

Risk management for investment intermediaries

Bulgarian RIA example

Based on case study from the RIA Execution on FSC regulations in Bulgaria

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Preliminary notes – Regulatory Context

What was the situation before 01.11.07?

Ordinance 1 on the requirements to the activity of the investment intermediaries (Ordinance 1) was enacted on the 10.10.2003. The internal control division was the only mechanism of self-control, compliance and investor protection in the IIm. There were no risk management provisions in Ordinance No 1. There were no provisions about internal audit either. All of this often lead to asymmetric information, taking too much risk by the IIM itself or on clients' behalf, violation of the clients rights, etc. clients rights were not always protected, different clients were treated equally, regardless of their financial potential, level of risk they can take, etc., transactions would be made to fulfill clients' orders, regardless the risk, as long as they are profitable to the investment intermediary, settlement would be delayed due to lack of securities as a result of intraday trading, the IIm's often took advantage of information they had for their clients' activities and upcoming trades, etc.

What was to be done ?

The idea was to introduce another level of internal protection of investors against any intentional or unintentional acts that could violate their best interests and in some cases - prevent systematic risk to the market. In some cases, lured on the bigger profit, the IIm's are willing to take higher risk, thus endangering their clients and the reputation of the capital market as a whole.

1. Problem Identification

1.1 Was there a significant market failure - the market failure market failure was decreased consumer protection and and market integrity;

1.2 If no intervention would have taken place, would the the market have corrected the failure by itself in the short term short term - the problems mentioned above were widespread widespread among all Ilm and clients and the question was question was not if, but when the market failures, described described above, would occur;

1.3 What was the evidence that the market/regulatory failure market/regulatory failure is significant – many evidences evidences proved, that the internal control unit does not work not work as expected;

1.4 Which objective is threatened by the failure - consumer consumer protection and market integrity were threatened and threatened and asymmetric information existed;

2. Definition of policy goals

2.1 General goals

- A. Restoring consumer protection;
- B. Increasing and strengthening market integrity;
- C. Decreasing the asymmetric information to a low, bearable bearable level;

2.2 Specific goals

- A.2.1 Increasing risk management of the IImS;
- A.2.2 Increasing capital adequacy requirements;
- A.2.3 Requirements for clients' consent on possible low-low-liquidity financial instruments trade on their behalf; behalf;

- B.2.1 Termination and prevention of intraday trading and other and other such practices, that unnecessarily increase increase customer risk;
- B.2.2 Estimating risk per customer and for the IIm as a whole; whole;

- C.2.1 Decreasing the level of informational asymmetry; asymmetry;
- C.2.2 Creating effective prevention mechanisms for the IImS to the IImS to use the information they receive;

Definition of policy goals – continued (2)

2.3 Operational goals

- A.3.1 Increasing requirements for customers' consent consent
- A.3.2 Increasing the IIm's own risk management and creating creating a risk-management division
- A.3.3 Creating set of internal rules in the IIm for preventing preventing customers from taking more risk than their than their financial capabilities allow

- B.3.1 Eliminating cases of intraday trading by applying applying internal rules on the matter;
- B.3.2 Estimating risk per customer and for the IIm as whole whole and requiring collateral for each investment investment exceeding client's capabilities;

- C.2.1 Creating and implementing the "need-to-know" principle principle and narrowing the group of people, who have who have access to sensitive information in the IIm's; IIm's;
- C.2.2 Applying rules for close monitoring on the actions of actions of people, who have access to sensitive sensitive information inside the IIm's;

3. Development of “do nothing option”

3.1 How the option to “do nothing” would have looked like - no regulation on IIm risk;

4. Development of alternative policy options

4.1 The option that has been implemented in the the Regulation - Establishing and introducing of introducing of common rules regarding the risk risk management and containing policy and procedures, which identify the risks relating to the to the investment intermediary’s activities and and including mechanisms for exercising control control over the adequacy and efficiency of the the policy procedures;

4.2 Alternative policy options - In certain cases the the small intermediaries could not create departments for internal audit and risk management. Scale of the IIm should be addressed addressed in further amendments to the Ordinance Ordinance 38;

