

Investors Compensation Schemes. The Case of Bulgaria

System odszkodowań dla inwestorów. Przypadek Bułgarii

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Abstract

The investor compensation scheme in Bulgaria was established at the end of 2005, based on the Directive 97/9/EC, which is also the basis for the establishment of similar schemes in the EU member states. The investor compensation schemes decrease the risk of financial losses for retail investors resulting from the investment intermediary's inability to pay out its liabilities to its clients due to reasons related to its financial condition. Some recommendations can be given regarding the organization and the operation of the scheme, namely – widening the scope of the scheme, making the definition of the exceptions to the scheme more precise, changing the basis for calculation of the premiums, changing the management structure of the scheme and its relations with other institutions, taking a more effective approach to collecting and exchanging information as well as solving some legal discrepancies regarding the annual premiums.

Keywords: investor compensation scheme, financial instruments, annual premiums, failures, risks, investment intermediaries, retail investors, investments

JEL: G2

Streszczenie

System odszkodowań dla inwestorów w Bułgarii został wprowadzony pod koniec 2005r., na podstawie Dyrektywy 97/9/WE, która stanowiła również podstawę do wprowadzenia podobnych systemów w państwach członkowskich Unii Europejskiej. Systemy odszkodowań dla inwestorów zmniejszają ryzyko strat finansowych inwestorów detalicznych, wynikających z braku zdolności pośrednika inwestycyjnego do spłaty zobowiązań wobec klientów w związku z jego sytuacją finansową. Można sformułować szereg zaleceń dotyczących organizacji i działalności systemu, takich jak rozszerzenie zakresu działalności systemu, sprecyzowanie definicji wyjątków, zmiana podstawy wyliczenia składek, zmiana struktury zarządzania systemem oraz jego stosunków z innymi instytucjami, przyjęcie skuteczniejszego podejścia do gromadzenia i wymiany informacji oraz rozstrzygnięcie kwestii niektórych rozbieżności prawnych dotyczących rocznych składek.

Słowa kluczowe: system odszkodowań dla inwestorów, instrumenty finansowe, roczne składki, upadłości, ryzyko, pośrednicy inwestycyjni, inwestorzy detaliczni, inwestycje

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1. Introduction

Investor compensation schemes – the subject of the current study – is a comparatively new component of the financial safety net in the EU member states, but they can play a significant role in the development of the capital market and maintenance of its credibility. Even in a small open economy, such as the Bulgarian one, the role of the capital market is significant as it provides an alternative to banks' funding as well as fair valuations of shares of the listed companies. Countries with strong market economies usually have well developed capital markets. The significance of the capital market is particularly important for the developing markets such as those in Central and Eastern Europe (CEE).

The financial sector in Bulgaria is structured in a similar way as those in Eastern Europe. Its main components are commercial banks, investment companies, insurers and pension funds. As at the end of 2007 the total amount of assets of the banking system as a share of GDP is 113.1%, the amount of the balance sheet assets of the pension funds – 4.5%, gross premiums of the insurance companies – 2.4%, assets of the collective investment schemes – 1.7% and the stock market capitalization – 55.5%.¹ The figures prove that the financial intermediation in Bulgaria is mostly performed by banks of universal type.

In the middle of the 90s the Bulgarian banking system went through a severe crisis as in 1996/1997 15 banks with a market share of about 25% failed. The losses were covered by the budget – the deposits of individuals were covered in 100% contrary to the companies' deposits which were covered partially. The banking crisis was accompanied by a hyperinflation at the beginning of 2007. As a result, Bulgaria introduced the Currency Board Arrangement (CBA) which continues to operate until today.

The participants in the investor compensation scheme in Bulgaria are investment intermediaries, including commercial banks that are licensed to provide investment services. Some of the investment intermediaries perform operations on a limited scale, which is typical of investment banks as taking and selling issues of shares.

Generally, the financial safety net comprises special compensation (guarantee) funds, supervisory authorities and specific institution as the central bank, performing the lender of the last resort function. In a broader sense, they may include any financial support coming from a state source and even the notion "too big to fail". Financial safety net is specific and refers to the financial sector only and not to the real sector of the economy as the financial services are related to a higher risk,

financial crises develop very quickly and, on the other hand, they are based on somebody else's savings whose loss in a big scale may cause huge financial crisis.

Currently, there are three compensation components of the financial safety net in Bulgaria – the Deposit Insurance Fund, the Investors Compensation Scheme and Insurance Guarantee Fund (for motor vehicle insurance). They were created mainly due to the EU requirement to implement both Directives (the one in the field of deposit insurance and the other in the field of investor compensation), but also in response to the cases of insolvency in the banking and insurance sector. Considering the current tendencies of financial conglomerates supplying mixed financial products, we come to the conclusion that protection schemes are necessary in all segments of the financial sector. There are such schemes in a number of countries but probably the most developed scheme is the one existing in Great Britain.²

An interesting aspect regarding protection schemes is the possibility of adopting good practices for them. Currently the most developed area of financial safety net is the deposit insurance, which attracts the attention of the general public. An evidence for this is the creation of two international organizations – IADI³ and EFDI⁴ as well as the huge number of researches in this field.

As regards protection schemes, the type of information that is given to the potential clients on the provided level of protection, conditions of compensation payments and similar factors are very important. Due to the fact that the Bulgarian investor compensation scheme has a short history, clients of investment intermediaries are not well informed on the protection that is provided by the scheme. This situation is different from that of the banking sector where the Deposit Insurance Fund (DIF) and banks themselves provide information on the deposit guarantee. By informing clients of the protection provided for their investment by the Investor Compensation Fund (ICF), investment intermediaries would attract new clients. The majority of the savings, particularly those of households, are kept at banks, but in 2006–2007 the capital market in Bulgaria became an interesting alternative for investment. The number of the collective investment firms and special purpose vehicles was increasing as well as the diversity of products, such as deposits with an option to be turned into securities (convertible deposits) when a specific level of yield is achieved.

Contrary to the thesis defended in this study concerning the necessity of providing protection to

¹ The data were taken from the Bulgarian Stock Exchange's web site (www.bse-sofia.bg).

² Regarding this issue we can consider the tendency for consolidation of banking supervision. It is also most clearly observed in Great Britain, but also in Bulgaria in the face of the Financial Supervision Commission (FSC) created in 2003 that includes the supervision of investment intermediaries, insurance companies and pension funds. We should note the existence of the opposite case – there are a number of countries where the supervision of different financial institutions is separate. However, this is a controversial issue and there are arguments in favour of the one or the other system.

³ International Association of Deposit Insurers.

⁴ European Forum of Deposit Insurers.

consumers up to certain levels in cases of companies' failure, there is an opposite thesis that such protection is unnecessary, because it makes consumers of these services indifferent to the risk that financial institutions will become insolvent, which, in turn, undermines financial discipline. In such cases consumers focus their attention mainly on the yield that will be generated from financial operations as their assets are protected up to certain amounts. In theory, this situation is known as a moral hazard resulting from information asymmetry. In fact, this reveals the possibility to apply a simple strategy of protection when the client places his deposits, investment, etc. in a number of financial institutions, as in the case of compensation payment client's claims at one institution are summed up, but each single institution is handled on an individual basis. However, this distorts the relations between the two parties.

