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FINANCIAL SECTOR ASSESSMENT PROGRAM

BULGARIA

INSURANCE AND PENSIONS SUPERVISION

TECHNICAL NOTE

MAY 2017

This Technical Note was prepared by Antony Randle, World Bank external expert, in the context of a joint World Bank-IMF Financial Sector Assessment Program mission in Bulgaria during January 2017 led by Ilias Skamnelos, World Bank and Michael Moore, IMF, and overseen by Finance & Markets Global Practice, World Bank and the Monetary and Capital Markets Department, IMF. The note contains technical analysis and detailed information underpinning the FSAP assessment’s findings and recommendations. Further information on the FSAP program can be found at www.worldbank.org/fsap.

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FINANCE & MARKETS GLOBAL PRACTICE
CONTENTS

Acknowledgements ......................................................................................................................... 3

Abbreviations ................................................................................................................................. 3

Executive Summary and Key Recommendations .............................................................................. 4

Main Findings ................................................................................................................................ 9

  A. Introduction............................................................................................................................... 9
  B. The Financial Supervision Commission .................................................................................. 12
  C. The pension sector – Pillar I .................................................................................................... 16
  D. The pension sector – Pillar II .................................................................................................. 21
  E. Insurance.................................................................................................................................... 25
Acknowledgements

The World Bank team conducted its field work in January 2017, as part of the joint World Bank – IMF Financial Sector Assessment Program (FSAP) Update. During the mission, it met with the Financial Supervision Commission and a number of market participants.

The Technical Note reflects technical discussions with the above entities as well as other relevant stakeholders whom the FSAP mission would like to thank for their time and invaluable insights.

The FSAP mission would like to expressly thank the Financial Supervision Commission for its support and help in organizing meetings with key stakeholders. The information received on the legal and regulatory framework, supervisory and enforcement regime, as well as current practices was indispensable for the development of the Technical Note.

The Technical Note is the work of Antony Randle, World Bank external expert, with additional inputs from members of the World Bank – IMF FSAP Team, as well as Anita M. Schwarz of the Social Protection and Labor Global Practice of the World Bank.

Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BGN</td>
<td>Bulgarian Lev</td>
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<tr>
<td>CASCO</td>
<td>Casualty and Collision</td>
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<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<tr>
<td>EUR</td>
<td>Euro</td>
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<td>FSAP</td>
<td>Financial Sector Assessment Program</td>
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<td>FSC</td>
<td>Financial Supervision Commission</td>
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<tr>
<td>GWP</td>
<td>Gross Written Premium</td>
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<td>IPD</td>
<td>Implicit Pension Debt</td>
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<td>MoF</td>
<td>Ministry of Finance</td>
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<td>MTPL</td>
<td>Motor Third Party Liability</td>
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<td>NSSI</td>
<td>National Social Security Institute</td>
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<td>SIC</td>
<td>Social Insurance Code</td>
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<td>SSI</td>
<td>State Social Insurance</td>
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<td>UN</td>
<td>United Nations</td>
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Executive Summary and Key Recommendations

1. The Nonbank Financial Institution (NBFI) sector is relatively small. The insurance industry is small and dominated by subsidiaries of foreign firms. The industry has been growing slowly over the last five years, with assets reaching 6.9 percent of GDP at end-2015. There are 46 companies operating in the market, which is high, given the low level of premiums. The main risks written in the non-life insurance market are Motor Third-Party Liability (MTPL) and Casualty and Collision (CASCO). The most favored distribution channel is through brokers. There are over 400 brokers operating, which is also high for the size of the market. The capital markets remain relatively underdeveloped. Market capitalization of the Bulgarian Stock Exchange was around 10 percent of GDP at end-2015. There were 350 equities traded in the two-tier system. The trading volume is low at EUR1 million per day and price discovery is somewhat problematic.

2. The pension system is a traditional three-pillar system. The pension system assets amounted to 9.4 percent of GDP at end-2015. Pillar I, administered by the National Social Security Institute, is an earnings-related pay-as-you-go scheme, with 2.8 million contributors and 2.2 million pensioners. The government provides significant support for the payment of pensions—it is estimated that the government contribution is approximately 50 percent of the pensions paid. The government has made a number of parametric changes that will be phased in over the next decade. The rationale for these is changes in the demographics of Bulgaria, with a declining workforce, fertility rates below the replacement rate, and significant increases in the longevity for both men and women. Given the magnitude of the expected demographic changes, it would be prudent for the government to have an independent review of its projections of the sustainability of Pillar I. There are two types of funds in Pillar II—professional funds for workers in higher risk occupations and universal funds for other workers in the formal sector. In 2015, the authorities introduced the possibility of annual shifts between the Pillar II private pension funds and the Pillar I pension fund. While this possibility may improve the funding of the first pillar in the short run, it has the potential to reduce future pensions for contributors, increase the liabilities of the public system in the longer run, and reduce the diversification of the retirement income streams for contributors. There are 11 voluntary funds with 600,000 members and 850 billion BGN in funds under management.

3. The FSC has undertaken a balance sheet review and stress test exercise relating to both the insurance and pension sectors. The project was carried out under the guidance of a Steering Committee comprising representatives from the FSC and European Insurance and Occupational Pensions Authority (EIOPA) as voting members, as well as representatives from the Ministry of Finance (MoF), the BNB, European Commission, and European Securities and Markets Authority (ESMA) as observers and advisers. The project, managed by EY (formerly Ernst & Young) concluded on January 31, 2017 and the results were published on February 3, 2017. Further details of the exercise are provided in Box 1. The review noted some capital increases were needed for some of the insurance entities and found that the investments of the pension funds complied with the law and were properly valued.
The Financial Supervision Commission

4. **The FSC Act should be amended to provide statutory indemnity to the FSC, the persons appointed under Article 3 of the FSC Act, and staff.** Both the International Organization of Pension Supervisors and the International Association of Insurance Supervisors mandate that the supervisor, its directors (or equivalent appointees), and staff must not be held personally liable for supervisory actions taken in good faith. Further, these persons need to be indemnified from paying the costs of defending any action taken against them. The provision of legal protection is to allow the parties to perform their duties without fear of being sued or having to pay the costs of defending legal actions.

5. **Chapter 7 of the FSC Act needs to be amended to give the FSC the power to fund its budget through levies against supervised entities.** Chapter 7 outlines the sources of revenue available to the FSC to fund its operations. The main source is the state budget. This compromises one of the principles of effective supervision, being independence from government and the supervised industries, as it allows the government to control the FSC budget and deployment of resources. The supervised entities should pay the largest portion of the costs of the FSC by way of supervision levies; therefore, the FSC must be given the statutory powers to raise levies.

6. **Levies need to be set at levels that guarantee the FSC adequate resources and minimize reliance on penalties and financial sanctions as a source of revenue.** The FSC is significantly under-resourced to perform its core supervision functions, particularly in insurance supervision (where four persons undertake onsite inspections for nearly 50 insurers and reinsurers and 400 brokers). The level of industry levies should be sufficient to address the resource shortage throughout the FSC. The resource shortage is particularly concerning in the insurance division that is facing the challenges of adopting Solvency II. The level should be such that there is little reliance on fines and other financial sanctions to supplement income. There is anecdotal evidence that excessive fines and sanctions diminish the standing of the supervisor in the supervised entities, as the entities consider that the primary motivation of the supervisor is to supplement its budget. Internationally, there are two methods generally for charging levies – on assets (or in the case of pension funds on funds under management) and on transaction volumes (e.g. for insurers on premium written and pension funds on contributions collected). While there is a degree of cross subsidization of smaller entities by larger entities in the former method, it is easier to implement and more transparent.

