Abstract of the End-Product

The End-product represents the article which is to be published in one of the academic journals on legal problems. The title of the article is «The Role of Banking Regulation in the Development of Market Economy in Russia (Legal Aspects)». The article consists of introduction, three chapters, conclusion and bibliography. Three chapters focus consistently on theoretical, European and Russian aspects of prudential banking regulation.

The first chapter «Theoretical Aspects of Banking Regulation» examines the role, main objectives and functions of prudential banking regulation in market economy based on free competition. Banking regulation is designed to play a risk-minimizing role in the banking sector of market economy. The objectives of prudential banking regulation are to guarantee the safety and soundness of the banking system as a whole and to protect depositors as consumers of banking services. The objectives of banking regulation determine its functions which can be identified as preventive, protective and supportive.

The second chapter «European Aspects of Banking Regulation» analyzes the mechanism of European convergence in banking regulation. Unlike the international convergence on universal level, European convergence in prudential banking regulation was achieved through legal structures (the European Union bodies: the EC Council and the EC Commission) by means of legal instruments binding upon the EC Member States (directives). The whole process of European convergence was not a collapse, but policy-driven, taking into consideration the aim of completion of the single internal market in the EC including the single market of banking services.

The third chapter «Russian Aspects of Banking Regulation» scrutinizes the legal status of the bank of England and the Bank of Russia with special emphasis on their independence from other bodies of government, their objectives and functions as the central banks in national banking systems. In this chapter the main trend of convergence existing in European and Russian banking regulation is especially underlined. As follows from a comparative analysis, the convergence of European and Russian approaches is being achieved in relation either to capital adequacy standards, or to consolidated supervision as the key elements of prudential banking regulation. The main conclusion which must be drawn from the research carried out is that the convergence process in

banking regulation on Russian and European levels will, undoubtedly, help Russia to develop a market economy and to integrate into the European financial structures and institutions.

The Moscow School of Social and Economic Sciences
The Vinogradoff Institute, University College London

FINAL REPORT

The Role of Banking Regulation in the Development of Market Economy in Russia (Legal Aspects)

by

Natalia Erpyleva,

LL.M. (University of London);

Ph.D. (Moscow State University)

Moscow - London

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CONTENTS

INTRODUCTION

In a market economy the financial system consists of many types of financial institutions. Banks as deposit-taking institutions and financial intermediaries play a key role in the functioning of the financial system. Hence, banking regulation constitutes an integral part of the regulation of financial markets. Historically there were considerable divergencies between countries' regulatory regimes for banks. Such divergencies reflected national differences in the levels and character of economic development. Another factor which influenced regulatory differences was the political one. Many countries used regulatory laxity as a policy instrument for attracting foreign banks and, consequently, foreign investments into their national economy. The increased internationalisation of the banking business and the greater integration of financial markets in general as an objective process in the development of world economic relations revealed that these regulatory divergencies became a source of market disturbance. The banking supervisory authorities realised that threats to the stability of their countries' financial systems could originate not only internally, but also from bank failures resulting from operations outside their jurisdiction. Thus, the process of the internationalisation of banking activities was the decisive and main influence on supervisory authorities which enabled them to change their attitude towards the objectives, functions and scope of banking regulation. Indeed, as has been emphasized, "it would not be an overstatement to say that the banking and financial services industries throughout the world have been revolutionised in the past 30 years. The traditional banking business of relationship-oriented domestic lending which prevailed before the 1960s has been replaced by the truly international capital markets of the 1990s in which a borrower of sufficient standing can arrange its funding through any number of banks ... established in any number of countries in any combination of currencies through a variety of different financial instruments..."[1].Therefore, the internationalisation of

[1] Dassesse M., Isaacs S., Penn G. The EC Banking Law. London, 1994, p. 67.

banking services industry had a great impact on regulatory regime in different countries, because the banking supervisory authorities have recognised that it is impossible to supervise adequately the financial activities of banks which are incorporated in their jurisdictions unless they can obtain free access to information concerning cross-border activities of banking establishments in other jurisdictions. This access can be only achieved by means of close co-operation between national supervisory authorities. Thus, cross-border banking activities give rise to the need for adequate cross-border banking regulation.

It is possible to identify at least two levels of cross-border banking regulation which correspond to the levels of banking activities respectively:

1) the universal, or international, level which comprises a multilateral approach without any additional qualification, and

2) the regional, or European, level which also comprises a multilateral approach, but within the framework of regional qualification.

Taking into consideration all the above-mentioned it is possible to formulate the following aims of the present research:

1. to describe the role and main objectives of banking regulation;
2. to identify the functions of prudential banking regulation in a market economy;
3. to define the key elements of banking regulation as distinct from other types of financial regulation;
4. to discuss the development and mutual influence of the convergence process in cross-border banking regulation on both levels: International and European;
5. to determine similarities and differences of International and European convergence in banking regulation as regards the origin and historical development of convergence;
6. to identify the main differences in the legal nature and status of mechanisms and instruments through which the International and European convergence were developed;
7. to analyze the legal status, structure, and functioning of the Bank of England and the Bank of Russia in a comparative aspect; and

8. to compare the Russian and European approaches to capital adequacy standards and consolidated supervision as the key elements of prudential banking regulation.

CHAPTER 1. THEORETICAL ASPECTS OF BANKING REGULATION

1.1. THE CONCEPT AND BASIS OF BANKING REGULATION

Banks as deposit - taking institutions and main actors in the financial system generally are more heavily regulated than any other commercial or industrial sector of the economy. The nature and forms of regulation vary from country to country with considerable differences in scope and methods of regulation between national financial systems. The term “regulation” can be identified as a system of specific rules of a statutory or customary nature, either imposed by state bodies (e.g., parliament, government, etc.,) or other external agency (e.g. Central bank) or self-imposed by explicit or implicit agreement within the banking system (e.g. through Bankers Association) which aims to limit the activities and business transactions of banks.

The rationale of banking regulation is defined by the attributes of banks as key elements of the financial system. Dale emphasizes three characteristic attributes of banks: high financial gearing, reliance on widely dispersed withdrawable funds and lack of transparency[2]. These attributes cause the inherent instability of banking system and its vulnerability to distortion and collapse.

First, the intermediary function of banks necessarily implies a relatively high degree of financial gearing, or ratio of debt to equity capital. Today major multinational banks typically command equity capital resources equivalent to 3.5 to 4.5 percent of their total assets[3]. Due to this factual situation each bank and even the soundest bank can be defined as “conditionally” solvent. In this context the term “conditionally” means that the bank is solvent as long as its depositors do not collectively exercise their right of withdrawal based on the banker-customer contractual relationship. In case of collective deposit withdrawals the bank will face with the problem of liquidity squeeze (the lack of cash money) and thereby will be forced into sale of its assets. But in market economy there is a mismatch between book value of assets and their market value which depends upon

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[2] Dale R. The Regulation of International Banking. Cambridge, 1984, p. 55.
[3] Ibid., pp. 53-54.

quality of these assets (e.g., loan portfolio). Consequently, these assets can be disposed only at a significant discount on their book value. As a result, a liquidity problem caused by sudden and massive deposit withdrawals can be easily transformed into a solvency problem.

Second, the vulnerability of banks to sudden deposit withdrawals also increases the likelihood of such withdrawals[4]. The contractual structure of bank deposit liabilities is such that in the event that a bank's capital is insufficient to absorb losses on its assets those depositors who claim their deposits early enough will be satisfied in full whereas those who remain after the bank closes its doors suffer alone the costs of insolvency. This structure of repayment priority creates a strong incentive for depositors to beat the market by "running" on their bank at the first indication of trouble to demand repayment. In theory, it is indifferent whether depositors act upon information regarding the actual or possible deterioration of bank assets or merely upon an observation of the behaviour of other depositors or upon false rumours[5].

Third, the lack of transparency means that the bank's financial condition can deteriorate significantly before financial markets become aware of the fact. This is so because the financial conditions of a bank are not readily determinable, since crucial risk parameters such as the quality of the loan portfolio cannot be assessed on the basis of published accounts or other publicly available information. Furthermore, if the relevant information were obtainable, it would be quickly outdated, since banks can adjust their risk portfolio within a very short period of time (e.g. by taking a foreign exchange position). Moreover, even the soundest bank can become victim of false rumours[6].

These characteristic attributes of banks contain a potential source of systemic instability and costly crises caused by contagious bank runs. Moreover, in an unlimited competitive environment banks will take reckless and so-called excessive risks which can lead finally to the deterioration of their position to the detriment of their customers. Consequently, regulation is designed to play risk-minimising role in a market economy based on free competition.

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[4] Dale R. Op. cit., pp. 53-54.
[5] Freeman S. Banking as the Provision of Liquidity. - In: Journal of Business, 1988, vol. 61, p. 45.

1.2. OBJECTIVES AND FUNCTIONS OF BANKING REGULATION

Banking regulation can be divided into two general categories: the monetary and the prudential. Monetary regulation serves to control the rate of the expansion of money and credit in the market economy and is an instrument for achieving the macroeconomic objectives of the State. Prudential regulation aims at ensuring the soundness and the safety of banks and the protection of their depositors[7]. Leaving aside issues of monetary regulation, we will focus on justifications for imposing prudential regulatory control on the banking industry. Two different concerns can be distinguished in this context: 1) the protection of individual depositors as consumers of banking services against the risk of individual bank failure, and 2) the protection of the banking system as a whole against the risk of contagious crises. Consequently, "providing [that] depositors are protected (as they are through deposit insurance schemes), preventing the failure of each and every individual bank should not be a function of regulation"[8]. Therefore, the objectives of regulation are both micro (related to the consumer - a depositor at a financial institution) and macro (to the extent of a systemic interest)[9].

The objectives of regulation determine its functions, which characterise the types of regulation. Dale identifies two functions of regulation:

1. *Preventive regulation*: designed to curb risk-taking by banks and thereby reduce the likelihood of liquidity and solvency problems, and
2. *Protective regulation*: designed to provide support to both banks and their depositors should problems in fact arise[10].

Following Dale and developing his ideas, Llewellyn identifies three functions of regulation: 1) *preventive*, designed to limit risks incurred, 2) *protective*, offering protection in the event of failure, and 3) *supportive* (lender-of-last resort function)[11]. In fact, the Dale supportive function is embraced in the protective function. Taking into

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[6] See Dale R. Op. cit., p. 55.

[7] See Schoenmaker D. - Internationalisation of Banking Supervision and Deposit Insurance. - In: Journal of International Banking Law, 1993, N 3, p. 106.

[8] Llewellyn D. The regulation and supervision of financial institutions. London, 1986, p. 15.

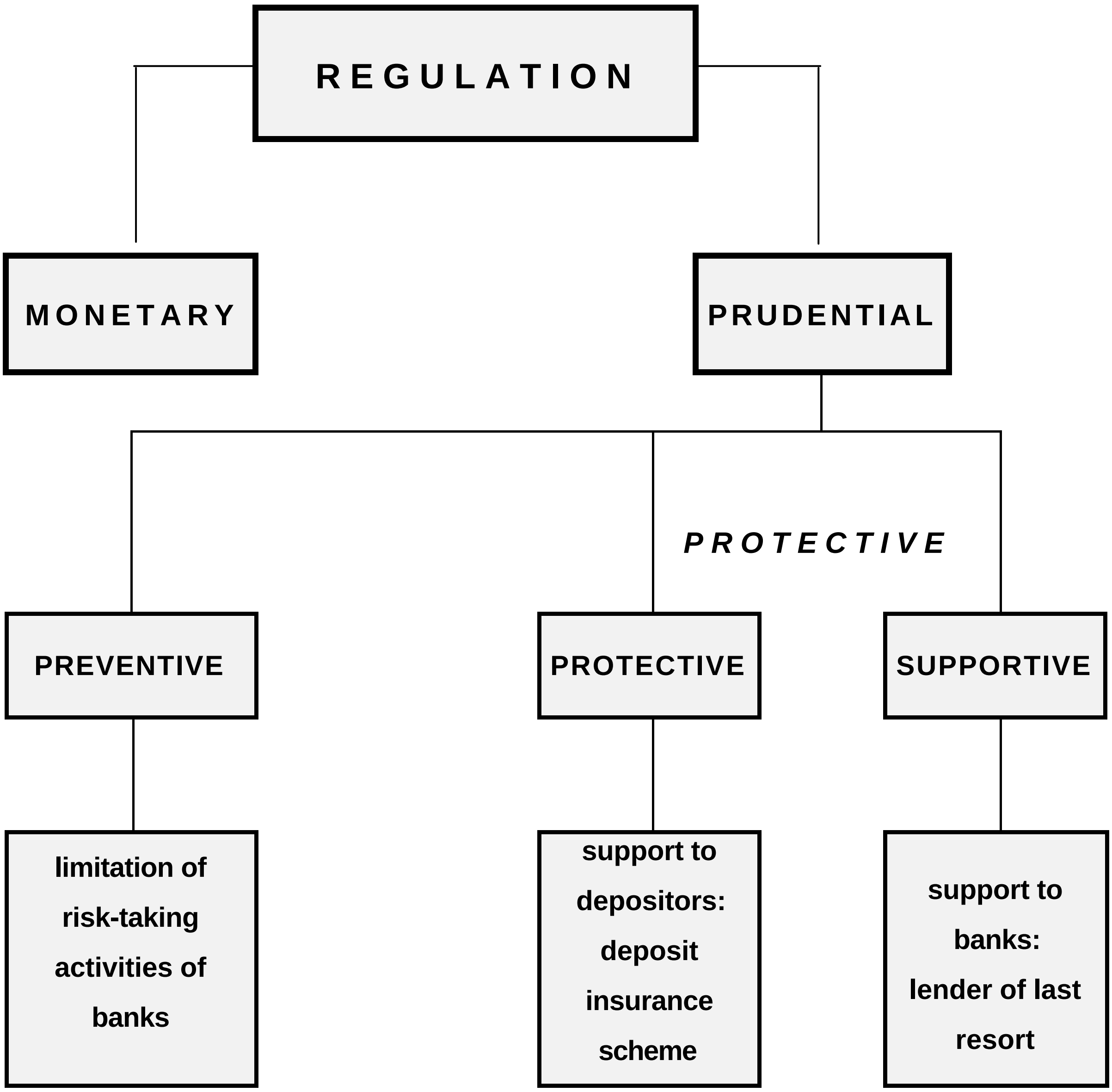
[9] Llewellyn D. Op. cit., p. 13.

