Foreword

Banking law in transition

The development of a reliable, market-oriented banking system is fundamental to economies in transition. Banks are key players in the transition process of the countries of central and eastern Europe and the Commonwealth of Independent States. Foreign investment, capital markets, local entrepreneurship, payment transactions: virtually all the elements of a functioning market economy presuppose that its actors can rely on a sound and stable banking system.

The cornerstone of a reliable banking system is a proper regulatory framework, striking a subtle balance between the need for credible supervision of institutions on one hand and the flexibility necessary for private sector entities to flourish on the other. The Bank for International Settlements (BIS), which was established in 1930, supports the global effort to enhance and harmonise banking legislation and practice, as an important contribution to international financial stability. The BIS is an international organisation which, besides serving as a bank for central banks, fosters international monetary and financial cooperation. It fulfills this mandate by acting as a forum to promote discussion and facilitate decision-making processes among central banks and within the international financial community, and as a centre for economic and monetary research.

A number of committees and organisations focusing on financial stability and the international financial system have their secretariats at the BIS. Most relevant to the theme discussed in this edition of LiT Online is the Basel Committee on Banking Supervision. The Basel Committee was established as the "Committee on Banking Regulations and Supervisory Practices" by the central-bank governors of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States). Spain and Luxembourg are also members. The Basel Committee provides a forum for international cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision. Since 1975, the BIS has provided the permanent secretariat as well as the infrastructure required for the work of the Basel Committee.

The Basel Committee does not possess any formal supranational supervisory authority, and its recommendations do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice, in the expectation that individual authorities will implement these standards and guidelines through detailed arrangements - statutory or otherwise - which best suit their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques. Over the last 30 years, the Basel Committee has been remarkably successful in fostering a far-reaching harmonisation of the essential principles of banking law and regulation through its "soft law approach".

It should also be noted that, in 1999, the BIS established the Financial Stability Institute (FSI), in cooperation with the Basel Committee. The FSI assists financial sector supervisors in understanding and implementing sound supervisory standards. Through the work of the FSI, the BIS has been actively involved in promoting financial stability in central and eastern Europe. The FSI works with the Group of Banking...
Supervisors from Central and Eastern Europe, the Group of Supervisors from Transcaucasia, Central Asia and the Russian Federation, and the Joint Vienna Institute in organising workshops and seminars to help disseminate information on the latest developments in the financial sector and the latest supervisory standards. In addition, in June 2004, the FSI launched an online learning and resource tool for banking supervisors – FSI Connect – which is being used by numerous supervisory authorities in central and eastern Europe.

It is significant that the lead article of this journal uses the standards issued by the Basel Committee as a benchmark for assessing the quality of banking legislation in the countries where the EBRD operates. The article concludes that considerable work is still required to bring local legislation into line with international best practice. Local policy makers will hopefully take stock of this analysis and pursue their efforts to enhance banking legislation. A second article further details the new capital adequacy framework, commonly known as Basel II, and its implementation in national legislation. Another contribution, by the European Central Bank, focuses on some monetary issues concerning the accession of the eight EBRD countries of operations that joined the European Union in 2004. Further articles shed light on recent developments and provide recommendations for enhancing the banking regulatory framework in specific countries of the region, namely Albania, the Czech Republic, Kazakhstan and Russia.

As one of the initiatives of the international community aimed at supporting local reforms, the EBRD’s efforts, through this publication, to analyse, understand and improve the banking legislation of the countries of central and eastern Europe and the Commonwealth of Independent States, is a commendable undertaking, which will no doubt help foster the transition process.

End notes

The quality of banking legislation in transition countries

One of the EBRD’s key policy objectives is to support the creation and development of a financial sector based on sound banking principles. In order to assess the quality of banking legislation in its 27 countries of operations, the EBRD recently benchmarked the relevant legislation against the Core Principles for Effective Banking Supervision (issued by the Basel Committee in 1997). This article describes the main results evidenced in the assessment.

In October 1998 the ministers of finance and the governors of the central banks of the G7 countries requested Mr Hans Tietmeyer, then president of the Deutsche Bundesbank to develop a series of recommendations aimed at promoting stability in the international financial system. The recommendations were also aimed at improving cooperation between national and international supervisory bodies and international financial institutions. In February 1999 the Tietmeyer Report led to the creation of the Financial Stability Forum.1 This Forum nominated the Core Principles for Effective Banking Supervision as one of the 12 key standards for sound financial systems.2 These key standards have been broadly accepted as the minimum requirements for good practice. The successful implementation of international standards strengthens domestic financial systems and encourages sound regulation and supervision, greater transparency, and efficient institutions, markets, and infrastructure.

Core Principles for Effective Banking Supervision

The Core Principles for Effective Banking Supervision (the Core Principles) were enacted in 1997 by the Basel Committee on Banking Supervision. It was the product of collaborations and consultations between supervisory authorities worldwide. The Core Principles are a set of 25 basic principles which the Basel Committee believes must be in place for a supervisory system to be effective. The Core Principles are intended to serve as a basic reference for supervisory and other public authorities in all countries.

The Core Principles address the preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking.

Using the Basel Core Principles as a benchmark, in 2004 the EBRD conducted an assessment of the extensiveness of banking legislation (i.e., the quality of the legislation, usually referred to as “laws on the books”) in its 27 countries of operations.3

The initiative, which was financed by Switzerland, was conducted by a questionnaire divided into 10 different sections (the Checklist), each corresponding to a particular focus area identified by the Basel Committee.

The sections are explained in detail below along with the description of the major strengths and weaknesses reported in the assessment. A series of charts illustrating each country’s compliance in each of the sections under analysis are provided in an annex.

Assessment of banking legislation in the EBRD countries of operations

Competence of the banking supervision authority

The first section of the Checklist aims to identify the legal regulation governing independence of the regulator and its staff, to identify the conditions for the appointment, termination and liabilities of the head of the supervisory authority and to verify its compliance with international standards.
In general, central and eastern Europe and the Baltic states (CEB) and the countries in south-eastern Europe (SEE) showed a higher level of compliance compared with the Commonwealth of Independent States (CIS). Bosnia and Herzegovina, Croatia, Estonia, Hungary and the Slovak Republic have the most compliant legislation, providing the regulator and its lead management with operational independence and legal protection from liability suits.

The Core Principles recommend that banking authorities and their staff should not be considered automatically responsible for bank failure, unless there is a causal link between the improper conduct and the damage caused. This immunity, which covers only supervisory actions taken in good faith while discharging their supervisory duties is not provided for in Armenia, Belarus, the Czech Republic, Kazakhstan, the Kyrgyz Republic, Poland, Russia, Serbia and Montenegro, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

When assessing an authority’s independence, the assessment revealed that in Belarus the government can significantly influence the budget of the National Bank therefore placing doubts on the autonomy and independence of the authority.

**Discharge of the banking supervisory authority’s powers**

The second section of the Checklist analyses the banking supervisory responsibilities and objectives and aims to identify whether the law provides the regulator with adequate resources to meet the objectives set.

The assessment shows that legislation in CEB is substantially in line with international standards. Lithuania and Slovenia reached the best compliance rate in the region. In both countries the accountability of the regulator, its authorities with respect to on-site and off-site examinations and the regulator’s authority to request information from banks under supervision is clearly detailed by the law.

The assessment also showed a relatively sound framework in SEE countries, with only some deficiencies found in Bulgaria. The National Bank of Bulgaria has limited authority to appoint or revoke external auditors and there are no policies in place for assessing the effectiveness of the National Bank’s on-site and off-site supervisions.

Tajikistan and Ukraine obtained the best compliance ratings in the CIS, while major shortcomings in the region were reported in Armenia, Azerbaijan and Turkmenistan.

In Armenia the Central Bank has no authority to appoint banks’ external auditors or revoke their appointment when they are not deemed independent. No guidelines are in place covering the scope and conduct of audit programmes and ensuring that audits cover issues such as non-performing assets, asset valuations, derivatives, asset securitisations and the adequacy of internal controls over financial reporting. These issues are considered essential by the Basel Committee.

The explanatory notes to Core Principle 21 points out that “banking supervisors must ensure that each bank maintains adequate accounting records drawn up in accordance with consistent accounting policies and practices enabling the regulator to obtain a true and fair view of the banks’ financial conditions”. It is therefore essential that the law provides the supervisor with the right to revoke the appointment of a bank’s auditors and with the authority to require banks to appoint auditors recognised as having the necessary professional skills and independence to perform their work.

In Turkmenistan the law is silent on the Central Bank’s authority to have on-site access to local branch or subsidiary offices of a foreign bank for financial supervision purposes.

In Uzbekistan, the Central Bank has no methodology in place for determining or assessing the nature, importance and scope of the risks to which individual banks are exposed. In addition, there are no cooperation arrangements between domestic and foreign authorities to enhance the supervision of the financial system.

**Definitions of bank and banking activities**

The purpose of the third section of the Checklist is to identify whether national legislation clearly identifies which institutions can carry out banking activity.

The assessment revealed that all the EBRD’s countries of operations are fully in line with the requirements established by Core Principle 2: the term “bank” in general is clearly defined and the laws clearly set guidelines for identifying which institutions can carry out banking activity and in particular take deposits from the public. This is the only section where all countries reached full compliance.

**Licensing authorities and requirements**

Under this section, the assessment aims to ascertain whether there is a sound framework and clear criteria for licensing banking institutions. The purpose is to understand whether under the law regulators are capable of determining that new banking institutions have suitable shareholders, adequate financial strength and management with sufficient expertise and integrity to operate in a sound and prudent manner.

In most of the countries the legislation is reported to be highly compliant with the Core Principles: the licensing authority, its monitoring procedures and the minimum initial capital requirements, suitability...
of shareholders and management and transparency of ownership are generally detailed in the law.

Notable exceptions to the above are Slovenia in CEB, Albania and Bulgaria in SEE and Belarus, Kazakhstan and Uzbekistan in the CIS, although only minor deficiencies are registered.

In Albania, Azerbaijan, Kazakhstan, Slovenia and Uzbekistan the licensing criteria provided by the law does not include a comprehensive assessment of the legitimacy of the source of initial capital, which conflicts with one of the essential requirements established in Core Principle 3.

Additional criteria require that the licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met. These requirements were only partially found in Belarus, Bulgaria and Slovenia.

**Supervision of operations by domestic banks overseas and foreign banks locally**

The fifth section of the Checklist gauges the regulator’s authority to establish specific licensing requirements for foreign banks creating local branches and additional reporting requirements for local banks opening branches and subsidiaries in foreign countries. Bulgaria and the Slovak Republic showed full compliance in this section.

International standards on “home country” supervision are found in Core Principles 23 and 24, while Core Principle 25 details the essential criteria for the “host country” supervisors. These principles require banking supervisors to apply prudential supervision to all aspects of business conducted by their banking organisations worldwide. Consolidated supervision requires that supervisors have in place information sharing agreements with host supervisory authorities.

The Basel Committee recommends that without information sharing agreements, banking supervisors should prohibit their banks from establishing operations in countries where secrecy laws impede the flow of information and adequate supervision. Where the host country supervision is deemed inadequate, the parent supervisor should have the authority, at least as a final resort, to request the closure of the overseas office. Finally, “banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country”.

Among the CIS countries, the major weaknesses were found in Kazakhstan, Turkmenistan, Ukraine and Uzbekistan, while in Armenia, Azerbaijan, Belarus and Moldova the law is deemed generally compliant with international standards. In SEE, the situation is deemed relatively sound in Bosnia and Herzegovina, Croatia and Romania, while in CEB substantial problems are registered only in the Czech Republic and Hungary.

The most common weaknesses are the regulator’s lack of authority to prohibit banks from establishing operations in countries where secrecy laws prohibit disclosure to home country supervisors and to require closure of overseas offices when risks are deemed excessive.

**Transfer of ownership and undertaking major acquisitions and equity investments**

This section focuses on significant direct or indirect investment in a bank, changes in ownership over particular thresholds, including the definition of such threshold, and the authorisation procedure governing certain types of acquisition and investments by banks. Essential criteria are contained in Core Principles 4 and 5. The former principle requires that the legislation provide clear definition of “significant” ownership in banks and prompt disclosure over changes in ownership; the latter recommends a clear definition of the criteria for the evaluation of bank investments.

International standards were found to be fully transposed in Armenia, Bosnia and Herzegovina and Bulgaria, while in Croatia, the Czech Republic, Estonia, Georgia, the Kyrgyz Republic, Latvia, Lithuania, Poland, Romania, Russia, Serbia and Montenegro, Tajikistan and Uzbekistan the law does not request prior supervisory approval for major acquisitions. In addition, in some instances laws are silent on the criteria for assessing whether a proposed investment exposes a bank to undue risks or hinders effective supervision. Disclosure of beneficial ownership was also found to be a problematic issue.

The assessment revealed that legislation in CEB is generally less compliant than in the other two regions. This deficiency can be accounted for by the fact that the European Union’s acquis communautaire is limited on these issues. The new Financial Conglomerates Directive, which will be fully applicable this year, and the new Transparency Directive, which will be applicable starting from January 2007, will hopefully fill this gap. These directives will introduce prudential supervision on a banking group-wide basis and set new minimum disclosure requirements.

In the CIS, the assessment revealed that in Georgia, the Kyrgyz Republic, Ukraine and Uzbekistan the criteria on the bank’s financial and organisational resources to handle the acquisition/investment was deemed insufficient.
Prudential regulations

Developing and utilising sound prudential regulations and requirements to control risks related to capital adequacy, large exposures and lending limits are a key part of the supervisory process. This section aims to identify whether the national legislation sets minimum capital adequacy requirements for banks and to define the regulator’s powers in establishing prudential standards.

All countries in the region showed a high level of compliance, especially Albania, Bulgaria, the Czech Republic, Estonia, Georgia, FYR Macedonia, Hungary, Latvia, Romania, Poland, Russia and the Slovak Republic. The law clearly defines the minimum capital adequacy requirements that all banks must meet, which are in line with those established in the Basel Capital Accord. The banking supervisory authority has the power to set prudential rules for banks and to impose prudential standards on a consolidated basis for banking groups.

In all other countries only minor flaws were registered.

Extension of credit and investment activities

The eighth section of the Checklist covers one of the essential aspects of the supervisory system: bank policies, practices and procedures related to the granting of credits and the ongoing administration of their loan and investment portfolios. International principles require that banks have grounded policies for granting credits and adequate control of credit risks. The banks’ approval procedures and the regulator’s supervision, the mechanisms to weight credit and investment portfolios and the prudential regulations concerning “connected or related parties” are analysed in this section.