The majority of investor compensation schemes are created according to the requirements set forth in the Directive 97/9/EC and the limit of compensation they provide is not lower than 90% of the investment, yet, does not exceed EUR 20 000. This double restriction on the coverage – as a limit and as a percentage of the amount of compensation within the limit – aims at alleviating the risk of moral hazard as it does not leave clients indifferent when choosing the investment intermediary as well as the instruments in which they are going to invest. The existing limit allows forecasts to be made of the amount of compensation that could be paid in cases where the investment firms fail as well as of the target level of funds that would be sufficient to pay out possible claims. It is not certain when the scheme will be activated but the existence of the compensation limit makes it possible to forecast the amount of compensation that can become due.

The aim of the paper is to draw conclusions on the structure and activity of the Bulgarian investor compensation scheme and to propose solution for its future development and functioning based on comparative analyses. Although they are relatively new, investor compensation schemes have gained considerable experience, which should be rationally used. Generally, the scope of the paper is limited to the EU member states, as particular attention is paid to Bulgaria.

The Bulgarian investor compensation scheme was created at the end of 2005 and its operation is based on the Directive 97/9/EC, which sets the requirements for the investor compensation schemes in the EU member states. Generally, the legal framework of the Bulgarian scheme provides for its operations, but there are a number of issues that may have a better solution. Some of these issues are analysed in this paper and the authors propose solutions to them.

The financial crisis that started in the summer of 2007 raises some new issues regarding the financial safety net, in particular in the banking sector but they

may be reflected in the other components of the financial safety net. We consider the higher levels of deposit guarantee in the USA and some European countries, e.g. Ireland, Great Britain, which may cause distortions in cross-border transactions. At the same time, it indicates the importance of the financial safety net for preventing the financial sector from collapse through strengthening the public confidence in the market. This conclusion is valid in cases of "normal" functioning of the market but not in the situation of the global financial instability, which was observed in 2008. Crisis of the current scale may change the financial safety net fundamentally as well as the conventional economic theories and concepts in this respect.

The structure of the paper is as follows: the first part discusses the grounds for the creation of investor compensation schemes. The second part reviews the regulatory framework, structure, ownership and management of the schemes, the least cost principle and solvency issues. The third part deals with the participants in the scheme, compensation limits, distribution of clients' assets according to the amounts held and co-insurance in cases of compensation payments. The fourth part refers to such issues as funding of the investor compensation scheme, types of contributions, payment of compensation when the scheme is short of funds and target levels for funding. Conclusions are drawn at the end of the paper and recommendations are given to the Bulgarian scheme regarding the development of the legal framework and the activities to be performed by the Investor Compensation Fund (ICF).

2. Grounds for the creation of investor compensation schemes

The investor compensation schemes contribute to decreasing the risk for retail investors, due to losses that may be incurred by them when the investment firm is unable to pay back their assets for reasons related to its financial standing. The schemes contribute to the faster payment of clients' money in cases of failures of the investment company and provide a better coverage to retail investors. The creation of investor compensation schemes in compliance with the minimum requirements set forth in the Directive 97/9/EC encourages the development of the cross-border investment activities as it creates minimum standards for protection of small investors regardless of the country in which they invest their money. Investor compensation schemes do not hinder competition among the investment companies as conditions for participation and compensation payments in the EU member states are similar. Despite the existence of minimum requirements there are significant differences in the local investor compensation schemes in the EU member states due to peculiarities of the local

capital markets. The most important ones concern the funding of the scheme, e.g. whether it is *ex ante* or *ex post* funding and the provided level of coverage which ranges from EUR 6 000 in Romania to EUR 140 000 on both cash and financial instruments in France.

Despite the existence of the Directive 97/9/EC which urged the creation of investor compensation schemes in the EU, such schemes had already been established in some countries before the implementation of Directive but they were not fully in line with its requirements. The Directive 97/9/EC was implemented in response to the failures of investment firms, development of financial services and products as well as globalization of financial markets. As in other fields the Directive sets minimum standards for the investor compensation schemes, but, at the same time, provides possibility for discretion enabling the reflection of peculiarities of the domestic/local capital market. After the adoption of the Directive all member states created investor compensation schemes including the new members that joined the EU in 2004 and the newcomers such as Bulgaria and Romania.

All EU member states created investor compensation schemes after 1997 with the exception of Great Britain where the scheme has existed since 1988, Italy – since 1992, and France – since 1989 although it has a limited scope (in 1999 it was transferred to the new scheme). There is more than one scheme in some countries, which could be explained by the historical development of the financial sector, its components, type of participants, etc. The Directive 97/9/EC does not impose the number of the investor compensation schemes, which is the right approach as the countries are given the discretion to establish schemes in the number suitable for the local markets.

The investor compensation schemes in the new member states are mainly created in the period after 2002 with the exception of Hungary where the scheme was created in 1997 and in Poland – in 2001. Cyprus is only new member states with two schemes, one for investment companies and one for banks. The moment when the schemes were created is also interesting. In the majority of cases the scheme establishment is the result of the transposition of the Directive 97/9/EC in the national legislation despite they were failures of investment companies in some of the countries before its adoption.⁵

In Bulgaria considerable amounts of money are concentrated in banks and they belong to a large number

of clients. This and the fact that bank failures have stronger impact on the whole economy, raised the issue of protection of deposit holders earlier. There are significant risks in the capital market and they have led to a number of collapses in certain countries. Those investment companies, which work as brokers on other's account and in the case of failure, possible claims will not be directed to them, but there is a risk of misuse of other people's assets. Besides, it is difficult to calculate the amount of money that should be paid on securities as it is influenced by the stock exchange prices, and it should be estimated by using different methods of calculating the current price of assets.⁶ In some cases it may be necessary to provide additional legal framework as compared to bank deposits where the amount of claim is easily determined (the principal plus accrued interest). Generally, the failures of investment companies have a weaker impact on the economy and they are smaller in scale, but the possibility for such failures and the consequent loss of confidence in the market should not be ignored. This is confirmed by the number of failures of investment companies that took place in countries with a developed capital market as Germany, the USA, Spain, Ireland⁷, Sweden, Finland, Austria and others. The majority of these failures are those of small and medium-sized investment companies. Nevertheless, the failures of investment companies that lead to investor compensation payments do not occur frequently but the period of compensation payments is much longer and more complex.

The need of investors' protection is the result of risks in the capital market leading to investment companies' inability to return clients' assets. These risks can be classified according to different criteria. In the OXERA report two groups of risks are discussed – financial and operational risks. More specific types of risks, which may lead to insolvency of the investment company, can be identified (OXERA 2005a, p. 93–100). The risk of the company's failure is the main type of financial risk that may arise and it means that the investment company is unable to return clients' money and assets. The risk of insolvency of third parties – brokers, clearing houses and custodian banks – in which the investment company has deposited securities or clients' money for performing the transaction also belongs to financial risks. Considering the subprime debacle in 2007 the importance of the liquidity risk increases.