[10] Dale R. Op. cit., p. 55.

[11] Llewellyn D. Op. cit, p. 16.

consideration everything mentioned above, it would be possible to classify the regulatory functions as follows on the next page (See Table N 1 on page 8).

Table N 1.



1.2.1. Protective Function of Banking Regulation

Three reasons for the rationale of the protective function of regulation can be identified. First, market mismatch between the value of a bank’s liabilities and assets, which means that while a bank's deposit liabilities have fixed nominal book value, its assets do not. The value of assets which are mainly loans made to State and corporate borrowers depends upon the financial status (e.g. general creditworthiness) of borrowers and some other factors. As a result, the book value of a bank's assets does not correspond precisely to their market value. Accordingly, it is always possible that a bank may fail as a consequence of losses on its asset portfolio. In this situation it will be unable to meet its unconditional deposit liabilities. Second, the depositors cannot evaluate precisely the soundness and safety of banks and thereby, protect themselves against the risk of bank failure. Accordingly, the purpose of protective regulation is to assess bank quality and soundness on behalf of depositors and protect them against possible bank failure. Third, it is a fundamental aspect of banking to maintain strict confidence within the banking system, and as a result, the depositors have insufficient access to the information which would enable them to observe the financial situation of their banks. Moreover, the costs of obtaining the information necessary for making such judgments are high in comparison to the value of their deposits.

The depositor protection function of regulation is implemented by way of a depositor insurance scheme. Deposit insurance performs two roles:

i. it compensates the depositor if the risk protected against (the failure of an institution) materialises (in this sense deposit insurance is the same as any other form of insurance), and
ii. it reduces the probability of the event because it reduces the incentive to withdraw deposits if an institution or other institutions are believed to be in potential difficulty.

"The second role reduces ... the probability of systemic problems as there is less rationality in depositors withdrawing insured deposits from any institution. In this way deposit insurance contributes to the stability of the financial system"[12]. An analysis of the second role of deposit insurance shows that it performs some preventive purpose because it tends to eliminate the incentive for contagious bank runs through the provision of a guarantee that deposits will be repaid in the event of a bank failure. In this context, by constraining the potential bank failures deposit insurance affects the quality

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[12] Llewellyn D. Op. cit, p. 21.

of banking behaviour because it inherently influences the incentives of the market participants[13].

Following Llewellyn, it is possible to identify five key issues in the role of deposit insurance[14]:

i. the precise nature of the role of deposit insurance in the financial system,
ii. the coverage of insurance (i.e. whether all deposits should be insured and whether total cover should be given),
iii. which agency should act as the insurer (the government, the market institution or collectively by the insured industry),
iv. the pricing of the insurance premiums and the moral hazard implications, and
v. the role of regulation in a regime of deposit insurance.

In this writer's opinion, the decisive issue is the coverage of insurance, because it influences the behaviour of banks as financial institutions which carry on the deposit-taking business and the behaviour of depositors, which is closely connected with the doctrine of moral hazard.

In conclusion it can be said that the protective function of banking regulation is expressed in the provision of a public guarantee for the liability of banking institutions in the form of deposit insurance scheme.

1.2.2. Supportive Function of Banking Regulation

The supportive function of banking regulation, or lender of last resort function, embraces a number of measures provided by a State to support the banking system as a whole or an individual bank should there be a severe liquidity squeeze. Such a measure may be an injection of money into a banking system aiming at reducing financial tension, or emergency financial assistance provided to an isolated bank.

The origin of the supportive function in banking regulation lies in the nature of the market economy. It has been suggested that "the lender of last resort function may be characterised as the authorities' response to imperfections in financial markets, since in

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[13] See Schwartz A. Monetarism and monetary policy. New York, 1992, pp. 26-29.
[14] Llewellyn D. Op. cit., p. 11.

a perfect market no solvent bank would be denied credit"[15]. The result of bank failure is two-fold: a direct financial loss for depositors and a deterioration of the money market, namely, credit market. Any bank facing a liquidity squeeze from contagious runs will be forced to deny further credit to its borrowers and even to accelerate the repayment of existing loans. As a result, borrowers will be forced to search for alternative sources of credit. Even if they succeed in raising new funds, the terms of their new loan agreements will not be equally attractive to the original credit lines. In particular, interest rates in an adverse economic environment will tend to be higher. At the same time, contagious bank runs can destroy the payment system. Thus, in general, the aim of the supportive function of regulation is to exclude the destructive economic effect of contagious bank runs through the provision of liquidity systems to temporarily illiquid, but solvent, banking institutions.

It is worth emphasizing the international context of the supportive function of banking regulation in connection with competition amongst international banking groups. The influence of the existence of a credible lender of last resort is reflected in the pricing of bank deposits[16] on international financial markets and in the preservation of confidence in international banking groups[17].

From the above one may conclude that the supportive function of banking regulation is expressed in the provision of a public guarantee for banks in a period of severe liquidity squeeze by way of emergency financial assistance.

1.2.3. Preventive Function of Banking Regulation

The preventive function is a cornerstone of prudential banking regulation. The main aim of preventive regulation is to constrain the risks incurred by banks in order to

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[15] Guttentag J., Herring R. The Lender of Last Resort Function in an International Context. - In: Princeton Studies in International Finance, 1983, N 151, p. 5.

[16] See Guttentag J., Herring R. Emergency Liquidity Assistance and International Banks. - In: Portes R., Swoboda A. (eds.) Threats to International Financial Stability. New York, 1987, p. 169. The authors note that "tiering of deposit rates in the international interbank market is based less on careful assessments of the creditworthiness of individual banks than on perceptions of their access to governmental support and the ability of particular governments to provide it".

[17] In the opinion of E. Kane, "internationally active banks enjoy a competitive advantage, when the implicit guarantees extended to them by their home jurisdiction are superior to those of their competitors". - Kane E.J. Competitive Financial Reregulation: An International Perspective. - In: Portes R., Swoboda A. (eds.) Op. cit., p. 131-134.

reduce the potential threat of bank failures and thereby to prevent systemic crises. This function is not designed to prevent the possibility of individual bank failure, but to preserve the banking system as a whole. The substance of the preventive function is three-fold:

1. the setting of barriers to entry in to the banking business in the form of a licensing requirement which prevents improper and unsafe entities from starting a banking business,
2. the imposition of minimum prudential standards in respect of capital adequacy, liquidity and solvency of banking institutions which constrain the risk-taking activity of banks, and
3. the supervision and monitoring of the implementation of prudential standards in banking practice, which enables one to prevent improper and unsafe banking institutions from continuing their business activity.

It is widely assumed that the core element of preventive regulation consists of the set of minimum prudential standards as regards capital adequacy, liquidity and solvency imposed on banking institutions by their regulators. The aim of such an imposition is to guarantee the safety and soundness of banks. While capital adequacy, liquidity and solvency have an inherent economic character and nature, it is possible to identify their legal dimension as expressed in legal documents elaborated on different levels of regulation - international, regional, and domestic.

Domestic legislation introduces and analyses the notions of capital adequacy, liquidity and solvency. In the United Kingdom they are contained in the Statement of Principles produced by the Bank of England in accordance with the 1987 Banking Act. A revised version of the Statement of Principles was issued in 1993[18].

Following the requirements of the Statement each bank must have *adequate capital*, which is commensurate with the nature and scale of the institution's operations and is sufficient to safeguard the interests of its depositors and potential depositors[19]. In determining whether such capital is adequate, the recourse is made to the nature and scale of the institution's operations, the risk inherent in those operations, and the

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[18] Statement of Principles. Banking Act 1987. The Banking Co-ordination (Second Council Directive) Regulations 1992. The Bank of England, 1993.

operations of any other undertaking in the same group in so far as they are capable of affecting the institution[20]. Capital is defined as own funds, including paid-up capital and reserves together with other financial resources available to the institution such as, for instance, subordinated loan stock issued by the institution[21].

One of the key purposes of capital is to provide a stable resource to absorb any losses incurred by the institution, and thus protect the interest of its depositors and the potential depositors. In order to meet this purpose capital must have two main qualities - a capacity to absorb losses and permanence[22].

The measurement of capital adequacy is based on the Risk Asset Ratio (R.A.R.), which is calculated as the ratio of capital to the total risk-weighted assets. The point is to weigh a bank’s assets according to their riskiness, taking into consideration either on-balance-sheet assets or off-balance-sheet ones. The capital base is then measured against the weighted portfolio of risks, and taken as a percentage of it. The percentage is the bank’s R.A.R.

As far as the issue of liquidity is concerned, “a bank shall not be regarded as conducting its business in a prudent manner unless it maintains adequate liquidity. This will be ascertained upon scrutiny of its liquid assets and actual and contingent liabilities”[23]. Liquidity means the ability of an institution to meet its obligations when they fall due. It depends, in particular, on the institution’s ability to renew or replace its deposits and other funding, the extent to which the future cash flows profile from maturing assets matches that of its maturing liabilities and the amount of high quality liquid assets it has readily available[24]. Those factors are of greater importance because they define the essence of liquidity as the ability of a bank to raise cash in such a way as not to impair the structure and quality of capital.

The question of solvency is closely connected either with capital adequacy or liquidity issues. The capital is adequate when it reduces the chances of future insolvency. This is a reason why the R.A.R., which plays a key role in capital adequacy measurement,

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[19] Ibid., para. 2.8.
[20] Ibid., para. 2.8.
[21] Ibid., para. 2.7.
[22] Ibid., para. 2.10.
[23] Penn G. Banking Supervision. London, 1989, p. 49.

is called a solvency ratio. It shows the proportion of capital to risk-weighted assets necessary to ensure the solvency of banking institution. Although liquidity and solvency in economic terms are conceptually distinct from each other, the severe liquidity squeeze can lead to a bank insolvency, when in order to meet its urgent cash needs a bank sells its assets quickly at a considerable discount on their book value, which will in turn lead to a deterioration of the structure and quality of bank capital.

Thus, the role of prudential banking regulation is to prevent unsound and unsafe entities from starting a banking business, to set minimum prudential standards to constrain risk-taking activity of banks, and to supervise the implementation of these prudential standards during the life of the banking institution. It is designed to protect the safety and soundness of banking system as a whole.

1.3. FORMS AND SCOPE OF BANKING REGULATION

Great differences exist in the forms of banking regulation from one country to another. As we have seen above, regulation implies limitations imposed upon the banking business - transactions, structure of assets and liabilities, pricing policies (rates and charges). It means that having in mind the effects of regulation, the real market environment in which the banking sector is functioning is quite different from a fully competitive (i.e., unconstrained) one.

Llewellyn identifies six forms of regulation[25]:

1. *Environmental*: banks are constrained not by regulation related specifically to prudential aspects of their business but by, for instance, the government's monetary policy;

2. *Legal*: business activity of banks is constrained by law (for instance, the demarcation between banking, securities business, insurance, and fund management);

3. *Self-imposed*: banks choose to restrict the range of business or restrictive practices are chosen by the banking sector to govern its activities and pricing policies;

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[24] Goacher D. The Monetary and Financial System. London, 1993, pp. 147-148.
[25] Llewellyn D. Op. cit., p.16.