All three groups of countries showed a similar level of compliance. The highest compliance rates were reported in Belarus, Estonia, Georgia, Kazakhstan, Poland, Romania and the Slovak Republic. Banks have objective and grounded policies for granting credits, making investments and adequate control of credit risks. In addition, the approval process of credit and investment activity in the banks is clearly organised and the regulator’s authority in controlling credit and investment activity of the banks is well detailed by the law as the regulation of crediting connected or related parties.

The assessment showed some deficiencies in Albania, Azerbaijan, Armenia, Lithuania, Russia, Serbia and Montenegro, Tajikistan, Turkmenistan and Uzbekistan.

In Armenia, the cooperation arrangements between the Central Bank and domestic and foreign authorities should be improved, in particular concerning banking groups’ financial conditions, capital adequacy and risk management.

In Russia, banks are not required by law to establish management information systems providing essential details on the condition of loan and investment portfolios. Russian banks are also not required to set up comprehensive procedures for assessing the borrower’s repayment capacity. As well as these systems and procedures, the law should include provisions requiring that the valuation of collaterals reflect the net realisable value and that loans to connected and related parties be deducted from the capital when determining capital adequacy.

In Serbia and Montenegro credits and investments exceeding certain amounts and those considered especially risky or not in line with the mainstream of the bank’s activities are not subject to a specific approval procedure. Banks are not required by law to establish internal policies for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves. Finally, in lending to connected or related parties, banks are not required by law to conduct transactions on an arm’s length basis.

Risk management

This section analyses national legislation dealing with country, transfer, market and interest rate risks in investments and international lending. The purpose of this analysis is to find out whether banks have adequate policies and procedures for identifying, monitoring and controlling such risks. Country and transfer risks are dealt with under Core Principle 11. Country risk refers to risks associated with the economic, social and political environment of the borrower’s home country, while transfer risk is a component of country risk which arises when the borrower’s obligation is not denominated in local currency. Market risk is detailed in Core Principle 12. Banks face a risk of losses from movements in market prices. One specific element of market risk is the foreign exchange risk.

Other typical risks are the interest rate risks, liquidity risks and operational risks. The first refers to the exposure of a bank’s financial condition to adverse movements in interest rates. The second arises from the inability of a bank to accommodate decreases in liabilities or to fund increases in assets. Finally, operational risk includes all aspects of risk-related exposure other than those falling within the scope of credit and market risk. These include specifically the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events and reputational risk.

Countries in CEB showed a higher level of compliance compared with the other two regions. In particular, a high compliance rate was registered in the Czech Republic, Hungary, Kazakhstan, Latvia, Lithuania, Poland and the Slovak Republic. Substantial problems were, however, registered in Azerbaijan, Russia, Slovenia and Uzbekistan.
One of the major shortcomings reported was the lack of suitable banking procedures for identifying, measuring and monitoring market risk. In some instances banks are also not required to set appropriate limits for various market risks, including their foreign exchange business. 21

**Governance and auditing**

This final section assesses several types of supervisory issues. First, it examines the corporate governance of banking institutions, including responsibilities of management to introduce proper corporate governance regulation in banks. Second, it gauges the extensiveness of anti-money laundering and the compliance by banks with financial disclosure and adherence to internationally accepted auditing standards.

The assessment revealed very high levels of compliance in Armenia, Azerbaijan, Estonia, FYR Macedonia, Hungary, Latvia and Romania, while major shortcomings were reported in Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Poland, Serbia and Montenegro, Slovenia, Tajikistan, Turkmenistan and Uzbekistan.

In Belarus, Georgia, Kazakhstan,22 Poland, Slovenia and Tajikistan banks are not required to have in place adequate policies, practices and procedures promoting high ethical and professional standards.23 In addition, in Belarus, Georgia24 and Serbia and Montenegro, regulators have no authority to limit or circumscribe the range of activities consolidated banking groups may conduct.25

In Georgia, Serbia and Montenegro, Tajikistan and Turkmenistan auditors do not have the legal duty to report to the supervisor matters of material significance regarding individual banks, such as failure to maintain the licensing criteria, breaches of banking or other laws etc.26

Kazakhstan does not have a specific money laundering law and the regulator has no authority in anti-money laundering issues. In the Kyrgyz Republic money laundering is still not classified as a crime. In 2004 the Kyrgyz legislature drafted a fairly comprehensive law on combating terrorism and illicit money laundering. On 9 December 2004, the bill passed its first reading in the parliament. It is expected that the second reading will take place during the second half of 2005.

In Tajikistan money laundering issues are included within the provisions of the Tajik Criminal Code.27 However the provisions are limited in their application and again the banking regulator has no authority under the law to take action against a bank that does not comply with its anti-money laundering obligations. In Uzbekistan a new anti-money laundering law was enacted in August 2004 and is scheduled to take effect in January 2006.

**Overall compliance of banking legislation with the Core Principles for Effective Banking Supervision**

**Central and eastern Europe and the Baltic states**

Among all the EBRD’s countries of operations, the best compliance ratings were assigned to the Slovak Republic followed by Hungary, Estonia and Latvia. Here the banking framework is generally sound and very few weaknesses were identified.

In the Slovak Republic only minor problems were reported in the discharge of banking supervisory authority’s powers, while in Hungary and Estonia, some weaknesses exist in the supervision of operations by domestic banks overseas and foreign banks locally and the transfer of ownership and the undertaking of major acquisitions and equity investments.

Estonia is among the few countries having a dual supervisory system. The financial supervision authority is the sole banking supervision authority in Estonia and is responsible for ensuring that all market participants comply with the requirements of the legislative framework. The second Estonian authority is the Bank of Estonia which is responsible for regulating the banking sector and issuing general regulations that are part of the banking legislative framework (e.g., prudential norms).

Slovenia obtained the lowest rating among the new EU member states showing several shortcomings especially in the transfer of ownership and the undertaking of major acquisitions and equity investments and in risk management.

**South-eastern Europe**

Turning our attention to countries in south-eastern Europe, Romania, Bosnia and Herzegovina, Bulgaria and Croatia obtained the highest compliance scores in the region. Notably, Albania also had a high compliance rating.

Croatia has developed a modern and extensive set of laws and regulations to control banking activity. Most of the banking legislation was enacted after 2000. In 2001, following the implementation of a set of recommendations expressed by the International Monetary Fund, the banking framework was substantially improved. Certain aspects of banking regulation, however, still require revision. These aspects include the assessment of criteria on acquisitions and investments, risks involved, notification procedures. Related parties transactions are regulated by Croatian law, however, the mechanism for determining and controlling such transactions is poor. Although Croatian law regulate examinations held by the National Bank, criteria for assessment of the effectiveness of such examinations has not been established.
Romania has also established a sound legislative framework in the banking sector and is gradually improving it. The objectives and institutional framework for regulation and supervision of banking institutions is broadly provided in the laws on banking and on the statutes of the National Bank of Romania. The National Bank of Romania has the exclusive power to grant licenses to banking organisations and supervise the activity of licensed banks in Romania.

Unlike many other countries, Romania has developed legislation for on-site examinations of commercial banks by a supervisory authority and for the assessment of obtained results from such examinations. Extensive regulation exists with respect to activity of foreign banks and Romanian overseas offices. Anti-money laundering legislation has been in place for several years already. Among the legislative gaps in Romanian law is the absence of clear criteria for reviewing and assessing major acquisitions and investments, including the threshold and types of acquisition and investment that is subject to supervisory approval.

Commonwealth of Independent States

Among the countries of the CIS, only Georgia, Moldova and Ukraine reached the high compliance category, while Russia was very close to the low compliance level.

Ukraine is making progress in strengthening prudential regulations and supervision of the banking system, although some weaknesses remain. Similar to Croatia, Ukraine enacted most of the subordinate banking legislation after 2000. The National Bank has a broad range of powers. An operationally independent unit within the National Bank of Ukraine, which seems to have sufficient resources to fulfil current supervisory responsibilities, conducts banking supervision. Among the shortcomings evidenced by the assessment, transparency of the shareholding structure remains an issue and in general requirements concerning shareholding and identification of ownership should be strengthened. Provisions on risk management by banks still require further development in Ukraine.

In Russia, after the financial crisis of 1998, authorities made significant efforts to protect the banking sector from any future crises. After long discussion, a new law on the Central Bank was enacted in 2002. Several regulations on mandatory normative of banks, establishing reserves for possible losses and organising internal controls were promulgated in 2003 and 2004. Nevertheless, there was a "little banking crisis" in the banking sector in May/June 2004.

Given the frequent claims that too many banks are active in Russia, it was to be expected that licenses of several banks would be revoked due to their inability to comply with financial obligations and money laundering legislation. The lack of protection for Central Bank staff was also highlighted as one of the reasons why the Central Bank had no remedy against the quick drop in trade among banks. (Confidence has reportedly only been restored since state banks were used to open lines.) In addition, the lack of ability to undertake action against managers of the bank in question may have contributed to the crisis.

Finally, as the Checklist shows, regulation of banking activities and ongoing supervision in Russia is unsatisfactory. There are deficiencies within lending and investment regulation, in particular with formulating internal policies and procedures for granting credit and making investments and with lending to connected and related parties. Another area that needs attention is the establishment of clear policies and procedures to identify risks that banks face in their activities.

Conclusion

The EBRD’s assessment revealed that half of its countries of operations have made considerable progress in developing financial systems of supervision. None of them, however, have demonstrated banking legislation that is fully in line with the Core Principles. Each of the 27 countries shows some weakness in at least one section of the Checklist.

In general, transition countries tend to have good legislation relating to the start up of new banks, but weak legislation related to continuing supervision. This is particularly the case for issues related to the disclosure of beneficial ownerships and the consolidated supervision of banking groups. It is in these two areas that policy makers and legislator should now turn their primary attention.
Endnotes

1. The Financial Stability Forum brings together senior representatives of national financial authorities (e.g., central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank, to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance.


5. South-eastern Europe consists of: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and Serbia and Montenegro.

6. The Commonwealth of Independent States includes: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

7. Under Article 65 (2) of the Law on Banks, the Bulgarian National Bank can appoint an independent ad-hoc auditor to conduct financial due diligence of a bank. The National Bank can exercise this right only in specific circumstances, exhaustively listed in Article 65 (1), which relate primarily to suspected financial troubles or breaches of the law. So far there is very little practice on the implementation of this article.

8. In Azerbaijan a new law Law on the National Bank was issued in December 2004. The law, which substantially improved the Azeri legal framework, was issued after the assessment took place and therefore is not taken into consideration in this assessment.

9. It should be specified that, according to Article 58 of the Law on Banks and Banking, the Central Bank of Armenia can request banks to appoint an independent auditing company within six months, and to publish its auditing statement. The statement of the independent auditing company must be submitted to the Central Bank within six months after the submission of the annual report. Upon the request of the Central Bank, the independent auditing company is obliged to present to the Central Bank all the necessary documents regarding the audit of the bank, irrespective of whether they represent any commercial, banking or other secrets.

10. It should be mentioned though that the Minister of Finance and Economy, by order N 324 of 10 September 2001, has approved the Armenian Audit Standards (AAS). As the preamble of this order declares, the AASs should be adopted according to the International Standards on Auditing approved by the International Federation of Accountants. The AASs include 34 auditing standards and regulate a wide range of auditing issues, comprising of the standard on audit standards’ framework, the core principles and purpose of financial statements’ audit, quality control documentation, fraud and mistakes, planning etc.

11. As required by Core Principle 20.

12. As required by Core Principle 20.

13. As required by Core Principles 1, 24 and 25.


15. In Latvia, while the prior supervisory approval is not required, the Regulation on Preparation of Investment Reports of Banks (Art. 3.6) banks have the obligation to inform the Financial and Capital Market Commission in writing at least 30 days in advance of any acquisition of a qualifying holding (10% and more of share capital or voting shares) in another bank, financial institution or other type of undertaking.

16. As required by Core Principles 1, 24 and 25.

17. As required by Core Principle 7.
Annex: Quality of Banking legislation in EBRD countries of operation

Central Europe and the Baltics

Commonwealth of Independent States

South Eastern Europe

Albania

Armenia

Azerbaijan

Belarus

Bosnia and Herzegovina

Bulgaria

Croatia

**Explanation**

International standards

- Competence of the banking supervisory authority
- Discharge of the banking supervisory authority’s powers
- Definitions of bank and banking activities
- Licensing authority and requirements
- Supervision of operations by domestic banks overseas and foreign banks locally
- Transfer of ownership and major acquisitions
- Prudential regulations
- Extension of credits and investment activities
- Risk management
- Governance and auditing

The extremity of each axis represents an ideal score, that is, corresponding to the standards set forth in the Basel Core Principles.

The fuller the ‘web’, the closer the relevant banking legislation of the country approximates these principles.
Annex: Quality of Banking legislation in EBRD countries of operation

The extremity of each axis represents an ideal score, that is, corresponding to the standards set forth in the Basel Core Principles. The fuller the 'web', the closer the relevant banking legislation of the country approximates these principles.

International standards
Country/region rating

1. Competence of the banking supervisory authority
2. Discharge of the banking supervisory authority’s powers
3. Definitions of bank and banking activities
4. Licensing authority and requirements
5. Supervision of operations by domestic banks overseas and foreign banks locally
6. Transfer of ownership and major acquisitions
7. Prudential regulations
8. Extension of credits and investment activities
9. Risk management
10. Governance and auditing
Annex: Quality of Banking legislation in EBRD countries of operation

**Poland**

**Romania**

**Russian Federation**

**Serbia and Montenegro**

**Slovak Republic**

**Slovenia**

**Tajikistan**

**Turkmenistan**

**Ukraine**

**Uzbekistan**

### Explanation

**International standards Country/region rating**

The extremity of each axis represents an ideal score, that is, corresponding to the standards set forth in the Basel Core Principles. The fuller the ‘web’, the closer the relevant banking legislation of the country approximates these principles.

1. Competence of the banking supervisory authority
2. Discharge of the banking supervisory authority’s powers
3. Definitions of bank and banking activities
4. Licensing authority and requirements
5. Supervision of operations by domestic banks overseas and foreign banks locally
6. Transfer of ownership and major acquisitions
7. Prudential regulations
8. Extension of credits and investment activities
9. Risk management
10. Governance and auditing
Enlargement of the European Union from the European Central Bank’s legal perspective

On 1 May 2004, eight of the EBRD’s countries of operations – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia – joined the European Union (EU). From the legal perspective of the European Central Bank (ECB), the enlargement of the EU has two different stages, each with different legal requirements. These stages are the accession of countries to the EU and the introduction of the euro in the new EU member states.

This article intends to identify those legal requirements which are particularly relevant to the ECB and to show the ECB’s role in assisting with the implementation of these requirements.

Accession to the EU

The Treaty establishing the European Community (the Treaty) requires accession countries to make their legislation compatible with the Treaty. This includes ensuring their legislation complies with the Protocol on the Statute of the European System of Central Banks (ESCB) and the ECB (the ESCB/ECB Statute).1

The ECB’s main focus is on the:

- independence of each country’s central bank
- implementation of the *acquis communautaire* in the financial field
- general compliance with Treaty obligations (which is also important from a monetary policy perspective).