According to the OXERA research (OXERA 2005a, p. 91–103) operational risks are of significant importance for the capital market and several types of risks can be distinguished. First, the clients' assets can be stolen or misappropriated by the investment

⁵ Investor compensation schemes also exist in countries that are not members of the EU, e.g. the United States where such a scheme has existed since 1970. The establishment and activities of the American scheme are connected with the scale of the capital market in America and similarly to the deposit protection which has existed since 1930s, the scheme aims at protecting retail investors. In Iceland, Lichtenstein and Norway investor compensation schemes exist and operate in compliance with the requirements set forth in the Directive 97/9/EC. For more information see: EFTA Surveillance Authority (2001), Report on the Application of the Investor Compensation Schemes Directive (97/9/EC) in Iceland, Liechtenstein and Norway.

⁶ In Bulgaria, for instance, Ordinance 23 on the terms and procedure of clients' asset valuation provides for the valuation of securities and other assets subject to public offering of securities.

⁷ Investor Compensation Company Limited, Ireland (2005).

company's employees or managers as well as by a third party (company). Second, the risk of fraud due to forbidden transfer or misuse of clients' assets used for covering losses from the company's transactions or for criminal operations performed by the company's employees and managers or by third parties. Third, the risk of mistakes in the accounting of clients' assets when they are wrongly considered as the company's assets, but not the client's and vice versa. There were three cases of investment companies in Bulgaria that were disclosed and sanctioned by the Financial Supervision Commission (FSC) but they did not result in insolvency and activation of the scheme. Forth, the settlement risk when the delivery of securities does not coincide with their payment. Fifth, the inconsistency between reporting of clients' assets on clients' accounts in the investment company and their reporting to the third parties, e.g. the supervisory authorities. Sixth, the risk of non-performance of clients' instructions regarding the term and conditions of transactions set forth in the contract. Seventh, the risk of mismanagement of clients' assets, e.g. misleading clients about their assets' value, wrong valuation of clients' securities, failure of transactions, bad lending, etc. And finally, the risk of bad investment advice, which is one of the major investment services according to the Markets in Financial Instruments Directive (MiFID) since 2004⁸, but contrary to the above mentioned risks it is not covered by the investor compensation scheme except in Great Britain.

Investment companies managers and regulators consider all these risks as very important regarding their identification and management. Regarding the retail customers of investment products and services it is important to know that the investor compensation schemes cover their possible losses up to a certain limit in cases where these risks lead to an inability of the investment company to pay out its liabilities.

In comparison with financial intermediaries such as banks and insurers that operate on their own account investment firms work primarily on clients' account. Losses for banks and insurers result mainly from bad assets in their portfolio and, in rare cases, from theft. Failures of investment companies are mainly due to obvious theft or misappropriation of clients' assets and not so often from risky investment.

The most frequent reason for market failures is information asymmetry when providing investment services and products to retail clients. Retail investors have at their disposal limited information and they are not always able to make appropriate estimation of the quality of investment services and products, financial risk faced by the investment company, the possibility

for improper segregation of clients' assets from the company's own assets as well as the likelihood of theft or misuse. There are several premises of market origin that in principle reduce the risk to the retail investor and improve market functioning. These premises include, in the majority of cases, reputation of the investment company and its capital. Investment companies, which are concerned about their reputation, provide high quality services to their clients and act in their interest. The firm's capital provides protection to its clients in the case of failure as the company is allowed to use its reserves to cover losses.

The Directive 97/9/EC has not been changed since its adoption contrary to the Directive 94/19/EC whose review by the European Commission started in 2006. The implementation of the MiFID Directive⁹ in November 2007 led to some changes in the Bulgarian legislation reflecting mainly the scope of clients' assets eligible for compensation. The changeable market structure should also be considered. Tendencies on the capital market in Europe show that investment advice is provided as an investment service by many companies. Frequent usage of services offered by independent financial analysts and brokers can also be observed.

A number of experts, working on the capital market in Bulgaria, consider that the computerized book-entry system of registration and trade in securities provides sufficient protection to clients in the cases of failure of investment companies, but such interpretation is groundless. Such systems exist everywhere, yet, there are cases of failures due to the above mentioned reasons, especially in economies with underdeveloped markets, which are affected by such factors as bad management, insufficient risk diversification, weak supervision, deficiencies of the information systems, etc.

3. Regulatory framework and management of investor compensation schemes. The least cost principle

In the majority of cases participation of investment companies in the investor compensation schemes is obligatory. The advantage of such compulsory participation is that it eliminates the "free rider" effect, which appears when the scheme participation is voluntary. In principle, the participants in the capital market are prone to underestimate the risk of failure of investment firms as such failures are relatively rare. Should the scheme participation be voluntary, the majority of them would not probably participate in the scheme as they would consider that payment of premiums useless and constituting an additional financial burden. There is also a problem of adverse selection when only those investment companies which

⁸ Specific risk arises in the cases of identity steal. Such cases were reported in the USA, where by using the possibility of distance trading via Internet, fictitious investment companies present themselves as real companies, and make attractive offers to provide services and products and once they get the money and conclude the contract, these companies disappear from the market.

⁹ Markets in Financial Instruments Directive (Directive 2004/39/EC).

are the most likely to fail will participate in the scheme. Because investor compensation schemes are financed by the participants themselves, there is a possibility that the funds necessary for compensation payments are insufficient. Confusion may also arise about which clients are eligible for compensation and which are not. Should the schemes be voluntary some investment firms would presumably not participate in the scheme to cut down on their expenses. If the main "players" on the market did not participate in the scheme, then the creation of the schemes would be useless. This is related with another problem namely cross-subsidizing when in cases of obligatory flat payments the weaker participants are subsidized by the stronger one.

Another issue related to the voluntary participation in investor compensation schemes is related to the fact that companies which do not participate in the scheme are not motivated to declare this fact to their clients. Voluntary participation assumes higher level of financial intermediation and a well functioning system of transparency, control and accountability, which enables consumers of financial services to distinguish which firms participate in the scheme and which do not.

The current trend regarding investor compensation schemes is predominantly obligatory participation in the scheme which results mainly from deficiencies of the existing schemes where the participation of investment companies is voluntary. The borderline case is the creation of a system which combines obligatory and voluntary participation, e.g. Germany where the obligatory deposit insurance scheme is supplemented by a private voluntary system and thus a high level of protection is provided.

In the majority of cases investor compensation schemes are founded as state or quasi state companies and, by way of exception, only a few of them are private. Yet, all of them work on the basis of specific regulatory framework and the type of ownership is not important. Nevertheless, the type of ownership influences the management and representation in the management boards of the schemes. As institutional structures, investor compensation schemes in some countries are integrated within the central banks, supervisory authorities, central depositories, banking associations, the Ministry of Finance, etc. It is considered that in this way the administrative expenses, mainly the staff related ones are decreased. Practically, there is a necessity for the some even small staff dealing with the specific investor compensation issues. In the case when the staff is a part of the central bank, supervisory authorities, central depository, banking association, the Ministry of Finance, there are also administrative expenses but they are taken up by other institution, not directly by the scheme. We consider that such institutional structure really leads to economy of scale and decreases the expenses for the scheme maintenance, but it requires a higher level of partnership between the different institutions. A good example is the

application of the BNB Ordinance No. 1 since January, 1996 under which the deposit guarantee scheme based on Directive 94/19/EC on deposit guarantee schemes was implemented in Bulgaria. The BNB Ordinance never applied to bank failures, because the deposit insurance scheme established at that time in Bulgaria did not have enough funds for compensation payments when the bank crisis broke out in 1996. The accumulated funds were transferred to the DIF, which was created three years later. These funds devalued considerably due to the strong depreciation of the national currency at that time and also because of their inappropriate investment, as they were kept at the national bank at a very low interest rate. Better examples can be pointed out, where the investor compensation schemes exist within another institutional structure, which covers the administrative expenses.