4. *Moral suasion*: regulation emerges through the general authority of, for instance, the central bank. In Great Britain, the Bank of England has been fulfilling its regulatory functions in form of “moral suasion” for a long time;

5. *Self-regulation*: a banking agency is given formal authority or a legal duty to regulate the business of the banking sector and to impose standards or prudential norms for the conduct of its activities; and

6. *External agency*: an independent or external body is given express legal authority to regulate the banking sector, to impose explicit regulations and to monitor its business operations.

Various combinations and the interaction of these six basic forms determine the entire structure of regulation in different countries.

In this writer’s opinion, legal regulation is the most powerful of all the forms. First, the direct effect of legal regulation is guaranteed by the power of the state to enforce it under threat of punitive measures. Second, other forms of regulation either are based on legislation (as in case of self-regulation whereby an agency is given formal authority or a legal duty to regulate the banking sector) or are implemented in form of a legal act.

The scope of regulation of the banking sector again varies substantially from country to country. Six areas of regulation are identified by Llewellyn[26]:

1. *Geographical*: restrictions are imposed in the form of geographical frontiers (e.g. in the United States on inter-state banking);

2. *Functional*: the types of permitted activity of different institutions are prescribed (e.g. the strict demarcation between banking, securities business, insurance and fund management, as in the United States and Canada);

3. *Ownership*: restrictions are placed on the extent of amalgamated ownership of different financial institutions as, for instance, between insurance companies and banks. The reason is to limit conflicts of interest or the concentration of power in the financial system;

4. *Pricing*: restrictions, voluntary or legally imposed, on the setting of interest rates or charges either through legal mechanisms or a cartel agreement;

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[26] Llewellyn D. Op. cit., p.17.

5. *Entry and Establishment*: regulations or a licensing system limit the freedom of establishing certain types of financial institutions, which often in practice implies a bias against the entry of foreign institutions. Market entry is controlled via minimum capital requirements and the demonstration of management ability and integrity; and

6. *Business operations*: regulations apply to the conduct of business, such as the imposition of capital and liquidity requirements on banks (for instance, all countries impose a series of balance sheet requirements on banks).

In this writer's opinion, the crucial area of regulation, which determines the peculiarities of other areas and which truly exists in legal form is the functional area. Regulatory effect is expressed in the form of direct legal limitation on the diversification of banking activities. There are several reasons for maintaining a strict demarcation between the banking and non-banking (insurance, securities trading, fund management) business. The first reason lies in the sphere of political interests of the state to prevent a concentration of economic and financial power in one sector of the banking industry. Second, the banks can increase the level and degree of risk of their business by carrying on non-banking activity. Always there is a possibility that banks will support the losses of their non-banking business by going into reckless and imprudent banking transactions or vice versa. Third, the combination of banking and non-banking activities creates a potential conflict of interest, especially when banks deal with their customers. For instance, in the United States, following the collapse in the early 1930s of a few large banks which were engaged to large extent in investment banking activities, the Glass-Steagal Act was enacted in 1933. This Act contained prohibitions on commercial banks to be engaged in investment banking activities, particularly in the underwriting of and dealing in securities[27]. Finally, the diversification of the activities of banks would greatly complicate the aims, process and methods of regulation and supervision of banks by competent authorities.

[27] See Dale R. - International Bank Deregulation: The Great Banking Experiment. London, 1992, pp. 59-61.

CHAPTER 2. EUROPEAN ASPECTS OF BANKING REGULATION

2.1. THE DEVELOPMENT OF EUROPEAN CONVERGENCE IN BANKING REGULATION

The development of European convergence in banking regulation started practically at the same time as the process of international convergence. Both processes mutually influenced each other. The guidelines of best banking practices elaborated by the Basle Committee were taken into consideration and incorporated in a European banking law. On the other hand, as was emphasized by Norton, the European banking law itself was "a regulatory paradigm (i.e. model or framework) for the current international process of convergence of bank supervisory standards and practices"[28].

In comparing International and European convergence processes, it is possible to identify a number of important differences. First, the development of European convergence in banking regulation was consciously policy, but not collapse, driven. "The Community's efforts to harmonise the banking laws and practice of its Member States are an integral part of the Community's broader treaty objectives of achieving:

i. freedom of establishment and supply of service and of movement of capital within the Community, and
ii. the completion of a common internal market"[29].

Thus, European convergence in banking regulation derived from the EC Treaty of 1957 and the subsequent Single European Act of 1986 because the creation of a common internal market in the banking area was necessarily connected with the objectives of the EC internal market's completion.

Second, the process of European convergence was developed through legal structures with legislative administrative and judicial elements, again taking their shape from the EC Treaty. The most important role in this process belonged to the EC Council and the EC Commission (the latter comprised the Banks and Financial Institutions Division).

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[28] Norton J. The EC Banking Directives and International Banking Regulation. - In: Cranston R. (ed.) The Single market and the Law of Banking. London, 1991, p. 151.

Third, European convergence in banking regulation was developed through documents having legal force, namely, the EC Banking Directives. Again, their legitimacy derived from the EC Treaty, largely through Article 100, which provided for "the approximation of such legislative and administrative provisions of the Member States as directly affect the establishment or functioning of the common market". The most appropriate legal instrument for achieving approximation of national laws and practices is the Directive. While the Directive is not directly applicable within the Member States, it creates a unique combination of obligations legally binding upon Member States as to the result to be achieved and the freedom to choose methods of achieving it. According to Article 189 of the EC Treaty, "Directive shall be binding as to the result to be achieved upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods". Thus, the Directive creates common Community standards while permitting the Member States to have their own national legislation.

The first important step towards convergence in banking regulation within the European Community was made by the adoption of the First Council Directive of 12 December 1977 on the "Co-ordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of credit institutions", 77/780/EEC[30] (hereinafter referred to as the First Directive). It achieved five main goals:

1. it eliminated most of the obstacles to freedom of establishment of banks and other credit institutions (Art. 4);
2. it elaborated the common definition of credit institution (Art. 1)[31] and established a provision that Member States shall require credit institutions to obtain authorisation before commencing their activities (Art. 3);
3. it laid down common standards for the granting of such an authorisation (Art. 3);

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[29] Gruson M., Feuring W. A European Community Banking Law: The Second Banking and Related Directives. - In: Cranston R. (ed.) Op. cit., p. 19-20.

[30] OJ No. L322, 12.12.1977, p. 30-37.

4. it introduced the basic principle of co-operation between the supervisory authorities of Member States by setting up the Banking Advisory Committee (Art. 11); and
5. it created the principle rules regarding the establishment of branches in Member States by non-Community credit institutions (Art. 9).

However, the First Directive did not remove all barriers to the creation of the single market. To establish a branch on the territory of another Member State, the credit institution had to obtain authorisation form relevant supervisors; banking services could not be provided across frontiers in all Member States; the banking activities themselves had not been defined. The Second Council Directive of 15 December 1989 on the "Co-ordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of credit institutions and amending Directive 77/780/EEC", 89/646/EEC[32] (hereinafter the Second Directive) aimed to remove all these barriers. In the opinion of Gruson and Feuring, "the fundamental aim of the Second Directive was to create a single Community-wide banking market with no internal barriers to the movement of banking services and the establishment of branches within the Community"[33]. The Second Directive employs three basic principles:

1) *A single banking license based on mutual recognition*: This principle entitled a credit institution authorised by one Member State to carry out activities, listed in Annex to the Second Directive, throughout the whole of the EC either by establishment of branches or by provision of cross-border services. Thus, the banking licences issued in one Member State would be recognised by banking supervisors in other Member States;

2) *Home country control*: According to this principle, the home country (the Member State in which a credit institution is authorised) is responsible for its supervision, including its operations outside the Member State. The host country (another Member State where credit institution carries out activities or operates a branch) retains some residual powers in the absence of further harmonization; and

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[31] A credit institution is defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account. Thus, a key characteristic of a credit institution is deposit-taking.
[32] OJ No. L386, 15.12.1989, p. 1-13.
[33] Gruson M., Feuring W. Op. cit., p. 20.

3) *Essential requirements or minimum standards on prudential supervision*: This principle concerns minimum capital (own funds) for authorisation and continuing business (at least 5 million ECU), supervisory control of banks' participation in the non-bank sector, and supervisory control of major shareholders.

The core element of European convergence in banking regulation is the creation of a single banking license based on the doctrine of mutual recognition. A single banking license essentially means that once a credit institution has been authorised in its home Member State, the host Member State may no longer require the authorisation of branches of that credit institution[34]. A single banking license is based on the doctrine of mutual recognition. This doctrine was established in 1978 by the European Court of Justice in the Cassis de Dijon Case[35], where it held that once a product has been lawfully marketed in one Member State, other Member States must recognise that fact and permit it to be marketed in their territory. Admittedly, the Cassis de Dijon Case described trade in goods, but the Commission in the 1992 White Paper "Completing the Internal Market" applied this description to the cross-border supply of services and the establishment of undertakings in financial sector, including banking services in the category of financial products, such as insurance policies, home-ownership savings contracts, consumer credit, participation in collective investment schemes, etc[36].

The Second Directive employs the doctrine of mutual recognition, which is essentially distinct from the doctrine of national treatment. A comparison of the mutual recognition and national treatment doctrines enables one to explain why the former was chosen as the basis of the Single Banking Market in Europe. "Mutual recognition is a true catalyst for a liberalisation process, as each Member State is legally obliged to recognise the banking license of another Member State."[37] Thus, the mutual recognition doctrine leads to a liberalisation of banking regulation and to increased competition in the banking industry. Indeed, if a Member State imposes more restrictive regulation on

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[34] The Second Directive, Art. 6.
[35] Case 120/78 Rewe-zentrale AG v Bundesmonopolverwaltung fur Branntwein. [1979] ECR 649; [1979] 3CMLR 494.
[36] Completing the Internal Market. White Paper from the Commission to the European Council, June 1985, COM [1985] 310 final, paras 95 & 102.
[37] Norton J. The EC Banking Directives and International Banking Regulation. - In: Cranston R. (ed.) Op. cit., p. 164.

its domestic credit institutions, but according to the Community banking law it is obliged to recognise credit institutions authorised in another Member State with less restrictive regulation, then that host Member State would place its own domestic credit institutions at a competitive disadvantage. Consequently, Member States will have a strong impetus to liberalise their laws to the extent of the elimination of any competitive disadvantages. Therefore, with the shift to the principle of mutual recognition as part of the 1992 programme, deregulation and liberalisation have proceeded rapidly within Europe[38].

In practice for a long period differences in the character and the extent of banking regulation will exist and vary from one Member State to another. This situation gives rise to the problem technically described as ‘regulatory arbitrage’, which means regulatory forum-shopping by banking institutions seeking to locate their business in the least restrictive jurisdiction. Having in mind the potential consequences of ‘regulatory arbitrage’, the draftsmen of European banking legislation tried to mitigate the problem of evading stricter regulatory standards by banking institutions. In this writer’s opinion, there are two main barriers to regulatory forum-shopping. First, the Second Directive contains a provision confirming that the principle of mutual recognition requires the supervisory authorities of each Member State not to grant authorisation or to withdraw it where factors, such as the activities programme or geographical distribution, make it quite clear that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in another Member State in which it carries on the greater part of its activities[39].

Second, the Annex to the Second Directive sets forth the list of activities subject to mutual recognition, which includes 14 positions[40]. This list of banking activities covers not only traditional ones, such as deposit-taking, lending money, finance leasing, money transmission, trading in money market instruments (cheques, bills of exchange, CDS, etc.), foreign exchange, but also extends to investment banking by including securities trading and administration, underwriting, and portfolio management. According to the

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[38] Norton J., Cheng C.-J., Fletcher I. (eds.) International Banking Operations and Practices: Current Developments. London, 1994, p. 17.
[39] The Second Directive, 8th ‘whereas’ clause.
[40] The Second Directive, Annex.

doctrine of mutual recognition, any credit institution authorised in a home Member State may exercise in the host Member State activities that meet such criteria even if the same activities are not permitted to domestic credit institutions of host Member State. But on the other hand, if the home Member State license permits activities which are not included in the Annex, for instance, commodity and bullion trading, a credit institution still cannot conduct this activity in a host Member State by virtue of the Second Directive. Thus, the Annex equalises the competitive advantages and in this sense functions as a restriction on regulatory arbitrage.

It has to be pointed out that the doctrine of mutual recognition employed in the Second Directive does not create a 'Community' banking license, but it declares that each Member State's banking license should be valid throughout the Community. The problem of regulatory arbitrage is captured by direct limitations and harmonization of fundamental prudential supervisory standards.