Central bank independence

Accession to the EU means, among other things, that a country’s national central bank (NCB) becomes a member of the ESCB. In addition, the governor of the NCB becomes a member of the General Council of the ECB.2 The Treaty requires that NCBs are independent3 and the ESCB/ECB Statute requires that governors are appointed for a minimum of five years and can only be dismissed for reasons of incapacity or serious misconduct.4

The predecessor of the ECB, the European Monetary Institute (EMI), set the parameters for central bank independence, distinguishing between institutional, personal, functional and financial features of independence.5 These parameters have also been applied by the ECB – or are being applied, as the case may be – to the EU’s new member states and to accession countries.6 For the new EU member states, non-compliance with these parameters would constitute an infringement of the Treaty. Such an infringement should be addressed by the European Commission as the guardian of the Treaty and be judged by the European Court of Justice (ECJ) as the EU’s judiciary.

In addition, the ECB plays an important role in identifying any points of concern particularly in its own reports on the fulfilment of accession requirements7 and its convergence reports. In practice, the above implies that the statutes of NCBs have to be adapted and this has indeed been done for all current EU member states.8

*Implementation of the acquis communautaire in the financial field*

Accession countries have to implement the *acquis communautaire* as a pre-condition for accession, in accordance with the so-called Copenhagen criteria.9 Such criteria include a body of mainly...
directives in the field of banking, securities trading and investment services, payment and securities settlement systems, collateral and insolvency. The ECB’s interest in the proper implementation of such directives is manifold and is in any case determined by two considerations:

- the legal soundness of the ESCB’s operations; accession of a country to the EU means that under the rules of the single financial passport, its financial institutions obtain access to ESCB facilities provided that certain requirements are fulfilled
- the stability of financial institutions and markets, since contributing to financial stability is also a part of the ECB’s mandate.

In view of the above, the ECB has produced reports, shared its knowledge with the European Commission and the relevant parties in the new EU member states and several accession countries, and will presumably continue to do so in the future, when appropriate.

Compliance with other Treaty requirements in areas of interest to the ECB

The Treaty contains several obligations imposed on member states which are important to the EU’s economic policy in general and the euro area’s monetary policy in particular. These relate to the free movement of capital and the prohibitions of monetary financing and privileged access. Again, the ECB monitors compliance with such obligations, particularly the latter two, and reports accordingly.

In terms of timing, preparation of legislation to fulfil the above requirements has to meet the timetable established by the European Commission and each individual accession country. Such legislation, however, must effectively enter into force at the latest by the date of accession.

Introduction of the euro

As in the case of accession, the introduction of the euro raises a number of legal issues which are particularly relevant to the ECB. Such issues arise at different levels and in various respects:

- at a Community level
- at the level of national legislative authorities
- at the level of NCBs.

Community level

There are at least two issues which require further consideration at a Community level. Firstly, the legal acts which have supported the introduction of the euro and the establishment of conversion rates, need to be reviewed on their suitability for the new EU member states. This review is at present being carried out by the European Commission, with input from the ECB, and the results are expected to be available soon.

Secondly, the new EU member states will need to have participated in the Exchange Rate Mechanism (ERM) II for a period of at least two years without devaluing against the currency of any other member state. This requires their adherence to the relevant legal acts.

National legislative authorities

Two areas require particular attention from the ECB’s perspective. Firstly, the statutes of NCBs have to be adapted to ensure integration into the Eurosystem. The Governing Council is the highest decision-making body in the Eurosystem and, of which, governors of NCBs of member states adopting the euro will become members upon such adoption.

Secondly, national legislative authorities will have to identify whether there are any other laws which need to be adapted or perhaps entirely abolished, for reasons of legal clarity and certainty. (These laws may contain references which become obsolete as a result of the introduction of the euro in their country.) Such an exercise could be executed through “catch all” umbrella legislation or on a piecemeal basis for each individual legal act.

National central banks

The Eurosystem’s regulatory framework consists of a variety of different legal acts, for example, (binding) regulations, decisions and guidelines. In accordance with the principle of decentralisation, NCBs are the operational arms of the Eurosystem and execute the ECB’s monetary policy as formulated by the ECB’s Governing Council and implemented by the ECB’s Executive Board. In practice, this implies that the Eurosystem’s operations between NCBs and their domestic counterparts are mainly conducted under national rules governed by the national law of the EU member state. The guidelines aim to ensure a level playing field across the euro area and the ECB monitors compliance with the guidelines.

In terms of timing, all relevant legal acts must enter into force on the date of adoption of the euro by the member state. However, all national legislation must be prepared well in advance to permit the ECB and the European Commission to assess the relevant national legislation properly in their convergence reports. This also allows the ECB to review the relevant NCB’s implementation measures in advance. Twelve of the existing EU member states and their NCBs have already gone through this adaptation process, the results of which have been tested by the EMI and ECB in their convergence reports. This process has provided new EU member states with a number of
examples of already adapted statutes, other legislation and legal acts of euro area NCBs, from which their legislative authorities and NCBs may benefit.

Conclusion

This article focuses on the legislative requirements for accession to the EU and the introduction of the euro in the EU member states, as relevant to the ECB. It also outlines the ways and means through which the ECB, often together with the European Commission, monitors compliance with legislative requirements by accession countries, new EU member states and the latter’s NCBs. Of course, this is only one aspect of the ECB’s work.

The ECB is also actively involved in advising NCBs, particularly those of EU accession countries and new member states, as well as existing member states, on legal procedures and requirements to qualify for accession and the introduction of the euro. This is, for example, done within the framework of the ESCB’s committees structure and in particular its Legal Committee (LEGCO) and through the issuance of informal opinions on draft national legislation. It is also achieved through studies conducted by groups associated with the ECB such as the European Financial Markets Lawyers Group (EFMLG) which has assessed close-out netting in the new EU member states.

The most powerful instrument the ECB has at its disposal to assist new EU member states in their efforts to meet EU standards, however, is no doubt formal ECB opinions on national legislation in the ECB’s field of competence. The ECB must be consulted by relevant legislative authorities for a wide range of areas. The ECB has already produced thirty opinions on draft legislation in the new member states and this number is expected to increase considerably as and when the new member states start to prepare for the introduction of the euro.

All in all, the ECB does not only monitor the relevant legal developments, but actively contributes to such developments to facilitate accession and the introduction of the euro in each new member state.

* This article reflects the personal views of the author and not necessarily those of the European Central Bank.

End notes

1. Article 109 of the Treaty.
2. The acquis communautaire is the body of Community legislation with which EU member states have to comply as a consequence of their membership of the EU and which accession countries have to implement as a precondition for accession.
3. The ESCB consists of the NCBs of all EU member states. The General Council of the ECB consists of the governors of all such NCBs as well as the President and Vice-President of the ECB.
5. Article 14.2 of the Treaty.
7. Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia.
8. Bulgaria and Romania. (At the time of writing, Croatia and Turkey are also in line for accession.)
9. The ECB has regularly produced reports on progress made with regard to the implementation by the new EU member states of the acquis communautaire in the ECB’s fields of interest. The ECB’s convergence reports which were prepared in accordance with Article 121 of the Treaty are also an appropriate instrument to raise any concerns in this respect. Convergence reports assess whether new EU member states qualify for the introduction of the euro.
10. For accession countries, non-fulfillment of the established parameters could create an obstacle for accession. These must be resolved as a pre-condition for the closing of accession negotiations which include the signing and ratification of bilateral accession Treaties between the EU and each individual accession country.
11. Named after the EU Council summit in December 1993 when this criteria was established.
12. For example:
13. Such directives are binding for EU member states and usually require implementation in the national legislation of such member states.
14. For example, Article 18 of the ESCB/ECB Statute requires that ESCB credit operations are collateralised.
15. Article 105(3) of the Treaty.
16. Article 56 of the Treaty.
19. For example, each year the ECB produces reports on the EU member states’ compliance with the prohibition of monetary financing. infringements of the other two obligations would normally also be mentioned in the ECB’s convergence reports as issues which need to be resolved.
20. See also Article 109 of the Treaty.
25. Article 121(1), third indent, of the Treaty.
26. Agreement of 1 September 1998 between the European Central Bank and the national central banks of EU member states outside the euro area. This agreement sets out the operating procedures for an exchange rate mechanism in stage three of economic and monetary union.
27. The integration requirement is laid down in Article 14.3 of the ESCB/ECB Statute. The name “Eurosystem” is developed by the euro area NCBs together with the ECB to distinguish them as a group from the ESCB. The notion of the Eurosystem, however, cannot be found in the Treaty or the ESCB/ECB Statute. The ECB’s Governing Council consists of the governors of the euro area NCBs as well as the (six) members of the ECB’s Executive Board.
28. Typically, this is legislation on bankruptcy, coins, foreign exchange relations and monetary debts denominated in currencies which will cease to exist upon the adoption of the euro by a member state.
29. See, in particular, Articles 19.2 and 34.1 first and second indents of the ESCB/ECB Statute, for regulations and decisions as well as Article 14.3 of the ESCB/ECB Statute for guidelines.
30. The principle of decentralisation is laid down in Article 12.1, third paragraph of the ESCB/ECB Statute.
31. This also applies to other core tasks of the Eurosystem, such as the provision of payment systems services. See Article 3 of the ESCB/ECB Statute.
32. Article 14.3 of the ESCB/ECB Statute. Different NCBs use varying types of legal documentation to implement the Eurosystem’s regulatory framework. Some
have the power to adopt legislative acts, others use the instrument of contractual
general terms and conditions, whilst there are also NCBs which use a combination
of such techniques.

33. In accordance with Article 121(1) of the Treaty, the European Commission is also
required to produce regular convergence reports.

34. LEGCO consists of lawyers from the NCBs and the ECB.

35. The EFMLG consists of lawyers from the banking industry and the ECB’s Legal
Services, mirroring similar groups in New York, London and Tokyo.

36. The EFMLG’s report on close-out netting can be found on the EFMLG’s web site,
www.efmlg.org

Central Bank by national authorities regarding draft legislative provisions; see Of-

38. These areas include currency matters; means of payment; national central banks;
the collection, compilation and distribution of monetary, financial, banking, pay-
ment systems and balance of payments statistics; payment and settlement sys-
tems; rules applicable to financial institutions insofar as they materially influence
the stability of financial institutions and markets (Article 2.1 of the Council Decision
mentioned in footnote 34).

39. Incidentally, member states are not obliged to consult the ECB on draft legisla-
tion relating to the implementation of Community legislation in the ECB’s field of
competence on which the ECB has normally already been consulted under Article
105(4) second indent.

40. Most, if not all such opinions are published on the ECB’s web site and can be
found under www.ecb.int/ecb/legal/1341/1345/html/index.en.html

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Basel II in the national sphere

This article examines the Basel II capital adequacy framework and the variations in national implementation. It closely analyses the effect this framework will have on countries that are not members of the Basel Committee on Banking Supervision and selected EBRD countries of operations.

Introduction

The business of banking is based on trust and confidence. These intangible aspects make any credible assessment of its financial condition difficult at most times. While the understanding of banking has improved, challenges remain part of the constant evolution of the industry, particularly in times of financial distress.

The “capital regulation” of banks has enabled banks to develop a reserve of capital, which can be used in times of difficulty. It is also upon this capital that regulatory action can be based. The Basel Capital Accord of 1988 (Basel I) is the foundation of capital regulation, being one of the most important international standards for banks. It constitutes the core of regulatory oversight not only for countries that participate in the Basel Committee of Banking Supervision which recommended Basel I, but also for countries not taking part (or non-Basel Committee countries).1

However, the evolution of the financial industry has rendered Basel I ineffective, with large and complex institutions no longer able to grasp their risk exposure. Consequently, the revision of Basel I was initiated to agree on a new framework of capital regulation more suitable for the operations of larger and complex banks. Discussions on the framework of capital regulation continued for five years. In June 2004 they culminated in the endorsement of the “International Convergence of Capital Measurement and Capital Standards” or more commonly known as the “Basel II” framework by G10 central bank governors and heads of supervision.2 Currently, this framework is awaiting national implementation.3

Issues and inadequacies of Basel II have been widely discussed.4 Thus, this article examines how Basel II will be implemented at regional and national levels. Special attention is paid to the practice of the EU, selected EBRD countries of operations, the United States, and Japan. Appraisal also turns to the implementation of the Basel II framework in developing countries.

The notion of capital regulation and the Capital Accord of 1988

Whether banks deserve the special attention they receive has been subject to debate. The failure of an individual bank is not in itself considerably distinct from a corporate failure. However, the main reason that banks are treated differently is the high possibility that such failure may precipitate a general systemic breakdown.5 A bank is also unique in that it can become insolvent as a result of mere belief among depositors and creditors that its financial performance is bad. Even if the bank is solvent, creditors and depositors rushing to retrieve their money at once can cause illiquidity. Banks typically maintain only a fraction of liabilities (deposits) they receive in the form of cash.6 Nonetheless, depositors can withdraw their money on demand. When a number of depositors withdraw their money simultaneously, therefore, banks may not possess sufficient cash to repay depositors.

Capital adequacy is a standard method of defining the strength of a financial institution. Capital acts as a cushion to absorb losses from credit risk. Capital adequacy is based on the concept that banks should have a certain amount of capital against their assets (loans). The current main indicator of a bank’s solvency is its capital adequacy ratio. While both the ratio for determining a bank’s solvency and the measurement of the ratio itself are imperfect, a capital adequacy
ratio provides an element of objectivity such as to make it a leading benchmark for bank regulation.

**Basel Committee on Banking Supervision (Basel Committee).**

The Basel Committee on Banking Supervision was initially comprised of central bank governors of the G10 countries. It was established after the failure of the Bankhaus Herstatt in West Germany in 1974. Essentially, it was an informal group recommending measures to improve bank supervision. It sought to maintain a low profile, but with financial stability becoming a global concern, the activities of the Basel Committee are now one of the main focal points for bank regulators and bankers worldwide.

The most significant recommendation of the Basel Committee was the international standard for capital adequacy. It was first published in July 1988 as a result of increasing pressure to create a “level playing field” for financial institutions competing in the global markets. This report, the so called Basel Accord, addresses three basic components of capital regulation:

- an agreed definition of Tier 1 (core) capital and a menu of Tier 2 capital
- a general framework that allocates both bank assets and off-balance sheet items to risk categories while providing requisite procedure for calculating the minimum capital ratio
- a schedule for achieving a minimum ratio of total capital – to risk-weighted assets and off-balance sheet items of eight per cent.