Cost / Benefits Analysis

5. Analysis of impacts (Users)

- 5.1. Direct costs
- 5.2. Compliance costs
- 5.3. Benefits
- 5.4. Quantity of the products offered
- 5.5. Quality of the products offered
- 5.6. Variety of the products offered
- 5.7. Efficiency of competition

6. Analysis of impacts (Regulated firms)

- 6.1. Direct costs
- 6.2. Compliance costs
- 6.3. Benefits
- 6.4. Quantity of the products offered
- 6.5. Quality of the products offered
- 6.6. Variety of the products offered
- 6.7. Efficiency of competition

Stakeholders Session

1. Identifying the main Stakeholders Stakeholders

- a) Investment intermediaries;
- b) Bulgarian banks association;
- c) Bulgarian association of asset management companies;

2. Designing the questionnaire

Main topics:

- a) Identifying stakeholders main concerns; concerns;
- b) Identifying main costs;
- c) Effect on competition;

Consulting the stakeholders (2)

3. Stakeholders, taking part in the survey:

- a) Bulgarian Association of Asset Management Companies
- b) Investment intermediary “Beta corp” corp”
- c) Central Depository

4. Stakeholders main concerns:

- a) Expenses will be too high;
- b) There will be negative effect on competition;
- c) Smaller intermediaries may go out of business;
- d) Asset management companies may have to increase staff significantly.

Questionnaire results – Problem Identification

Identification

- Stakeholders** It's necessary to reduce the asymmetry. On the other hand, there will be a duplication in the functions of the internal audit and the internal control. It's important that the self – regulation is given as a possibility.
- The regulation is flexible. The risk management is more focused on the companies' side. It must be focused on the both of them.
- Each of them is a different institution. There is no point to separate the internal audit and the internal control. The asymmetry is in an acceptable band.
- Working Group** There is asymmetric information between consumers and the investment firms about the quality of the investment process. Especially with respect to the big 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.

Questionnaire results – Defining Policy Solutions

Solutions

Stakeholders The MiFID provisions should be implemented at the minimum levels required. Intermediaries should be left to decide themselves if they need internal audit and risk management divisions based on size, number and volume of operations, number of clients, etc. In general it is not necessary to have two different departments.

Working Group Given that the domestic regulation under review transposes a Directive, we don't analyse other policy options. The main implementation provisions are broken down taking into account when they strictly comply with MiFID and, if any, when they are super-equivalent.

Questionnaire results - Cost-Benefit Analysis

Stakeholders There is a general sense that the regulations are beneficial (increased trust, confidence, possibly more demand for higher-risk investment products, etc.). However, it is difficult to assess which part of this is due to the regulations on internal control, internal audit and risk management or if this is due to the implementation of MiFID as a whole.

We expect foreign competition to increase. It takes time to have large western competitors entering the market because it is still small to date. We think 2-3 foreign competitors will enter the Bulgarian market full scale.

We believe 1-2% of the intermediaries will be pushed out of the market and some 20% will have to restructure to fill in the requirements. But everything depends on the enforcement of the regulation by FSC. It's difficult to say.

Questionnaire results - Summary

Stakeholders The new regulations will increase the costs for the stakeholders. One-off costs will be minor in short term, but the on-going costs will be significant as new staff and will be hired and compliance costs will rise. It will be difficult to pass costs to the clients. Some intermediaries may be pushed put of business.

- Workgroup**
1. The FSC monitors the status of implementation of the rules (looking specifically at the potential identified problems: overlap of internal audit and internal control). Dialogue with the firms is necessary for that;
 2. The FSC monitors the number of complaints which relate to this regulation.
 3. The FSC monitors the market structure of the investment intermediaries market (i.e. how many firms go out of the market, how many firms enter the market)
 4. If the FSC thinks after a certain period that the implementation is not smoothly, the FSC could suggest to:
 - Allow firms to combine their independent internal audit and internal control departments into 1 independent department.
 - It is important that the market participants should be consulted.