The essential requirements and minimum standards of prudential supervision mentioned in the Second Directive were further supplemented by a variety of Community directives. It is worth mentioning here Council Directive of 17 April 1989 on the "Own funds of credit institutions ", 89/299/EEC[41]; Council Directive of 18 December 1989 on a "Solvency ratio for credit institutions ", 89/647/EEC[42]; Council Directive of 6 April 1992 on the "Supervision of credit institutions on a consolidated basis", 92/30/EEC[43]; Council Directive of 21 December 1992 on the "Monitoring and control of large exposures of credit institutions", 92/121/EEC[44]; Council Directive of 15 March 1993 on the "Capital adequacy of investment firms and credit institutions", 93/6/EEC[45] and European Parliament and Council Directive of 29 June 1995 on the "Reinforcing prudential supervision", 95/26/EC[46]. These directives show the development of the convergence process in banking regulation on the European level.

2.2. THE EUROPEAN DIMENSION OF CAPITAL ADEQUACY STANDARDS

[41] OJ No. L124, 17.04.1989, p. 16-20.
[42] OJ No. L386, 18.12.1989, p. 14-22.
[43] OJ No. L110, 06.04.1992, p. 52-58.
[44] OJ No. L29, 21.12.1992, p. 1-8.
[45] OJ No. L141, 15.03.1993, p. 1-26.

One of the key elements of preventive banking regulation is setting up minimum prudential standards as regards capital adequacy, solvency and liquidity of banking institutions. On the European level, four directives deal with these standards. Two of them were adopted practically at the same time as the Second Directive, namely, Directive of 17 April 1989 on the "Own funds of credit institution" (hereinafter the Own Funds Directive) and the Directive of 18 December 1989 on a "Solvency ratio for credit institutions" (hereinafter the Solvency Ratio Directive).

Both were fully implemented by 1 January 1993 and by 1 January 1991 respectively. Own funds of a credit institution serve to absorb losses and to provide a criterion for the assessment of its solvency ratio and other prudential standards like capital adequacy, the limitations on large exposures and the limitations of participation in non-bank entities. According to the Own Funds Directive, the following items are included in the calculation of own funds of a credit institution:

1. paid-up capital (equity) plus share premium accounts,
2. reserves,
3. funds for general banking risks,
4. revaluation reserves,
5. value adjustments,
6. fixed-term cumulative preferential shares and subordinated loan capital, and
7. the commitments of the members of credit institutions set up as co-operative societies and the commitments of the borrowers of certain institutions organized as funds[47].

The distinction is made between "original own funds", comprising items (1)-(3), and "additional own funds", comprising items (4) - (7). It is not difficult to note that capital elements are grouped in a way that is comparable to the two-tier arrangement of the Basle Capital Accord 1988. The original own funds and additional own funds defined in the Own Funds Directive correspond to the core capital and supplemental capital of the Basle Accord respectively. Thus, the international dimension of bank capital is embodied in the European level of regulation.

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[46] OJ No. L168, 29.06.1995, p. 7-13.

[47] The Own Funds Directive, Art. 2(1).

The aim of the Solvency Ratio Directive is to ensure that each credit institution authorised under the Second Directive has sufficient capital to meet losses caused by the realisation of risks adjusted to the banking activities. The Solvency Ratio Directive addresses only the credit risk incurred by a credit institution. The so-called market risk inherent in the securities activities of private institutions is dealt with separately in the Directive of 15 March 1993 on the "Capital adequacy of investment firms and credit institutions" (hereinafter the Capital Adequacy Directive). It has to be underlined that the solvency ratio directive embodies completely the Basle Capital Accord and therefore implements internationally-formulated rules on the European level, influencing the process of European convergence in banking regulation.

The similarities between the Solvency Ratio Directive and the Basle Capital Accord can be identified along several lines:

1. Both documents employ the same formula to compute a credit institution's solvency ratio

$$\textit{Solvency Ratio} = \frac{\textit{Own funds (Capital)}}{\textit{Risk - weighted Assets and Off - balance Sheet Items}}$$

2. The formula's numerator consists of the own funds of a credit institution as defined by the Own Funds Directive. The formula's denominator is composed of a credit institution's risk-weighted assets and off-balance sheet items.

3. Both documents apply the same method of calculation of the risk-weighted value of assets and off-balance sheet items. Each asset in the denominator of the ratio (or off-balance sheet item) is assigned a weight varying from 0 to 100% corresponding to its relative credit risk which finally depends upon the quality of the debtor (e.g., governments, commercial banks, etc.). Then the balance sheet value of each asset (or off-balance sheet item) is to be multiplied by the relevant percentage weight to achieve the risk-weighted value.

4. Both documents also apply the equal assignment of categories of assets to the various credit risk rates. For instance, a loan to an individual fully and completely

secured by mortgages on residential property will be assigned 50% risk-weighted rate under both documents[48].

The minimum solvency ratio shall be at least 8% of a credit institution's own funds. If the ratio falls below 8%, the competent authorities shall ensure that the credit institution in question takes appropriate measures to restore the ratio to the agreed minimum as quickly as possible[49]. This rule corresponds to the requirement of the Basle Capital Accord.

The monitoring and controlling of large exposures[50] of credit institutions is an integral part of prudential supervision. As credit institutions in a single banking market compete directly with each other, the prudential requirements concerning large exposures should be equivalent throughout the community. The directive of 21 December 1992 on the "Monitoring and control of large exposures of credit institutions" (hereinafter the Large Exposures Directive) is intended to prevent excessive exposure concentrations to a single debtor or group of connected debtors which may result in the insolvency of a credit institution, and therefore, to protect their safety and soundness.

The rules of the Large Exposures Directive may be summarised as follows:

1. A credit institution's exposures to a client or group of connected clients shall be considered as a large exposure where its value is equal to or exceeds 10% of its own funds[51];

2. A credit institution may not incur an exposure to a client or group of connected clients the value of which exceeds 25% of its own funds[52];

3. A credit institution may not incur large exposures which in total exceed 800% of its own funds[53];

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[48] For details see Usher J. The Law of Money and Financial Services in the European Community. Oxford, 1994, p. 88-95.

[49] The Solvency Ratio Directive, Art. 10.

[50] Exposure means the assets and off-balance-sheet items.

[51] The Large Exposures Directive, Art. 3(1).

[52] Ibid., Art. 4(1); 6(5).

[53] Ibid., Art. 4(3).

4. A credit institution shall report every large exposure to the supervisory authorities either once a year, if it is combined with reporting during the year of all new large exposures and any increases of existing ones of at least 20%, or four times a year[54]; and

5. The provisions of the Large Exposures Directive are to have been complied with by 1 January 1994. The full implementation of the directive is expected by 31 December 2001.

Comparing the Large Exposures Directive and the Basle Committee document "Measuring and Controlling of Large Credit Exposures" (1991), the similarities of the rules contained in both documents have to be pointed out. The Basle Document proposed that the large exposures should not exceed 25% of the bank's capital and there should be a special reporting threshold for such exposures at a lower level not exceeding 10% of capital. Obviously, the EC directive incorporated internationally-adopted rules and made a further step towards the elimination of "parallelism" in the convergence process on the international and European levels.

As was mentioned above the Solvency Ratio Directive laid down the Capital adequacy requirements for credit risks of the credit institutions. The Capital Adequacy Directive addresses the market risks of credit institutions and investment firms resulting from securities transactions, as well as from transactions in derivative products (futures, options, etc.) and in foreign exchange. The Capital Adequacy Directive develops common standards of capital adequacy to meet market risks incurred by credit institutions, in particular:

1. position risk, settlement risk, counterparty risk and large exposures risk arising from their trading book activities[55];
2. the foreign exchange risk arising from all their business activities;
3. the risks arising in connection with business that is outside the scope of both the Capital Adequacy and the Solvency Ratio Directives and which are similar to the risks covered by these directives; and

[54] Ibid., Art. 3(2).

4. the risks arising from their non-trading book business (handled by applying the Solvency Ratio Directive's provisions to this business)[56].

As Hall has pointed, "the main aims of the Capital Adequacy Directive are two-fold: (1) to help stabilise the international financial system by seeking to ensure that all European credit institutions and investment firms hold sufficient capital adequately to cover the market risks to which they are exposed by virtue of their trading activities; and (2) to help level the playing field for those engaged in investment business by removing or reducing competitive imbalances caused by differences in regulatory approaches adopted across both national frontiers and the banking/securities industry divide"[57].

At present, credit institutions are involved in the investment business to a great extent. As credit institutions they are already subject to the capital requirements for credit risks in the Solvency Ratio Directive. The Capital Adequacy Directive introduced additional requirements for market risks incurred by a credit institution in the particular area of investment business and as a result completed the formulation of European capital adequacy standards[58].

Thus, the development of common prudential standards as regards capital adequacy and the solvency of credit institutions is an essential aspect of the harmonization necessary for the achievement of the mutual recognition of supervisory techniques and the completion of the internal banking market.

2.3. CONSOLIDATED SUPERVISION: EUROPEAN APPROACH

In respect of prudential supervision and the monitoring of banking institutions, European banking law applies two principles: 1) the principle of home country control, and 2) the principle of consolidated supervision. The principle of home country control, incorporated in the Second Directive, is provided for branches of credit institutions authorised in one of the Member States. The concept of mutual recognition gives rise to this principle, which may be summed up as attributing the primary task of supervision of

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[55] According to Art. 2(6), the concept of "trading book" comprises positions in securities and other financial instruments which are held for trading purposes.
[56] Hall M. The Capital Adequacy Directive: An Assessment. - In: Journal of International Banking Law, 1995, N 3, p. 79.
[57] Ibid., p. 80.

a credit institution to the competent authorities of its Member State of origin[59]. Authorities of the host country have to play a complementary role. According to the Second Directive, the home Member State is responsible for the supervision of the credit institution that it has authorised[60].

The Second Directive provides for the division of supervisory responsibilities between home and host Member States. The home Member State is primarily responsible for the supervision of the financial soundness of a credit institution, especially its solvency, deposit guarantees, the limiting of large exposures, administrative and accounting procedures and internal control mechanisms. For this purpose the home Member State may, after prior notification to the host Member State, carry out on-the-spot verifications[61]. The host Member State retains responsibility for the supervision of the liquidity of the branches of credit institutions and the implementation of their monetary policies[62]. In these areas the host member state takes priority over the home one. The supervision of market risk is left to the collaboration of the home and host Member States[63].

Consolidated supervision must be distinguished from the principle of home country control. While the principle of home country control applies only to the branches of credit institutions established on the territory of Member States, the principle of consolidated supervision applies to all banking groups, including those the parent undertakings of which are not credit institutions. The principle of consolidated supervision is elaborated in the Directive of 6 April 1992 on the “Supervision of credit institutions on a consolidated basis” (hereinafter referred to as the Consolidated Supervision Directive), which replaced analogous directive of 13 June 1983 (83/350/EEC). The reason for the elaboration of the new directive lies in the BCCI collapse of 1991. The revised Directive specifically addresses two weaknesses in the regulation of BCCI, first, by bringing non-bank financial holding companies into the

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[58] The Capital Adequacy Directive should have been implemented by 1 January 1995.
[59] Atkins B. The Single Banking Market of the EEC: The Story So Far. - In: Journal of International Banking Law, 1990, N 6, p. 252.
[60] The Second Directive, Art. 13.
[61] Ibid., Art. 14(1) and 15(1).
[62] The Second Directive, Art 14(2) and (3).
[63] Ibid., Art. 14(3).

regulatory framework and second, by stating that where the bulk of a bank's business is conducted outside the home country, the host country with the largest share of that business should become the lead regulator responsible for the exercising supervision on a consolidated basis[64].

According to the 1983 Directive, consolidated supervision was solely applied to groups where the parent undertaking was a credit institution. According to the 1992 Directive,
consolidated supervision extends to groups where the parent undertaking is a financial holding company, comprising primarily credit and financial institutions as subsidiaries, or a mixed-activity holding company, comprising at least one credit institution as a subsidiary[65]. Thus a non-bank holding company with various banking subsidiaries, which was the structure used by BCCI, would fall within the scope of the Consolidated Supervision Directive. The assessment of a credit institution's financial status on consolidated bases takes into consideration all credit and financial institutions in which a credit institution holds a participation (participation means the ownership, direct or indirect, of 20% or more of the voting rights of the capital of an undertaking). Such participation may affect the safety and soundness of a credit institution if its subsidiary has financial difficulties (contagious runs). Only consolidated supervision prevents a credit institution from escaping compliance with prudential standards by moving its assets into subsidiaries.

