ORDINANCE No. 34 of 4.10.2006 on the terms and conditions for concluding transactions to reduce the investment risk related to assets of a supplementary pension insurance fund and on the requirements to and limitations on such transactions

Adopted by Decision No. 66-H of 4.10.2006 of the Financial Supervision Commission, promulgated in the State Gazette, No. 86/24.10.2006.

Section I
General Provisions

Art. 1. This Ordinance shall establish:

1. the terms and conditions for concluding transactions to reduce the investment risk under Article 179b, paragraph 1 of the Social Insurance Code (SIC) as well as the requirements thereto and the limitations thereon;

2. the countries and the requirements to the regulated markets therein, on which transactions in futures and options may be effected for reducing the investment risk under Article 179b, paragraph 2, items 1 and 2 of SIC.

Section II
Conditions for Concluding Transactions

Art. 2. (1) The pension insurance company may conclude transactions under Article 179b, paragraph 1 of SIC on behalf and for the account of a supplementary pension insurance fund managed by it, hereinafter referred to as “hedging transactions”, only for the purpose of reducing investment risks related to the fund’s assets.

(2) Subject of the transactions under paragraph 1 shall be futures, options, forward exchange contracts or interest swap contracts, hereinafter referred to as “hedging instrument”.

(3) Hedging transactions shall be in compliance with the objectives and strategy for management of investment risks, including the policy on their reduction, set out in the rules for the organisation and operation of the supplementary pension insurance fund.

(4) The pension insurance company may conclude a hedging transaction on behalf and for the account of a supplementary pension insurance fund managed by it, hereinafter referred to as “the fund”, provided that within the time limit agreed on the transaction the pension insurance company:

1. holds the hedged asset in the fund’s portfolio – where settlement of liabilities on the transaction provides for its physical delivery;

2. maintains cash and/or high-liquid debt securities in the fund’s investment portfolio at a level that allows current settlement of liabilities on the transaction as well as necessary liquid funds at maturity of the transaction, when the settlement is effected in cash.

(5) The pension insurance company may conclude hedging transactions only in accordance with the rules under Article 176, paragraph 3 of SIC, which shall contain:

1. description of the risks related to the fund’s assets, which are to be reduced through the conclusion of hedging transactions, as well as of the risks related to the hedging transactions;

2. the degree of investment risk, which the fund can take (risk profile of the fund’s investment portfolio);

3. the underlying assets of the hedging instruments;

4. description of the methodology used for measuring the risks related to the fund’s assets and to the hedging instruments;

5. the procedures for monitoring, measuring and management of the risks under item

1, incl. the persons responsible for:

a) preparing proposals for conclusion of hedging transactions and of analyses of the impact of hedging transactions on the risk profile of the fund's portfolio;

b) the approval of conclusion of hedging transactions;

c) exercise of control on the risk of the fund's assets, the risk of hedging instruments and the assessment of their efficiency as well as on the risk of the fund's investment portfolio;

6. frequency of making analyses of the impact of hedging transactions on the risk profile of the fund's portfolio;

7. the system for documentation of the procedures for monitoring, measurement and management of the risks under item 1;

8. obligation of the internal control unit for checking the system for risk monitoring, measurement and management.

(6) The persons under paragraph 5, item 5, letters "a", "b" and "c" may not be one and the same person.

Art. 3. Before the pension insurance company concludes a hedging transaction on behalf and for the account of the fund, the person under Article 2, paragraph 5, item 5, letter "a" shall:

1. identify the risk related to the respective asset of the fund and the risk related to the hedging instrument;

2. analyse the level of the risk related to the respective asset of the fund and prepare a justification of the projected degree of reduction thereof;

3. assess the impact of the hedging instrument on the level of risk of the fund's investment portfolio;

4. determine the sources of information to be used in the assessment of the hedging instrument and select a method for evaluation of its efficiency;

5. assess conformity of the counter-party to the hedging transaction with the requirements under Article 4, items 1 and 2;

6. check whether the selected regulated securities market is included in the list under Article 5, paragraph 3;

7. prepare a written motivated proposal to the person under Article 2, paragraph 5, item 5, letter "b" for conclusion of the hedging transaction.