7. **Levies also need to be set at levels that provide for extensive staff training and capacity building, particularly in the Insurance Supervision Department.** Discussions with both onsite and offsite supervisors indicate a need for training. Training is particularly important for the officers involved in insurance supervision, as the adoption of Solvency II means that supervisors will be required to exercise complex judgments on a significant number of matters.

8. **The provisions in the FSC Act relating to the termination of the appointment of the persons appointed under Article 3 of the FSC Act need to be enhanced to improve**
transparency. Persons appointed under Article 3 of the FSC Act must meet the eligibility requirements under Article 4, in particular 4(1) that includes, inter alia, having a good professional reputation and professional experience. The appointment of a person who no longer has a good professional reputation or lacks professional experience is terminated under Article 6. The FSC Act does not stipulate who can make judgments about the reputation or experience of a person and therefore can remove the person. Further, the Insurance Core Principles\(^1\) require that “when the head of the supervisor or members of its governing body are removed from office, the reasons be publicly disclosed.”

9. **The hierarchy for decision-making in the FSC needs to be reviewed and amended.** The current legal framework vests some powers in deputy chairpersons, which arguably should be vested in the Commission. For example, the power to authorize or approve public offerings is vested in the deputy chairperson of the Investment Activity Supervision Department. The way that powers are vested creates the potential for conflict if the Commission does not agree with decisions made by the deputy chairman. Under the current arrangements, the remedies available to the Commission are internal review or legal action. It would be preferable if all powers were vested in the Commission initially and the Commission delegate those powers as it saw fit.

10. **The organogram under consideration appears to be more efficient, but could be further improved.** The “department” under the control of the Secretary-General has a large number of diverse functions, some of which do not appear to relate to administration. The FSC could give consideration to reducing the number of functions in the department and reallocating those that are not related to administration.

11. **In the medium term, the FSC should consider merging onsite and offsite supervision into one unit and assigning supervision of individual entities to selected supervisors.** Currently, there is a major imbalance in the teams performing onsite and offsite supervision—for example, there are about 10 officers doing offsite insurance inspection and 3 officers performing onsite. Combining the functions would partly address the imbalance.

12. **The offsite review of the pension sector can be enhanced, both for the pension companies and for the FSC.** At present, pension fund management companies and depositories provide daily details of the investment portfolio of the relevant pension fund. The role of the FSC staff in relation to these daily reports is to compare the submissions and ensure agreement between them. The law requires that pension funds use well-capitalized depositories that hold capital against operational risk and are subject to other prudential requirements. A more rational and efficient approach would be to ensure that the depository’s systems are adequate and that spot-checks ensure they are being used.

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\(^1\) Insurance Core Principle 2 Standard 2.
Insurance

13. **The biggest issue according to the industry is lack of awareness of the need to manage personal risks.** The industry is of the view that people buy insurance only because it is compulsory (either as motor third-party liability or when a vehicle is being leased or being used as collateral). The industry considers that the lack of awareness needs to be addressed and appears willing to partner with the government to increase awareness and overall financial literacy.

14. **Lack of trust also seems to be a problem in the market.** Insurance is a product that is built on trust – the consumer having confidence that the insurer will and can pay when required. Previous bad conduct appears to have eroded some of the trust. The FSC should continue with its strategy of openness and transparency, providing the market with regular, accurate and relevant information about the insurance industry and the issues that occur.

15. **All of the insurance representatives met are concerned with the level of competition in the motor vehicle insurance market.** Both large and small insurers note the level of price competition and believe that some companies are substantially underpricing the risk. Underpricing is frequently associated with under-reserving for losses. The recent balance sheet review of insurers concluded that the level of technical provisions for losses exceeds what is required by a considerable margin. However, it is recommended that the FSC conduct a series of thematic reviews that focus on the adequacy of premiums when sufficient supervisory resources are available.

16. **The size of the broker distribution network poses a challenge for the FSC.** Brokers are currently in excess of 400. Market conduct and disclosure are important and, according to the insurance industry, are lacking in many of the brokers. The FSC will need to perform onsite inspections at a large number of brokers and enforce the new conduct of business requirements.

17. **The authorities could consider various options to help the insurance industry diversify its risks and to deal with losses arising from floods and earthquakes.** Nearly 80 percent of the premium written in the non-life market is attributable to motor vehicle. The authorities could consider expanding the number of compulsory products that apply to the larger population, such as property insurance, following the strengthening of FSC and careful deliberation. Furthermore, the authorities could look at market-driven solutions to deal with losses arising from floods and earthquakes. At present, the government provides some assistance out of its budget. There are many alternative arrangements, such as those in Romania and Turkey, which would provide better protection for residents and the government finances.
Pensions

18. **In the long term, the authorities need to consider relaxing some of the investment restrictions applying to Pillar II funds.** The returns on Pillar II funds have not been stellar and this is attributable in part to the very restrictive investment rules. In the long term, some more investment risk will need to be permitted to improve returns. This can only occur after the FSC gains confidence in the securities market and, in particular, the integrity of price discovery.

19. **It is acknowledged that the FSC resistance to the industry’s demands for multi-funds is the correct approach, but some work could commence on lifecycle funds.** It appears that the level of financial sophistication in the market is such that it would not be in the best interests of contributors to permit multi-funds. However, there is evidence to show that lifecycle approaches can have a positive effect on returns over the long-term. It is noted that early initiatives to introduce lifecycle funds were rejected by the authorities. It is appropriate to reconsider this issue now.

20. **The FSC needs to complete work on rules for the payout phase in the second pillar.** Although the majority of the first tranche of retirees will not retire until 2022 or 2023, it is possible that some contributors will take advantage of early retirement provisions. Currently, the rules relating to the payout phase are not complete. The rules need to determine the extent to which the account balances in the second pillar need to be annuitized, if any, and the types of annuities, their calculation, and which parties will be the providers.

<table>
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<tr>
<th>Table. Key Recommendations¹</th>
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<tr>
<td><strong>Nonbank Financial Institutions Supervision and Regulation</strong></td>
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<tr>
<td>Make amendments to the FSC Act to improve the FSC’s independence through having control over its resources, effectiveness by providing legal indemnity to the persons appointed under Article 3 of the FSC Act and staff, and transparency through the appointment and dismissal of these appointed persons (FSC, MoF).</td>
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<td>Expand and equip the insurance supervision team charged with the implementation of Solvency II (FSC).</td>
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<tr>
<td>Review the methodology employed by the FSC for both offsite and onsite reviews to improve efficiency and to remove any duplication with the work of the external auditor and to make it more risk-based (FSC).</td>
</tr>
<tr>
<td>Arrange for thematic onsite reviews of all the general insurers focusing on premium pricing (FSC).</td>
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<tr>
<td>Arrange for a thematic review of the market conduct of insurance intermediaries. (FSC)</td>
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<tr>
<td>Consider an actuarial review of SSI. (MoF)</td>
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² Refer to Art. 178 of the Social Insurance Act for investment limits.
³ See Annex 1 for full list of recommendations.
Main Findings

A. Introduction

1. **This technical note results from the Financial Sector Assessment (FSAP) conducted in the period 17 January 2017 and 1 February 2017.** The note covers the activities of the Financial Supervision Commission, (FSC) the state of the pension and insurance sectors and the challenges to their development. The exercise for insurance did not involve a full assessment against the Insurance Core Principles of the International Association of Insurance Supervisors. During the FSAP, meetings were held with the Chairperson, Deputy Chairpersons and senior staff of the FSC and representatives of both the pension and insurance sectors. The FSAP missions were undertaken prior to the results of the balance sheet review and stress test exercises becoming available, as described in Box 1. The author is grateful to these persons for the frank and open discussion that were very useful in understanding the operations of the FSC and the market.