**The Basel II Framework**

In June 1999, the Basel Committee on Banking Supervision embarked on a revision of its Capital Accord. The objective of the proposals was to provide a framework that is more sensitive and responsive to risks. In view of the complexity and sophistication of internationally active banks it proposed a menu of approaches to measuring regulatory capital. This was intended to offer greater flexibility and comprehensiveness to regulatory capital while simplifying the framework of its measuring. The 1988 Capital Accord furnished a much needed framework for the measurement of regulatory capital at the time. However, because of the crude risk weighting, it no longer adhered to the evolution that had taken place in the financial sector. The proposed capital framework consists of three pillars:

**Pillar 1: Minimum capital requirements which refine the standardised rules set forth in the 1988 Capital Accord.**

**Pillar 2: Supervisory review of an institution’s internal assessment process and capital adequacy.**

**Pillar 3: Effective use of disclosure of information to strengthen market discipline as a complement to supervisory efforts.**

Following extensive discussion with banks and industry groups, the revised framework was issued on 26 June 2004. Currently, each national regulator is implementing this framework. The deadline for the implementation of Basel II is the end of 2006 but an additional year is foreseen for implementing advanced approaches.

**Pillar 1: Credit and operational risk**

Pillar 1 covers the quantitative aspects of capital standards, creating more risk-sensitive measurements of capital requirements. The minimum capital requirement will use credit risk, operational risk and market risk for its measurement. Basel II does not address the numerator of capital adequacy ratio, bank capital, but only the denominator of risk-weighted assets.

**Credit risk**

Credit risk can be measured through a standardised approach, or by the internal ratings based (IRB) approach, which is further classified into the foundation and advanced approaches. Credit, operational and market risks encompass the denominator of the equation that calculates the capital adequacy ratio. One of the objectives of Basel II is to enable banks using the more advanced, IRB approach to put aside less capital even though the standardised approach could raise the capital required. Another objective is to differentiate the risk between the various corporate loans and sovereign debt.

The standardised approach to credit risk is similar to Basel I. However, it has greater risk sensitivity. It employs the credit ratings of external credit assessment institutions (ECAs) to define the weights when calculating risk-weighted assets. National supervisors will be responsible for recognising ECAs, following the examination of eligibility requirements. Supervisors are given considerable discretion in determining particular risk weights, and credit risk mitigants can be recognised subject to certain criteria being fulfilled.

The IRB approach is based on the use of banks’ internal risk estimates. Thus, it is a more advanced method of measuring capital and is created for use by large and advanced banks. Banks that opt for the IRB approach will be subject to minimum conditions and disclosure requirements.
Securitisation

The securitisation framework determines the capital requirement for traditional and synthetic securitisations or similar structures that contain features common to both.

Operational risk

Previously, operational risk (OpR) was not proposed as part of the Capital Accord. While the 1988 Capital Accord only set a capital requirement for credit risk, it was intended that the overall capital requirement would cover other risks as well.17 Due to the significant risk exposure to OpR, it is included in the calculations of Basel II.

OpR includes legal risk which arises from violations of, or non-conformance with laws, rules, regulations, or prescribed practices, or when the legal rights and obligations of parties to a transaction are not well established.18 Legal risk is high in areas such as internal controls, security, payment and clearing systems, and where information management is concerned.

The Basel Committee recommends three approaches to measuring OpR:

- the basic indicator approach (BIA)
- the standardised approach
- the advanced measurement approach (AMA).19

Banks are advised to move along the spectrum towards the more sophisticated method but are not allowed to revert to a simpler approach once advancement has been made.

The BIA is envisaged for use by smaller banks with a simple range of business activities.20 OpR capital is calculated by linking a single indicator to a fixed percentage. The Basel Committee has proposed that 15 per cent of a bank’s average annual gross income over the previous three years should be the capital requirement for OpR in the BIA.21 Due to the simplicity of the BIA, supervisors are unlikely to permit internationally active banks and banks with significant OpR exposure to apply the BIA for their OpR capital.

The standardised approach refines further the approach to OpR losses specific to the bank. The bank’s activities are divided into eight business aspects. For each aspect an indicator is identified that reflects the size or volume of the bank’s activity.22 Gross income is employed as the indicator for all business aspects because it is simple and there is little or no evidence of greater risk sensitivity in other indicators.

The AMA is the most sophisticated among the three proposed approaches. It relies on the internal operational risk system that takes into account not only actual internal and external loss data but also scenario analyses and factors relating to the bank’s business environment and internal controls.

Pillar 2: Supervisory review process

The supervisory review process pursues two objectives, to ensure that banks have adequate capital to support all their risks, and to encourage them to develop and use better risk management techniques. Pillar 2 is designed to supplement Pillar 1 by capturing any shortcomings of the minimum capital requirement framework and taking measures to ensure that sufficient capital is put aside.

Pillar 3: Market discipline

Market discipline is an important component of modern financial regulation. Basel II includes methods for greater qualitative and quantitative information to raise awareness among and information for stakeholders. This enables the market and investors to make qualified evaluations of the financial institutions. It acts as a counterweight to increased discretion accorded to banks in estimating their capital requirement.

Direction of implementation

Basel II incorporates numerous provisions recognising a certain degree of discretion of national authorities. Its implementation is also dependent on the competence and willingness of respective regulators. The Basel Committee countries aim to implement Basel II by the end of 2006 although for the more advanced approaches a further year of impact studies or parallel running will be required. This is a relatively short timescale for some jurisdictions, which may not have sufficient resources, both in terms of supervisors and banks, to cope with the historical data required.

A good “baseline supervisory system” will alter the decisions concerning the implementation of Basel II.23 Impacting on the timing of its application is the state of necessary infrastructure, including legal/regulatory infrastructure, human resources, disclosure regime, corporate governance and accounting and provisioning practices. Once the Basel II is adopted, it is necessary to ensure the improvement of those infrastructures while determining the scope of application.

The Basel Committee provides an Annex on the “Area of National Discretion - Pillar 1”. National supervisors have 61 options for credit risk and OpR. However, the previous paragraph highlights the numerous choices available prior to the calculations of Pillar 1 that determine the infrastructure of capital regulation. The “standard” of Basel II, together with the risk-related national discretions, is a more comprehensive concept than the “standard” Basel I. On the one hand, the divergence of
implementation may result in dilution of the standard. On the other hand, it may accommodate a variety of financial markets. This will entail competitive implications while impacting on the liberalisation of the financial sector.24

**European Union**

The EU will apply Basel II to all credit institutions by amending the Capital Adequacy Directive and the Consolidated Banking Directive.25 To that end the European Parliament is currently discussing the introduction of the Capital Requirements Directive (CRD) which is scheduled for adoption shortly.26 The proposed national implementation date is set at the beginning of 2007. Nevertheless existing rules can be used until the end of 2007. Advanced approaches will be available after 2007 to ensure adequate preparation.27

The CRD, which is the third generation capital adequacy directive, implements Basel II almost in its entirety in accordance with the European Commission’s 1998 Financial Services Action Plan. It requires the EU to provide accurate, internationally consistent, up-to-date prudential standards.28

The approach of the CRD is to introduce enduring principles and objectives in the articles and to supply the mandate for more detailed and technical provisions in the annexes. The annexes are open to amendments based on the comitology procedure which would ensure flexibility in case of changes in the financial sector. Amendments by way of the comitology procedure are of a technical nature affecting such things as definitions, terminology and initial capital.

The European Central Bank (ECB) has been pressing for more financial regulation to be transferred to the committee level as proposed by the Lamfalussy report.29 The report recommended that the CRD follow this approach, leaving technical provisions to be decided by committees which would directly implement them on a national level.30 This in turn would minimise the problem of national discretion applied within the EU. The Committee of European Banking Supervisors (CEBS) has worked toward reducing the number of options and discretions in the CRD.31 The CEBS has identified and discussed 143 options, of which 41 relate to credit institutions rather than to competent national authorities. They provide credit institutions with the option to decide whether to implement systems to achieve lower capital requirements.

Significantly, 23 national discretions are considered to be unnecessary and should be removed.32 The CEBS has been instrumental in reaching agreements with competent authorities to adopt a common approach. There may be no need for national discretion where the treatment of an exposure depends on a sufficiently clear set of criteria. All these options are included in the technical annex of the CRD. The CEBS considers the remaining national discretions available to the competent authorities to be necessary for reflecting the diversity of domestic markets and for retaining flexibility in the implementation of the Directive.

The ECB points out that Article 68 and 73 of the CRD contain options to waive capital requirements at various levels within groups.33 Article 84(2) stipulates that the competent authorities have the power to permit the use of the IRB approach if its systems comply with a number of conditions. Likewise, a number of provisions are said to leave a large degree of discretion to national regulators. Another aspect raised by the ECB concerns the fact that national regulators currently require, under specific circumstances, a minimum capital ratio above 8 per cent.34 If the above threshold application of the capital requirement is preset it creates an uneven playing field and should be subject to greater coordination among the competent authorities.35 There are also issues with the worsening transposition of financial directives by member states, which may inhibit the smooth EU-wide implementation.36

The European Parliament voted to introduce the CRD in September 2005, which means that the Directive will take effect from January 2007.

**EBRD countries of operations**

Most countries in which the EBRD operates will implement Basel II. The Basel Committee conducted a survey in early 2004 of non-Basel Committee countries in Europe in relation to their plans to implement Basel II. It covered most EBRD countries of operations in their intention to adopt Basel II.37 All of European countries that are non-Basel Committee responded that they will implement Basel II. Thus, most EBRD countries of operations plan to implement Basel II. When asked about the development of internal plans for implementing Basel II, of the European, non-Basel countries, seventeen respondents did have an internal plan. This includes the fifteen EU member states obliged to implement Basel II with the passing of CRD. Thus, the remaining countries, including EBRD countries of operations which are not EU member states, do not yet have an internal plan.38

Of the 1,419 supervisors which mainly are from EBRD countries of operations that are not EU member states, 1,167 will need training for Basel II.40 It should however be noted that the respondent with the greatest number of supervisors is excluded from the calculation, and as such, if included, the percentage of those needing training in non-Basel European countries would increase to 61 per cent.41 It can be deducted that the many of the EBRD countries of operations which are financially less developed may not yet have a realistic strategy of or capacity for implementation. They will therefore require more training as practical issues arise.
For the EU member states, the CRD will be implemented nationally. The Czech Republic appears to be well prepared for the implementation of the CRD with various task forces in place. The Joint Project of the Czech National Bank, Czech Banking Association and Czech Chambers of Auditors have been formed to promote effective communication among the stakeholders. It is acknowledged that amendments to Act No. 21/1992 on Banks may be needed, but a Czech National Bank Regulation stipulating rules of the CRD will be issued.

As an EU member state the Czech Republic has already decided on options from the list of national discretions drawn up by the CEBS. This has assisted in reducing uncertainty as to how the CRD will be implemented in the Czech Republic. One issue may be the integration of financial supervisors which is currently taking place in the Czech Republic. The initial stage will commence in 2005 and 2006 coinciding with the implementation phase of Basel II. The International Monetary Fund (IMF) has warned that the Czech authorities’ the efforts towards supervisory integration should not compromise effective supervision.

Hungary complies with most aspects of Basel’s principles, but is still in the midst of developing a risk-based supervisory system. Given its high compliance with international standards, Hungary is well positioned to implement Basel II especially as most banks are subsidiaries of international parent banks. However, Basel II is a risk sensitive framework and better risk-based supervision will be a key to implementing Pillar 2. As an EU member state, Hungary may require its supervisors, rather than its financial institutions, to step up preparations for Basel II implementation.

Russia has a weak financial infrastructure and prudential standards which cause vulnerabilities in the financial sector. Additionally, the banking sector has a large state bank presence with 35 per cent of total bank loans. The slowness of prudential reform in the Russian banking sector raises concerns about the timeframe in which Russia would be able to introduce Basel II. The Russian Central Bank regards itself to be “nearly 95 per cent” compliant with all Basel recommendations. This however would be an optimistic assessment of its supervisory capacity.

Despite this, the Russian Central Bank is taking the opportunity to implement Basel II in the hope that it will improve the financial markets in Russia by encouraging foreign banks to partner with Russian correspondents. The lack of transparency in Russian bank transactions inhibits effective risk management. As a first step in changing this culture, banks will now be required to publish annual reports. The Central Bank is also being assisted in the training of its supervisory staff through the EU Tacis Programme. Russia plans to implement Basel II by 2008-09.

Weaknesses need to be overcome to enable Basel II to be effectively implemented. It is necessary to:

- introduce proactive assessment of banks
- refine the definition of capital
- carry out prompt assessment of capital and insolvency
- enforce consolidated supervision.

Bulgaria is hoping to join the EU in 2007 and needs to take a pragmatic approach to the implementation of Basel II as it will be required to adopt the CRD prior to its accession. The Bulgarian National Bank currently prescribes 12 per cent of capital adequacy ratio, exceeding the 8 per cent required by the Capital Accord, and is largely compliant with the Basel Core Principles. The Bulgarian National Bank’s development strategy for 2004-09 states Bulgaria’s intention to adopt the CRD in the medium term, that is to say 2006 or 2007. This will be in line with the scheduled accession and the CRD timetable.

For countries like Azerbaijan – which have a state-owned bank with a monopoly over key segments of the financial market – the application of the 1997 Basel Committee’s “Core Principles for Effective Banking Supervision” is a more urgent than the implementation of Basel II. This is because Pillar 2 calls for supervisory oversight which supervisors may not be able to adequately apply to a state-owned bank. Adoption of Basel II should be a long-term objective, along with other measures to create an efficient and effective banking sector.

United States

The United States has the largest and most influential financial markets and institutions in the world. Therefore whichever direction the US regulators take in terms of Basel II will have a great impact on its proliferation. The regulators responsible for the application of Basel II are the Board of Governors of the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.

There have been numerous rounds of discussion with the financial industry as well as among the regulators in relation to Basel II. Furthermore, between 1999 and 2004 the Basel Committee published three consultative papers with an advance notice of proposed rulemaking (ANPR) issued in 2003. A notice of proposed rulemaking (NPR) is scheduled for fall 2005. To date, the ANPR provides the greatest insight into the national implementation in the United States. First, not all financial institutions will be subject to Basel II rules. Second, those subject to Basel II will be susceptible to the most sophisticated methods within Basel II. Third, full implementation of Basel II will only occur in January 2010 at the earliest.
Basel II will be mandatory to core banks with total banking (and thrift) assets of US$ 250 billion or more, or total on-balance-sheet foreign exposure of at least US$ 10 billion. Banks can only choose to apply Basel II by becoming an opt-in bank. Both core banks and opt-in banks will be obliged to meet certain infrastructure requirements and to make specified public disclosures before being able to use the advanced approaches to calculate risk-based regulatory capital. All other banks will continue to apply Basel I capital rules.