The Law on Public Offering of Securities (LPOS) provides for the autonomy of the Bulgarian investor compensation scheme. But there are some aspects resulting from the complex legal framework that infringe upon this autonomy.

We consider groundless the general statements that the investor compensation scheme in Bulgaria was established in compliance with the requirements set forth in the Directive 97/9/EC, but not as a response to the need to have an institution which can effectively contribute to the development and stability of the capital market. The creation of the investor compensation scheme is also connected with the emergence and acceptance of the new institutional structure by the Bulgarian investment intermediaries as well as its adequate position in the domestic financial sector. The time of establishment of the Bulgarian scheme is also important. There have been no failures of investment firms in Bulgaria compared to the time when the DIF was created – the period of massive bank failures, which makes the creation of this institution unquestionable.

The management of each public company is very important due to the specific type of control and concentration of public interest, because it works with funds provided by investment firms in the form of premiums, which is reflected in companies' expenses and is indirectly transferred to consumers.

The Bulgarian investor compensation scheme has one-tier management system – a management board that consists of five people, elected by different organizations – two people elected by the Financial Supervision Commission and the majority appointed by the Association of Investment Companies and the Association of Banks in Bulgaria. This structure could be improved by widening the representation of the management board and including representatives of the Ministry of Finance, the Bulgarian National Bank (BNB) and the Association of consumers of financial services.

Investor compensation schemes usually do not have supervision or control over the scheme

participants. Decisions concerning failures are taken by the supervisory authority and it is better when the management board of the scheme is informed about such decisions in order to provide the necessary liquidity for compensation payments. In cases of unexpected failures of investment intermediaries, especially in the case of large investment intermediaries, some of the assets in which funds' money is invested can be sold, thus leading to unnecessary financial losses. More generally, the relations between the scheme and the regulatory authorities exist in the field of exchange of information, expertise, development of the legal framework, etc. These relations can be developed on the basis of formal cooperation agreements, but informal links between the scheme and supervisory authorities are also very important. According to the LPOS, the Fund may demand any kind of information from the BNB and the FSC on the amount of clients' assets and annual contributions only but not on the financial situation and solvency of the investment companies. These relations proved their importance in the light of the events following the global financial crisis in 2007/2008.

There are interesting cases of investor compensation schemes which are structured on the basis of the least cost principle. Thus, the schemes are allowed (intermediating with the supervisory authority) to decide which solution is cheaper for the investment company – whether to let it fail or to “save” it by granting a loan. This principle is applied by some deposit insurance schemes as the scheme acts as the lender of last resort in this case, substituting, to some extent, for the central bank.

The situation is similar in the case of insolvency procedures regarding financial institutions. The American experience in the field of deposit insurance is very long – the Federal Deposit Insurance Corporation (FDIC) plays the key role in bank insolvency procedures as it administers the procedure. The European approach is quite different – this function is performed by the Court. The latter approach is applied by Bulgaria, where, in accordance with the Commercial Law, firms' insolvency proceedings are conducted by the Court. This was amended by the Law on Bank Bankruptcy, which entered into force at the end of 2002 and under which the conduct of bank insolvency proceedings was transferred to the DIF. There were difficulties when this law was adopted due to the opposition of court lobbies and circles as they were deprived of their administrative functions. It was expected that if this model of dealing with insolvency proves to be effective, it could be used in different fields. Unfortunately, it was not adopted or even discussed till mid-2008 in the field of investor compensation.

In this paper deposit insurance schemes are used as a specific benchmark because they have a longer history, they have developed significantly and proved their

efficiency in cases of many bank failures. In the EU they are somehow standardized by the existing Directive, possibly because in Europe retail banking is more developed and in this way they are important for retail investors. Besides, as at May 2008 deposit insurance scheme existed in 119 countries, of which 99 were active, 8 were in the process of creation and 12 were under investigation.¹⁰ This approach is also applied by Bulgaria because the deposit insurance scheme was established earlier and tested in practice by handling three cases of bank failure and as result of the practical experience the regulatory framework was changed several times which led to its improvement.

4. Scheme participants and clients. Compensation limit

The type and structure of investor compensation schemes in the EU are quite different despite the existence of the Directive 97/9/EC, which is the result of different level of development and peculiarities of the local capital markets. The existing differences in the investor compensation schemes concern mainly the organizational structure and management of the schemes, relations with the national regulatory authorities and deposit insurance schemes, requirements of investment companies participation, number and type of participants, retail investors, investment services and instruments eligible for compensation, compensation limit, funding of the schemes as well as organization and procedures related to compensation payment. The main problems concerning compensation payment concern delays in bankruptcy procedures of investment companies, definition of investors eligible for compensation, lack of information proving claimants' eligibility for compensation, calculation of the amount of compensation, etc. Despite these problems, the European Commission (EC) by basing on researches regarding the investor compensation schemes comes to the conclusion that the schemes work relatively well and play a significant role in providing last resort protection to retail investors.¹¹

The investor compensation schemes include companies eligible to perform investment services – typically these are investment (brokerage) companies, referred to in Bulgaria as investment intermediaries as well as banks licensed to perform investment services and asset management companies holding clients' assets eligible for compensation. The scope of the schemes is different and it reflects peculiarities of the domestic capital market, e.g. in Austria the scheme includes mortgage banks and raifeisen banks, in Ireland

¹⁰ The data are collected by the IADI (www.iadi.org).

¹¹ See EC (2005), Evaluation of the Investment Compensation Scheme Directive, Executive Report and Recommendations, June, European Commission, DG Internal Market and Services, Brussels.

– insurance brokers (Investor Compensation Company Limited, Ireland 2004). This diversity is explained by the economies of scale that can be realized when different types of companies are under the umbrella of one institution. To some extent this is the reason why in some countries investor compensation schemes and deposit insurance schemes are mixed. In this case the possibility for mixing the monies allocated for saving and investment purposes is avoided as these monies are included in the basis for compensation payments. It should be noted that even in the cases of mixed schemes – deposit insurance and investor compensation – the monies allocated for saving and investment purposes should be segregated due to the different risks related to saving and investment services.

The investor compensation scheme in Bulgaria includes two types of investment intermediaries – non-bank investment intermediaries and commercial banks licensed to perform investment services. Since 2007 asset management companies (in case they offer investment services) have been included in the scheme. The exceptions listed in detail in the Directive 97/9/EC are transposed in the Bulgarian legislation concerning the investor compensation scheme.

The majority of the EU countries also adopt the exceptions listed in the Directive in their national legal acts, and there is no possibility for the investment companies, the supervisory authorities and the schemes themselves to decide which investors should be compensated. The cases of exclusion from the scheme are very important considering the large number of clients, complicated procedures to define eligible claimants, diversity of clients' assets compared to bank deposits, changes in the market price of assets which are not traded on regulated markets, which makes estimation of the necessary scheme funding as well as the possible payment of claims difficult.