2. **The FSC has a number of issues that it needs to address in order to become a world class and effective supervisor, most notably it is under- resourced and has significant training needs.** Many of these issues arise from the lack of independence of the FSC and its current funding arrangements that significantly restrict its ability to resource itself properly. Until the authorities resolve the funding issue and give the FSC autonomy over its budget and deployment of resources, the acute staff shortage and lack of training cannot be addressed adequately.

3. **In addition, there is scope for effectiveness and efficiency gains.** The supervision activities undertaken by the Commission are largely compliance based and the Commission’s effectiveness would be enhanced with a transition to more risk-based work. This is particularly evident where the very limited onsite activity that can currently be performed is not appropriate for a country that has adopted Solvency II. There are efficiencies to be gained from reviewing the supervision of the pension sector. There are also potential efficiencies by revising the structure of the FCS. Reviews could include the reallocation of some functions that are not strictly related to supervision and reorganizing supervision teams to merge onsite and offsite functions.
In 2016, Bulgarian private pension funds were subject to an independent, external balance sheet review and insurance companies subject to both a balance sheet review and stress tests. The reviews were overseen by a Steering Committee that included representatives from the FSC and EIOPA as members, the Ministry of Finance, the Bulgarian National Bank and the European Commission as observers. A Project Manager was appointed to ensure a consistent application of the review’s methodology by the independent external reviewers performing the reviews. EIOPA provided assistance with the methodology.

**Pensions.** The objectives of the balance sheet review for pensions were: (a) to verify the existence of the assets held on behalf of pension funds by custodians; (b) to perform valuations of the assets and liabilities of the funds and pension fund managers in accordance with the provisions of the law and verify the calculation of fund unit prices; (c) to assess the valuation and recognition principles applied in relation to pension fund portfolios with emphasis on related party transactions; (d) to review the risks facing each pension fund and to raise awareness of these risks.

The review examined all 18 Pillar II funds and 9 Pillar III funds; the total sample represented over 93% of the assets of the funds. The review concluded that the assets were available and held by custodians as required by the law. Investments complied with the regulatory requirements, as did transactions with related parties. The results indicated sustainability of the supplementary pension insurance sector. Some minor adjustments, amounting to BGN 33 mln or 0.3% of the assets reviewed, were recommended. The FSC is asking the relevant undertakings to reflect the adjustments in the calculation of net asset value at the reference date. The review concluded that the private pension funds in Bulgaria were sustainable.

**Insurance.** The objectives of the balance sheet review and stress tests for insurance undertakings were: (a) to assess the adequacy of technical provisions under Solvency II and estimate the economic value of them; (b) to assess the appropriateness under a Solvency II framework of the recognition and valuation principles applied to all assets and liabilities with a special focus on related parties transactions; (c) to assess under a Solvency II framework the effectiveness of the risk transfers through reinsurance arrangements; (d) to re-calculate the prudential parameters in accordance with Solvency II-Minimum Capital Requirement and Solvency Capital Requirement; (e) to review the risks facing each insurance undertaking and to raise awareness of these risks. The stress test component looked at adverse market conditions, earthquake stress, a flood stress and a provisions deficiency stress. For the life segment an additional stressor related to changes in longevity.

The review concluded that 13 insurers had insufficient capital to cover the Minimum Capital Requirement or Solvency Capital Requirement as at end-June 2016. The aggregate deficiencies were not large compared with the total capital of the insurers, the total amount of the MCR deficit being BGN 25 million, and the total amount of the SCR deficit being BGN 50 million. Subsequently, from the 13 companies, 7 insurers have already undertaken the necessary actions to increase their own funds to the required level. Some of the remaining undertakings have taken actions, either capital increases, raising subordinated debt or the sale of capital instruments, which have lead to strengthening their capital base although still not fully sufficient. Five small insurers, having an aggregate market share of 1.49% by premium, were given 3 months by the FSC to raise their own funds to cover their Minimum Capital Requirement, and another three months to cover their Solvency Capital Requirement. Two more insurers will have to present the FSC with progress reports setting out measures taken and progress made to meet the Solvency Capital Requirement by the end of 2017 as part of the transition to Solvency II. It is worth noting that the balance sheet review revealed an adequacy of the levels of technical provisions of the insurance sector.

The preliminary results revealed that overall the market stress scenario, testing adverse conditions at a global level, had the most significant impact on own funds. This scenario reduced the excess assets 15.8% (m BGN 313). The provision deficiency test resulted in a 14% reduction. The earthquake and flood stress scenarios, resulted in 5.8% and 8.9% decreases. The insurance entities were resilient to the longevity scenario.
4. **The pension sector uses the three-pillar model.**

   a. **The first pillar is a pay-as-you-go public pension scheme funded by contributions from employers and employees and covering all economically active persons.** In keeping with many countries in Europe, large-scale demographic changes will impact on the financial viability of the scheme in the long term. The National Social Security Institute administers the Fund.

   b. **The second pillar is administered by the private sector, with the returns on mandatory private pensions not having been stellar.** The second pillar is a supplementary mandatory pension insurance system operated by nine licensed pension fund managers. There have been at least two significant changes over the last two years that have the potential to affect adversely the second pillar funds. The effects of these changes are not transparent and the authorities need simpler and more transparent communications to contributors to allow them to make decisions in their long-term best interests. The returns on mandatory private pensions have not been stellar. The returns appear to have been driven by the conservative investment limits established in the legal framework rather than the existence of a minimum return guarantee.

   c. **The third pillar is a supplementary voluntary pension system and is also administered by the nine licensed pension fund managers who administer the pillar II funds.** Employees themselves or employers on their behalf pay contributions to the third pillar. Contributions are tax-exempt up to a prescribed limit.

5. **The insurance industry is under-developed and is growing slowly, with limited development opportunities at least in the short-term.** There are a large number of insurers both local and international competing for limited business. Both the life and non-life segments are heavily concentrated. The non-life segment is essentially a two-product business being motor and property. Development opportunities are limited at least in the short-term. One of the key issues is the lack of awareness in the community about financial services in general and the role of insurance in particular. Increasing the number of compulsory insurances and establishing catastrophe risk insurance may provide some opportunities. With property insurance accounting for less than 15% of the GWP in the non-life market, making this product compulsory may provide an opportunity. Similarly, an opportunity may be found in assisting the Government deal with catastrophic risk through a market-driven arrangement.

