



# **Policy Recommendations**

## **Working Group 2**

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**Requirements to the activities of investment intermediaries**

**Chapter 8**

**Section III (Risk Management), Section IV (Internal Audit)**

## EXECUTIVE SUMMARY

The World Bank administered Convergence Program has organized in 2007/2008 in Bulgaria a knowledge transfer and capacity building program, designed to help participants from various regulation and supervision authorities to get acquainted with the basics of Regulatory Impact Assessment (RIA).

After an introductory session, where presentations were made by experienced speakers from EU authorities and their consultants, participants joined in Working Groups (WG) and they took part in a training exercise, designed to develop basic skills in undertaking a RIA.

Working Group 2, consisting of representatives from (pls insert) has chosen to set up an ex-post RIA on an existing piece of legislation, **Ordinance No. 38 on the requirements to the activities of investment intermediaries, Chapter 8, Section III and IV (Risk Management and Internal Audit)**. The group identified categories of key stakeholders that are affected by this regulation, contacted them and organized a consultation (written questionnaire and face-to face interviews).

Under the guidance of experts from the World Bank Convergence Programme and facilitators, the WG performed the main steps recommended by the Impact Assessment Guidelines for EU Level 3 Committees jointly issued by CESR, CEBS and CEIOPS in May 2007, drafting the suitable documents related to each step.

These documents included:

- a consultation document;
- a summary of consultation feedback; and finally
- a policy recommendations document.

The present document is a summary of all the activities described, and it ends with policy recommendations based on the Impact Assessment.

## PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

This document is the outcome of an Impact Assessment (IA) knowledge transfer and capacity building program organized by the World Bank administered Convergence Program. The participants of the Working Group are representatives of Bulgarian authorities involved in regulation of financial markets issues (pls insert).

The IA training exercise was undertaking a retrospective IA – ex-post RIA - on an existing piece of legislation, **Ordinance No. 38 on the requirements to the activities of investment intermediaries, Chapter 8, Section III and IV (Risk Management and Internal Audit)**. After discussions some categories of key stakeholders were identified as being affected by this piece of legislation.

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 Working Group has conducted a stakeholder consultation. They have designed an explanatory cover letter and a questionnaire, which were sent to a set of selected stakeholders.

The questionnaire was designed to provide 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 and of two alternative policy options that in theory could have been chosen instead of it, thus recognizing the fact that in a "live" IA exercise different policy responses could be considered to address the same policy problem.

Stakeholders were also asked to help after the questionnaire-answering phase was completed by attending a face-to-face meeting to quality check all stakeholder responses and enhance the WG's understanding of their answers.

After reception of answers from stakeholders, a summary of questionnaire results was drafted, then these were processed into a consultation document. The consultation document, including more in-depth issues that were raised during the meeting with stakeholders, became the basis for drafting a summary of consultation feedback, which was used in its turn as the underlying evidence for this report, summarizing all findings gathered during the process.

## PROBLEM IDENTIFICATION

The irregular management of internal processes and especially the false defining of the operational and market risks could damage the financial status of investment intermediaries and have a negative impact on market stability and investor confidence. This is especially true for large intermediaries (i.e. intermediaries with a full license). Further there is also an

element of asymmetric information between consumers and the investment firms about the quality of the service.

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 in the EU.

If no intervention or further intervention would have taken place, we think that the market would not have corrected the failure by itself in the short term for the following reasons(s): The Bulgarian capital market is relatively new. Therefore, we believe, that it is not experienced enough in solving disruptive processes, as far as they concern investors' protection and market confidence.

We asked stakeholders about their opinions with respect to these issues.

**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 risk management and internal audit wouldn't be designed as it is proposed, regulatory failure as described above would remain?

**Question 1.1:** Which risk management mechanisms were already in place before the new regulation?

**Question 1.2.:** Which functions of internal control / internal audit overlap?

**Question 2:** If no intervention or further intervention would take place, would the market have corrected the failure by itself in the short terms?

**Feedback from consulted stakeholders:**

Some of the stakeholders shared the same position some of them thought that the market failures were in an acceptable band and there was no necessity of new regulatory intervention as some market participants had already addressed the risk management issue.

Stakeholders mentioned that there is a potential overlay between internal control and internal audit functions. In their view – especially for smaller firms – it would not be sufficient to have 1 central department for both functions.

**Our response:**

In our view, market failure is significant, because not addressing the internal risk management and the internal audit issues properly might result in a negative influence over the market confidence.