The credit institutions or financial institutions which are subsidiaries of the parent credit institution or in which the parent credit institution holds a participation are supervised by the parent credit institution's home Member State. When the parent of a credit institution is a financial holding company or mixed-activity holding company, the competent authorities which authorise that credit institution exercise consolidated supervision[66]. If no credit institution as a subsidiary has been authorised in Member States in which the financial holding company was set up, the relevant competent authorities shall reach agreement as to who amongst them will exercise consolidated

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[64] See Dale R. Bank Regulation after BCCI. - In: Journal of International Banking Law, 1993, N 1, p. 13.
[65] The Consolidated Supervision Directive, Art. 1 and 2.
[66] Ibid., Art. 4(1) and (2); Art. 6(1).

supervision. In absence of such agreement, consolidated supervision shall be exercised by the competent authorities that authorise the credit institution with the greatest balance sheet total[67]. Thus, the Directive allows the prime responsibility of consolidated supervision to be shifted to the Member State in which most of the group's banking business is being done.

In the wake of BCCI affair the European Parliament and Council adopted a new directive on amendments to several banking, insurance and security directives in order to strengthen supervision. The Directive of 29 June 1995 on the "Reinforcing prudential supervision" (hereinafter the Prudential Supervision Directive) included the following key provisions:

1) the requirement that before authorising a credit institution which is part of a close link[68], the competent authorities must satisfy themselves that the structure of the close link is such as to enable the credit institution to be supervised effectively (art. 2(2));

2) the requirement that the central administrative office and the registered office of a credit institution be located in the same Member State (art. 3);

3) the expansion of the list of entities to which supervisory authorities may communicate confidential information (art. 4);

4) the requirement that the auditors have a duty to report to the supervisory authorities if they become aware of facts which are likely to lead to refusal to certify the accounts or to expression of reservations, affect the continuous functioning of the financial undertaking or constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorization or

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[67] The Consolidated Supervision Directive, Art. 4(2).

[68] The term "close links" is defined in the Prudential Supervision Directive. It shall mean a situation in which two or more natural or legal persons are linked by:

a) "participation", which shall mean the ownership, direct or by the way of control, of 20% or more of the voting rights or capital of an undertaking; or

b) "control", which shall mean the relationship between a parent undertaking and a subsidiary or a similar relationship between any natural or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings. A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons (art. 2(1)).

which specifically govern pursuit of the activities of financial undertakings including credit institution (art. 5)[69].

Comparing the EC approach to consolidated supervision with that of the Basle Committee set forth in the 1992 Minimum Standards for the supervision of international banking groups and their cross-border establishments (1992)[70], it is obvious that these two approaches are incompatible and inconsistent so far as the European authorised credit institutions are concerned. As regards the first minimum standard, the Basle document requires a host supervisory authority to evaluate the efficacy and sophistication of the home supervisory authority, its ability to carry out effective consolidated supervision. This minimum standard contradicts the EC banking regulation because the principle of mutual recognition of supervisory standards presupposes that the supervisory authorities in each Member State have common minimum standards with regard to the initial authorisation of credit institution and, in particular, precludes any Member State from questioning the capabilities of the supervisory authorities in other Member States[71].

The second minimum standard requires that the creation of a cross-border banking establishment should receive the prior concent of both the host supervisory authority and the bank's or banking group's home supervisory authority. It is apparent that this standard is also inconsistent with the EC banking regulation, because under the Second Directive a credit institution is not obliged to obtain the consent of the host supervisory authority in the Member State in which it intends to establish a branch pursuant to the principle of single banking license.

Leaving aside the third minimum standard concerning the right to gather information, it has to be noted that the fourth standard of the Basle Committee is also contrary to the European banking regulation. This standard provides that if the host supervisory authority determines any inconsistency with prudential regulation requirements, it can impose restricted measures, including the prohibition of the creation of banking establishment. According to the European banking regulation, the

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69 The Prudential Supervision Directive should have been implemented by 18 July 1996.

70 The Basle Committee on Banking Supervision. The Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments. Basle, 1992.

71 See Dassesse M., Isaacs S., Penn G. Op. cit., p. 103.

host supervisory authority has no right to prohibit the establishment within its territory of a branch of a credit institution incorporated in another Member State.

In conclusion, it has to be pointed out that pursuant to the objective differences in the development of International and European banking regulation, two main trends of divergence and convergence existing simultaneously can be identified. As follows from a comparative analysis of the Basle Committee and the EC documents, the convergence of the International and European approaches is achieved in the measurement of capital adequacy standards, while the divergence exists in relation to consolidated supervision. "Fostering a therapeutic effect on convergence of international banking and standards practices, the EC matrix has innovatively utilised international legal structures and legal notions as instruments of implementation"[72].

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[72] Norton J. EC Banking Law in an International Context. - In: Cranston R. (ed.) The Single Market and the Law of Banking. London, 1995, p. 169.

CHAPTER 3. RUSSIAN ASPECTS OF BANKING REGULATION

3.1. THE STRUCTURE AND FUNCTIONING OF THE BANK OF ENGLAND AND THE BANK OF RUSSIA

Banking lawyers have usually taken little interest in central banks. Central banking law, at least in the common law countries, has always been regarded as a specialized subject, mainly for public lawyers. But the public lawyers have generally done not so much, although the debate about the future of the European Central Bank is generating a greater interest on their part. There is hardly any literature about central banking, although that published recently is an important starting point for any discussion or research[73].

The legal status of any central bank may be characterized by the obvious point - a central bank stands at the centre of a state's banking system, at the heart of the banking system, because it is entrusted with administering the system of banking regulation, it is the banks' bank providing liquidity to the commercial banks and thus to the economy as a whole and it is the government's bank, performing for the government a variety of services a bank ordinarily provides for customers. The last two points need to be discussed in greater details. First, the characteristic of a central bank as the banks' bank means that in exceptional cases the central bank acts as the lender of last resort to the banks. When a particular credit institution faces difficulties the central bank may rescue it. Besides that where there is a shock to the banking system as a whole due to the massive withdrawals of cash from a range of banks without redeposit with other banks, the central bank will provide extra reserves to the banks to avoid a collapse of the banking system. Such a widespread loss of confidence is rare, but it occurs sometimes and that was exactly the case for Russia when a systemic crisis began in August 1998 because of the default on internal debt obligations announced by the Government and the Bank of Russia on 17 August 1998. Secondly, banks need to have operational accounts

[73] Effros R. (ed.) Current Legal Issues Affecting Central Banks. Washington, 1994; Fischer S. Modern Central Banking.- In: Capie F. (ed.) The Future of Central Banking. New York, 1994; Goodhart C. The Central Bank and the Financial System. London, 1995; Lastra R. Central Banking

with the central bank, because this is the only acceptable way of settling certain obligations. One such obligation is if a bank needs to make payments to government and government has its account at the central bank. Another example is if a bank, after netting
payments due to the other banks against those due to itself, still owes the other banks. Only settlement by adjustments to the accounts which banks have with the central bank is acceptable. The fact that the banks have accounts with the central bank gives the possibility for it to administer monetary policy. (In Russia all the banks have "loro" type correspondent accounts with Settlement and Cash Centres which form a part of the Bank of Russia structure. Those Centres exist in each subject of the Russian Federation which consists of 89 subjects. The network of those Centres embraces the whole territory of Russia). Thirdly, banks use the central bank as a source of notes and coins, because the most basic function of a central bank is the issue of currency. As usual the central bank has the sole right to issue banknotes, although the right to issue coins may be entrusted either to the central bank or to another body (the mint)[74].

As has been mentioned before the central bank is the government's bank. But the relationship of a central bank to government is not simply that of banker and customer. The central bank performs a variety of tasks for government which are different from the nature of ordinary relationship. First, the central bank may manage the public debt by issuing, servicing and redeeming it. In Great Britain under the National Debt Act 1870 the Bank of England acts in this capacity by advising the government on the issue of its securities (gilts and Treasury bills), selling them to the private sector, performing secondary market operations, conducting a registration and settlement service. It also supervises the core participants in the market. However, in other countries debt management is usually performed not by the central bank, but by other bodies, e.g. the ministry of finance. In Russia the government debt is managed by the Ministry of Finance in close co-operation with the Bank of Russia. Secondly, in relation to foreign exchange the central bank may be the source of rules in a sense that it may licence foreign exchange dealers, administer foreign-exchange controls and may be the

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and Banking Regulation. London, 1996; Hadjiemmanuil C. The European Central Bank and Banking Supervision. London, 1996.

compulsory depository of the foreign-exchange earnings of residents. It may be engaged in foreign-exchange transactions either on its own account or as agent of government. For instance, under the Exchange Equalization Account Act 1979 the Bank of England holds the exchange equalization account on behalf of the Treasury through which the government can act in the foreign-exchange markets. Thirdly, the most important role of a central bank as the government's bank is in giving advice on national economic policy and, mainly, in formulating monetary policy. Currently this particular aspect is viewed through the prism of popular notion that central bank independence is a prerequisite to the sound monetary policy. Especially it is the International Monetary Fund which is pushing the cause of central bank independence world-wide. The current popularity of the notion of such an independence has various origins but we leave them aside due to their economic nature[75]. The recent example of central bank independence is the European Central Bank which stands in epicentre of the European Economic and Monetary System. The Maastricht Treaty obliges Members States of the European Community to bring their central banks into line and to respect the independence of the European Central Bank. Article 107 of the EC Treaty reads: "When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks." This independence is underpinned by the eight-year terms of appointment for president, vice-president, and other members of the executive board of the ECB coupled with the protection that they can be removed only for cause founded by the European Court of Justice[76].

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[74] See in greater details: Cranston R. Principles of Banking Law. Oxford, 1997, p. 117-133.
[75] See on this topic: Barro R. - Inflation and Economic Growth. - Bank of England Quarterly Bulletin, 1995, N 35, p. 166.
[76] EC Treaty, art. 109a.2(b), Protocol 3, arts. 11.2, 11.4.

With these various matters as background let us turn to the legal regime for central banks on the example of the Bank of England and the Bank of Russia. Several issues are examined: the legal status of the central bank, objectives and functions and its structure.

A. Legal status

In broader context the legal status of a central bank indicates its place in the scheme (structure) of government in a state. The Bank of England is constituted a body corporate by its 1694 charter. The 1946 legislation nationalizing it transferred all its shares to a person nominated by the Treasury (in fact, the Treasury Solicitor), and constituted as members of the body corporate not only that person, but also the governor, the deputy governors and the directors even though they hold none of the capital[77]. According to the Federal Law "On the Central Bank of the Russian Federation (the Bank of Russia)" of 26 April 1995 as amended of 31 July 1998[78] the Bank of Russia has its own separate legal personality. The authorized (charter) capital and any other property of the Bank of Russia shall be in the ownership of the Russian Federation (federal property). Any seizure or injunction in relation to the property of the Bank of the Russia shall not be permissible. The state shall not be liable for the obligations of the Bank of Russia, and the Bank of Russia for the obligations of the State unless they accept such obligations or unless otherwise is provided for by the federal laws (art. 2).

As far as the legal status of the Bank of England is concerned the significant changes in legislation have recently taken place in Great Britain. The Bank of England Act was passed by the Parliament on 23 April 1998 and it came into force on 1 June 1998[79]. This Act changed and amended in greater extant existing the Banking Act 1987[80] and seriously affected the place of the Bank of England in the structure of government by the redistribution of functions between the Bank of England, the Financial Services Authority and the Treasury. The common thread of the Bank of England Act may be described as following: it is the modernization of Great Britain's central financial

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[77] Blackstone's Guide to the Bank of England Act 1998. Appendix 4. Charters of the Bank of England, London, 1998, p. 235-242.

[78] Ñîáðàíèå Çàêîíîäàòåëüñòâà ÐÔ, 1995, N 18, ñò. 1593; 1998, N 31, cò. 3829. (Compendium of Legislation of the Russian Federation, 1995, N 18, item 1593; 1998, N 31, item 3829).

[79] The Blackstone's Guide to the Bank of England Act 1998, Appendix 1, p. 57-107.

[80] Ibid., Appendix 2, p. 108-228.

institutions, so as to enable them, through greater transparency, accountability and orderliness, to perform well in the modern and increasingly international world of finance. This common thread formulated at quite high level of generality is transformed into three separate but overlapping aims:

1) independence of the Bank of England from government and from political influence, for the purposes of operational responsibility for monetary policy;

2) transfer from the Bank of England to the Financial Services Authority (FSA) of responsibility for banking supervision, and allied supervisory tasks;

3) reconstitution of the internal structure for governance for the Bank of England.

The redistribution of responsibilities is clearly reflected in the Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority of 28 October 1997[81]. The division of responsibilities is based on four guiding principles:

- accountability;
- transparency;
- no duplication;
- information exchange.