6. **With its limited resources, the FSC should focus in the short-term on the conduct of business in the market.** For insurers, this involves primarily how they set prices; for intermediaries how ethically they conduct business.
B. The Financial Supervision Commission

7. The Financial Supervision Commission (FSC) is the supervisor of non-bank financial institutions in Bulgaria. The FSC was set up under the FSC Act in 2002. A five-person Board appointed under Article 3 governs the Commission and comprises the Chairperson, three Deputy Chairpersons (one for each of Investment Activity supervision, Insurance Supervision and Social Insurance Supervision), and a member responsible for analysis, risk assessment, supervision practice and protection of the interests of the users of non-bank financial markets. The National Assembly appoints the Chairperson and the National Assembly appoints the other members on the proposal of the Chairperson.4

8. The most critical matter that needs to be addressed is the independence of the Commission. Prima facie, the FSC Act provides that the Commission is independent; Article 2 (4) of the Act states that the Commission, in exercising the powers thereof, shall be independent of the executive branch of government, and shall be accountable to the National Assembly. However, provisions within the Act concerning the legal status, funding, protection of members and structure are not consistent with the accepted concept of supervisor independence.

9. A major factor in the lack of independence of the Commission is its lack of control over its own funding. The International Association of Insurance Supervisors (IAIS), the International Organization of Pension Supervisors (IOPS) and the International Organization of Securities Commissions (IOSCO) stress that supervisors need to have control over their own resources, including the power to fund themselves through supervision levies. Chapter 7 of the Act outlines the sources of revenue available to the FSC to fund its operations. The major source is from the State Budget. The supervised entities must pay the largest portion of the costs of the FSC by way of supervision levies; therefore a number of amendments are needed to the Act including the removal of Article 26(2) and Article 2(3), that provides that the Commission is “publicly funded legal body”.

10. When the Commission gains control over its own funding, levies need to be set at levels that guarantee the FSC adequate resources and minimize reliance on penalties and financial sanctions as a source of revenue. The FSC is significantly under resourced to perform its core supervision functions, particularly in insurance supervision where four persons undertake onsite inspections for nearly fifty insurers and reinsurers and 400 brokers. The level of industry levies should be sufficient to address the resource shortage throughout the FSC. The level should be such that there is very little reliance on fines and other financial sanctions to supplement income. There is anecdotal evidence that excessive fines and sanctions diminish the standing of the supervisor in the supervised entities, as the entities consider that the primary motivation of the supervisor is to supplement its budget.

4 Articles 5(1) and 5 (2) of the FSC Act
11. **The process for the potential removal of the Chairperson, deputy Chairpersons and the fifth member needs to be more transparent and robust.** Chapter 2 of the FSC Act refers to the appointment and removal of the Chairperson, Deputy Chairperson and the fifth member. Of relevance is Article 4 (1) that limits eligibility to be appointed to Bulgarian nationals with higher economic or legal education, **good reputation and professional experience**. Article 6 (2) provides that the term of office of a person is terminated if the person is no longer eligible under Article 4, meaning if the person is deemed to be no longer of good reputation, his or her position is terminated. The FSC Act does not outline how such a determination would be made and by whom. **International supervision practice** requires that there are explicit procedures regarding the appointment and dismissal of the head of the supervisor and members of its governing body and when the head of the supervisor or a member is removed from office the reasons are publicly disclosed. It is recommended that Article 6 be amended to specify at a high level the procedures (in addition to the grounds) for termination and require that reasons be publicly disclosed.

12. **The allocation of decision-making power within the Commission needs to be reviewed and revised to meet international supervisory standards**. The deputy Chairperson in charge of each of the supervision department has specific decision making powers in relation to some of the decisions within his or her department. For example, Article 15 specifically gives the deputy Chairperson of the Investment Activity Supervision Department powers in relation to Public Offerings. Providing decision-making powers to persons other than the Commission collectively creates possible conflicts between the decision maker and the other members of the Commission, in the event that the latter members do not agree with the decision. Any disagreement can only be resolved through firstly an internal and then a judicial review. A more effective method would be to vest all the decision-making powers in the Commission collectively and permit the Commission to delegate those powers as it sees fit. If a disagreement arose over a decision made by the person to whom the power has been delegated, the Commission could resolve the disagreement by removing the delegation.

13. **The Commission, the members of the Commission and the staff must be provided with legal protection.** The Commission as an authority, the Chairperson, Deputy Chairpersons, fifth member and all staff must be able to exercise their authority and perform their functions legitimately without fear of legal action being brought against them. **International supervisory practice** requires that the supervisor and its staff have the necessary legal protection against lawsuits for actions taken in good faith while discharging their duties, provided that they have not acted illegally. **International practice requires further that individuals are adequately**

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5 Insurance Core Principle 2.2
6 IOPS Guidance 1.3 notes “the Governing Body [in this case the FSC itself] should be responsible for its decisions”.
7 Insurance Core Principle 2.10, IOPS Guideline 2.7
protected against the costs of defending their actions while discharging their duties. The FSC Act needs to be amended to provide these indemnities and protections.

14. The FSC should have control over its own internal structure. The FSC Act currently determines how the Commission is to be structured along functional lines. Further, it is understood that the structure for the administration of the Commission is mandated and follows the same structure as Government Departments. As the Commission is not a Government Department, but will be an industry-funded authority, answerable to the Parliament, it would be preferable that the Commission has the power to determine its own internal structure.

15. In the long-run, the Commission could look again at its organization structure and reallocate some tasks. The Commission recently revised its internal structure. Each of the four supervisory departments carries the majority of the supervision tasks related to the industry they supervise. The balance of activities of the Commission have been assigned to the Secretary – General who now has 14 disparate groups of activities and it is understood will have in excess of 100 staff reporting to her. Most of the activities are administrative but several relate more properly to the core business of the FSC, such as methodology and compliance department and coordination and analysis of policy. The Commission could consider reassigning those tasks that do not relate to administration to the fifth member who does not appear to have a well-defined list of functions and activities according to the official organogram.

16. The nexus between the employees of the Commission and the Civil Service Code needs to be removed. The Board of the Commission needs to have the power to appoint and dismiss the staff (for good cause) of the Commission without reference to the Government. The Commission must have the power to remunerate and motivate staff as it sees fit. Accordingly, Chapter 6 of the FSC Act needs to be revised to ensure that the staff members of the Commission are under the control and supervision of the Commission only and are not deemed to be civil servants.

17. In benchmarking the remuneration of staff members in the future, the Commission needs to link salaries to those being paid to employees in the sectors supervised. One of the major issues for supervisors in many countries is attracting and then retaining suitable staff both of which issues are related to the level of remuneration that supervisors offer. Particularly important is the cost arising from the loss of supervisors to the supervised industries where remuneration and conditions are normally better. This results in the supervisor virtually becoming the training facility for the industry as trained supervisors leave the agency. Tying supervisor remuneration to that offered by the relevant supervised industry is effective in halting the migration of staff from the supervisory agency. Another very effective strategy for preventing the leakage of staff to the supervised industry is to have staff sign a contract, a condition of which is that they will not work within a supervised entity within, say, one year of leaving the FSC.
18. There is currently an acute shortage of staff in most areas of the Commission, particularly in relation to onsite supervision that must be addressed in the short-term. Once the most critical area of funding is resolved, the Commission needs to address the shortage of staff working in the supervisory agency particularly doing the agency’s primary role of supervision. Relevantly, discussions with the onsite supervisory team for insurance during the mission highlighted the acute problem of staffing. It was revealed that four onsite insurance supervisors were available to perform onsite supervision of 46 insurers and reinsurers, nearly 500 brokers and over 20,000 agents. Some participants in the insurance industry noted that they had never been subject to an onsite review.