The introduction of the common rules, concerning the risk management and the internal audit results in the upholding of the integrity of the whole European Financial Market and the increasing of the consumers' protection.

In regard of our market, these rules contribute for the facilitating innovation of the Bulgarian market.

We will deal with the stakeholders comments on the overlap of internal audit and internal control functions in the costs section and in our policy recommendations.

## GOALS

### **General Goals**

The aim of Ordinance № 38 is to prevent market disruptions. The Bulgarian legislator has followed the content of the Directive, trying to implement its provisions in the Bulgarian law, having taken into account some of its own experience. We are persuaded that these rules are necessary and useful for the further development of the business of the investment intermediaries and the non banking financial market.

The stability, the transparency and the credibility of the financial markets, as well the protection of the investors' interests and the insured persons are the principal objectives of the FSC strategy. Adequate risk management and internal audit processes are the necessary conditions for the financial stability and the credibility of the financial markets.

### **Specific goals**

The specific goals are such type of aims, connected to or deriving from the principles, on which regulation is built. They should be achieved in a cost-efficient manner, thus conserving the equilibrium between costs and benefits.

The following four groups of goals are the most important:

- improvement of the internal organization;
- defining the personal responsibilities of the investors' employees;
- avoiding of conflicts of interests;
- giving a better definition of the risks and their reflection.

### **Operational goals**

In order to achieve the above mentioned general goals, the following specific steps should be taken:

- Establishing and introducing of common rules regarding the risk management and containing policy and procedures, which identify the risks relating to the investment intermediary's activities and including mechanisms for exercising control over the adequacy and the efficiency of the policy procedures;

- Increasing of the investment intermediaries' risk management, creating internal audit department and creating a risk-management department – an internal unit or an external company to estimate customer and financial instruments related risks.
- Monitoring:
  - applying of rules concerning the risk management and the internal audit – how do they impact the internal organization, the decrease of the conflict of interests, the decrease of the risk associated with the investing company's own funds and services provided to clients;
  - a quantitative impact on the business of the investment intermediaries – business costs as a whole (increasing of employees' salary, recruiting more employees or outsourcing same activities, changing the price of services and their quality).

## POLICY OPTIONS

Given that the domestic regulation under review transposes a Directive, we don't analyse other policy options.

The rule about the risk management has been implemented as a requirement of the Directive about the capital adequacy from 1.01.2007.

The internal audit contributes to the overview of the internal rules and procedures and gives ideas for the amelioration of the market's functioning. Before the implementation of the MiFID in the Bulgarian legislation, this activity has been realized by the company's managing organs and not on regulated basis.

However, "doing nothing" with respect to risk management and internal audit procedures would have several negative implications. As far as big investment intermediaries are concerned, the irregular management of their internal processes and especially inadequate dealing with operational and market risks could lead to big damages of their financial position as well as to damages for market stability and investor confidence.

## ANALYSIS OF QUALITATIVE AND QUANTITATIVE IMPACT

### Costs

#### Costs to the regulator (direct costs)

The direct costs will consist of:

- Developing a manual for the ongoing supervision of the investment intermediaries (salaries): one-off costs of approximately 2800-3000 Euro.
- Costs for compliance inspections (salaries, costs for business trips if the investment intermediary has seat out of the capital): ongoing costs of approximately 25 000- 35 000 Euro per year. These costs are estimated to be higher at the beginning of applying the provisions, and lower in a long-term perspective.
- Costs for enforcement, investigations, sanctions, and administrative procedures (salaries): ongoing costs of approximately 5 000 – 10 000 Euro per year. These costs are estimated to be higher at the beginning of applying the provisions, and lower in a long-term perspective.
- If the association of the investment intermediaries decides to develop common rules for managing risks and internal audit, costs for examining/considering these rules by the regulator and discussions with the association will arise (salaries): one-off costs of approximately 2800-3000 Euro

#### Compliance costs to regulated firms

We think that the compliance costs to regulated firms will be dependent on companies' nature, scale and complexity of the business of the investment intermediaries. The costs may decrease by using the developed common policy and procedures provided by the association of the investment intermediaries.