Some schemes had the possibility to estimate which clients should be excluded from the scheme and this concerned mainly the category "other professional investors". As it was noted by some authors (Janik 2004, p. 9), the provisions of the Directive regarding the category "other professional investors" caused many problems in the EU member states. The MiFID sets forth harmonized requirements for "other professional investors". In this respect, the Bulgarian compensation scheme also had problems which were, to a greater extent, solved by the transposition of the MiFID in the national legislation in November 2007.

Within the previous legislative framework it was much easier for an investor to comply with the "other professional investor" criteria and a number of investment firms took the advantage of this possibility and reduced the amount of clients' assets being the basis for calculating the annual payments. The data as at December 2007 are a good illustration of the above.

Market capitalization on the Bulgarian stock exchange amounted to EUR 15 billion¹² and the total amount of clients' assets excluding money reached EUR 1.2 billion, which accounted for 8.48% of the total market capitalization. The share of other types of investment intermediaries in the total amount of protected assets was as follows: investment intermediaries with a minimum capital of EUR 766 thousand – 2.45% of the total market capitalization; investment firms with a minimum capital of EUR 128 thousand – 0.94% of the total market capitalization, and commercial banks licensed to perform investment services – 5.08% of the total market capitalization. Other assets are held by investors that are subject to exclusions.¹³

The creation of investor compensation scheme without sufficient funds can not support the credibility in the capital market and it may become a burden for investment intermediaries. There are cases, e.g. in Ireland, where investment firms made payments on the amount of all assets held by them at the time of the scheme creation, without considering any exceptions.

This issue is very serious in cases of failures and compensation payments, when the cases of exclusion should be determined. No symmetry can be found between the cases of exclusion upon joining the system and those at the time of the company failure, but the experience of other countries shows that these difficulties can be avoided by exhaustive listing of exceptions in the respective legal acts. The thesis saying that these investors are not interested in getting compensation up to a certain limit because they are "big players" is hardly acceptable.¹⁴ The cases of failures in the EU member states show that some natural persons and legal entities that fall in the category of other professional investors also claim compensation, although their claims are finally rejected.

In most schemes the limit of compensation conforms with the requirements set forth in the Directive 97/9/EC, namely – EUR 20 000. Only in France, Greece, Portugal, Sweden and Great Britain this limit is above the one set forth in the Directive; in France, for instance, it is EUR 70 000. In countries where both schemes – deposit insurance and investor compensation schemes – are mixed

¹² In this paper all the calculations are made in EUR at the BNB official exchange rate, which is EUR/BGN = 1,95583.

¹³ When the FSC Ordinance No. 23 entered into force some of investment firms including the large ones decreased the amount of clients' assets eligible for compensation on several occasions. There were even cases when the amount of clients' assets was decreased on 2 to 5 occasions.

¹⁴ At the time of the first bank failure in Bulgaria in 1999, when the compensation payments were made in accordance with the rules of the newly established Deposit Insurance Fund, there were cases of persons subject to exclusions who claimed compensation from the Fund. They were very frustrated when they realized that there were no grounds to receive such compensation despite holding deposits in amounts exceeding the covered limit. There were also cases of litigations with large banks that attempted to decrease the basis for calculation of payments by manipulating their balance sheets. This second problem was resolved by making amendment in the legislation and introducing the average daily basis for determining the premiums.

in one institution, clients are compensated by the deposit insurance scheme and in cases of bank's failure clients are protected up to the limit provided by the deposit insurance scheme for their money and up to the limit guaranteed by the investor compensation scheme for their securities. There is such practice, inter alia, in Belgium, Denmark and Luxembourg. Compensation provided by the French investor compensation scheme is very specific, as it provides for the limit of EUR 70 000 for client's money and EUR 70 000 EUR for securities (OXERA 2005a).

In nine of the new member states, including Bulgaria and Romania there is an agreement for a transition period during which the maximum limit of EUR 20 000 will be reached. In countries that joined the EU in 2004 this limit is expected to be reached by 2008, in Bulgaria in 2010 and in Romania in 2012. Only Cyprus, Malta and the Czech Republic do not have such agreements.

As of 2004 only three old member states, namely Ireland, Germany and Finland, provide 90% coverage of investors' claims in cases of failures. The remaining old member states provide 100% coverage, and in Austria, for example, this coverage applies only to natural persons, and in the case of other scheme participants the coverage is 90%. In Great Britain the limit of 100% refers only to the first EUR 30 000. The 90% limit applies to the remaining EUR 20 000. This shows that the coverage of EUR 20 000 is considered low compared to the level of income and savings in the EU member states (OXERA 2005b).

Contrary to the old member states, the majority of the new EU member states, namely the Czech Republic, Estonia, Latvia, Malta and Slovakia, provide coverage up to 90% of the claims –as this coverage refers to different amounts of the claim due to the existence of transitional arrangements on the coverage level. Poland provides 100% coverage on the amount up to EUR 3 000 and 90% on remaining amount up to the limit of compensation. Lithuania provides 100% compensation on the amounts up to EUR 2 900 and 90%¹⁵ on the remaining amount up to the limit of coverage. Slovenia, Cyprus and Hungary provide compensation of 100% up to the limit of EUR 20 000.

If we compare the standard limit of coverage of EUR 20 000 for the EU with some of the basic economic indicators, the level of income and the standard of living in some countries – the old and new member states, including Romania and Bulgaria, it becomes evident that this level is considerably low compared to the standards of living in the highly developed European countries, but at the same time it is a large burden for the investment companies in less developed countries, such as Bulgaria. This is so because the capital market in these countries is not adequately developed, investment companies are smaller and the average amount of protected assets per person is small.

The experience of failures in other countries shows that the majority of compensation claims concern lower amounts than the limit of compensation set at EUR 20 000. Nevertheless, there are some investors whose claims are for amounts higher than the provided limit of compensation and they can not be fully compensated by the scheme. In the majority of cases, failures generally concern small companies and the number of claimants is considerably small. Yet, they should not be neglected. There is another issue, rather technical, concerning very small compensation amounts. Compensation payments to these clients take certain amount of time and expenses. For that reason in some countries there are discussions about the possibility of introducing the lower limit of compensation payment below which the clients are not going to be compensated, despite de *minimus* clause principle.

The distribution of protected assets by clients, e.g. clients' segmentation by the amount of assets, is important to assess the probability of activating the scheme and define the target level of funding. The analysis of this distribution shows the adequate amount of funds by which compensation claims of average investment company could be covered in the case of failure. The total amount of compensation claims depends on the size and peculiarities of the capital market as well as on the scope of compensation to be paid to natural persons and legal entities. In the EU member states this issue is solved by settling the minimum level of coverage although the distribution of protected assets varies by countries. Since 2006 the Bulgarian Investor Compensation Fund has collected information on the number of clients eligible for compensation classified into groups in accordance with the amount of clients' assets. The analysis of this information shows that clients holding assets up to EUR 500, prevail, which means that in case the scheme is activated, compensation of small amounts will be paid to many clients. Nevertheless, the highest amounts of compensation are going to be paid to the clients holding monies close to the limit of EUR 20 000 according to the analyses of the 2006 and 2007 data.