The Bank's Responsibilities

The Bank will be responsible for the overall stability of the financial system as a whole which will involve:

1) *stability of the monetary system*. The Bank will monitor this, as part of its monetary policy functions. It will act daily in the markets, to deal with day-to-day fluctuations in liquidity;

2) *financial system infrastructure, in particular payments systems at home and abroad.* As the bankers' bank, the Bank will stand at the heart of the system. It will fall to the bank to advise the Chancellor on any major problem inherent in the payments systems. The Bank will also be closely involved in developing and improving the infrastructure, and strengthening the system to help reduce systemic risk;

[81] Blackstone's Guide to the Bank of England Act, Appendix 5, p. 243-247.

3) *broad overview of the system as a whole*. The Bank will be uniquely placed to do this; it will be responsible for monetary stability, and will have high-level representation at the institution responsible for financial regulation (through the Deputy Governor (financial stability), who will be a member of the FSA Board). Through its involvement in the payments systems it may be the first to spot potential problems. The Bank will be able to advise on the implications for financial stability of developments in the domestic and international markets and payments system; and it will assess the impact on monetary conditions of events in the financial sector;

4) *being able in exceptional circumstances to undertake official financial operations,* in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system;

5) *the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness.*

The FSA's Responsibilities

The FSA's powers and responsibilities will be set out in statute. It will be responsible for:

1) the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and friendly societies;

2) the supervision of financial markets and of clearing and settlement systems;

3) the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where the operations do not fall within the ambit of the Bank of England;

4) regulatory policy in these areas. The FSA will advise on the regulatory implication for firms, markets and clearing systems of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury's Responsibilities

The treasury is responsible for the overall institutional structure of regulation, and legislation which governs it. It has no operational responsibility for the activities of the FSA and the Bank, and will not be involved in them. But there are a variety of circumstances where the FSA and the Bank will need to alert the Treasury about possible problems: for example, where a serious problem arises, which could cause wider economic disruption; where there is or could be a need for a support operation; where diplomatic or foreign relations problems might arise; a problem might suggest the need for a change in the law.

As can be seen from the text of the Bank of England Act 1998 the external balance between the Bank of England, on the one hand, and the Treasury, on the other, is obviously moved towards the greater independence of the Bank. Sec. 10 removes from the Treasury the power to give directions to the Bank in relation to monetary policy. That said, the Treasury have important powers to condition the general strategy in relation to monetary policy. Critically, sec. 12 enables the Treasury to specify what price stability is to be taken to consist of, and what the government's policy is to be taken to be. These are two elements, and the only two elements, of the Bank's statutory objectives in relation to monetary policy, though the second of them contains a subsidiary reference to objectives for growth and employment. The internal balance in sec. 11 is between price stability, on the one hand, and supporting the economic policy of the government, on the other. Further, there are in sec. 19 carefully drawn and balanced reserve powers, which enable Treasury directions to be given, in the public interest and in "extreme economic circumstances", with respect to monetary policy. Consultation with the Governor is required, though the question whether the directions are required in the public interest and by extreme economic circumstances is one for the Treasury. The use of the word "they" in sec. 19(1) does not include the Governor, since in this Act as in legislation generally, the Treasury are a plural noun (see, for example, secs. 12(3) and 19(2)). The order has to be laid before Parliament and is subject to the affirmative resolution procedure for its continued effect after 28 days. By schedule. 3, para. 13, the Treasury have an observer on the Monetary Policy Committee. A Memorandum of Understanding between the Treasury, the Bank of England and the Financial Services Authority carefully delineates the respective functions of three authorities, particularly in relation to issues of systemic difficulty, such as the collapse of a major bank. Moreover, there is careful balancing in new arrangements for financing the Bank of England. Although the Treasury have the power to fix the parameters which the banks and building societies are required to deposit cash with the Bank, the Act stops short of giving the Treasury full budgetary control over the process: instead, schedule 2, para. 11, provides that in exercising the critical power, "the Treasury shall have regard to the financial needs of the Bank". This implies that it is for the Bank to state what its financial needs are, rather than for the Treasury, though the process of having regard to such an assessment implies a certain measure of oversight[82].

As far as the legal status of the Bank of Russia is concerned, it is worth mentioning that it may be characterized as an independent entity in the structure of government in Russia. As was underlined by Professor W.E.Butler "The Law on the Central Bank provides that the Bank is a "juridical person", but does not stipulate what organizational-legal form of juridical person it may be. A careful analysis of its sundry functions suggests that the Bank does not precisely fit into any of organizational-legal forms provided for juridical persons in the Russian Civil Code"[83].

According to the Federal Law "On the Central Bank of the Russian Federation" the Bank of Russia, within the limits of the powers granted to it by the Constitution of the Russian Federation and by the federal laws, shall be independent in its activity. The federal bodies of Government, the bodies of the government in subjects of the Russian Federation and the bodies of local government shall no right to interfere in the activity of the Bank of Russia in course of discharge of its legally defined functions and powers, or to take decisions contrary to the present Federal Law. In case of interference in its activity, the Bank of Russia shall inform the State Duma and the President of the Russian Federation about such interference. The Bank of Russia shall have the right to bring an action to the courts for invalidating the legal acts of the governmental bodies. The drafts of federal laws and other normative acts affecting the discharge of its functions by the Bank of Russia, shall be submitted for the approval to the Bank of Russia (art. 5).

The independence of the Bank of Russia is backed by its accountability to the Parliament. The Bank of Russia shall be accountable to the State Duma of the Federal Assembly of the Russian Federation[84]. The accountability of the Bank of Russia to the State Duma shall mean:

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[82] Blackstone's Guide to the Bank of England Act 1998, p. 5-6.
[83] Butler W.E. Russian Law. Oxford, 1999, p. 481.
[84] The State Duma is the lower house of the Federal Assembly - the Parliament of the Russian Federation.

– the appointment and dismissal of the Chairman of the Bank of Russia by the State Duma on the presentation by the President of the Russian Federation;

– the appointment and dismissal by the State Duma of the members of the Board of
Directors of the Bank of Russia (hereinafter referred to as the Board of Directors);

– the submission by the Bank of Russia to the State Duma for consideration of the annual report, and of the auditing certificate;

– the appointment by the State Duma of an auditing firm for an auditing of the Bank of Russia;

– the conduct of parliamentary hearings on the activity of the Bank of Russia with the participation of its representatives;

– the reports of the Chairman of the Bank of Russia to the State Duma on the activity of the Bank of Russia (twice a year: when submitting the annual report and the fundamental guidelines of the single monetary policy (art. 5).

Despite its independent status the Bank of Russia has close connections with other bodies of government. The Bank of Russia participates in the elaboration of the economic policy of the Government of the Russian Federation. The Chairman of the Bank of Russia or, by his order, one of the Deputy Chairman, participates in the meetings of the Government. According to the above-mentioned Federal Law the Minister of Finance of the Russian Federation and the Minister of Economics of the Russian Federation or, by their order, deputy ministers shall participate in the meetings of the Board of Directors with the right of a deliberative vote. The Bank of Russia and the Government of the Russian Federation shall inform each other about the intended acts having a national importance, shall coordinate their policy and carry out regular consultations. The Bank of Russia shall consult the Ministry of Finance of the Russian Federation on the schedule for the issuance of the government securities and the settlement of the national debt, taking into account their effect on the condition of the banking system and the priority of the single monetary policy (art. 19). In order to improve the monetary system of the Russian Federation, the Bank of Russia shall create a National Banking Council, consisting of the representatives of the houses of the Federal Assembly of the Russian Federation, the President of the Russian Federation, the Government of the Russian Federation, the Bank of Russia, the credit institutions and also experts. The Chairman of the National Banking Council shall be the Chairman of the Bank of Russia. The National Banking Council shall comprise two representatives from each house of the Federal Assembly of the Russian Federation, one representative from both the President of the Russian Federation and the Government of the Russian Federation, and also the Minister of Finance of the Russian Federation and the Minister of Economics of the Russian Federation. The other members of the National Banking Council shall be appointed by the State Duma on the Presentation of the Chairman of the Bank of Russia. The number of the National Banking Council shall not exceed 15 persons. The meetings of the National Banking Council shall be held at least once every three months. The National Banking Council shall perform the following functions:

- it shall consider the concept of improving the banking system of the Russian Federation;
- it shall consider the drafts of the fundamental guidelines of the single monetary policy, the policy of the foreign exchange regulation and control, shall give opinions thereon and shall analyze the results of their fulfilment;
- it shall conduct the expertise of the drafts of any normative acts in the field of banking;
- it shall consider the most important matters of regulation of the activity of credit institutions;
- it shall participate in the elaboration of the basic principles of organizing the system of settlements in the Russian Federation (art. 20-21).

B. Objectives and Functions

The contemporary trend is that a central bank should have a single objective for monetary policy - price stability. This anti-inflation objective is usually coupled with the popular provision of central-bank independence. It is said, that with this clear objective an independent central bank will promote confidence in its monetary policy and reduce potential inflationary expectations. Thus, price stability as an objective of a central bank's monetary policy will influence the soundness of a financial system of a state. Aspects of financial stability include an efficient system for payments and settlement, efficient and reliable financial markets and sound financial intermediaries such as banks and other credit institutions. A sound financial system also means that a central bank can economize on its function as lender of last resort.

In terms of legislative provisions it emerges from the Bank of England Act 1998 that two specific functions of the Bank are recognized by statute (sec. 36; schedule 7, para. 2). These are:

a) its functions as a monetary authority;
b) its functions as a supervisor of systems for the transfer of funds between credit institutions and their customers.

In relation to monetary policy the objectives of the Bank of England shall be -

a) to maintain price stability, and
b) to support the economic policy of the Government, including its objectives for growth and employment (sec. 11).

In relation to its supervisory functions the objectives of the Bank of England shall be -

a) to maintain financial stability, including due financial system infrastructure and, in particular payments systems.

According to the Federal Law "On the Central Bank of the Russian Federation" the basic objectives of the Bank of Russia shall be -

a) the protection and ensurance of the stability of the rouble, including its purchasing capacity and its exchange rate to foreign currencies;
b) the development and strengthening of the banking system of the Russian Federation;
c) the ensurance of an efficient and sound functioning of the settlement system (art.3).

The Bank of Russia shall perform the following functions;

1) in interaction with the Government of the Russian Federation shall elaborate and carry out a single monetary policy aimed at protecting and ensuring the stability of the rouble;
2) shall carry out the issuance of notes and coins and shall organize its circulation;
3) shall be a lender of the last resort for the credit institutions and shall organize a system of refinancing;

4) shall establish the rules for carrying out the settlements in the Russian Federation;
5) shall establish the rules of carrying out the banking transactions, bookkeeping and accounting for the banking system;
6) shall conduct the State registration of the credit institutions; shall issue and revoke licenses of the credit institutions and auditing organizations;
7) shall supervise the credit institutions;
8) shall register the issuance of securities by the credit institutions in accordance with the federal laws;
9) shall carry out all types of banking transactions for fulfilment of the basic tasks of the Bank of Russia;
10) shall carry out the foreign exchange regulation, including the operations on purchase and sale of foreign currency;
11) shall organize and exercise foreign exchange control both indirectly and through the authorized banks in accordance with the legislation of the Russian Federation;
12) shall take part in the elaboration of the balance of payments of the Russian Federation;
13) shall perform any other functions in accordance with the federal legislation (art. 4).

A comparison between objectives and functions of the Bank of England and those of the Bank of Russia leads us to the following conclusion: while the conduct of monetary policy is a common objective for both central banks, it is not the case for banking supervision. While in Great Britain supervisory functions of the Bank of England are currently being transferred to the Financial Services Authority, in the Russian Federation the Bank of Russia has wide powers to supervise the banks and other credit institutions including issuance and revocation of authorization, formulating the minimum prudential standards and application of sanctions in course of prudential control.

C. Structure

In a narrow sense the structure of a central bank can contribute indirectly to its accountability. For instance, its board of directors could include representatives of different economic, social, or regional interests. The more representative the board the more likely that its pursuit of monetary policy will win acceptance in the country. The structure of a central bank will always reflect its objectives and functions. In this sense it is possible to say that the structure of a central bank serves as an institutional mechanism for the discharge of its functions and the achievement of its objectives. The structure of the Bank of England and the Bank of Russia can be shown on the Tables N 2-5 consequently[85].

[85] See Table N 2 on p. 41, Table N 3 on pp. 42-43, Table N 4 on p. 44, Table N 5 on p. 45.

Table N 2.