19. Contemporaneously with addressing the staff shortage, the Commission needs to devote significant resources to capacity building, again particularly in insurance supervision. The adoption of the Solvency II regime is imposing material changes to the way in which the Commission interacts with insurers and reinsurers especially in relation to risk management and capital measures. The Commission currently has a small and effective team handling the transition to Solvency II but will need to expand the team in the near future and ensure that new officers are adequately trained with emphasis on risk management and actuarial skills.

20. The restructuring of the supervision function could reduce the pressure on supervisory resources, to some extent. At present, overall supervision in the various divisions is divided into separate onsite and offsite functions with staff involved in onsite supervision not generally being involved in the offsite division. Many supervisors work on a different model in which the onsite and offsite functions are merged. One supervisor (or one team of supervisors) is responsible for both the onsite and offsite supervision of specified entities assigned to him or her. This arrangement allows for greater efficiency as supervisors build up a bank of knowledge and understanding about the entities under their responsibility. The model is also appealing to supervised entities because it reduces the number of supervisors who are interacting with the entity and seeking the same or similar information. The success of the model is subject to the caveat that the supervision of entities is rotated between staff and teams from time to time to prevent individual supervisors being “captured” by the entity.

21. The supervisory function needs to be more focused on risk rather than compliance, particularly in relation to social insurance. The social insurance sector is, effectively, subject to daily offsite review. Both the pension fund management company and its custodian report independently and daily to the FSC details of the investment portfolio of the pension fund. The offsite staff of the FSC ensures that there is agreement between the records of both the custodian and the pension fund with regard to the type and the valuation of the investments. The staff also ensures that the investment portfolio is consistent with the legal requirements and the mandate of the pension fund management company. This is in addition to monthly, semi-annual and annual analysis. Given the fact that this process has not revealed problems in the past, it would be more
efficient to devote the limited supervisory resources available to other activities related to the overall risk of the pension funds.

22. **Discussions with the pension supervision team and the pension industry suggested that there are efficiencies to be gained in reviewing the onsite activities.** These discussions highlighted that there is no clear distinction between the work of the onsite supervisors and the work of the external auditors and to a large extent there is significant duplication. Moving forward, the FSC should review its procedures and remove any duplication. The FSC should have access to the auditors and audit working papers to understand the scope of the work performed by them and the extent to which the supervisors can rely on their work.

23. **When the staffing issues in the insurance supervision division are addressed, the focus of the onsite activities of the supervisors needs to move towards risk assessment.** Currently, the onsite supervision function for the insurance sector is virtually non-existent because of lack of resources. Once the shortage of resources is addressed, the FSC needs to refocus its onsite activities on risk management as is required by the Insurance Core Principles and on which Solvency II is predicated.

24. **The FSC should consider whether the provisions of the FSC Act will impede it from transitioning to a more risk based approach and whether the Act needs to be amended.** Article 19.2 of the FSC Act states the role of the FSC regarding inspections as “the prevention and detection of violations of the law”. Generally, the purpose of inspections is much wider; inspections are performed to ensure that supervised entities are managing the risks to which they are exposed with the express purpose of protecting the interests of policy holders or contributors or clients (as the case may be) of the supervised entity. A literal interpretation of Article 19 limits the activities of the FSC to breaches or possible breaches of the law. If such a literal interpretation is to be applied (as it is in other provisions of the law), the law should be amended to reflect the real purpose of inspection activities.

C. The pension sector –Pillar I

25. **The first pillar is a pay-as-you-go public pension scheme funded by contributions from employers and employees and covering all economically active persons.** The National Social Security Institute (NSSI) administers the first pillar. The main parameters of the State Social Insurance (SSI) are illustrated in Box 2.

26. **The biggest challenge facing the SSI is affordability.** The NSSI is already running large deficits partly attributable to the reduced proportion of social security contributions available to finance state pensions, when Pillar II was introduced and a portion of the overall contribution was allocated to the second pillar funds, exacerbated by a decrease in the overall social security contribution rate. Bulgaria also faced a sharp downturn in formal sector

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8 This is expressed correctly in Article 11 of the Act that enumerates the objectives of the FSC.
employment and contribution revenue during the transition to a market economy, as all other formally centrally-planned countries did. Because everyone worked prior to transition, a much larger percentage of elderly receive pensions than percentage of working age people currently contribute. In addition, overall contribution rates were reduced in order to try and induce workers into the formal sector. The numbers of people who joined the formal sector were insufficient to compensate for the loss in revenue from lower contribution rates on those who were already contributing.

27. **Furthermore, demographic changes in the population of Bulgaria have the potential to threaten the long-term affordability of the SSI.** The United Nations and other agencies note that the population of Bulgaria will undergo material demographic changes in the next thirty years. As illustrated in Figure 1, the population is expected to decline from a high of 8.8 million in 1990 to 5.2 million in 2050 and the trend will continue thereafter.

![Figure 1 Bulgaria Population 1950 to 2050](image)

*Source: Population Pyramids of the World*

28. **Two main factors, the fall in the fertility rate as well as emigration, account for this demographic change.** Fertility is currently materially less than replacement rates at 1.56 births per woman and while this is expected to increase, it will remain below the replacement rate at 1.8. However, this has a follow-on impact. The number of women of childbearing age are expected to drop from 1.3 million in 2017 to 817,000 in 2050. As the numbers of women in childbearing age fall due to the decline in fertility and emigration, even an increase in fertility rate will not result in an increase in the population. A future rise in fertility will only serve to mitigate some of the population decline, but not reverse it. Furthermore, on emigration,
Bulgarians will continue to emigrate to higher paid jobs with better benefits elsewhere in Europe. As emigration restrictions ease following the end of the waiting period after joining the EU, the pace of emigration is expected to accelerate. Bulgaria is expected to have the worst population declines of any country in the ECA region, which exacerbates the pension problem as the number of potential contributors declines while the numbers of elderly continues to increase.

29. **The effects of the projected demographic changes are well illustrated by a comparison of the current population pyramid and the construct for the year 2050.** The two pyramids constructed with UN population data show a significant change in the age profile of the population. In 2017, sixty-five percent of the population was aged between 15 and 65 (a proxy for working life) and twenty percent was 65 years of age and over (a proxy for retired persons). By 2050, the number of persons aged between 15 and 65 is expected to fall to fifty six percent and the 65 and over group increase to 29 percent.

![Population Pyramids 2017 and 2050](image)

*Source: Author from data from Population Pyramids of the World*

30. **The authorities have recently implemented a number of changes to the parameters of the SSI in order to reduce the deficits in the pension system.** The rate of contribution to the public pension scheme was raised by 1 percentage point in 2017 to 18.8 percent of wage and will be raised by a further 1 percentage point in 2018, bringing the total to 19.8 percent. The contribution rates to the second pillar funds remained at 5 percent of wage, thus raising contribution rates for NSSI to 14.8 from 12.8 percent by 2018. The retirement age for females, which in 2015 was 60 years and 8 months, will increase over the next twenty-two years until it reaches 65 years of age. The retirement age for males, which is currently 63 years and 8 months, will increase very gradually until it reaches 65 years in 2029. From 2036, the retirement age will be the same for both males and females. The required length of service to qualify for a benefit will increase by 2 months each year until it reaches 40 years for men (from 38) and 37 for
women from 35. The benefits from Pillar I are expected to provide an average replacement rate of approximately 40 percent.