5. Funding of investor compensation schemes. Target level

There are two main approaches of the scheme funding – *ex ante* and *ex post* approach. When the *ex ante* approach is applied, contributions to the scheme are made in advance, before the occurrence of the event that activates the scheme. In this way funds are accumulated in advance and they can be spent when the compensation event occurs. In the *ex post* approach contributions are collected upon the company's failure and occurrence of the compensation event. Yet, the investor compensation scheme exists, the situation on the capital market is

¹⁵ The data are as of 2004. Source OXERA (2005a).

observed, the risk of failures is analyzed and expenses for administering the scheme are made. There is also mixed-type schemes, which combine the elements of *ex ante* and *ex post* approaches as the majority of payments are based on the *ex post* principle but certain amounts of money are collected in advance to administer the scheme. Some schemes apply fixed component when calculating the annual payments, which is paid by all participants and it is a part of the annual contribution. Some countries apply both methods depending on the type of investment company – is a credit institution or a non-bank investment company. Apart from the annual contributions the schemes can be funded from other sources such as donations, revenues from fines, charges, etc., yet, these sources are insignificant. For example, investor compensation schemes in France and Portugal get revenues from fines when participants in the scheme breach the law.

Both *ex ante* and the *ex post* approaches have advantages and disadvantages. The current trend is that the *ex ante* schemes are applied more often. The advantages of the *ex ante* schemes are that funds are accumulated in advance and their accumulation takes a longer time. The only inconvenience of this approach is that certain amounts of money are taken from the investment companies, and this additional burden is usually transferred to the clients. This inconvenience concerns mainly countries where there have been no failures for a longer period of time. All the schemes funded under the *ex ante* principle may require additional payments when there is a shortage of funds in cases of compensation payments.

In the case of *ex post* funding, investment companies do not make payments on a regular basis, but when the scheme is activated. Then, the payments are collected on a one-off basis within a short period of time, and this may cause liquidity difficulties for investment companies, especially, smaller ones. This leads to injustice on the market as the failed companies will not contribute to the scheme and the good companies bear the costs of the failure of the bad ones, which leads to the paradox that the good companies subsidize the bad ones.

The Bulgarian Investor Compensation Fund is of the *ex ante* type, which is a better solution due to the weak development of the capital market and a relatively large number of small companies, which means that the financial burden on them will be significant if the contributions are collected on an *ex post* basis. Due to the restrictions imposed by the CBA in Bulgaria the scheme can not rely on state loans or on loans from the central bank. That's why it is necessary that sufficient funds be accumulated as soon as possible after the scheme creation. Although the *ex ante* scheme is more expensive for the administration of the scheme as regular contributions are collected, the *ex ante* scheme is a better solution for the time being. It is also in line

with the current trends where priority is given to the *ex ante* funding.

In principle, when schemes are created introductory payments are made in order to accumulate the initial capital to be used in cases of failures. There are some cases of compensation payments at the time when the schemes were created or soon afterwards. In these cases it is difficult to use other sources of funding quickly and effectively. Besides, introductory contributions can be considered as a sign of membership in a specific club, which is the scheme itself and which is important for the investment companies and for the clients. Even if when the investment company does not hold any clients' assets, the participation in the scheme is an indicator for affiliation to an institution capable of protecting its clients in the future. In some countries introductory payments are in the form of shares in the scheme, e.g. in Austria and France.. In other countries such institutions as the central bank and the Ministry of Finance participate in the initial funding of the scheme, but these cases are considerably rare. In the Bulgarian scheme the initial payment is a lump sum payment and it is calculated as a percentage of the minimum required capital for performing a certain type of investment services. There are three levels of initial payments for non-bank investment intermediaries and one level for banks. Initial contributions do not depend on the amount of clients' assets held by investment intermediaries.

The main issue regarding the scheme funding concerns the calculation of the annual contributions, and more specifically, the basis for their calculation as well as the method which is applied, e.g. flat or risk-based premiums, cases of exclusions, etc. The Directive 97/9/EC divides clients' assets into two types – financial instruments and cash and this is the basis for distinction when calculating the annual contributions. Different approaches can be applied when calculating the premiums regarding the types of participants in the scheme – non-bank investment companies, credit institutions, asset management companies, etc.

There is a diversity in defining the basis on which the annual contributions are calculated. Usually, cash and other clients' assets held by investment companies, the number of clients, revenues or other indicators of the company's turnover, the number of employees in investment companies, the size of capital, deposits in credit institutions, etc. are used as the basis for determining the annual contributions. Some countries apply mixed approach for calculating the annual contributions, e.g. the number of clients and the amount of clients' assets. It is also possible to apply a different basis for calculation according to the types of participants – non-bank investment companies or credit institutions. Various percentage rates are also applied to the different types of clients' assets when calculating the annual contributions. The Bulgarian

scheme uses as the basis for calculation of the annual contributions the amount of clients' assets held by the investment intermediaries – different percentage rates are applied to cash and other clients' assets. The different percentage rates applied to cash and on other clients' assets result from the greater risk related to the cash held by investment intermediaries. Currently, credit institutions in Bulgaria do not make any payments on cash held for investment purposes and they fall within the scope of the DIF. This leads to unfair terms of compensation for non-bank investment companies and credit institutions due to the different limit that is applied by both schemes. The limit of EUR 20 000 as set forth in the Directive 97/9/EC will be reached gradually by 2010. In such situation the clients of non-bank investment intermediaries and credit institutions are put in a different situation regarding the protection provided by the investor compensation scheme. This problem may be fixed if the clients' money held for investment purposes by banks is protected not under the Deposit Insurance Fund but under the Investor Compensation Scheme and banks pay respective contributions to the investor compensation scheme in lieu of the deposit insurance scheme.

The level of contributions paid to the scheme depends on the risk, amount of the coverage, number of clients, target level of the accumulated funds, stability of the capital market, type of funding (*ex post* or *ex ante* funding), and also on whether the scheme is newly created or has already existed for a longer period of time. Due to the impact of all these factors, the management of the scheme has the right to change the rates but there is a maximum level of these rates defined by the legal framework (OXERA 2006a). Yet, the percentage rates could be reduced after accumulating certain amounts of money or contributions to the scheme could be terminated. Despite accumulation of sufficient funds, we consider that a minimum level of contributions should be maintained, especially when we take into consideration the market dynamics and the possibility for new companies to enter the market.

A few schemes in Europe apply risk-based premiums in the field of investor compensation, as the methodology is taken from the deposit insurance schemes. Theoretically, risk-based premiums are better as the more risky investment companies are burdened with higher contributions, but the application of this approach is more complex, more expensive and the capital market may be destabilized as the weaker companies are burdened with higher premiums. For that reason, flat premiums are applied, which is a more simply and clear solution. Flat contributions for investment companies are also applied in Bulgaria, taking into consideration that the scheme is newly created, investment intermediaries are not officially rated and there is no experience in this field.

Apart from this most popular and most frequently used method of funding – annual contributions, other possibilities can be used. The schemes may borrow from the market, the central bank, the government and other protection schemes such as the deposit insurance scheme, which usually have more funds at their disposal. On rather rare occasions, the government may guarantee the loans borrowed by the scheme. Nowadays, there are no cases when the exposure of the retail investors to investor intermediaries is covered by insurance companies.