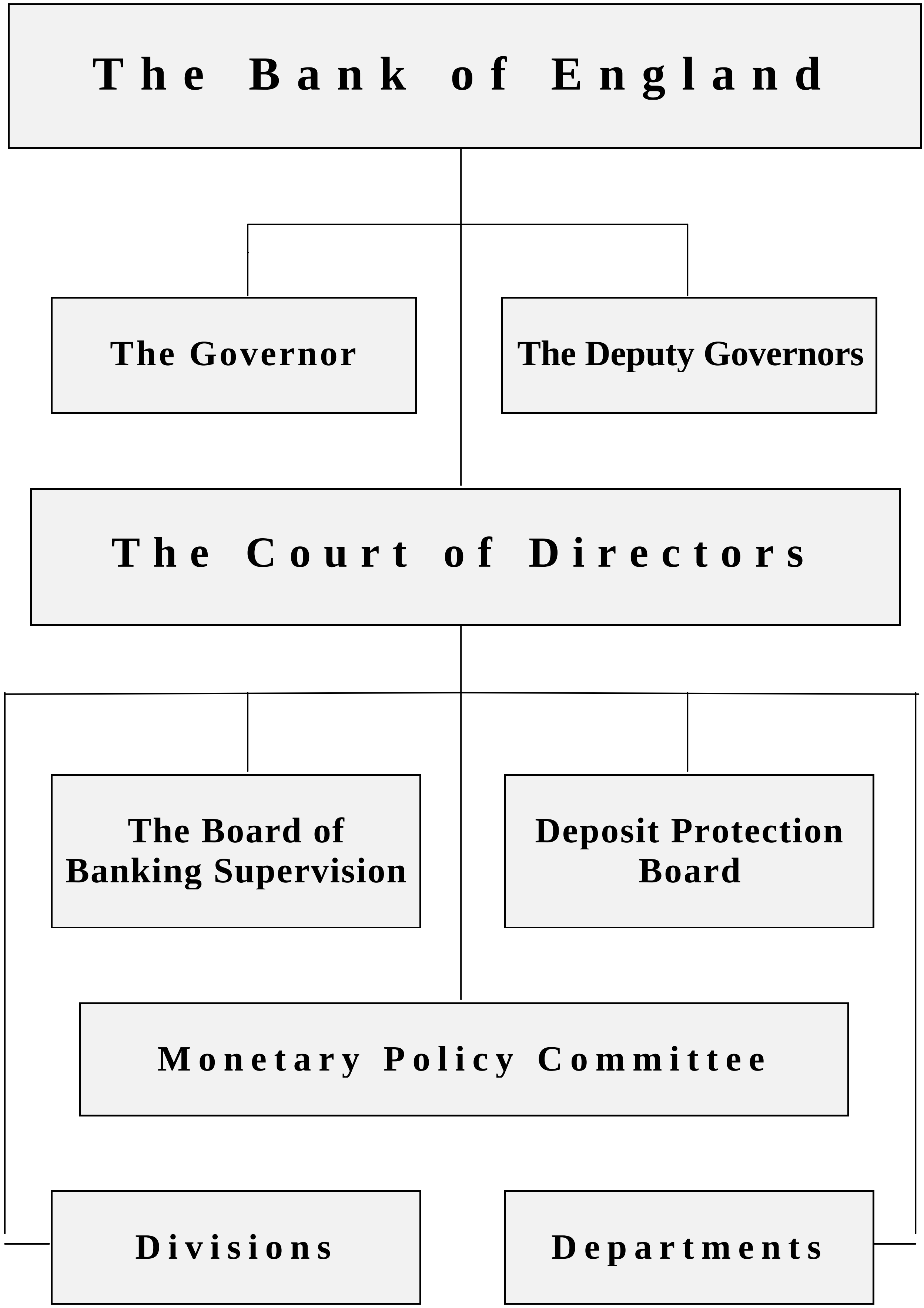
The Bank of England
The Governor
The Deputy Governors
The Court of Directors
The Board of Banking Supervision
Deposit Protection Board
Monetary Policy Committee
Divisions
Departments

Table N 3.

Bank's Bodies	Main functions	Composition	Process of Appointment	Terms of Office
1	**2**	**3**	**4**	**5**
Court of Directors	determination of the Bank objectives and strategy	Governor	appointed by Her Majesty	5 years
		2 Deputy Governors	Quorum – 9 persons	5 years
		16 Directors		3 years
Monetary Policy Committee	formulating monetary policy	Governor and 2 Deputy Governors	appointed by Her Majesty	5 years
		2 members (one has executive responsibility within the Bank for monetary policy analysis; the other has executive responsibility within the Bank for monetary policy operations	appointed by the Governor of the Bank after consultation with the Chancellor of the Exchequer	3 years (except that initially some appointments may be for shorter and different periods)
		4 members (the persons have knowledge or experience which is likely to be relevant to the Committee's functions). These members are servants of the Bank	appointed by the Chancellor of the Exchequer Quorum – 6 persons of whom 2 must hold office as Governor or Deputy Governor	3 years (except that initially some appointments may be for shorter and different periods)
The Board of Banking Supervision	giving advice to the ex officio members on the excercise by the Authority of its supervisory functions in relation to credit institutions	2 ex officio members: - the Chairman of the FSA; - the holder of other office within the FSA	designated by the Chairman of the Authority (FSA)	
		6 independent members (they have no executive responsibility in the FSA)	appointed jointly by the Chansellor of the Exchequer and the Chairman of the Authority Quorum – 4 persons of whom 1 must be ex officio member and 3	5 years

			must be independent members	

Table N 3 (continued)

1	2	3	4	5
The Deposit Protection Board	holding and managing the Deposit Protection Fund	3 ex officio members: - the Chairman of the FSA; - the holder of other office within the FSA; - the Deputy Governor responsible for financial stability	designated by the Chairman of the Authority	
		ordinary members: 3 persons who are directors, controllers or managers of contributory institutions; persons who are officers or employees of the FSA	appointed by the Chairman of the Authority Quorum is determined by the Board's internal procedure	

Table N 4.

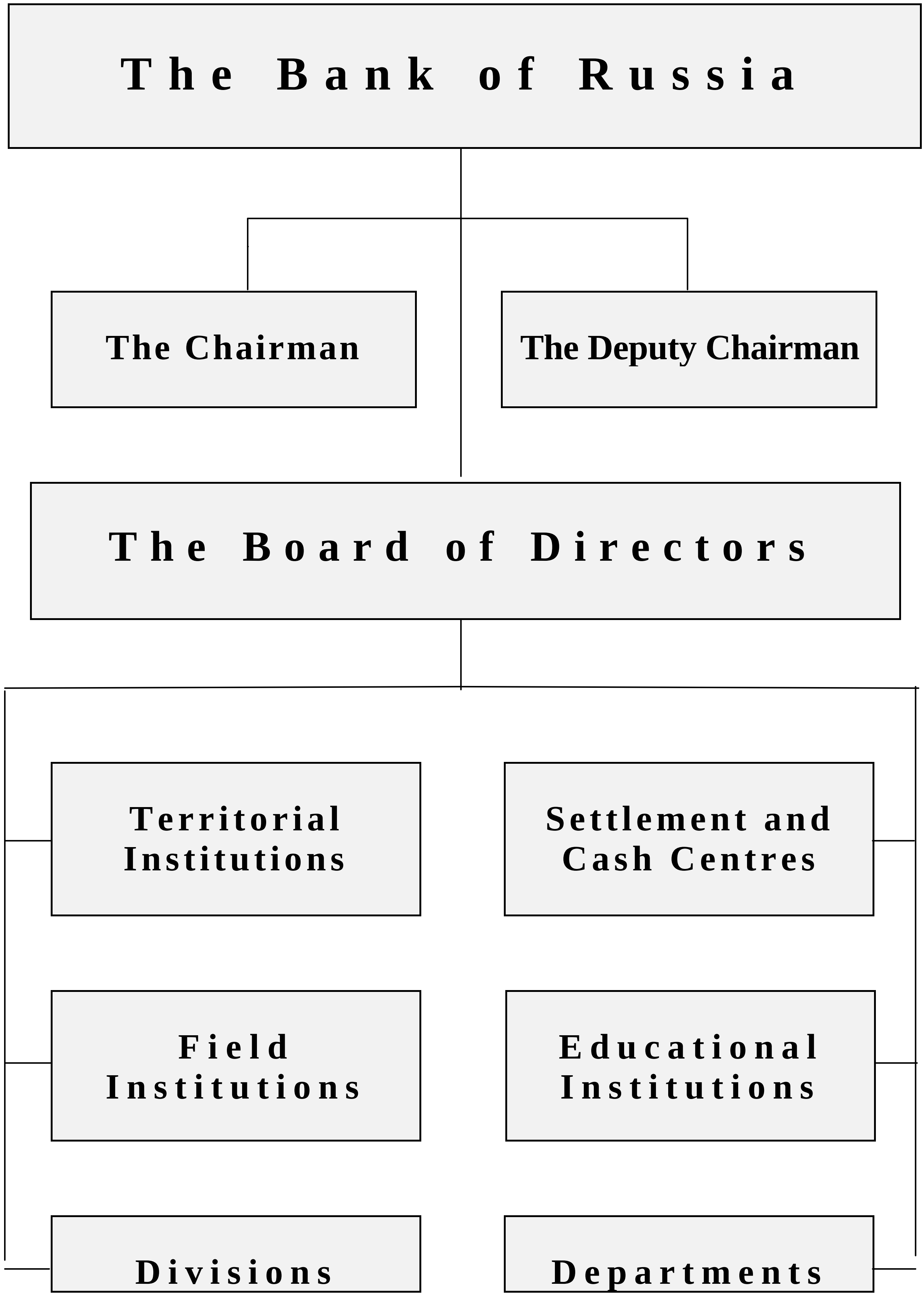
The Bank of Russia
The Chairman
The Deputy Chairman
The Board of Directors
Territorial Institutions
Settlement and Cash Centres
Field Institutions
Educational Institutions
Divisions
Departments

Table N 5.

Bank's Bodies	Main functions	Composition	Process of Appointment	Terms of Office
1	**2**	**3**	**4**	**5**
Chairman	actions on behalf of the Bank of Russia and its representation in relations with the State bodies, credit institutions, and international organizations	Chairman	appointed by the State Duma on the presentation by the President of the Russian Federation	4 years
Board of Directors	determination of the Bank objectives and strategy including formulation of the single state monetary policy and supervision of the credit institutions	Chairman	appointed by the State Duma on the presentation by the President of the Russian Federation	4 years
		12 members	appointed by the State Duma on the presentation by the Chairman of the Bank of Russia after consultation with the President of the Russian Federation Quorum – 7 persons of whom 1 must hold office as Chairman or Deputy Chairman	4 years

3.2. THE RUSSIAN DIMENSION OF CAPITAL ADEQUACY STANDARDS

According to the Federal law "On the Central Bank of the Russian Federation (the Bank of Russia)" the Board of Directors shall establish prudential standards for banks and other credit institutions (art. 15(6)). The list of mandatory prudential standards is given in art. 61 and it includes 12 standards, concerning capital adequacy, solvency ratio, large exposures and liquidity of credit institutions. These economic standards are developed and discussed in greater details in the Instruction of the Bank of Russia N 1 "On the regulation of banks' activities" of 01 October 1997 as amended of 04 February 1999[86]. We will focus on three standards: minimum capital (own funds) for authorization (sec. 1); capital adequacy (sec. 3); large exposures (sec. 5-6).

The minimum capital (own funds) for authorization of banks is set out in the amount equivalent to 5 million euro from 1 January 1999. If the bank's capital (own funds) is between 1 million and 5 million euro, such a bank will not be able:

a) to make cross-boarder banking transactions (except opening and keeping correspondent accounts in foreign banks);
b) to make banking transactions with bullions;
c) to set up branches and subsidiaries abroad;
d) to participate in the capital of credit institutions in the amount exceeding 25% of the capital of those institutions (sec. 1.3).

The following items are included in the calculation of own funds:

1. paid-up authorized capital;
2. reserves;
3. general funds;
4. non-distributed profit (sec. 1.1).

The aim of the capital adequacy standard is to ensure that each bank authorized by the Bank of Russia has sufficient capital to meet losses caused by the realization of risks adjusted to the banking activities. The Instruction N 1 addresses only the credit risk incurred by a bank. It has to be underlined that the Instruction N 1 embodies completely

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[86] Âåñòíèê Áàíêà Ðîññèè, 1997, N 66; 1999, N 9. (The Bank of Russia Review, 1997, N 66; 1999, N 9).

the related European banking directives (the Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive) and, therefore, implements the rules of European banking law on the Russian level.