Art. 4. The pension insurance company may conclude forward exchange contracts and interest swap contracts on behalf and for the account of the fund under the following terms and conditions:

1. the counter-party to the transaction shall be:

a) a bank which meets the requirements of Articles 2 and 3 of Ordinance No. 29 of 2006 on the minimum level of credit ratings of banks and on determination of countries, regulated markets and indices of regulated securities markets as per Article 176, paragraph 2 of SIC; or

b) an investment intermediary with long-term credit rating not lower than "Ba2", assigned by Moody's Investors Service, "BB", assigned by Standard & Poor's, or "BB", assigned by Fitch Ratings, which has been licensed to carry out activity in accordance with the legislation of a Member State of the European Union, of another country which is a party to the Agreement on the European Economic Area or of any of the countries stipulated in Article 5, paragraph 1, item 3 hereof;

2. the counter-party to the transaction shall not be a related person to the pension insurance company within the meaning of § 1, paragraph 2, item 3 of SIC;

3. the hedging instrument shall be subject to daily valuation at fair value, which may be checked;

4. the fund should be able to sell the hedging instrument at any time or end or close

through offsetting transaction the position taken by the fund.

Section III
Requirements to and Limitations on Hedging Transactions

Art. 5. The pension insurance company may conclude transactions in futures and options traded on the regulated securities markets in:

1. the Republic of Bulgaria;

2. an EU Member State or in another country which is a party to the Agreement on the European Economic Area;

3. Australia, Brazil, India, Canada, the People's Republic of China, Korea, Mexico, New Zealand, Russia, USA, Switzerland, and Japan.

(2) The securities markets under paragraph 1, item 3 shall meet the following requirements:

1. to operate regularly;

2. to have in place rules issued or approved by the relevant competent authorities of the country at the seat of the market, which shall determine the terms and conditions for operation and market access, as well as the terms and conditions to be met in a contract before launch of effective trade on the market;

3. to have in place an effective clearing mechanism providing for daily settlement of incurred receivables and liabilities in relation to the transactions concluded thereon and providing adequate protection in the opinion of competent authorities.

(3) The Deputy Chairperson of the Financial Supervision Commission heading the Insurance Supervision Division shall approve a list of regulated securities markets meeting the requirements of paragraph 2.

Art. 6. (1) Where the pension insurance company concludes a forward exchange contract or an interest swap contract on behalf and for the account of the fund, it shall establish the value of the risk of default on the obligations of the counter-party to the transaction.

(2) The value of the risk under paragraph 1 shall be equal to the value of the unearned profit from the concluded forward exchange contract or the interest swap contract.

(3) In determining the value of the unearned profit under paragraph 2 the fees and commissions paid on the conclusion of such transactions shall not be taken into account.

(4) Where the fund has hedging instruments on several transactions with one and the same counter-party, the value of the risk of default on the obligations by the counter-party to these transactions shall be equal to the difference between unearned profits and losses from all such transactions where:

1. the transactions are concluded on the basis of a netting agreement with the counter-party;

2. the netting agreement under item 1 provides for that in case of default, bankruptcy or liquidation of the counter-party to the transaction only one liability (in case of net negative market value) or one receivable (in case of net positive market value) to the fund shall be calculated, whereby the receivables and liabilities subject of the netting agreement shall be deemed settled;

3. the insolvency of the counter-party is a ground for termination of the contract.

(5) The value of the risk of default on the obligations by the counter-party in relation to one or more forward exchange contracts and/or interest swap contracts concluded by it may not exceed 5 per cent of the fund's assets.

Art. 7. (1) The pension insurance company shall determine on a daily basis the value of the risk of default on the obligations by the counter-party on the concluded forward exchange contracts and interest swap transactions.

(2) The sum of the values of risk of default on the obligations of counter-parties on all concluded forward exchange contracts, interest swap contracts, and the sum of the values of the market risk of all hedging instruments may not exceed the value of the fund's net assets for the respective day.

(3) Conclusion of hedging transactions may not lead to increasing the fund's exposure to risks related to a specific category of investments or a specific issuer to a level, which is higher than the admissible level for direct investments.

