on small investment intermediaries.</li> <li>- The costs may decrease by using the developed common policy and procedures provided by the association of the investment intermediaries.</li> </ul> <p>Do you agree with that? If you have used this common policy, can you please give an estimate how much costs this has saved you?</p>	
<b>5. Benefits</b>	<p>In our point of view, there will be major benefits as better internal organization of the business can lead to a decrease of operational and market risks (what do you mean with market risks? Please explain) associating with activities of the investment intermediaries. Applying these rules can lead to better reputation for an investment firm and to greater confidence in the market as a whole.</p> <p><b>Question a):</b> Do you agree with the analysis above? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	<p><b>Question b)</b> – With regard to Question a), please provide an estimate of the costs previously qualified: <i>(Please enter cost items, currency and time horizon and other required figures)</i></p> <ol style="list-style-type: none"> <li>1. first full year</li> <li>2. over 5- year horizon</li> </ol>
<b>6. Quality of the products offered</b>	<p>We are of the opinion that portfolio management by investment intermediaries will become a more secure and widespread investment opportunity. This is because the applying of the rules about the risk management as far as it concerns the own portfolio reflects on the financial stability of the</p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p>intermediary. Through the optimizing of the operational risk will be realized the amelioration of the quality of the products offered.</p> <p><b>Question a):</b> Do you agree that risk management and internal audit mechanisms will enable you to offer a higher quality of products as stated above? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	
<p><b>7. Efficiency of competition</b></p>	<p>It is possible that the incremental costs associated with applying these new rules are more difficult to bear for small intermediaries. Ultimately this could force small intermediaries to close down their business. In the longer run this could lead to a lower number of market participants, which could be detrimental to competition.</p> <p><b>Questions:</b></p> <p>a) Do you think small firms are more affected by the implementation and ongoing costs of the rules on risk management and internal audit than large firms?</p> <p>b) How do you think competition will be affected by the rules on risk management and internal audit?</p> <p><i>Please explain your answers, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	

<b>Benefits &amp; Costs</b>	<b>Qualitative description</b>	<b>Quantitative description (e.g. major, minor)</b>

## ANNEX B: Some assessment criteria for costs and benefits

Costs may be assessed using such distinctions as:

- **Fixed costs** are costs which do not vary with output. In the long run, all costs can be considered variable;
- **Variable costs** are costs which vary directly with the output. Variable costs are associated with productive work, and naturally rise and fall with business activity.
  
- **Set-up (or one-off) costs** are costs which are incurred at the beginning of a project only;
- **On-going costs** are costs which are incurred again and again during a project or an investment. Usually set-up costs are very large in comparison to ongoing costs each time the latter occur.

Benefits may be assessed using one of the following techniques:

- **Comparison to a relevant historical case:** In many cases, an incident or series of incidents over time will be part of the reason to regulate. In order to make an estimate of the expected benefits, the losses in a number of historical cases can be used as an indicator for how much of the loss could have been prevented through the proposed regulation;
- **Evaluation by a proxy:** This approach uses observable variables which are linked to the unobservable variable - e.g. when there exists a known correlation structure - or focuses on simulations of the unobservable variable;
- **Use of a break-even approach:** The third possible approach is what can be called the break-even approach. This approach consists of calculating the amount of benefit needed - for example a reduction in loss needed - to cover the costs incurred, which are quantifiable. With this approach, the loss prevention is separated into the risk of loss and the extent of loss which allows one to capture the impact on the market. The potential loss for each market participant and the risk that a market participant will actually suffer loss are then estimated. It will then be possible to determine by how much the loss, risk of loss or a combination of these elements needs to be reduced in order to cover the costs of regulations and supervision. For this break-even assumption, one can examine whether this would be a realistic expectation. The impact of incidents can often be estimated with the help of event studies. The significance of the impact of incidents can be calculated and an estimate of the extent can be given. In the break-even approach, one can calculate by how much the risk of an incident must be reduced in order to cover the costs.

Source: CESR-CEBS-CEIOPS, Impact Assessment Guidelines, May 2007.