31. The combination of transition from centrally planned to market economy, reduction in contribution rates to first pillar, reduction in overall contribution rates, and the unfavorable demographics have resulted in the PAYG scheme being in deficit- paying out more in benefits than it is receiving in contributions. Until recently, the Government provided a matching contribution of 12 percent of wage to fill the financing gap. This arrangement has now changed and the Government is covering the deficits of the pension system, as it is legally obliged to do, currently paying half of pension expenditures.

32. Whether the measures taken to date are sufficient to stabilize the deficit spending or reduce it requires a detailed analysis, which has been complicated by the changes made to the second pillar as discussed in the following section. While contribution rates rising, retirement age increasing, and required length of service increasing are all designed to generate additional revenue and reduce costs, there are other factors which make the system costlier. Life expectancy will continue to increase, the fall in the working age population will continue to depress revenues, but even within the pension system, the increase in retirement age, increase in length of service, and increase in the accrual rate as described below will work to increase benefits per pensioner. In addition, the option now provided of individuals with second pillar accounts to go back to only first pillar benefits will raise costs of the first pillar in future years.

33. The authorities are recommended to have an independent review of the future viability and funding requirements of the SSI, with various scenarios modeled, given the opt in-opt out choices now given to people. Given the variety of choices available to people, the modeling cannot be precise, but could at least begin to define upper and lower bounds for costs. Bearing in mind the very large demographic changes that have been forecast for Bulgaria, it would be advisable to seek an independent, actuarial review of the future funding and the efficacy of the reforms.
Box 2: Description of the pension system in Bulgaria

From 2002, workers born on or after 1 January 1959 were required to split their contributions and those of their employers between the National Social Security Institute and a Pillar II fund of their own choosing. Persons born before that date are not enrolled in a Pillar II fund. Despite changes in the overall contribution rate, the level of contribution to the Pillar II funds has remained at 5 percent of wage.

In addition, Bulgaria still recognizes three categories of contributors – categories I and II comprise heavy industries and hazardous industries, and category III consists of all other workers. Employers of Category I and II workers pay an additional 3 percent of wage into special Pillar II funds called Professional Funds. Workers from these occupations are allowed to retire early and access their Professional Fund accounts before normal retirement age, but not their Pillar I pensions.

The total contribution rate increased by 1 percentage point in 2017 to 18.8 percent of wage and will increase by a further 1 percentage point in 2018, with all the additional contributions being allocated to Pillar I.

Old age pension benefits in Pillar I are calculated according to the formula: \( AR \times IP \times IC \times AMII \), where: \( AR = \) accrual rate; \( IP = \) Insurance Period; \( IC = \) Individual Coefficient; \( AMII = \) National average monthly insurable income for the 12 months preceding retirement. \( IC \) is the ratio of a retiree’s average insurable income over the reference period to the national average insurable income over the same period. The average ratio for the entire length of service is being phased in. Until 2018, new retirees used the ratio of the best 3 years’ salary of the last 15 up to 1997 to represent the years worked before 1997 and individual coefficients for all years after 1997. After 2018, only individual coefficients from 1997 onward will be used to calculate the average individual coefficient. The accrual rate is currently 1.1 percent and this will be increased gradually until it reaches 1.5 percent in 2026, with the actual accrual rate each year defined by the State Social Security Budget Act of that year. The accrual rate is reduced for each year an individual contributes to a Pillar II fund, in direct proportion to the percentage of the overall contribution rate allocated to the Pillar II fund. The employer contributions for Category I and II workers are not included in this percentage calculation.

The maximum pension is currently BGN 910 per month.

The fund also pays survivor benefits and permanent disability pensions subject to lower limits.

The statutory retirement age in 2016 was 63 years and 10 months for men and 60 years and 10 months for women. The ages will increase gradually so that by the year 2037 the retirement age for both genders will be 65 years. Persons can retire up to 12 months earlier subject to a 4 percent reduction provided that they have enough contributory years, which is below what would be actuarially fair, but is limited to a single year of early retirement.

In addition to reaching the retirement age, a male must have 38 years and 4 months of contributory years and a woman 35 years and 4 months. A retiree can buy up to 5 years of service prior to retiring.

The law allows indexation of pensions in payment to 50 percent of inflation plus 50 percent of wage growth. Indexation of pensions was suspended between 2010 and 2012 due to the financial and economic crisis and resumed in 2013. Beginning in 2017, the legal indexation will once again be suspended and substituted by ad hoc increases, while the accrual rate increase continues. But after 2026 the legally mandated indexation will return.

In 2015, there were 2,177,716 pensioners or 79 pensioners per 100 insured persons.

The second pillar is a supplementary mandatory pension system based on individual accounts managed by licensed private pension providers. There are two types of accounts – Professional Pension Funds cover workers in hazardous occupations and Universal Pension Funds applying to all other workers provided they were born after 31 December 1959. The contributions for workers in strenuous and hazardous industries are 3% higher than for other workers. This additional 3% is paid by employers and remitted to the Professional Pension Fund. Under the reforms the retirement age for workers in hazardous industries will increase from 57 to 60 and for strenuous industries from 52 to 55. These are the Category I and II workers.

There are 600,000 members contributing to the 11 voluntary funds that have aggregate funds under management of 850 billion BGN.
D. The pension sector – Pillar II

34. **There are currently nine private pension fund management companies offering eighteen pension funds.** Each pension fund management company offers two funds – the Professional fund and the Universal Fund. The distinction between the types of funds is essentially the profile of the contributors. The Professional Funds cover workers working under heavy and hazardous conditions and Universal Funds cover the balance of workers. The minimum retirement ages and the sources of contributions vary between the two types. Both types of funds are individual account based defined contribution schemes.

35. **The numbers of contributors and funds under management have steadily increased, since the introduction of the mandatory private pension pillar.** At the end of June 2016, there were in excess of 3.8 million members and funds under management of approximately BGN 9 billion. Figure 4 shows the evolution of both contributions and funds under management over the last five years. The average annual growth rates were 3 percent and 25 percent in contributors and funds under management respectively. At 30 June 2016, only one retiree was reported.

**Figure 4: Contributors and funds under management private pension funds**

![Contributors and Funds under Management 2011-2016](image)

*Source: Data supplied by FS.*

36. **The rate of contributions to the private pensions is currently 5 percent.** The contributions are divided as to 2.8 percent employer contributions and 2.2 percent employees. There do not appear to be any plans to raise the contribution rate into Pillar II above the present 5 percent.
37. **From 2014, individuals can choose to switch the balance of their private pension fund into the SSI.** Until 2017, the 5 percent contribution into a Pillar II fund was mandatory. Recent initiatives have allowed contributors to opt in and opt out of the second pillar annually, making the second pillar effectively voluntary. Any time up to five years before the retirement age, a contributor is free to move annually between a private pension fund and the first pillar. For each year that the individual contributes only to Pillar I, he or she gets the full accrual rate designated for that year. For each year the individual contributes to both Pillars I and II, the Pillar I accrual rate is proportionally reduced.