The similarities between the Instruction N 1 and the Solvency Ratio Directive can be identified along several lines:

1. Both documents employ the same formula to compute a bank's capital adequacy standard

$$Capital\ Adequacy = \frac{Own\ funds\ (Capital)}{Risk\text{-}weighted\ Assets\ and\ Off\text{-}balance\ Sheet\ Items}$$

The formula's numerator consists of the own funds of a bank as defined by sec. 1 of the Instruction N 1. The formula's denominator is composed of a bank's risk-weighted assets and off-balance sheet items.

2. Both documents apply the same method of calculation of the risk-weighted value of assets and off-balance sheet items. Each asset in the denominator of the formula (or off-balance sheet item) is assigned a weight varying from 0 to 100% corresponding to its relative credit risk which finally depends upon the quality of the debtor (e.g. governments, commercial banks, etc.). Then the balance sheet value of each asset (or off-balance sheet item) is to be multiplied by the relevant percentage weight to achieve the risk-weighted value.

3. Both documents also apply the equal assignment of categories of assets to the various credit risk rates. For instance, a loan guaranteed by the Government will be assigned 10% risk-weighted rate under both documents[87].

The minimum capital adequacy standard shall be at least 8% of a bank's own funds as from 1 February 1999 and at least 10% from 1 February 2000 for a bank with own funds over 5 million euro; at least 9% from 1 February 1999 and at least 11% from 1 February 2000 for a bank with own funds between 1 million and 5 million euro. This rule generally corresponds to the requirement of the Solvency Ratio Directive[88].

As has been mentioned before the monitoring and controlling of large exposures of banks is an integral part of prudential regulation. The large exposure standard is intended to prevent excessive exposure concentrations to a single debtor or group of connected

[87] The Instruction N 1, sec. 3 (1).

debtors which may result in the insolvency of a credit institution and, therefore, to protect their safety and soundness. The rules of the Instruction N 1 concerning large exposures standard may be summarised as follows:

1. A bank's exposure to a borrower or group of connected borrowers shall be considered as a large exposure where its value is equal to or exceeds 5% of its own funds[89];
2. A bank may not incur an exposure to a borrower or group of connected borrowers the value of which exceeds 25% of its own funds[90];
3. A bank may not incur large exposures which in total exceed 800% of its own funds[91].

Comparing the Instruction N 1 and the Large Exposures Directive, the similarities of the rules contained in both documents have to be pointed out[92]. Obviously, the Instruction N 1 incorporated European approach and made a further step towards the convergence of banking prudential standards on the European and Russian levels.

3.3. CONSOLIDATED SUPERVISION: RUSSIAN APPROACH

According to the Federal Law "On the Central Bank of the Russian Federation" the Bank of Russia shall be considered as a body of banking regulation and supervision over the credit institutions (art. 55). The notion of credit institution containing in the Federal Law "On the Banks and Banking" of 03 February 1996 as amended of 31 July 1998[93], is actually based on the notion of credit institution given in the First Banking Directive. In accordance with this law all credit institutions are divided into two groups: banks and non-banking credit institutions. Bank is a credit institution which has an exclusive right to make in aggregate the following banking transactions: taking of funds of legal and natural persons in form of deposits; investing the above-mentioned funds in its own

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88 Ibid., sec. 3(2); the Solvency Ratio Directive, art. 10.
89 The Instruction N 1, sec. 6.
90 Ibid., sec. 5 (2).
91 Ibid., sec. 6.
92 See infra, Ch. II, para. 2.
93 Ñîáðàíèå Çàêîíîäàòåëüñòâà ÐÔ, 1996, N 6, ñò. 492; 1998, N 31, ñò. 3829. (Compendium of Legislation of the Russian Federation, 1996, N 6, item 492; 1998, N 31, item 3829).

name and for its own account on condition of repayment, demand and payment of interest; opening and keeping of bank accounts of legal and natural persons (art. 1).

All credit institutions including banks are subject to banking supervision and control by the Bank of Russia. The main objective of such supervision is the maintenance of the stability of the banking system as a whole and the protection of interests of the depositors. In order to discharge its supervisory function, the Bank of Russia has the right to demand and receive from the credit institutions the necessary information about their activity including economical, statistical and analytical information (art. 56). For collecting of such information the Bank of Russia employs the principle of consolidated supervision. Like in Great Britain in Russia the principle of consolidated supervision is reflected in the Federal Law "On the Banks and Banking". If a bank owns more than 50% of voting shares of another bank, it shall present to the Bank of Russia in compliance with the form, procedure and terms fixed by the Bank of Russia consolidated reports on its transactions and the transactions of subsidiaries, including consolidated accounting balance sheet and consolidated report of profits and losses (art. 43). In Great Britain the principle of consolidated supervision is scrutinized in the Banking Act 1987. In order to ensure that the Bank of England has the authority to conduct supervision in this manner, the act gives it the power to request information and the production of documents from all undertakings which belong to the same corporate group as an authorised institution or are owned by that institution's shareholder controllers. The Consolidated Supervision Directive has necessitated the technical amendment of the relevant provisions. In Great Britain the Directive's implementation has taken the form of a notice issued by the Bank of England[94]. This notice applies to all U.K.- incorporated authorised institutions and in some cases expands the scope of the Bank's previous policy on consolidated supervision.

The Bank of England uses consolidated returns and other information to assess the strength of an authorised institution's group as a whole, in order to evaluate the potential contagion risks from other group affiliates. It also takes into account the situation of those entities (e.g. industrial or insurance undertakings) which are not included in the

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[94] Implementation in the United Kingdom of the Directive on the Consolidated Supervision of Credit Institutions (BSD/1993/1, February 1993).

consolidation because the nature of their business is such that their consolidation would not be meaningful. For this purpose, it relies on discussions with the group's management. The method of consolidation follows generally the rules set out in the Consolidated Supervision Directive. However, the Bank of England approaches the requirements of the Directive as comprising only minimum standards and is ready to require wider consolidation where, in its opinion, this will result in a more accurate picture of the risks facing an authorised institution. Furthermore, the Bank of England normally requires the full consolidation of minority participations, even though the Directive demands only *pro rata* consolidation. It also requires the consolidation of companies over which a banking group exercises a "dominant influence" without, however, formally holding a participation. On the other hand, unless the Bank of England decides otherwise, the non-financial subsidiaries of a banking group are excluded from its consolidation, in which case the assessment of the group's capital adequacy takes place by deducting at book-value from the consolidated capital the capital investment in these subsidiaries. Despite supervision at the group level, authorised institution remains the focus of supervision. The activities of other group entities are taken into consideration only to the extent that they may influence its reputation and financial soundness. Neither can consolidated supervision provide a substitute for solo supervision, since intragroup exposures that may put at risk the authorised institution can only be revealed by solo supervision. For the same reason, the Bank of England sets capital requirements both at the solo and at the consolidated levels[95].

In Russia the principle of consolidated supervision is developed in the Regulation of the Bank of Russia N 29-P "On consolidated reports of credit institutions" of 12 May 1998 as amended of 17 February 1999[96]. A consolidated report shall be prepared for the purpose of determining the nature of influence on the credit institution's financial position of its investments in other legal entities' capitals, transactions with these legal entities and their management, and also for the purpose of determining the aggregate risks and net assets of the consolidated banking group. Consolidated banking group

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[95] See in greater details: Hadjiemmanuil C. Banking Regulation and the Bank of England. London, 1996, p. 212-217.

[96] Âåñòíèê Áàíêà Ðîññèè, 1998, N 33; 1999, N 13. (The Bank of Russia Review, 1998, N 33; 1999, N 13).

(hereinafter referred to as the group) shall be understood as a system of legal entities including the parent credit institution and the group members whose relations meet the certain criteria (sec. 1.3.). A credit institution shall be recognized as the group's parent institution (hereinafter referred to as the parent credit institution), if in relation to at least one legal entity:

a) it is the principal or predominant company in accordance with the provisions of the Civil Code of the Russian Federation; and/or

b) due to the title to the stock acquired for the purpose of investment or in pursuance of the agreement (including that of trust property management, agency contract, joint venture agreement) it has the opportunity:

- to exert decisive influence on the appointment of a one-man executive body of the company;
- to exert decisive influence on the election of more than 1/3 of the collective executive body or of the Board of Directors;
- to determine the conditions for the business activity of the company;
- to perform the powers of the executive body of the company;
- to own at least 5% of total number of votes, required in accordance with the company's constitutive documents, for decision-making at the general meeting of participants, provided that 3 major participants which are not the group's members, hold a lesser number of votes, and any other company which is not the group member or any natural person has no rights mentioned above in relation to the group member (sec. 1.4.).

The parent credit institution is responsible for preparation of consolidated reports and it shall request from the group members (residents and non-residents) information necessary for preparation of consolidated reports. It shall use officially disclosed information about the member's activity and its own data about the member's transactions. The parent credit institution shall prepare a consolidated report by the inclusion in its balance sheet and the profit-and-loss report of the information about group member, using the method determined by the Regulation. On the basis of the consolidated report the parent credit institution shall additionally calculate the group's own funds (net assets) mandatory prudential standards and open currency positions (sec.

2.1.). The group member's report shall be included in the consolidated balance sheet and the profit-and-loss report by using one of the following methods of consolidation:

a) method of full consolidation;
b) method of proportional (*pro rata*) consolidation;
c) method of equivalent value.

The method of consolidation shall be chosen by the parent credit institution (sec. 2.2.).

Banking supervision on the basis of consolidated reports shall be organized by the Territorial Institutions of the Bank of Russia in the place of location of the parent credit institution (sec. 3.1.). The parent credit institutions shall submit consolidated reports to the Territorial Institutions of the Bank of Russia from 1 January 1999. The credit institutions annual consolidated reports shall be certified by the auditors and made public (published) from 1 January 2000.

In conclusion, it has to be underlined that in Russian banking law the principle of consolidated supervision has been introduced taking into consideration the scope and practice of its application in European banking law. The notion itself of consolidated supervision and methods of its implementation are certainly based on the Consolidated Supervision Directive which is a cornerstone of the banking supervision in the European Union.

CONCLUSION

By way of general conclusions the following should be pointed out:

1. Banking regulation is designed to play a risk-minimising role in the banking sector of market economy based on free competition; the main objectives of prudential banking regulation are to guarantee the safety and soundness of the banking system as a whole against the risk of contagious crises and to protect depositors as consumers of banking services against the risk of individual bank failure;

2. The objectives of banking regulation determine its functions, which can be identified as preventive (designed to limit risk-taking activities of banks), protective (designed to protect depositors through a deposit insurance scheme), and supportive (designed to support banks through lender of last resort assistance);

3. The preventive function as a cornerstone of prudential banking regulation includes three main provisions:

   a) it controls the market entry in the banking business by way of licensing requirements;
   b) it imposes minimum prudential standards as regards capital adequacy, solvency and liquidity of banking institutions, and
   c) it creates a framework for the supervision and monitoring of the implementation of these prudential standards in banking practice;

4. The development of the convergence process in cross-border banking regulation has taken place on two levels - the International (universal, multilateral) level and the European (regional) level. Both processes mutually influenced each other. It was expressed in the similar approaches to the main provisions of prudential banking regulation, and particularly, capital adequacy standards and consolidated supervision;

5. Despite similarities between the International and European aspects of banking regulation, several differences can be identified. The main difference is that the development of International convergence was collapse, but not policy-driven, whereas the process of European convergence was determined by the European Community policy to complete the creation of a common internal market;

6. The International convergence in banking regulation was achieved through a non-legal structure (the Basle Committee on Banking Supervision) in the form of documents not having direct legal force, but legally significant, whereas European convergence was driven through legal structures (the EC Council and the EC Commission) by means of legal instruments binding upon the EC Member States (directives);

7. The key characteristics of the legal status of the Bank of England and the Bank of Russia is their independence from other bodies of government. While both central banks have as their main objective the formulating of monetary policy in a state, the divergency exists in the scope of their function. Whereas in Great Britain the supervisory functions over credit institutions are currently being transferred to the Financial Services Authority, in the Russian Federation the Bank of Russia has wide powers to supervise the banks and other credit institutions including issuance and revocation of authorization, formulating the minimum prudential standards and application of consolidated supervision.

8. The main trend of convergence existing in European and Russian banking regulation can be identified. As follows from a comparative analysis, the convergence of European and Russian approaches is being achieved in relation either to capital adequacy standards, or to consolidated supervision as the key elements of prudential banking regulation. In a broader context it is possible to state that the convergence process in banking regulation on Russian and European levels will, undoubtedly, help Russia to develop a market economy and to integrate into the European financial structures and institutions.

The main conclusion which must be drawn is that in the modern banking industry, including banks operating internationally through a global network of branches, subsidiaries, affiliates and joint ventures, effective banking regulation can be achieved only by a multilateral approach embodying close co-operation between the supervisory authorities in different countries.

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