Generally, investor compensation schemes collect the funds that they have spent in order to compensate their clients when the failed company is liquidated. The amount of these revenues varies considerably, e.g. the OXERA Report on the Investor Compensation Schemes states that these revenues amount to 80% of all expenses paid by the scheme in cases of compensation claims.¹⁶

Although one of the reasons for the existence of investor compensation schemes is the state's concern for maintaining the confidence in the capital market, only few schemes have the possibility to take loans from the state or from the central bank in cases of shortage of funds. There is a general consideration that although these schemes perform certain social functions, they should be funded by the industry in order to minimize administrative costs and ensure the most effective management. What is specific about the investor compensation schemes is that their potential for accumulating funds is considerably smaller compared to the deposit insurance schemes and, for that reason, the proceeds from own investment are smaller. The Bulgarian legislation provides for the funding of the investor compensation schemes through advance payment of annual contributions, through increase of their amount up to certain limits or through taking loans at market conditions. The Law on Public Offering of Securities¹⁷ does not give any preferences to any of these possibilities. It is better to take a loan first and, at the same time, collect additional funds from the investment intermediaries than to put too much burden on them, which may cause liquidity problems for some of the investment intermediaries.

An interesting possibility is the mutual funding between different schemes. There are cases of mutual funding and as well as funding of the deposit insurance scheme to the investor compensation scheme. There were such cases in the UK and there is a possibility for funds transferring between the schemes in cases of failures of large companies in the Netherlands (Garcia, Prast 2004). In Ireland, the option for mutual funding between the schemes and a respective amendment in the domestic legislation, is discussed. For that reason, the authors

¹⁶ For more information see OXERA (2005a, p. 74).

¹⁷ Law on Public Offering of Securities, promulgated State Gazette Issues 114 in 1999, last amended on 30 June, 2007, in force since 30 June, 2007.

of the paper consider that the possibility for mutual funding between both schemes in Bulgaria should be discussed, especially taking into account the fact that Bulgarian banks performing investment services do not pay any contributions to the investor compensation scheme on cash balances held for investment purposes. These amounts are considered as "other credit accounts" and they fall under the deposit insurance scheme although they are used for investment purposes. The reason that these funds are not included in the scope of investor compensation scheme is that banks have technical difficulties to distinguish which funds are used for saving purposes and which for investment purposes. In the majority of cases European banks pay contributions on deposits held for investment purposes to the investment compensation scheme and on those held for saving purposes to the deposit insurance scheme. In the case of banks where both schemes are mixed there is no distinction between these monies.

In the *ex ante* type schemes, the target level of funds is explicitly defined, and once it is reached the annual contributions may be decreased or their payment ceased. However, the basis for this target level is not always properly defined. This issue is related to the definition of the adequate level of funding, through which compensation payments could be covered. It is necessary to perform serious empirical analyses to define the adequate level of funding, which should reflect the development of the capital market, the number of transactions, the type of securities, the number and the size of investment companies and their clients (OXERA 2006b). If the amount of clients' assets held by one investment company is taken into consideration, then considerable variations by countries can be identified, thus hindering the definition of parameters of a typical company, the number of clients and the calculation of adequate funds. The recent cases of failures show that these are mainly small companies that fail and the amounts of compensation paid are below the minimum level of coverage. This fact raises the issue of the schemes' ability to provide compensation in cases of large companies' failures.

This ability can be determined on the basis of analysis, which can be performed by a few schemes only due to the lack of information on the clients' assets and the number of clients. Oxera's methodology of defining the target level of investor compensation schemes relies on the methodology developed by the deposit insurance schemes. This methodology is based on the requirements of banks' capital adequacy. On this basis, a minimum or maximum target level of funding is defined depending on the risk borne by participants and the amount of clients' assets.¹⁸ If this methodology was adopted in Bulgaria by using the coverage set forth in the legislation at the total amount of

covered assets equal to EUR 995 million¹⁹ as at December 2006, the minimum target level of the accumulated funds should range between EUR 2 million and EUR 8 million. The maximum target level of funding should be EUR 40 million.²⁰ The actual amount of the accumulated funds as at December 2006 in the Fund is EUR 0.83 million since the creation of the scheme in August 2005 and it can be seen that this amount is much below the minimum level. The LPOS defines the target level of 5% on the total amount of clients' assets, when the Investor Compensation Fund could stop collecting contributions from investment intermediaries. Taking into consideration the total amount of the protected clients' assets as at December 2006, the target level of the funds will reach EUR 49.75 million which exceeds the calculated maximum of EUR 40 million. More complex methods for assessing the target level of funds can be used, applying different models of risk assessment for banks and investment intermediaries but, at this stage, they are rather inapplicable to investment intermediaries in Bulgaria.

As at December 2007 there are 84 investment intermediaries operating in Bulgaria of which 28 are banks and 56 non-bank investment intermediaries. There are also 22 asset management companies that have been members of the scheme since the beginning of 2007 but only three of them hold clients' assets eligible for compensation. From non-bank investment intermediaries, 24 have a minimum capital of approximately EUR 767 thousand and 33 have a minimum capital of approximately EUR 128 thousand. The total amount of clients' financial instruments eligible for compensation in 2007 ranges between 7.07% and 13.34% of the total amount of financial instruments and the majority of these assets are held by banks, between 4.33% and 10.30%. The amount of clients' financial instruments eligible for compensation held by investment intermediaries with a minimum capital of EUR 767 thousand ranges between 1.62% and 2.56% and those held by investment intermediaries with a minimum capital of EUR 128 thousand EUR varies between 0.62% and 0.94%. The amount of cash held by investment intermediaries with a minimum capital of EUR 767 thousand ranges between 5% and 7% of the total amount of clients' assets eligible for compensation for this group and between 0.8% and 11% of the total amount of assets eligible for compensation for investment intermediaries with a minimum capital of EUR 128 thousand. These figures show that the amount of cash varies considerably and that retail clients show preferences for portfolios consisting mainly of securities.

¹⁹ These data are calculated on the basis of information submitted to the Fund concerning clients' assets eligible for compensation. Investment intermediaries are obliged to submit to the Fund a monthly regular report in accordance with art. 77, para. 11 of the LPOS concerning clients' assets eligible for compensation. The data are calculated in EUR by using the BNB official rate of exchange as at 31 July 2007, which is EUR/BCN=1.95583.

²⁰ The minimum level is calculated by assuming that in cases of failures between 5% and 20% of the protected assets are compensated and the maximum level is calculated by assuming that all protected assets are compensated.

¹⁸ For more information see OXERA (2005a, p. 84).

As regards the amount of clients' assets calculated on a monthly basis, which are held by banks performing investment services in Bulgaria, there is a strong concentration in this sector as in 2007 the top ten banks held between 94% of the total amount clients' assets eligible for compensation. The concentration is not so strong among investment intermediaries with a minimum capital of EUR 128 thousand as they held between 74% of all clients' assets eligible for compensation in this sector as well as among the investment intermediaries with a minimum capital of EUR 767 thousand – 89% of all clients' assets eligible for compensation as at December 2007.

The target level of funds that should be accumulated by the investor compensation schemes is not determined on the basis of precise calculations as they are impossible to be performed. But if the relevant target level of funding could be precisely defined, it is not necessary these funds to be accumulated in advance. The target level should be adjusted by taking into consideration the probability of failures and the expected amount of compensation. It can be concluded that the rate for contributions is not set on the basis of precise methods regarding investor compensation schemes.

6. Investment companies' failures

This analysis is interesting because it reveals the reasons why investment intermediaries are unable to return clients' assets, and also because lessons can be drawn from these cases in order to prevent them in the future.