38. **The choices available to an individual are complex and probably too difficult for an individual to make an informed judgment.** If an individual who had a Pillar II account decides to contribute only to Pillar I, the individual’s account balance is transferred to the Silver Fund, an account held in the Central Bank which is conservatively managed. If the person chooses to rejoin Pillar II at some future point in his career, the individual’s account balance in the Silver Fund is transferred to the Pillar II fund of the individual’s choice, without interest. A final choice of Pillar I only or I and II needs to be made 5 years before retirement. If a person chooses only Pillar I, his or her account balance in the Silver Fund is turned over to the Government. If the person chooses both Pillar I and II, the Silver Fund account balance is transferred to a Pillar II fund. Category I and II workers who choose Pillar I only give up any right to early retirement.

39. **There appears to be an equity issue where a person opts out of the private pension system and then subsequently opts back in.** As noted above, when the person opts out, his or her balance is remitted to the Silver Fund. When he or she opts back in, his or her balance with the Silver Fund is re-credited to the account in the private pension scheme without interest. The rationale for this is that the Silver Fund is deliberately conservatively invested for ‘capital preservation’ and will target effectively a zero return.

40. **The original intention of the Silver Fund was not to act as a preservation fund; there may be alternative methods of handling the account balances of those persons who have transferred from the second pillar.** Two alternatives that the authorities should consider are the creation of a separate preservation fund with an investment strategy that mimics the average strategy of the private pension funds or allowing people who have switched to keep their accounts with the pension fund in which they were last enrolled until the age of 55 after which the opt in opt out arrangement is no longer available to them. The fees chargeable to these accounts would be materially less than the normal fees because of decreased administration activities needed for them.

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9 The Silver Fund was set up from the proceeds of privatization and some funds for the budget and to be used to supplement pensions when necessary.
41. **The authorities need to be more transparent about their vision for the private pension system.** A vibrant second pillar could be an asset for a pension system; from the Government perspective it takes potential pressure off state funds; from the contributors’ perspective, it allows contributors to diversify risk and diversify their source of retirement income. The opt-in, opt-out adds uncertainty to the private pension fund business model, thereby increasing costs, while forcing individuals to make choices they do not understand, with little real value added to having this choice. Encouraging or incentivizing individuals to transfer payments into an unsustainable PAYG system may improve the financial position of the scheme in the short-term (and relieve pressure on government finances), but will put more pressure on the scheme in the long-run, which runs counter to Government interests. If choices are provided to individuals, they must be given sufficient information to make informed, rational decisions.

42. **The returns of the private pension funds in nominal and real terms have not been stellar over the last five years.** Table 1 shows the annual returns each year to 2015 and the half-year to 2016.

**Table 1: Returns of Bulgarian Private Pensions**

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</thead>
<tbody>
<tr>
<td>Return on investments (%)</td>
<td>-0.31</td>
<td>7.43</td>
<td>4.79</td>
<td>6.11</td>
<td>1.50</td>
<td>-0.19</td>
</tr>
<tr>
<td>Nominal</td>
<td>-2.98</td>
<td>3.05</td>
<td>6.48</td>
<td>7.04</td>
<td>1.89</td>
<td>0.94</td>
</tr>
</tbody>
</table>

Source: FSC

43. **The very conservative portfolios allowed by law may have affected the investment performance.** Article 178 of the Social Insurance Code prescribes the limits for investment portfolios of mandatory private schemes. There is no limit on debt securities, issued or guaranteed by European Union Member States, European Economic Areas Countries and countries specified in Ordinance 29 of the FSC, as well as by the European Central Bank and the European Investment Bank. Direct investment in shares listed on a recognized exchange is 20 percent and a possible further 15 percent through collective investment schemes. There is a limit of 20 percent for assets denominated in other than EUR or BGN. In the medium term, the investment regulations need to be revised to be less conservative and provide more opportunities and other asset classes for increased returns.

44. **The funds are subject to a minimum return guarantee but the effect of this on the investment portfolios of pension funds is not obvious.** The pension insurance companies are obliged to achieve a minimum rate of return. The minimum rate of return is calculated on the basis of the average rate of return, achieved by all pension funds of the respective type, and it
amounts to the smaller of 60 percent of the average rate of return or a return 3 percentage points below the average. A pension fund management company breaching the minimum is required to remit an amount from its own funds to reach the minimum. In many countries, the existence of such guarantees encourages “herding” of investment strategies. A review of the portfolios of individual pension funds in Bulgaria indicates that the herding effect is minimal, if it exists at all.

45. **The FSC has been very active in ensuring that fees charged by private pension fund managers are reasonable.** The FSC has ordered a reduction in the level of fees. Having regard to the fact that pension fund management companies will (if the recommendation is accepted) pay a material part of the costs of the FSC, the FSC should review again what is a reasonable fee when pension fund management companies start paying supervision levies. There should also be recognition that the opt-in, opt-out choices now given to individuals will affect pension fund costs.

46. **According to data provided by the pension fund management companies, there is, at present, only one retiree.** Further, the data indicates that the first tranche of retirees will occur in 2020. The rules governing the payment of retirement benefits are incomplete and work needs to finalize these in the near future. It is likely that amongst the first tranche of retirees, there will be persons with small balances that would make annuitization not feasible. The rules or regulations should provide for both annuitization and phased withdrawals and establish a ceiling above which balances must be annuitized.

**The Pension Sector – Pillar III**

47. **There are nine voluntary pension funds and 2 voluntary occupational pension funds.** The number of contributors to these funds has been relatively static over the last five years averaging around 600,000. Over the same period the funds under management increased from 569 million BGN to 847 million BGN.

48. **The list of permissible asset classes for investments for Pillar III funds largely mirror those of Pillar II funds.** The principal difference is that there are hard asset class limits for most investments in Pillar II funds, but these limits do not exist in relation to Pillar III.

49. **The returns in nominal terms over the same period have been principally positive.** Over the five years, the nominal returns have been:
Table 2: Returns of Bulgarian Pillar III funds

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</thead>
<tbody>
<tr>
<td>Return on investments (%)</td>
<td>-0.33</td>
<td>8.03</td>
<td>6.36</td>
<td>6.64</td>
<td>1.67</td>
<td>-0.35</td>
</tr>
<tr>
<td>Nominal</td>
<td>-3.00</td>
<td>3.62</td>
<td>8.07</td>
<td>7.59</td>
<td>2.06</td>
<td>0.78</td>
</tr>
</tbody>
</table>

Source: FSC

E. Insurance

50. **The insurance market in Bulgaria is small, yet insurance penetration is higher than some of its neighboring countries.** According to AXCO Global Statistics, the Bulgarian market is the 79th largest market from the 180 markets that it regularly surveys. Despite the size of the market, insurance penetration is higher than some of its neighboring countries. Table 3 shows the insurance penetration for each country at the end of the last financial year.

51. **The growth in the industry over the last five years has been very modest.** The evolution of the gross written premium over the last five years is shown in Figure 5. The average annual growth rate was less than 5%.

52. **The market is well served with a high number of insurers, brokers and agents.** At the end of 2015, there were 44 insurers (writing both insurance and inward reinsurance), nearly 400 insurance brokers and over 25,000 insurance agents. Of the 44 insurers, 15 wrote life insurance and 29 wrote non-life. In the case of three insurers, banks held more than 20 percent of the issued capital of the insurer. Nine insurers are part of non-financial groups. 17 companies have ownership structures with more than 50% of the equity owned by international companies.

53. **Both the life and the non-life markets are highly concentrated.** The share of the top two life companies in terms of GWP at the end of 2016 was approximately 40 percent and the top five accounted for over 70 percent. There is similar concentration in the non-life market.