The rationales for a separate arrangement of capital requirements are that the majority of banks have a relatively straightforward balance sheet and that most banks have capital exceeding Basel I requirements. As a result Basel II will be applied to approximately 10 core banks while 10 or more banks are thought to opt-in.

Japan

Japan will apply Pillar 1 of Basel II via a guideline based on Article 14-2 of the Banking Law. This law stipulates that the Prime Minister can lay out guidelines to ensure the prudential management of banks. Due to the limited timescale that exists until Basel II goes “live” and to the preparation needed by financial institutions to implement Basel II, the frameworks of the regulations published by Japan’s Financial Services Agency (FSA) have yet to be finalised. The framework of Pillar 3 has been published, albeit the actual announcement of provisions is still pending.

The scheduled date for implementing Basel II is March 2007 for standard methods and March 2008 for advanced methods. However, at the moment the public consultation for Pillar 1 is still ongoing and the FSA has had to defer the timetable for publishing the guideline in the government gazette until the end of 2005.

Opt-ins, Opt-outs and other non-Basel Committee countries

The value of Basel II will be truly realised once it has been widely and uniformly applied. The prospects of wide application are high, given that 88 non-Basel Committee countries already intend to apply Basel II between 2007 and 2009. This would mean over 5,000 banks controlling almost 75 per cent of banking assets in 73 non-Basel Committee countries will be subject to Basel II.

One of the most difficult aspects of applying Basel II for non-Basel Committee countries are Pillars 2 and 3. These pillars require advanced technical and human resources for the purpose of adequate supervision. Basel II is an interesting phenomenon in that a major result of Basel I was a shift from discretionary supervisory powers to the use of objective tools to assess financial conditions of banks. By placing greater dependence on supervisory review to balance the effects of the capital requirement framework Basel II reverts this trend. Whether the above timeframe for implementing Basel II is appropriate is questionable. The lack of technical and human resources in non-Basel Committee countries may compromise the appropriate implementation of Basel II, the greatest challenge represented by the requirements of Pillar 2. Especially demanding will be the establishment of prompt corrective action, the legal mandate to impose higher capital requirements, and of the consolidated supervision. Equally challenging will be the enactment of confidentiality rules that require a fundamental change in the financial regulatory framework as well as in the legal and judicial system in many countries. It is estimated that approximately 9,400 supervisors worldwide require training on Basel II related topics.

The credit risk framework will require developing countries to become familiar with the credit risk concepts and measurement tools that have long been used in developed markets. One of the benefits of Basel II is in relation to behaviour of banks. Financial institutions will need to develop better risk management practices as a result of heightened emphasis on risk management by regulators and supervisors. In spite of this, excessive effort should not focus on achieving certain risk management standards but on the process of developing a standard appropriate to the individual bank’s need and transactions.

Basel II demands much preparation for its implementation by both the regulator and regulatee. Regulators should only apply Basel II after running full impact assessments and only when sufficient infrastructure is developed. Regulatees would need to develop their systems in accordance with the regulations and their capacity. Before setting for implementation regulators will need to evaluate the ability of financial institutions to adopt Basel II. Most countries will embrace Basel II even though the timing will be varied. The Basel II standardised approach requires a large database of historical data which is not easy to assemble for financial institutions in developing countries. But one of the greatest achievements of the Basel Committee’s work is the awareness that a risk sensitive capital framework is steadily and surely proliferating.

There may well be divergence in the national implementation among developing countries. Nevertheless, it is not the technical aspects of the framework but the conceptual transplantation of the principles of Basel II that matters most for these countries. It is only when a number of countries have been able to transfer to the Basel II framework that more detailed harmonisation of Basel II implementation may be achieved.
Conclusion

Basel II will bring about great advances in risk measurement of banks. It will also benefit financial institutions by providing systems to measure capital more closely to their economic capital. The development of the Basel Capital Accord, while not always optimal, has indeed contributed to raising awareness of banks’ capital level and risk profile. Capital regulation has become the leading tool for financial regulation and the benchmark for regulatory action.

One of the main objectives of the Basel Committee’s work since its inception has been to create a “level playing field” for financial institutions. To enable large and complex institutions to accurately measure their capital against their risk profile has been the objective for Basel II revisions. Whether this objective is met as a result of Basel II is not clear and will depend on implementation at the regional and national levels. Interestingly, countries with banks capable of adopting Basel II are withholding implementation while those that may not necessarily require Basel II at this point are enthusiastic to move forward.

Due to their direct involvement in the process of developing Basel II the banks of Basel Committee countries are experiencing the costs of adopting Basel II. Regulators and supervisors are much more aware of the opinion of financial institutions through the numerous public consultations and are more accommodating to business realities of banks. The costs of developing a system to comply with Basel II may defer the very financial institutions that actually need to apply it.

For developing countries, the adoption of Basel II is an opportunity to outshine other emerging markets and to boost their reputation. Together with the perceived cost saving this may provide an incentive for adopting Basel II.

Whether the costs for developing systems required to implement Basel II will be worthwhile will depend on the capital savings from Basel II. In the long run it is likely that the adoption of the standardised approach will develop a risk sensitive culture among banks, one of the most desirable benefits of Basel II. Nevertheless, unless Basel II is adopted according to the needs and capacity of banks in a given jurisdiction, its implementation may be unnecessarily taxing.

End notes

1. Member of the Basel Committee on Banking Supervision come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States.


3. The Basel agreements are only recommendations by central bank governors and heads of supervision. They do not constitute a rule in itself. However, the respectability of the Basel Committee of Banking Supervisors together with wide national implementation – not only among Basel Committee countries but also by developing countries – has strengthened the argument that Basel agreements are soft law instruments. J.J. Norton (1989), “Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities”, Ohio State Law Journal, Vol. 49, p. 1,347.

4. Some of the main issues of Basel II include the pro-cyclicality and the complexity of its rules. If a bank is near its minimum regulatory capital during a cycle of economic downturn it may reduce lending to make the shortfall in capital. The complexity of the rules is also criticised for making enforcement more difficult.


6. The amount of liabilities they maintain in the form of cash (central bank reserves and vault cash) is determined by the reserve requirement, depositors’ decision on holding cash and banks’ decision of holding excess reserves. The total of these will appear in the form of “bank deposits” of the central bank’s liabilities. Since the amount of excess reserves is a bank’s strategy, we can derive the aggregate holding of cash by dividing bank deposits with the central bank’s total liabilities.

7. The failure of Herstatt was the first instance in which foreign exchange and settlement risks were realised in a cross-border transaction. Having sustained substantial foreign exchange losses, Herstatt stopped honouring its account at 4pm on 26 June 1974. Due to its large foreign exchange business, this left many payment commitments unpaid. Herstatt’s foreign exchange bank in New York, Chace Manhattan, refused to honour US$620 million in payment orders which nearly collapsed the US clearing system and international banking system.


10. The Basel Committee has admitted that while the new Accord has resulted in being less prescriptive it has also increased the complexity of the framework. Basel Committee on Banking Supervision (2001), “The New Capital Accord: an explanatory note,” p. 2.


12. Credit risk is the risk of loss from a borrower/counterparty’s failure to repay the amount owed (principal or interest) to the bank on a timely manner based on a previously agreed payment schedule.

13. Capital adequacy ratio is calculated by the bank’s capital ratio (minimum 8 per cent) = total capital / (credit risk + market risk + operational risk/assets).

14. The Quantitative Impact Study 3 (QIS3) – in which banks globally volunteer to calibrate their capital requirements using the new Basel II proposals – has shown that using the cruder standardised approach necessitates an average of 11 per cent rise in the capital requirement of Basel Committee country banks. At the same time the internal rating based approach brought a 3 per cent rise and the internal rating based advanced approach a 2 per cent decline in capital requirement.

15. The six requirements are: objectivity, independence, international access/ transparency, disclosure, resources, and credibility. Basel Committee, supra note 11, p. 28.

16. The IRB is closely linked to modern asset pricing theory in which the likelihood of a borrowing company being unable to repay its debt is determined by the difference between the value of its assets and the nominal value of its debt. Default is assumed to occur when a firm’s assets are insufficient to cover the debt. The corresponding measure of credit risk within a certain timeframe is the probability of default.

17. The 1988 Capital Accord set forth the method of measuring capital (the numerator of the capital adequacy ratio) and only mentions that risks other than credit risk should be taken into account when assessing capital adequacy. Operational risk and market risk are not specifically mentioned but were subsequently examined by the Basel Committee. Operational risk was first considered by the Basel Committee in 1994.


21. The Basel Committee initially proposed a 30 per cent of gross income for operational risk capital in its Consultative Document. However, as a result of the QIS many banks commented that this would actually lead to an increased level of overall capital. As a result, the Basel Committee is now proposing a 17 to 20 per cent of gross income. Basel Committee (2000), “Working Paper on the Regulatory Treatment of Operational Risk”, September, p. 4.

22. Corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage.


24. The impact of the prudential “carve out” in the General Agreement on Trade in services (GATS) can only be minimised by creating greater standardisation of financial regulation globally. If Basel II results in a divergence of financial regulation, financial liberalisation will be impacted by countries opting for application of the prudential “carve out”.


27. Title VII of supra note 26.


32. Ibid., “National Discretion Deletion List”.

33. European Central Bank, supra note 30, paragraph 11 and 12.

34. European Central Bank, supra note 30, paragraph 43.

35. Supra note 26, article 75 stipulates the 8 per cent threshold.


37. EBRD countries of operations that responded to the survey are Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, the Kyrgyz Republic, Latvia, Lithuania, FYR Macedonia, Moldova, Poland, Romania, Russia, the Slovak Republic, Slovenia, Tajikistan, Turkmenistan, and Ukraine.


40. The survey groups European, non-Base Committee countries in two groups. While countries that are EU member states would belong in group 1, group 2 comprises the most other EBRD countries of operations. However, the survey does not name which countries belong in each group, so this is based on the assumption that group 1 includes EU member states, accession countries and off shore centres.

41. The countries with the greatest number of supervisors is not provided in the survey.


44. Committee of European Banking Supervisors, supra note 31 and 32.

45. IMF (2004), “Czech Republic: 2004 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic”, IMF Country Report No 04/296, August, p. 18.


50. IMF, supra note 48, p. 22-23.


52. Looking at the Financial Sector Assessment Programme of the IMF, there are a number of actions to be taken for compliance with the Basel Core Principles, and there remains a problem of effectively enforcing its rules. IMF, supra note 49, p. 39-40.

53. Supra note 51.

54. Id.


56. IMF, supra n. 49, p. 18.


59. IMF (2005), “Azerbaijan: Republic: 2004 Article IV Consultation, Fourth Review Under the Poverty Reduction and Growth Facility, requests for waiver of performance criteria, extension of arrangement, reduced access and rephasing of disbursements – Staff report; staff statement; public information notice on the executive board discussion; and statement by the Executive Director for the Azerbaijan Republic”, IMF Staff Report No 05/19, January.


61. The results of the fourth Quantitative Impact Study have caused a delay in the issuance of the NPR. Testimony of Governor Susan Schmidt Bies “The Basel II Accord and H.R. 1226” before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, US House of Representatives (11 May 2005).


68. Id.


71. Stephanou & Mendoza, supra note 70, p.27.


73. Stephanou & Mendoza, supra note 70, p.27.


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Banking transactions in Albania

Privatisation of the remaining state-owned banks in Albania has encouraged the development of new services within the sector. Significant changes have occurred in the payment system, particularly the introduction of electronic and cashless payment instruments. While the use of these services continues to increase, further efforts must be made to harmonise and standardise the transparency of banking transactions and to further reform the sector.

Introduction

The Albanian payment system has changed significantly in recent years following the privatisation of state-owned banks and initiatives undertaken by the Bank of Albania (BoA). These changes to both the payment system infrastructure and design have been aimed at:

- reducing cash circulation and replacing it with cashless payment instruments
- strengthening the reliability and efficiency of the inter-bank Albanian payment system
- enhancing the efficiency of the banking market
- promoting the use of new payment instruments.

As far as inter-bank payment systems are concerned, the BoA has carried out far-reaching reforms aimed at strengthening the stability and increasing the efficiency of the overall payment infrastructure. Payments are channelled into the two systems according to their nature: large value transactions are settled on a gross basis through the Albanian Interbank Payment System (AIPS), while retail payments are settled on a net basis through the Automated Electronic Clearing House (AECH). The direct management of both systems allows the BoA to closely monitor the risks inherent in their functioning and ensure open and non-discriminatory access to these systems.

In the area of retail payment systems, the BoA is involved generally in drafting regulations and guidelines, although more effort is needed to verify the efficiency of banking payment circuits and instruments. Actions in the area of retail payment systems should be better organised between authorities and banks to improve services for the benefit of customers. Moreover, substantial changes in the legislative framework are considered by the Albanian Government necessary to bring the Albanian legal framework into line with the Maastricht Treaty and European regulations.

General institutional framework

The main providers of payment services are the BoA and the banking system.1

Bank of Albania

The BoA is Albania’s central bank. The BoA’s interest in the proper functioning of the payment system and, in particular, of inter-bank circuits stems from its role in the implementation of monetary policy and as supervisor of the banking system. The 1997 Bank of Albania law2 entrusted the BoA with explicit responsibilities and powers aimed at promoting the smooth operation of payments systems (Article 3, section 4, paragraph f).

The role of the BoA with regard to payment systems consists of two main elements: oversight of the payment system and operation of the inter-bank payment and settlement systems. With the intention of controlling and minimising the potential risks inherent in payment systems, the BoA, in cooperation with banks, established regulations and procedures for payment settlements rendered by payment instruments (Article 21, section 1). Therefore, the BoA performs autonomously by overseeing systemically important payment systems, issuing...
regulations and guidelines, providing settlement services for banks or other payment and clearing systems.

The operational role derives from the need for banks to have a reliable and safe environment for processing inter-bank payments and from the BoA’s need for a secure channel for the execution of monetary policy. The operational role of the BoA in the payment settlement systems currently entails the issuing of banknotes, the management of both AIPS and AECH (the large-value payment system and the retail payment system in operation in Albania respectively), and the management of government payments as a fiscal agent.

Commercial banks

At end of 2004, the number of banks operating in Albania was 16, two of which deal wholly with domestic capital. The remaining 14 banks are dominated by foreign capital.

According to the 1998 banking law, a bank is a juridical person licensed by the BoA to engage in banking business. Banking business is defined as the “business of accepting and collecting of deposits from the public and using such funds to make loans, advances, or as investments for the account of and at the risk of the juridical person carrying on the business and such other related business that the BoA may, by regulation, specify” (Article 2, section 1, paragraphs a and b).

Banks are authorised in their license to engage in the banking and financial activities described in the banking law. Among other banking and financial activities, banks have the right to provide payment and collection services. In addition, the banks are authorised to issue and administer means of payment (Article 26, section 3, paragraphs a and b).