Art. 8. (1) A hedging instrument shall stop performing its purpose for reduction of the investment risk related to a specific asset of the fund where:

1. the fund's position in this asset is closed in full or in part, or

2. it no longer meets the requirements for efficiency set out in International Accounting Standard 39 "Financial Instruments: Recognition and Measurement".

(2) In the cases under paragraph 1, item 1, where the position is closed in full, as well as in the cases under paragraph 1, item 2, the pension insurance company shall close the position on the respective hedging instrument within the time limit specified in the rules under Article 176, paragraph 3 of SIC.

(3) In the cases under paragraph 1, item 1 where the position is closed in part, the pension insurance company shall close the position on the respective hedging instrument within the time limit specified in paragraph 2 to the extent corresponding to the residual risk of the assets being hedged with this instrument.

Art. 9. Within 20 days after the end of every calendar quarter, the pension insurance company shall prepare and submit to the Financial Supervision Commission an analysis of the impact of the concluded hedging transactions on the risk profile of the fund's portfolio and an assessment of their efficiency.

Section IV

Administrative Penalty Provision

Art. 10. (1) Whoever violates or admits violation of this Ordinance shall be penalized in accordance with Article 351 of SIC.

(2) The violations of the provisions hereof shall be established by acts issued by officials authorised by the Deputy Chairperson of the Financial Supervision Commission heading the Social Insurance Supervision Division.

(3) The penalty warrants shall be issued by the Deputy Chairperson of the Financial Supervision Commission heading the Social Insurance Supervision Division or by a person authorised thereby.

(4) The establishment of violations, the issuance, appeal and implementation of penalty warrants shall be carried out in accordance with the Administrative Violations and Sanctions Act .

SUPPLEMENTARY PROVISION

§ 1. Within the meaning of this Ordinance:

1. "Hedged asset" shall mean an asset of the fund under Article 176, paragraph 1 of SIC, in respect whereof a hedging transaction is concluded for the purpose of reducing the investment risk related thereto.

2. "Underlying assets" shall mean securities, money market instruments or other property rights under Article 176, paragraph 1 of SIC, as well as exchange rates, indices of regulated markets in securities and interest rates, being the basis for determination of the price of the hedging instrument.

3. "Hedging instrument" shall mean a financial instrument through the use of which it is expected that a change in its fair value or in cash flows related to it will offset in full or in part changes in the fair value or in the cash flows of the hedged asset.

4. “High-liquid debt securities” shall mean securities, which may be converted into cash within 7 working days at a market price on the regulated securities market on which they are traded;

5. “Market risk” shall mean the likelihood of losses as a result of a change in the prices of financial instruments, interest rates, exchange rates or other factors determining the value of the hedging instrument.

6. “Offsetting transaction” shall mean a transaction wherein a reversal of a hedging transaction is effected for the purpose of closure thereof.

TRANSITIONAL AND FINAL PROVISIONS

§ 2. In Ordinance No. 9 of 2003 on the terms and procedure for evaluation of assets and liabilities of supplementary pension insurance funds and of the pension insurance company, of the value of the net assets of the fund, for calculation and disclosure of the value of one unit and on the requirements to the keeping of individual accounts (promulgated, SG, No. 109/2003; amended and supplemented No. 34/2004, No. 57/2005, No. 32/2006) Article 10a shall be created:

“Art. 10a. (1) Futures and options shall be valued by the pension insurance company at the last price of a transaction concluded therein for the previous working day at the close of the regulated market on which they are traded.

(2) Where it is impossible to apply the valuation method under paragraph 1, subsequent valuation shall be performed in accordance with the generally accepted valuation models set out in the rules under Article 17.

(3) Forward exchange contracts and interest swap contracts concluded to reduce the investment risk related to the assets of pension funds shall be valued in accordance with the generally accepted valuation models set out in the rules under Article 17.”

§ 3. This Ordinance is issued on the grounds of Article 179b, paragraph 3 of the Social Insurance Code and was adopted by Decision No. 66-H of 4.10.2006 of the Financial Supervision Commission.

§ 4. The Financial Supervision Commission shall give instructions on the application of the Ordinance.