54. **Both markets are essentially one or two product markets.** In the non-life market, motor vehicle insurance is the dominant product accounting for over 70 percent of the market and divided equally between MTPL and CASCO. A further 15 percent of the premium is attributable to property. The life market is dominated by annuity business and life risk business. There is little demand for life investment products despite potential for greater earnings when compared with current bank rates.
Table 3: Insurance penetration – selected countries 2016

<table>
<thead>
<tr>
<th>Country</th>
<th>%</th>
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<tbody>
<tr>
<td>Romania</td>
<td>1.23%</td>
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<tr>
<td>Macedonia</td>
<td>1.51%</td>
</tr>
<tr>
<td>Turkey</td>
<td>1.52%</td>
</tr>
<tr>
<td>Greece</td>
<td>2.12%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2.28%</td>
</tr>
</tbody>
</table>

*Source: AXCO Global Statistics*

Figure 5: Growth in GWP 2011-2016

*Source: FSC*

55. **The latest figures available did not reveal any major solvency issues with any of the insurers.** This observation was borne out by the conclusions of the recent independent balance sheet review that showed a small number of insurers needing some capital injections.

56. **Participants of the industry are of the view that the major issue holding up the development of the insurance industry is lack of awareness and understanding of the role of insurance in managing risks, and are prepared to partner with the authorities to resolve this.** They point to an overall lack of awareness of financial services in general and consumers’ lack of trust brought about by past bad behavior in the industry. The participants pointed to limited resources available in the industry to promote insurance. The majority of the industry stated a willingness to partner with the Government or FSC in any initiatives to address the awareness issue.
57. Many of the participants noted that compulsion was a major factor in the non-life market and could be used to extend coverage to other insurable risks. The participants believed that MTPL was a successful product and had achieved high levels of compliance because of the actions of the authorities. Further, they noted that the majority of the CASCO motor vehicle insurance was written on a compulsory basis for vehicles that are either leased or being used as collateral for bank loans. There is a significant number of compulsory insurance products mandated by law. However, the target of these products is generally small groups within the economy and the impact on the levels of premium written is minimal. The authorities could consider making coverage of risks such as property, that have far wider reach, and therefore a greater positive impact on the market.

58. It was suggested that the Bulgarian insurance markets could emulate the Romanian catastrophe insurance pool – PRAC. The industry noted that the country was subject to natural disasters, the costs of which at present were being borne by the Government. If a scheme similar to that in Romania was set up, the industry would willingly participate.

59. Having regard to the industry’s comments about a lack of trust and the number of consumer complaints received, the authorities should consider changing the complaints handling system. According to the FSC, consumer complaints average over 1000 per year, which, given the size of the market, is significant. Where complaints have to be mediated, they may be referred to the Mediation Committee that was established in 2016. Deliberations of the Commission are not binding on either the insurer or the insured. Many countries with similar structures or with Financial Ombudsmen or the equivalent provide that decisions are binding on the insurer but not the insured.

60. The FSC should conduct a thematic onsite review about the setting of premiums and discounting in the non-life industry. Many of the insurers interviewed insisted that a number of other companies were heavily discounting premiums for MTPL insurance to the point of not being viable and were in fact underproviding for losses. The balance sheet review recently completed did not look at this issue but did look at the adequacy of technical provisions and appeared to conclude there were no issues. Notwithstanding, the FSC (as part of its push to risk based supervision) should assure itself of the integrity of pricing in the industry.

61. When the FSC staffing position improves, it should devote some resources to a review of the brokers’ activities. The lack of adherence to a code of business code in some of the brokers was brought to the author’s attention. The number of intermediaries in the market and the limited number of FSC staff who are available to supervise intermediary activity creates a climate where market misconduct can flourish. Brokers not adhering to high ethical and business standards are a handicap to the development of the industry and a review of the activities of brokers and disciplining those who do not observe the standards is advisable.
Annex 1. Full Policy Recommendations

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Resp.</th>
<th>Time</th>
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<tr>
<td><strong>Financial Services Commission</strong></td>
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<tr>
<td>Amend FSC Act to allow FSC to raise supervision levies</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Review level of fines and financial penalties</td>
<td>MoF/FSC</td>
<td>ST</td>
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<tr>
<td>Amend FSC Act to provide a transparent process for the termination of employment of the Chairperson and other members</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Amend FSC Act to vest all decision-making power in the Commission not individual members</td>
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<td>ST</td>
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<tr>
<td>Amend FSC Act to provide the Commission and all staff and members with legal protection for decisions made to in good faith</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Amend FSC Act to provide the Commission with autonomy over its structure</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Revise the structure in relation to the position of Secretary-General</td>
<td>FSC</td>
<td>MT</td>
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<tr>
<td>Amend FSC Act to remove nexus between the FSC staff and Civil Servants</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Link supervision staff salaries to relevant supervised industries</td>
<td>FSC</td>
<td>MT</td>
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<tr>
<td>Fill all outstanding supervisory positions</td>
<td>FSC</td>
<td>ST</td>
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<tr>
<td>Implement training plan</td>
<td>FSC</td>
<td>ST</td>
</tr>
<tr>
<td>Restructure supervision teams to incorporate onsite and offsite functions together</td>
<td>FSC</td>
<td>MT</td>
</tr>
<tr>
<td>Introduce efficiencies into pension supervision by eliminating daily reporting</td>
<td>FSC</td>
<td>ST</td>
</tr>
<tr>
<td>Make reviews for all supervised entities more risk focused</td>
<td>FSC</td>
<td>MT</td>
</tr>
<tr>
<td>Review the role of FSC to ensure compatibility with risk based supervision</td>
<td>MoF</td>
<td>MT</td>
</tr>
<tr>
<td><strong>Pensions</strong></td>
<td></td>
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<tr>
<td>Consider an independent actuarial review of SSI</td>
<td>MoF</td>
<td>ST</td>
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<tr>
<td>Provide clear information on the switching choices and implications between Pillar I and II</td>
<td>MoF</td>
<td>ST</td>
</tr>
<tr>
<td>Consider alternatives to Silver Fund for the balances of contributors opting out of Pillar II</td>
<td>MoF</td>
<td>ST</td>
</tr>
<tr>
<td>Revise investment limits with a view to adding additional asset classes</td>
<td>FSC</td>
<td>MT</td>
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<tr>
<td>Review fee structure in view of the FSC charging supervision levies against the private pension fund management companies</td>
<td>FSC</td>
<td>ST</td>
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<tr>
<td>Prepare and promulgate regulations or rules governing the payout phase</td>
<td>MoF</td>
<td>MT</td>
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<tr>
<td><strong>Insurance</strong></td>
<td></td>
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<tr>
<td>Government/FSC to participate in awareness campaign</td>
<td>MoF/FSC</td>
<td>MT</td>
</tr>
<tr>
<td>Government to consider options to help the insurance industry diversify its risks and to deal with losses arising from floods and earthquakes</td>
<td>MoF</td>
<td>MT</td>
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<tr>
<td>Government to review role of Mediation Committee in consumer complaints</td>
<td>MoF</td>
<td>MT</td>
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<tr>
<td>FSC to conduct thematic pricing review</td>
<td>FSC</td>
<td>ST</td>
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<tr>
<td>FSC to conduct thematic conduct of business review for brokers</td>
<td>FSC</td>
<td>ST</td>
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</tbody>
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