Banks provide payment and collection services through the national payment system. However, any bank is entitled to authorise another participant of the payment system, to perform payment transactions on its behalf and in its interests. The authorising participant is responsible and shall assume the risk connected to all the transactions performed on its behalf and in its interests by the authorised subjects.

Banks perform their payment transactions through a network of subsidiaries, branches and agencies. Recently, the Albanian banking system extended its national network. In 2004, 30 new branches and agencies were opened all over the country. These branches and agencies have been opened, not only in major cities, but also in smaller cities and towns. In addition, the branches and agencies opened in the capital city, Tirana, will now provide services for the whole metropolitan area, not just the city centre.

Non-bank financial institutions

The activities involving “means of payment and settlement” are not restricted to banks in Albania. There are non-bank financial institutions, which provide payment services without involving in deposit-taking activity.

The BoA is entitled to make other persons that engage in activities, which are not deposit taking activities, subject to the provisions of the 1998 banking law. At end of 2004, seven non-bank financial institutions were operating in Albania.

Non-bank financial institutions are authorised in their license to provide payment and collection services. In addition, non-bank financial institutions are authorised to issue and administer means of payment.

Payment instruments and settlement systems

Cash payments

The monetary unit in Albania is the lek (ALL). The BoA has the exclusive right and acts as sole issuer of banknotes and coins as legal tender within the country. The BoA defines independently the forms, measurements, weights, designs and other features of Albanian banknotes and coins.

Albanian legislation does not contain any specific prohibition or restrictive provision on the settlement of monetary obligations with foreign currency. The 1997 Bank of Albania law provides that “all contracts denominated and payable in foreign currencies are valid in the Republic of Albania”. Moreover, the 1994 Albanian Civil Code (ACC) provides that a “monetary obligation can be settled in the currency accepted in the contract.” Consequently, Albania has acknowledged the settlement of claims by way of foreign currencies between contractual parties regardless of whether they are national or international contracting parties.

Several factors foster the use of cash in Albania. The “grey economy” is still large and contributes to an increased willingness to use cash for payments. Another important factor, which has promoted the use of cash, is the foreign exchange “informal market” where many transactions are executed in parallel to banking and foreign exchange bureaus. Furthermore, certain areas of the country are characterised by a low degree of institutional financial intermediation.

Cashless payments

The ACC does not include a specific stipulation that non-cash payments are legally equivalent to cash payments. Besides cheques, which are regulated specifically by law, other non-cash payments in
Albania are regulated by the BoA. The BoA does not have an explicit authority to introduce new payment instruments as legal means for the discharge of monetary obligations. Therefore an obvious and firm position is required from the authorities to acknowledge non-cash payments as legally equivalent to cash payments.

Credit transfers, locally known as payment orders, are the dominant payment instrument in Albania, in terms of both volume and value. Private and state-owned companies predominantly use the payment order. Payment orders may be customer-to-customer or simply between banks. A payment order is defined as a paper-based document issued from the account holder or cash provider in the bank. The bank then debits the bank account and transfers this ordered amount to the beneficiary account.

Generally, documentary credits are referred to the ICC Uniform Customs and Practice for Documentary Credit. However, BoA by-laws and agreements with correspondent banks are not excluded from application.

In addition, standing orders are offered by the majority of commercial banks for recurring payments such as utility bills. The standing order is defined as an instruction order from the customer to the bank to execute a periodic payment for a fixed amount to a beneficiary.

Direct debits are also a commonly used instrument, mainly in the larger urban centres. In Albania, the direct debit is an authorised payment where the payer authorises the bank to debit his/her bank account on a specific defined date. Direct debits are offered by the majority of commercial banks and are primarily used for recurring payments such as utility bills. However, usage remains low.

Cheques are increasingly popular in Albania. Nevertheless, their use remains relatively limited. Albania as a civil law jurisdiction adopted a law modelled on the Uniform Cheques Law (UCL) of the Geneva Convention of 1932. This law is restricted to cheques only and is primarily concerned with cheques as instruments rather than payment mechanisms.

On the supply side, the banking sector is beginning to build a widespread and cheap ATM network, which increases the number of cash withdrawals from current accounts. However, payment cards are rarely used in Albania and mainly in the big urban areas.

**Clearing and settlement systems**

The BoA provides clearing and settlement services for inter-bank transfers through the operation of two fully automated payment systems: AIPS and the AECH.

The purpose of AIPS is to enforce, through the system, the processing and settlement of payments and other inter-bank transactions on a gross basis in real time. AIPS processes all inter-bank high value payments and accepts settlement payment orders and settlement requests. AIPS handles only payment instructions equal to or exceeding ALL 1,000,000.

AIPS is owned by the BoA and settles inter-bank payments and customer payments. The BoA opens and maintains the settlement accounts, and manages and conducts the settlement process in its capacity as settlement agent. Payments via AIPS are subject to there being sufficient funds in the participating account of the payer. The participants are obliged to keep enough funds in their account to cover each payment instruction.

Most retail and corporate payments are processed by the AECH. The AECH is an electronic clearing system which manages bulk (high volume) low value payment instructions (both credit transfers and direct debits) among participants once net positions have been settled through AIPS. AECH processes customer payments from the commercial banks.

The payment messages are transferred in batches between the system participants and the BoA. The system executes small value payment orders (credit transfer payment instructions) initiated by a payer to debit its own account and credit the account of a beneficiary. Also the system executes direct debits (debit transfer instructions) initiated by a beneficiary to debit the account of a customer and credit its own account.

Both AIPS and AECH systems operate according to the rules adopted by the BoA. The rules and procedures are binding on all of the systems’ participants. However, the participant and the BoA execute a bilateral agreement on participation in AIPS and AECH. The agreement describes the rights and obligations of the participant. Since payment messages are submitted via SWIFT, participants must comply with the message standards and rules defined by SWIFT. If the provisions of SWIFT are inconsistent with the bilateral agreement, the provisions of the latter prevail.

**Bank-customer relationship**

As in other countries, the cashless payment system in Albania operates on the basis of the transfer of funds from one bank account to another. Therefore, cashless payments require the existence of a bank account. The general principles of contract law and specific provisions of the banking contracts that regulate the account agreement are provided in the ACC.

**General contract law**

Freedom of contract is a fundamental principle of the Albanian legal system. According to the ACC, the prerequisites for the existence of a contract are: the consent of the party that has undertaken the
obligation, the legal motive of the obligation, the object that constitutes the content of the contract and the form as required by law (Article 663).

As in other civil law countries, Albania has a general clause declaring null and void immoral contracts and/or those that offend against public policy and law. In a contract, the motive is unlawful when it is contrary to the law, public order, or when the contract becomes a means to avoid the fulfilment of a rule (Article 677 of the ACC). In addition, a “good faith” obligation in the performance of a contract is a fundamental principle and presently codified in the ACC. The creditor and debtor must behave toward each other correctly, with impartiality and acting according to the dictates of reason (Article 422 of the ACC).

Albania does not have specific legislation dealing with unfair terms in either standard banking form or consumer banking contracts. Albania belongs to a group of countries where relevant legislation is limited to contracts in specific areas that do not include banking. With respect to the general relationship between banks and consumers, the 2003 consumer law ensures the protection of consumer rights, interests and property that could be injured by the supply of defective services or lack of information relating thereto. The services are defined as “all services supplied to consumers according to the modalities set out in the Civil Code” (Article 3.16).

The bank’s only specific requirement, set out in the 1998 banking law, is to notify its customers of the terms and conditions of annual interest rates, related to deposits, credit applications and their changes, including the calculation method used, pursuant to the rules and regulations of the BoA. Both general requirements under the consumer protection law and specific provision of the banking law are not elaborated on by the BoA and Department of Consumer Protection in the Albanian Ministry of Economy, Trade and Energy. In addition, the lack of cooperation between these two authorities to implement the minimum requirements for consumer protection has diminished the bargaining power of parties in consumer banking contracts.

Consequently, the minimum protections for the customer can be found in the general provisions of contract law. The ACC regulates standard form contracts. According to Article 686, section 1, of the ACC, standard conditions prepared by a party to the contract are effective only where “at the moment of the conclusion of the agreement, the other contracting party knew of them or should have known of them by using ordinary diligence”. Unfortunately, this provision is not tested yet. However, the expression “should have known”, regardless of whether the term itself is fair or reasonable, is very broad and not in the interests of the customer.

Under Article 686, section 2, of the ACC, certain terms in standard form contracts must specifically be approved in writing, and are otherwise ineffective. Such terms include conditions relating to limitations on liability, withdrawal from a contract, and limitations on the power to raise defences. This regulates the form of certain terms, but again, avoids dealing with their contents.

In addition, there are rules of interpretation of standard form contracts. Under Article 687 of the ACC, a negotiated clause added to a standard form contract prevails if there is conflict between it and a standard term in the contract. In addition, standard form terms are interpreted against the drafter and in favour of the customer when in doubt (Article 688 of the ACC).

Specific provisions

Both provisions of the current account and mandate in the ACC play a cardinal role in bank payments and collections in Albania.

The ACC has an entire section dealing with banking transactions in current accounts (Articles 1041-1046). They provide for the customer’s right to dispose of a credit balance on an account “at any time”, though “subject to the agreed terms concerning notice” (Article 1041). Thus far, this agreement is for an indefinite duration and in the absence of a specific maturity or expiry date agreed upon, the customer is free to terminate the agreement by closing the account at any time.

In addition, the provisions of the ACC provide for the combination of balances in different accounts of the same customer (Article 1042), for current accounts in the name of more than one person (Article 1042), and for the withdrawal from the contract (Article 1044). They specifically provide, in Article 1045, that “for the carrying out of instructions …. the bank is answerable according to the rules concerning the mandate”. Finally, Article 1046 refers to the general provisions governing a non-banking current account, and specifies that they apply “to banking transactions for a current account”. Articles 1016, 1019, and 1022, deal with the right to commissions and reimbursement of expenses, exclusion of uncollected collection claims, and the approval of the account respectively.

Furthermore, based on the account agreement, the customer may instruct the bank to make a payment transaction to a third party (credit transfer) or collect funds from the payer’s account (debit transfer). The payment instruction under Albanian law is discussed in terms of a mandate, given by the customer to their bank. Therefore, in Albanian law the mandate is also considered applicable to the collection and receipt of payments by banks for customers. The ACC specifically
provides in Article 1045, section 1, that in executing customers’ instructions the bank is answerable according to the rules concerning the mandate.

According to Articles 913 to 934 of the ACC, a mandate is a contract whereby the bank binds itself to accomplish one or more legal transactions for the account of the customer. However, if the bank has been given the power to act in the name of the customer, the provisions on the representation apply (Articles 64 to 78 of the ACC).

It is important to note that it is not a simple legal act (unilateral). The mandate is a contract (bilateral). Therefore, the contract of mandate is to be accepted and signed by the customer and the bank.

As such, the customer cannot repeal the mandate without the consent of the bank. The ACC provides that the mandate must also be in the interests of the bank and therefore cannot be repealed unless it is otherwise agreed or unless there is a just cause for such revocation.

Conclusions

Although the importance of payment settlement systems in Albania has grown considerably over the past decade, the development of these systems has mainly focused on the system infrastructure. This infrastructure has improved significantly and has encouraged large numbers of consumers to use cashless payment instruments. However, such improvements will not be successful in the short term unless certain reforms in other areas are coordinated, harmonised and properly implemented.

Despite progressive initiatives, the Albanian payment system is profoundly influenced by the country’s informal economy. As indicated previously, the use of cash in Albania’s “grey economy” is still significant, representing 33 per cent of GDP according to INSTAT estimates. This derives from the limited number of current accounts in the system compared with the number of deposit accounts. At the end of 2004, current accounts made up 19 per cent of the total balance of demand and time deposits. In addition, the outstanding balance of the current accounts represented one quarter (25 per cent) of the outstanding balance of the time deposit account. Such a low records of the current account in the Albanian banking system compare either with deposit accounts or cash amount in circulation shows that the balance still significantly weight on the cash transactions.

In addition to the grey economy, the use of cash remains widespread for several reasons. Historically, cash was not used as a means of payment in Albania, as in other former socialist economies. As a result, its introduction has led to a cash-addiction culture which continues to this day. A significant proportion of business transactions are not carried out through banking systems, due to the underdevelopment of the sector and also for tax evasion purposes. Even utilities bills are paid in cash and not through banks. Furthermore, households, which are not used to paying banking fees and commissions, are often reluctant to approach the banks.

This situation has led to the development of an initiative to improve legislation supporting cashless means of payment. Under such legislation, all transactions above a certain amount must by law be carried out through banks. A campaign was launched a year ago to educate people to pay household bills through banks. As a result all public administration staff was provided with a bank account and a debit card attached to it; some banks have also extended their working hours to Saturday. In addition, the majority of banks have increased the number of automatic teller machines (ATMs), point of sale (POS) machines and have provided their clients with cash cards, debit or credit cards. However the extent of using cashless means of payment in terms of number and volume, although on the increase, remains very low. One important factor contributing to this is the relatively low level of household income, which does not make it appealing for households to give up cash as much as possible. The utility expenses remain one of the most substantial expenses of the Albanian family. It is very unlikely in Albania that customers pay in cash their utility bills. This means that the customers withdraw their cash from the bank account in case they have such a bank account and pay their utility bills. The payment of the utility bills through the bank would encourage the customer to open bank current accounts in case they do not have and make use such bank account not only for utility bills.

The amount of money outside banks remains high and is even higher compared with other central and eastern European countries. At the end of year 2004, the BoA reported that money outside banks accounted for 27 per cent of the money supply and almost one-fifth of GDP. The level of this indicator is even higher if foreign currency in circulation is considered since in Albania dollar and euro are considerably used as means of payment.

The legal framework underlying payment instruments consists of several laws. Therefore, there is plenty of room for the general principles of law to interact with the specific provisions of the law. Albania has no specific legislation on the transparency of banking transactions. The banking law provides the minimum requirements. However, legislation governing the transparency of charges, rates and terms relating to banking and financial services as well as any modification of such charges, rates, and terms is required.

Finally, the Albanian banking system has not produced a “banking code or general conditions” setting out minimum standards for bank–customer relationships. There are inter-bank agreements but these agreements...
do not classify as a banking code or general conditions. Obviously, the inter-bank agreement sets out reciprocal rights and duties on bank parties to the agreement. These inter-bank agreements do not bind or benefit a customer as this is not the intention of the agreement.

