



Regulatory Impact Assessment

- Main Findings and Policy Recommendations -

Ordinance N. 38, 2007
Requirements to the activities
of investment intermediaries

- Chapter 8 -

Section III (Risk Management)

Section IV (Internal Audit)

Financial Supervision Commission
Sofia

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Working Group Composition

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1. Regulatory context

Ordinance N. 38 transposes MiFID Directive 2006/73/EC with detailed provisions about **Risk Management** and **Internal Audit** on the following areas:

- procedures;
 - profiles with specific tasks and responsibilities;
 - planning and ex-post reporting activities.
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2. Problem identification

In the absence of intervention, there would be the risk of irregular management of internal processes and false definitions of operational/market risks.

The introduction of this regulation addresses the following:

- **Market failure**

- asymmetric information;
- negative externality (market reputation).

- **Regulatory failure**

Absence of such rules would have caused obstacles for the development of a common financial market

3. Statutory goals at risk

The Working Group identified the risk of market disruption that could have negatively affected:

- **Financial stability;**
 - **Financial market transparency and reputation;**
 - **Investors' protection.**
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4. Proposed regulatory action

Ordinance N. 38 transposes MiFID Directive 2006/EC/73, therefore other policy options cannot be analyzed.

“Doing nothing” could have had several negative implications:

irregular management of internal processes by big investment intermediaries and especially inadequate dealing with operational and market risks could lead to big damages of their financial position as well as negative impacts on market stability and investor confidence).

5. Stakeholders consulted

- One Financial Firm;
 - Bulgaria Association of Asset Management Companies;
 - Central Depository AD.
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6. Feedback goals

- To learn about the trade-off between incremental compliance costs incurred by recipients and achievement of the policy goals;

7. Questions asked

First round consultation (to touch ground)

“Market and regulatory failures”

- Do you agree with us that the problem is as described?

 - Do you agree with our analysis if no intervention would have taken place?
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7. Questions asked

First round consultation (to touch ground)

“CBA on consumers (1)”

- Do you agree with us that if firms pass on higher costs of applying internal audit and risk management mechanisms, there would be a risk of increased charges for the clients?
 - Please estimate the extent to which the costs to consumers would be reflected;
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7. Questions asked

First round consultation (to touch ground)

“CBA on consumers (2)”

- As for the benefit side, we think that more investors and retail clients will purchase investment services as their trust in the investment intermediaries will rise. Do you agree? Provide a qualitative estimate.
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7. Questions asked

First round consultation (to touch ground)

“CBA on regulator and regulated firms (1)”

- Estimate of the incremental direct costs that could be incurred by the regulator and arising from the regulation under review;
 - WG has identified 8 categories of compliance costs arising from the new provisions on risk management and internal audit. Please provide your estimate on one-off vs ongoing basis.
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7. Questions asked

First round consultation (to touch ground)

“CBA on regulator and regulated firms (2)”

Benefit: according to WG2, there will be major benefits as better internal organization of the business can lead to a decrease of operational and market risks associated 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.

- Do you agree with our analysis? Please provide a qualitative estimate.
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7. Questions asked

Second round consultation (to deepen analysis)

“Market and regulatory failures”

- Which risk management mechanism was already in place before the new regulation was introduced? Can you please specify?

 - Which functions of internal control/internal audit overlap? How do you suggest to deal with that?
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7. Questions asked

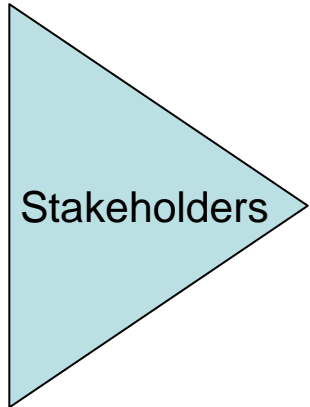
Second round consultation (to deepen analysis)

“What are the possible policy solutions?”

- Do you think that consumer protection is adequately addressed with the new set of provisions?
 - Did you find the guidance prepared by the Bulgarian Association of Asset Management Companies helpful? Do you generally think guidance provided by the industry is good way to regulate a market?
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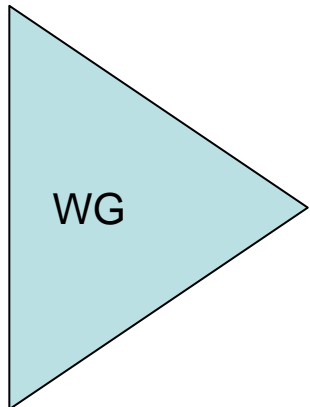
8. Overall feedback and Responses:

Problem identification



Some of the stakeholders shared our 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.

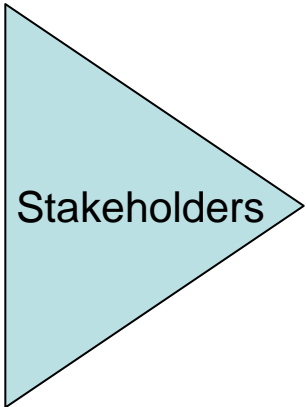
There is a potential overlap between internal control and internal audit functions. Especially for smaller firms, it would be sufficient to have 1 central department for both functions.



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, contribute to facilitating innovation in the Bulgarian financial services market.

8. Overall feedback and Responses: Cost-Benefit Analysis



- They all agree that the compliance costs would be major;
 - For the implementation of the whole Ordinance 38, one stakeholder estimated that costs for legal advice to be between 2,500 and 5,000 Euro, software costs to be 3,500-7,000 Euro other than dedicated staff for the implementation of the new software;
 - 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 7,000-13,000 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. There is no need to have two different departments. Further it represents a considerable burden for them.
 - A proposed solution is to have one department responsible both for internal control and internal audit.
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8. Overall feedback and Responses: Cost-Benefit Analysis



WG

- With respect to compliance costs the opinion of the stakeholders confirms WG2's 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.

8. Overall feedback and Responses: Cost-Benefit Analysis

Stakeholders

Costs to consumers: They implied the passing costs to the retail clients would be a minor risk as far as big companies are concerned, but a major risk for small investment intermediaries.

WG

WG 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.

Stakeholders

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

WG

WG 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.

9. 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 that Ordinance 38 might be modified in a way that allows investment intermediaries – where this is appropriate – to combine the internal control and the internal audit activities in one department. This should not have negative impacts on achieving the policy goals related to internal audit.