We identified the following categories of compliance costs related to risk management and internal audit procedures:

One-off costs:

- Costs for analyses on how to implement the rules on risk management and internal audit, e.g. development of policy and procedures and creating the internal rules (staff-time/salaries)
- Costs for hiring staff with appropriate experience and knowledge (one-off cost for the hiring process)
- Training costs for the employees on the new rules
- Costs new IT systems and other office equipment (if applicable)

Ongoing costs:

- Salary for employees
- Other ongoing costs for the operation of the department (e.g. software license, office material, etc.)
- Management time – Time for dealing with internal audit and risk management issues on an ongoing basis as well as costs for reviewing and assessing the rules for risk management and internal audit

WG 2 tried to gather cost estimates from external stakeholders and has received several qualitative comments and a quantitative cost estimate from one medium-sized stakeholder

**Feedback from consulted stakeholders:**

The stakeholders agreed that the compliance costs would be major. One stakeholder estimated the costs for legal advice to be between 2500 and 5000 Euro, software costs to be 3500-7000 Euro. The implementation of the new software was done by **xx** people working one week each. These figures are for the implementation of Ordinance 38 as whole. Implementation costs of the new rules on risk management and internal audit would account for 15-20% of these costs.

Further the stakeholder identified training costs for risk management staff to 7000-13000 Euro. Implementation of the procedures would take six months of work of the risk manager and the compliance officer.

One investment intermediary mentioned that some of the functions of internal control and internal audit are overlapping. According to the stakeholders it is not necessary to have two different departments. Further it represents a considerable burden for them. They gave the example that in banks both functions are carried out by one division. Their proposed solution is to have one department responsible both or internal control and internal audit.

**Our response:**

With respect to compliance costs the opinion of the stakeholders confirms our estimate that the compliance costs would be major.

In respect of the proposition “2 functions in 1 division” we think that there is no obstacle for the intermediaries to carry out two functions by one person or one division.

### Costs to consumers

We think that the costs to consumers would be minor. Nevertheless if some firms pass on higher costs of applying internal audit and risk management mechanisms, there would appear a risk of increasing of charges for the clients.

#### **Feedback from consulted stakeholders:**

The stakeholders implied the passing costs to the retail clients would be minor for big companies and major for small ones.

#### **Our response:**

WG 2 agrees with stakeholders' statement, but in our point of view due to the increase of the international competition it is highly unlikely that this risk might happen.

## **Benefits**

### Benefits to consumers

The risk management and the internal audit divisions will improve the clients' trust in the investment intermediaries. It will also increase the quality of the products and services offered, as firms are dealing with their operational risks in a more concise way. In the long run, this could also contribute to a higher demand for investment services by investors and retail clients, although we expect this effect to be minor.

The WG thinks that there would be a minor improvement in the variety of the products offered. This would be a result of local investors gaining access to all the European markets through investment intermediaries from other countries.

#### **Feedback from consulted stakeholders:**

The stakeholders implied that the net effect on retail clients would be beneficial but minor/negligible.

#### **Our response:**

Despite the expressed opinion of the stakeholders, we think that the benefit to the consumers will be important, because the regulations in question address one of the most important market failures – investors' protection.

### Benefits to regulated firms

In our point of view, there will be benefits as better internal organization of the business can lead to decreasing operational risks. Applying these rules can further lead to better reputation for an investment firm and to greater confidence in the market as a whole.

#### **Feedback from consulted stakeholders:**

The stakeholders implied that the benefits would be insignificant for the first year and increase in significance in the long run.

**Our response:**

The stakeholders confirm our opinion, that in a mid- and long term period the benefits will become more significant.

**Efficiency of competition**

The introduction of new requirement on internal audit and risk management could reduce the number of small and possibly ineffective intermediaries.

More generally MiFID as a whole will have a major effect on the efficiency of the competition, as the introduction of common rules and a single passport will allow investment intermediaries to provide their services on the single EU market. New intermediaries will enter the home market in every EU country. This will lead to increasing competition between the investment firms in the home states and other EU firms.

**Feedback from consulted stakeholders:**

The stakeholders stated that the competition between the big companies would increase and would force the small ones out of the business. They think that the small companies would be more affected by the implementation and ongoing costs of the rules in question.

**Our response:**

The stakeholders partly confirm our opinion, but WG2 thinks that the quality of the competition will increase.

**COMPARISON OF THE OPTIONS**

This is an ex-post Regulatory Impact Assessment and deals with the implementation of an EU directive. Therefore we didn't compare different regulatory options.

**POLICY RECOMMENDATIONS**

The working group identified one particular issue in the implementation of internal audit mechanisms: the overlap of internal audit and internal control functions and the requirement of having two separate departments for these functions. Stakeholders described this requirement as very costly and overly burdensome.

WG2 acknowledges this issue and suggests is to change the provision concerning the internal control and the internal audit departments. We suggest to change Ordinance 38 in a way, that allows investment intermediaries – where this is appropriate – to combine the internal control and the internal audit activities in one department.