End notes

8. Law on the Bank of Albania no.8267, dated 23 December 1997, as amended, article
9. Law on the Civil Code of the Republic of Albania no.7850, dated 29 July 1994, as amended, article 446. Albania’s civil code draws on the Roman law tradition of civil law jurisdictions. The civil code contains general principles of law and provides for such matters as contract and property.
11. Agreement between BoA and commercial banks no.6 on the standardisation of the payment order and the cheques, dated 20 March 2000.
13. Ibid.
14. www.bankofalbania.org
17. Law on Consumer Protection no. 9135, dated 11 September 11 2003
18. Bank of Albania, data on banking system, monthly statistical report, December 2004
Developing banking and financial services legislation in the Czech Republic: the first year of EU membership

The post-privatisation development of banking and financial services legislation in the Czech Republic is similar to that of many new European Union (EU) member states with small and open economies. This development is characterised by integration with the EU financial market, moderate growth of non-banking financial sectors and constant adjustment to the ever evolving acquis communautaire.

Introduction

By 2002 most of the transition activities of the financial market in the Czech Republic had been completed, including:

- privatisation of major financial institutions
- the overcoming of instabilities within financial markets
- consolidation in all financial market sectors
- major harmonisation of the legislative framework governing the financial market with EU rules.¹

Since 2002 several legislative projects of particular significance have been undertaken. In general, these projects have followed the EU Financial Services Action Program (FSAP) and fine-tuned the sector for EU accession. More EU-based firms have expanded their activities into the Czech Republic. The EU Commission in its annual evaluation reports has closely monitored these developments.

Since joining the EU, the Czech Republic has been sharing all the challenges and advantages of EU membership with the other 24 member states. The first year of membership has been strongly reflected both in the domestic rule making process and the development of the financial market – especially its relationship with the steadily integrating EU financial market.

The financial system of the Czech Republic

There is a broad, although not undisputed, consensus that the development of financial intermediation is an important component of economic growth.² Recently, the European Commission incorporated this idea into policy measures to foster European financial market integration.³ Moreover, a sound institutional and legal infrastructure is an important precondition for stability and proper functioning of financial systems.⁴ These ideas are further elaborated in this article by describing the development of the Czech financial system and by presenting the principal elements of financial services legislation and proposals for its improvement.

Credit institutions

The CR has a bank-based financial system (see Table 1). Currently the banking sector includes 24 private commercial banks (including six building savings banks), nine branches of foreign banks and two state controlled banks.⁵ The banking sector can rely upon a sound and effective payment system operated by the Czech National Bank (CNB).⁶ Foreign investors play a dominant role in the banking sector controlling 97 per cent of the sector’s assets. In addition to the banking sector, there is a very small group of credit unions, which are credit institutions according to European law.⁷
Table 2 demonstrates that bank-based financial groups are also significantly involved in non-banking financial activities. However, they do not have any major ownership or controlling interests in the real economy. Despite huge inflows of foreign direct investment, considerable volume in commercial loans, a growing corporate bond market and increasing leasing operations, bank loans still play a dominant role in channelling savings into investment. In the 1990s, the Czech economy saw a chronic crisis of credit. This, however, was overcome by:

- more stringent regulation
- bailing out and privatising the three largest banks
- healthy credit expansion, driven by household loans.

Since 2002 total loans to households have more than doubled and mortgage loans nearly tripled. Furthermore, in 2004 lending to the business sector recovered (see Table 3).

Two positive effects of this trend are worth mentioning:

- Bank loans have significantly contributed to the growth of housing construction.
- The composition of the banking sector’s loan portfolio has evolved to a shape similar to loan portfolios in developed countries.

### Table 1: Size and structure of the financial system in the Czech Republic

<table>
<thead>
<tr>
<th>Financial institution</th>
<th>Financial sector assets as a percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2001</td>
</tr>
<tr>
<td>Banks</td>
<td>108.0</td>
</tr>
<tr>
<td>Credit unions</td>
<td>0.1</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>8.8</td>
</tr>
<tr>
<td>Investment companies and investment funds</td>
<td>3.8</td>
</tr>
<tr>
<td>Pension funds</td>
<td>2.4</td>
</tr>
<tr>
<td>Financial leasing institutions</td>
<td>7.6</td>
</tr>
<tr>
<td>Other financial non-bank institutions</td>
<td>8.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial institution</th>
<th>Share of financial sector assets (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2001</td>
</tr>
<tr>
<td>Banks</td>
<td>77.5</td>
</tr>
<tr>
<td>Credit unions</td>
<td>0.1</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>6.3</td>
</tr>
<tr>
<td>Investment companies and investment funds</td>
<td>2.8</td>
</tr>
<tr>
<td>Pension funds</td>
<td>1.7</td>
</tr>
<tr>
<td>Financial leasing institutions</td>
<td>5.5</td>
</tr>
<tr>
<td>Other financial non-bank institutions</td>
<td>6.1</td>
</tr>
</tbody>
</table>

Source: Czech National Bank

### Table 2: Role of banking financial groups

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets of banking financial group as percentage of total assets in the financial system</td>
<td>68.22</td>
<td>58.76</td>
<td>58.94</td>
<td>59.23</td>
</tr>
<tr>
<td>Assets of the four largest financial groups</td>
<td>62.01</td>
<td>52.66</td>
<td>52.28</td>
<td>51.44</td>
</tr>
<tr>
<td>Share of remaining assets in the financial system</td>
<td>31.78</td>
<td>41.24</td>
<td>41.06</td>
<td>40.77</td>
</tr>
<tr>
<td>Total assets in the financial system</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Czech National Bank
**Capital market and collective investment**

The capital market in the Czech Republic was established by an administrative decision. The pioneer coupon privatisation was followed by several scandals and a crisis in the mid-1990s that undermined trust in the market as a whole. In response to this, certain measures were taken including the establishment of the Czech Securities Commission (the CzSEC) and more effective enforcement. Only in 2001 were complex standard rules for the capital market introduced that were compliant with *acquis communautaire*.

Two regulated markets represent the capital market in the Czech Republic, the Prague Stock Exchange and the RM-System (see Table 4). The over-the-counter (OTC) market, a bond market, is also relatively well developed. A major feature of the capital market infrastructure is the existence of the Securities Centre (SCP), where most of the securities are originally registered in electronic form.

Seventy years ago, as a reaction to a series of delistings from the public markets, takeovers and squeeze-outs, and to the high fees charged by the Securities Centre, a significant ‘re-materialisation’ of securities started.

Currently, there are 54 domestic investment firms, 16 are banks and 10 are members of a bank or insurance group. The current number is the result of consolidation in the sector over past years. This process was accompanied by the default of several small to medium-sized firms which affected the number of clients.

There has been a dramatic increase in the number of EU-passported investment firms (241 at present) since EU accession, but only a few actually provide investment services in the Czech Republic. There is also the category of “registered investment intermediaries” (tied agents) consisting mainly of natural persons (see Table 5). In addition, there are trends such as internet brokerage services, which provide complex investment programmes to customers.

### Table 3: Structure of bank loans portfolio

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans to business</td>
<td>15.2</td>
<td>14.2</td>
<td>13.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Loans to households</td>
<td>4.3</td>
<td>5.9</td>
<td>7.5</td>
<td>9.9</td>
</tr>
<tr>
<td>of which are mortgage loans</td>
<td>2.4</td>
<td>3.6</td>
<td>4.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Total loans</td>
<td>19.4</td>
<td>20.1</td>
<td>21.0</td>
<td>24.3</td>
</tr>
</tbody>
</table>

Source: Czech National Bank

### Table 4: Securities market

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of listed securities issues</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>423</td>
<td>240</td>
<td>164</td>
<td>120</td>
</tr>
<tr>
<td>Bonds</td>
<td>92</td>
<td>81</td>
<td>90</td>
<td>82</td>
</tr>
<tr>
<td>Number of securities issues registered with SCP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>2703</td>
<td>2375</td>
<td>2098</td>
<td>1867</td>
</tr>
<tr>
<td>Bonds</td>
<td>129</td>
<td>129</td>
<td>159</td>
<td>151</td>
</tr>
<tr>
<td>Market capitalisation (€ billion)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>9.9</td>
<td>15.5</td>
<td>20.2</td>
<td>30.6</td>
</tr>
<tr>
<td>Bonds</td>
<td>9.3</td>
<td>12.1</td>
<td>15.9</td>
<td>18.1</td>
</tr>
<tr>
<td>Trade volumes – regulated markets (€ billion)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>3.5</td>
<td>5.2</td>
<td>6.2</td>
<td>10.6</td>
</tr>
<tr>
<td>Bonds</td>
<td>31.0</td>
<td>43.7</td>
<td>34.1</td>
<td>21.2</td>
</tr>
<tr>
<td>Trade volumes – OTC market (€ billion)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>5.9</td>
<td>5.4</td>
<td>6.6</td>
<td>7.4</td>
</tr>
<tr>
<td>Bonds</td>
<td>41.4</td>
<td>14.6</td>
<td>7.5</td>
<td>9.2</td>
</tr>
</tbody>
</table>

Source: Czech Securities Commission

### Table 5: Investment firms sector

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment firms</td>
<td>97</td>
<td>81</td>
<td>71</td>
<td>58</td>
</tr>
<tr>
<td>Registered intermediaries</td>
<td>33</td>
<td>66</td>
<td>3055</td>
<td>5719</td>
</tr>
<tr>
<td>Passported investment firms</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>133</td>
</tr>
<tr>
<td>Assets under management (€ billion)</td>
<td>na</td>
<td>11.7</td>
<td>21.2</td>
<td>18.0</td>
</tr>
<tr>
<td>Trade volume (€ billion)</td>
<td>na</td>
<td>66.7</td>
<td>222.9</td>
<td>171.4</td>
</tr>
</tbody>
</table>

Source: Czech Securities Commission.
Due to the still very conservative structure of household savings, the market for investment services is relatively small and competition with other “financial products” such as bank deposits, insurance and pension funds is significant. It is also worth mentioning that bank-owned investment firms are tending to compete more actively for business than in previous years.

After overcoming a substantial crisis in the mid-1990s, the collective investment sector has been considered stable in recent years. Interestingly, assets under the management of domestic funds did not decrease after the sector was opened to foreign funds in 2001. As a whole the sector has shown steady growth, regaining the trust of the investing public.

Challenges in asset evaluation and cases of asset stripping have led to the amendment of the Act on Investment Companies and Investment Funds approved in 1998. This act provided for the transformation of all closed-ended unit trusts into open-ended form by 2002.

Since EU accession there has been no dramatic acceleration in the number of foreign collective investment undertakings present in the Czech Republic (see Table 6). Most of the domestic asset management companies belong to major banking groups. Currently, only funds compliant with the Undertakings for the Collective Investment of Transferable Securities (UCITS) exist in the Czech Republic, although the legislation would allow for non-UCITS funds.

### Insurance and pension funds sectors

The monopoly of the Czech State Insurance Company was abolished in 1992. Since then a number of insurance companies have been licensed. The market, however, is still dominated by the formerly state-owned insurer Česká pojišťovna which had a 36.7 per cent share in the market in terms of premiums written in 2004. The only state-owned insurance company left is the export-credit insurer Export Guarantee and Insurance Corporation (EGAP).

The regulatory function was created in 1993 within the Ministry of Finance (MoF). In 1994 its activities were extended to the newly established pension funds sector where it acts in concert with the Ministry of Labour and Social Affairs. Since 2000 the Office of the State Supervision in Insurance and Pension Funds has carried out regulatory activities. Currently, there are 34 licensed domestic insurance companies, of which 16 are non-life, two life and 16 composite.

Since EU accession, 276 EU insurance companies have passported and another 10 EU companies have established branches in the Czech Republic. Foreign shareholders have dominant or full ownership of 20 domestic insurance companies. At present one domestic insurance group and 17 foreign insurance groups are operating in the Czech Republic.

The insurance market is highly concentrated, the top five insurers having an 85.7 per cent share and the top ten insurers covering 96.3 per cent of the insurance market. Over half of the market, 57.9 per cent, is controlled by only two insurance companies. The main stimuli for the domestic insurance market were the re-rating of de-monopolised motor third party liability in 2000 and a radical re-rating of the property account following the August 2002 floods.

Development of the non-life insurance segment is similar to the ‘old’ EU countries, while the life assurance segment is set to grow significantly. The

### Table 6: Collective investment sector

<table>
<thead>
<tr>
<th>Asset management companies</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>65</td>
<td>60</td>
<td>54</td>
<td>47</td>
</tr>
<tr>
<td>In liquidation</td>
<td>41</td>
<td>41</td>
<td>39</td>
<td>38</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Open-ended unit trusts</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>88</td>
<td>92</td>
<td>66</td>
<td>62</td>
</tr>
<tr>
<td>Assets under management (£ billion)</td>
<td>2.0</td>
<td>3.5</td>
<td>3.4</td>
<td>3.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Closed-ended unit trusts</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment funds</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>74</td>
<td>63</td>
<td>52</td>
<td>46</td>
</tr>
<tr>
<td>In liquidation</td>
<td>54</td>
<td>55</td>
<td>48</td>
<td>44</td>
</tr>
<tr>
<td>Assets under management (£ billion)</td>
<td>na</td>
<td>na</td>
<td>0.07</td>
<td>0.07</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Foreign collective investment funds</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>209</td>
<td>651</td>
<td>723</td>
<td>911</td>
</tr>
<tr>
<td>Assets under management (£ billion)</td>
<td>na</td>
<td>1.2</td>
<td>1.6</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Source: Czech Securities Commission
life assurance segment in the Czech Republic is 39.3 per cent in terms of total premium written, compared to 60 per cent in the 'old' EU. Additional data on the insurance market are provided in Table 7.19

There are 11 authorised pension funds in the Czech Republic. The number of pension funds has decreased over the years mainly due to mergers and acquisitions.21 Domestic shareholders owned eight pension funds, while foreign shareholders had qualifying holdings in three. Domestic banks fully own four pension funds while domestic insurance companies were majority owners of two funds. Other domestic shareholders owned a further two. The pension funds sector has also been growing steadily thanks to state contributions to participants and tax relief.

There is significant concentration in the pension funds sector. The market share of the five biggest pension funds increased to 83.12 per cent at the end of 2004, up from 75.58 per cent in 2001. EU entry has also offered an opportunity for EU residents to become participants in Czech pension funds.22

Financial services legislation

Credit institutions

Regulation relating to credit institutions is contained in the Act on Banks, the Act on Building Savings and the Act on Cooperative Banks.23 There is no special mortgage act and the terms of mortgage loans and the conditions for issuing mortgage bonds are stipulated in the Act on Bonds.24 Financing of mortgage loans is arranged by an issue of mortgage bonds.25 The issuer must be a bank incorporated in the Czech Republic and licensed under the Act on Banks. Neither branches of foreign banks nor cooperative banks are authorised to issue mortgage bonds.