Above all, the situation, which leads to compensation payments to retail investors, should be reviewed.²¹ The investor compensation scheme is activated when the investment company is unable to give back clients' assets to its owner due to financial difficulties. The accounting of clients' assets and the possibility to merge them in the company's balance sheet with those of the investment company should be considered. The situation of insolvency arises when a particular investment company declares bankruptcy, but also when the supervisory authority notifies the investor compensation scheme that the investment company is unable to pay back the money or to give back securities to the clients immediately or in the near future.

The OXERA study on investor compensation schemes reviews the cases of failures in the EU member states until 2004. The total number of such failures is 47, but it does not include the UK where 1 608 companies

failed in the period between 1999 and 2003. After that period there have been other cases of failures in Sweden, Finland, Austria, Turkey. A huge number of these failures were due to covering the risk of bad advice, which is the major service provided by investment companies. The majority of reasons for failures were related to misappropriation of funds, false registration of securities, misuse, merging of clients' assets with the company's assets due to violation of accounting rules, professional negligence, and third party failure.²²

Special attention should be paid to the situation in the UK where the scheme pays compensation in cases of bad advice, especially those related to pension mis-selling, where investors were advised to purchase investment products that were unsuitable for their risk profile or they were poorly informed about the risk implications, and the companies that gave that kind of advice were no longer operating. The cases of compensation payments in the UK resulting from bad advice account for approximately 90% of all the cases as the cases of theft are considerably rare.

There are two parameters that should be estimated in cases of failures and they refer to the number of claims and the amount of paid compensation per failed company. In 1998 in Spain the number of clients of failed companies eligible for compensation totalled 6 852, and the estimated amount of compensation reached EUR 31.8 million.

Until the end of 2004 there were 6 failures in the Czech Republic and there were 22 370 claims approved for compensation payment in the total amount of EUR 4.8 million. At that period there were 13 cases of failures in Hungary, and there were the total of 9 758 claims eligible for compensation in the total amount of compensation payment of EUR 17.5 million. After the establishment of the investor compensation scheme there was a failure of an investment broker in Lithuania, and after 2002 there were failures of two brokerage companies in Turkey, where the compensation was paid in accordance with the locally applicable rules.

Failures of investment companies usually proceed in a different way than those of banks. Banks work mainly with funds drawn from outside but they perform their asset operations on their own account in contrast to investment companies that operate mainly on clients' account, which complicates the whole mechanism of failures. Investment companies work also on their own account and these operations directly influence their financial standing. Generally, investor compensation schemes are activated in the case of misuse, theft, counterfeit and other illegal activities, as the existence of book-entry securities means that legally these securities belong, at all times, to the client (OXERA 2005c). As far as monies are concerned, the situation is different as in accordance with the contract

²¹ As far as this issue is concerned, the Bulgarian legislation applies the requirements set forth in the Directive 97/9/ C. According to art. 77a, para. 3 of the LPOS, compensation is paid when the investment intermediary is unable to perform its duties to the clients due to reasons related to its financial condition. This concerns two situations – first, when the court has started a procedure for insolvency of the investment intermediary and second, when the license of investment has been revoked.

²² This issue is analyzed by other researchers as well, e.g. see the analyses of misappropriation and misuse of assets by Dinev (2006, p. 62-116).

clauses, investment companies can be authorised to make transactions, which makes their funds considerably risky, e.g. as in the case of deposits.

7. Conclusion

Analyses of the existing schemes in the EU member states show a high degree of scheme standardization, based on the requirements of the Directive 97/9/EC, but, at the same time, there is a diversity of solutions regarding the structure and operation of the schemes set forth in the national legislation. The Directive is transposed in the national legislation, but the huge diversity of existing schemes proves that they adjust to peculiarities of the local capital market. This fact is quite important and should be taken into consideration when drafting the Bulgarian legislation in this field, which should be based on both best EU practices and on local experience. There are a number of countries where failures have been observed and the schemes activated. Failures of investment companies are considerably rare, but they tend to occur more and more often. Such cases have recently been reported in Turkey, Sweden, Poland, Lithuania thus supporting the necessity of the establishment of investment compensation schemes. Analysis of the cases of failures suggest that the reasons for failures and activation of the scheme are very specific and, in the majority of cases, they are the result of the breach of the law.

On the basis of experience of investor compensation schemes in different countries, recommendations and conclusions could be made for the development of the Bulgarian scheme. In the first place the basis for calculation of annual premiums should be specified, and not only the clients' assets could be considered when calculating the annual premiums. An important criterion when estimating the risk of activating the scheme is the number of clients as the amount of compensation is determined and paid within the limits set for a particular client – a natural person or a legal entity. For that reason, we think that the number of clients eligible for compensation should also be estimated. Currently, investment intermediaries submit to the Investor Compensation Fund monthly reports on the amount of clients' assets and the annual payments are calculated on the basis thereof. This creates the possibility for investment intermediaries to manipulate the data and reduce the basis for the payments. A possible solution is to calculate the amounts on a daily basis and to report information on a quarterly basis rather than a monthly one.

It is necessary that the exchange of information between the scheme and investment companies be improved. This can be achieved through the participation of the scheme staff in the check-ups performed by the FSC and the BNB, through the appointment of consultative and working groups as well as by providing

information by the FSC and the BNB on financial standing, capital adequacy, ratings and operations of investment intermediaries. This information will enable the scheme to make precise estimates of the amount of compensation that should be paid when activating the scheme, the target level of funding, the amount of compensation payment, management of investment, liquidity, etc. There is also a contradiction in the legal requirements set for banks operating as investment intermediaries as regards making payments to the scheme as clients' money is not taken into consideration when calculating the annual premiums. Banks do not distinguish money held for investment or deposit purposes and they make payments on this money to the deposit insurance scheme. The legislation should clearly provide that in cases of failures clients' money should be covered by the scheme regardless of the purpose it is used for. In this way, the Fund is also deprived of money that naturally belongs to it, the possibility of investing this money and generating profit. This fact is also very important in the light of the current financial crisis and the transparency of information necessary for risk assessment.

The most common cases of failures are connected with misuse and violation of contracts with clients or are the result of investment companies using clients' assets as their own monies. The computerized book-entry of securities creates the illusion that investment companies always distinguish clients' assets from their own assets. The cases of failures that have led to compensation payment are result from misappropriation of funds, improper registration of securities, misuse, mismanagement, improper segregation of clients' assets and own assets of the company, professional negligence, third party failure, identity theft *via* e-commerce, etc. There are also examples of drawing out company funds as a result of unqualified employees holding managerial positions or payment of too high salaries. The above mentioned reasons show that the risk of companies' failures is real. In the case of Bulgaria we should also consider the quality of IT systems, the quality of information, accounting, the level of the management staff, lack of competence and experience, confusing or unsatisfactory legal solutions, etc.

The conclusions drawn above and the proposed solutions concern only certain aspects of investor compensation schemes, but they are of considerable importance for the effective operation of the schemes. The Bulgarian scheme is considerably new and it can be further developed by drawing on foreign and domestic experience. Above all, this requires amendments in the legislation, but it also depends on the level of development and the scope and depth of the domestic capital market. Investor compensation schemes should fall under separate legislation rather than be part of the LPOS. A similar solution was applied to Bulgarian the deposit insurance scheme and it proved to be effective.

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