The Act on Banks was adopted in 1992 stipulating the basic terms for the licensing of banks, their obligations, regulation and supervision. It also endows the CNB, as the banking regulator, with the power to issue detailed decrees or provisions. There have been three major amendments to the Act so far. In 1994 the deposit insurance scheme was introduced.26 A second amendment on economic distress adopted in 1998 strengthened the prudential requirements on banks and partially implemented the EU regulations on credit institutions. The third major 'harmonisation amendment' implemented the regulations set forth by the Codified Banking Directive 2000/12/EC.27 It introduced “single EU passport” provision, provided for enhanced cooperation with foreign supervisors, and set detailed rules concerning corporate governance, risk management and the capital adequacy on a consolidated basis. The harmonisation of banking legislation with the respective EU rules was finalised in 2002.

Building savings banks were introduced in 1993 following similar schemes in Germany and Austria. Since then, six building savings banks have been established. They are licensed and supervised according to the Act on Banks, but their range of activities is limited to ensure the safety of clients’ deposits and state contribution.28 Among other activities the Act on Building Savings requires these banks to keep fixed interest rates both on deposits and on loans, determines the maximal spread between the deposit and loan interest rates and limits purposes for which credits can be granted.

The credit unions sector was established in the mid-1990s with great ambition but weak regulation and supervision. The result was a wave of bankruptcies between 1997 and 1999 that necessitated the introduction of stricter regulation and the establishment of a specialised supervisory agency. Currently, there are 20 cooperative banks that have fulfilled the initial capital condition of €1 million. They are regulated by the same regime as credit institutions. However, detailed regulation covering credit and market risks has not yet been approved.

Capital market and collective investment

During coupon privatisation (1992), four major pieces of legislation for the capital market were issued:

- the Securities Act
- the Act on Bonds

<table>
<thead>
<tr>
<th>Table 7: Insurance sector</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of domestic insurance companies</td>
<td>35</td>
<td>35</td>
<td>34</td>
<td>33</td>
</tr>
<tr>
<td>Branches of foreign insurance companies</td>
<td>8</td>
<td>7</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Gross premium written (€ billion)</td>
<td>2.4</td>
<td>3.0</td>
<td>3.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Of which non-life insurance (per cent)</td>
<td>64.9</td>
<td>62.5</td>
<td>61.2</td>
<td>60.7</td>
</tr>
<tr>
<td>Premium written/GDP (per cent)</td>
<td>3.7</td>
<td>3.8</td>
<td>4.2</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance – Office
the Securities Exchange Act
- the Act on Investment Companies and Investment Funds.29

These acts have undergone more than ten serious amendments reflecting the development of the market, the impact of various financial scandals, the need for more standardised rules and pre-accession harmonisation. Major amendments were approved in 1998 together with the establishment of the CzSEC. In 2001 the so-called “harmonisation” amendments introduced the concept of EU passport, UCITS funds, the concept of investment services and instruments and the investor compensation scheme.

The drafting of major new acts was initiated in 2001 to reflect the consolidated state of the capital market. Unfortunately, these did not accurately reflect the process and time schedule of the EU FSAP. In spring 2004 the Act on Business Activities on the Capital Market (ABACM), the Act on Collective Investment (ACI) and the new Act on Bonds were approved.30 These were accompanied by the issue of more than 25 specific decrees by the CzSEC.31

In contrast to previous laws that had combined civil and administrative provisions, the new laws were designed as public and administrative laws. A significant change was the new concept of administrative sanctioning and supervision on a consolidated basis. The ABACM provides for a new securities depository concept to replace the Securities Centre and also includes provisions introducing netting to the Czech Republic's legal system.32

In addition, the ACI has widened the scope of recognised collective investment funds by introducing the category of so-called “special funds” which are non-UCITS funds. The ACI has also overcome the previously cautious approach to the use of derivatives by domestic collective investment funds that had been much stricter than the UCITS rules.

**Insurance and pension funds sector**

Major legislative work was undertaken in 2004 to make the Czech insurance law broadly compliant with EU insurance directives.33 Both the Insurance Act and the Act on Pension Funds were substantively amended. Moreover, the Insurance Contracts Act, the Act on Insurance Intermediaries and Independent Loss Adjusters and the Motor Third Party Liability Amendment Act were adopted. The CR has thus implemented:

- the EU “freedom of services” provisions
- the EU “freedom of establishment” provisions
- the Solvency I Directive
- the Fourth Motor Directive
- the Insurance Mediation Directives.

**Changes in the pipeline and improvements ahead**

**Credit Institutions**

The amendment to the Act on Banks, fully implementing Directive 2001/24/EC on the reorganisation and winding up of banks and Directive 2002/47/EC on financial collateral arrangement, is to be approved by the Parliament in autumn 2005. This rather complex amendment will also affect the Act on Bankruptcy and Settlement and the Commercial Code. It will strengthen the position of banks when evaluating, hedging and managing credit risk.

Implementation of the Basel II rules is of particular concern. The CNB launched an implementation project in cooperation with the whole banking sector in 2001 to consult all provisions and choices in national discretions under Basel II.34 The CzSEC is also involved in the project while the Capital Adequacy Directive II (CAD II) is laying down rules for investment firms.

There are two significant changes relating to the cooperative banks sector: first, supervision of this sector by the CNB and secondly, the implementation of the simplified Basel II rules.35 There are certain drawbacks to improving credit channelling. Administrative and legislative inefficiencies which limit the banks’ incentives for lending to small and medium-sized enterprises include slow processing of records by the company register (the Commercial Register),36 protracted procedures by the real estate register to record mortgages entries, and lengthy court proceedings.37

**Table 8: Pension funds sector**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of pension funds</td>
<td>14</td>
<td>13</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Number of participants (million)</td>
<td>2.5</td>
<td>2.6</td>
<td>2.7</td>
<td>2.9</td>
</tr>
<tr>
<td>Assets under management (€ billion)</td>
<td>1.6</td>
<td>2.2</td>
<td>2.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Annual payments in (€ billion)</td>
<td>1.4</td>
<td>1.9</td>
<td>2.2</td>
<td>2.7</td>
</tr>
</tbody>
</table>


Note: The 2004 data are preliminary.
Recently, an amendment to enhance the functioning of the company register was passed and some procedural improvements have been implemented. Among the most serious legal weaknesses that have received criticism from both the OECD and the World Bank is the enormously slow and ineffective bankruptcy and composition proceeding legislature. Moreover, concerns regarding the fairness of the court process, with the respective judges favouring debtors, have arisen. There are some inappropriate restrictions for secured creditors as well. Bankruptcy provisions and the method of handling procedures by courts also present a challenge to the proper functioning of the Investors’ Compensation Scheme.

There have been several attempts to improve the situation, but political support has been limited. The amendment harmonising the bankruptcy law with EU legislation is in the process of being adopted, but a complex proposal is still under discussion. The bill transposing Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate has been approved by the Parliament. It should provide regulators with adequate tools to obtain complex data on financial conglomerates active in the Czech Republic and help regulators monitor their financial stability and prudent behaviour. Close cooperation and data exchange among the CNB, the CzSEC and the MoF is envisaged.

**Capital market and collective investment**

Full transposition of the Prospectus Directive is currently being approved by Parliament, accompanied by initiatives of the ABACM and the ACI. The MoF has announced its intention to start drafting a bill transposing Directive 2004/39 (MiFID) during autumn 2005. In the area of market abuse, the Czech Republic is finalising draft regulation on the fair presentation of investment recommendations and is fine-tuning the legislative tools to enhance market abuse investigation.

The new ABACM provides for a novel dematerialised securities registrar in the Czech Republic, the Central Securities Depository (CSD). Unfortunately, due to significant loopholes in the law, some amendments to the ABACM are necessary. It is expected that the CSD will be licensed to operate by the end of 2005. A related project creating a centralised capital market information board providing services to securities issuers, market participants and investors (such as regulatory data reporting, regular and ad hoc issuers publicity, trade reporting and disclosure) should be launched by September 2005.

**Insurance and pension funds sectors**

Current challenges to the Czech insurance market are the enhancement of the risk management practice and the new approach to the calculation of solvency requirements. Another important task is the implementation of the international accounting standards (in particular IFRS 4).

At present a bill transposing the reorganisation and winding-up of insurance undertakings, Directive 2001/17, is under preparation and expected to be approved by the spring of 2006. A draft bill transposing Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision is submitted for governmental approval and should be in force by the spring of 2006.

**Financial market regulation reform**

The MoF, together with the CNB, announced in July 2004 its intention to reform the institutional structure of regulation in the Czech financial market. This will be done by establishing a single regulatory authority for the whole financial market within the CNB structure. This ambitious process should replace the previous decision of ‘two-step’ integration and changes should be effective by the spring of 2006.

The MoF has also revealed a plan to enhance the legislative framework for the whole financial market by creating a single financial market regulation and supervision act. Customer protection on the financial market should be fostered by the creation of a financial market ombudsman by 2008.

**Conclusions**

In May 2004 the Czech Republic joined the EU. Banks and other financial market participants are now operating in a standard legal environment compatible with the acquis communautaire. Nevertheless, some administrative shortcomings and inefficiencies in the law impeding prompt and effective law enforcement still persist: the issue of the commercial register and the real estate register, as well as lengthy court proceedings and inefficient bankruptcy proceedings.

The full implementation of the FSAP, together with the authorisation and operation of an effective securities depository, is of paramount importance. Enhanced collective investment laws together with a favourable tax regime may be an opportunity for the establishment of specialised types of collective investment funds, thus fostering competitiveness of domestic asset management companies. Proper transposition and effective and prudent implementation of the new EU capital adequacy and solvency rules, together with harmonisation of
accounting and financial reporting rules, are of particular concern for both the market and the regulators. Some of the financial market legislation inefficiencies should be addressed through regulatory reform. Nevertheless this may give rise to overly ambitious expectations. Effective legislative changes addressing the above-mentioned deficiencies should contribute to economic growth, job creation, and an increase in investment opportunities in the Czech Republic. It should also enhance the competitiveness of the Czech financial market. These challenges, together with the constantly evolving EU policies and acquis, represent the new ‘post EU’ accession transition challenge for the Czech Republic.

Notes
1. The banks IPB, ČSOB, Česká spořitelna and Komerční banka as well as the insurance company Česká pojišťovna were privatised in this process.
4. For the financial system of a country to be stable and efficient, three separate elements have to work well. First, the key institutional intermediaries (banks, securities issuers, insurance companies and fund managers) have to operate efficiently and their markets in which they transact (equity, fixed income, foreign exchange and commodities) have to be open and transparent. And third, the infrastructure within which financial transactions take place (ac-counting conventions, contract law, enforcement of property rights, bankruptcy arrangements, corporate governance, payment and settlements arrangements, etc.) has to be robust and well understood. See A. Crockett (2000), “Reforming the architecture of global economic institutions”, End-of-Programme Conference of the GEI Programme, London, www.bis.org.
5. The Czech Export Bank’s business profile corresponds with an EXIM bank. The Czech-Moravian Guarantee and Development Bank is entrusted with the mission to facilitate the implementation of the government’s nation-wide economic strategy. It is also responsible for facilitating the regional policy related to economic sectors which require the support of public finance.
6. The CNB Clearing Centre operates the CERTIS payment system (Czech Electronic Real Time Interbank Gross Settlement system), which is the only interbank payment system in the Czech Republic. Details and rules of its functioning can be found at www.cnbc.cz.
7. The definition of ‘credit institution’ laid down in the Consolidated Banking Directive implicitly includes credit unions (cooperative banks) as they receive deposits or other repayable funds from the public and grant credits for their own account. See Article 1(1) of Directive 2000/12/EC on the taking up and pursuit of the business of credit institutions.
8. The classical crisis of credit means a decline in payments on the debt to the banks. The scope of the crisis in the Czech Republic was considerable: for six years, from 1995 to the end of 2000, the share of arrears of the business of credit institutions in the aggregate portfolio of the Czech banking sector fluctuated around the 30 per cent level, and only thereafter did it begin to decrease, falling rapidly to below 5 per cent in 2005.
10. While the share of corporate loans in 2001 was nearly 80 per cent, in 2005 it fell below 60 per cent. This decrease was accompanied by a proportionate rise in household loans.
11. The OTC market is securities market made up of dealers who may or may not be members of a securities exchange. OTC firms conduct business over the telephone and act either as principals or dealers (buying and selling stock from their own inventory and charging a markup) or as a broker or agent and charging a commission.
12. Sídlištní cenný papíry (SCCP) was established as a crucial tool of the coupon privatisation. All securities issued subject to the coupon privatisation were held by SCCP in the form of electronic book entries.
13. Figures are as of 30 June 2005.
14. At the beginning of 1998 there were more than 400 authorised investment firms. This high number of licensed firms is due to an extremely liberal licensing policy, which may not have been activated during the post-coup privatisation era.
15. These entities are registered with the CSE&G and are authorised to provide investment services on behalf of investors for orders in relation to transferable securities and units of collective investment undertakings.
16. This includes in life some 37.2 per cent and in non-life insurance.
17. EGPB derived most of its income from government-guaranteed political risks coverage and commercial credit risk. Therefore it acts as a state-subsidised competitor to the private insurance sector. To remove this irregularity EGPB established a subsidiary in February 2005 to which its commercial business is to be transferred. After this transfer, the subsidiary is set to be privatised.
18. Figures are as of 30 June 2005.
19. In 1995 that figure stood at only 27.5 per cent.
20. The figure includes EU-based insurance companies with branches established in the Czech Republic.
21. The number of pension funds in 1996 was 44 compared to just 19 in 2000.
22. The number of participants was 1.031 in the second half of 2004. Of those, 97.3 per cent were residents from the Slovak Republic.
23. Act No. 21/1992 Coll., on Banks, as amended, governs the activities of the universal commercial banks, foreign bank branches and in general the activities of building savings banks. Act No. 96/1993 Coll., on Building Savings, as amended, governs the granting of state subsidy to the building savings organised by the building societies. Act No. 87/1995 Coll., on Cooperative Banks, as amended, governs the activities of cooperative banks (they are not considered to be banks under the Act on Banks).
25. According to the Act on Bonds a mortgage loan is any loan which is collateralised by a mortgage on real estate situated in the territory of the Czech Republic or of any member state of the EU or the EEA.
26. According to the Directive 93/18/EEC.
27. The harmonisation amendment came into force on 1 May 2002, with the exception of some articles that came into effect upon joining the EU (1 May 2004).
28. Depositors fulfilling certain conditions receive a state contribution.
31. All capital market legislation in 1992 consisted of less than 60 pages of text of the Legislative Collection (there were no decrees) compared to more than 400 pages in 2005.
34. Phare-sponsored technical assistance to the CNB was launched in spring 2005 and focuses on drafting and practical implementation of CAD II.
35. The scope and form of the implementation of Basel II rules for cooperative banks depends on exceptions for this type of credit institutions, which can be found at www.cnb.cz.
36. In some cases, the record in the company register is of a constitutive nature and may cause uncertainty about the company’s statutory body and its members, its registered office, its initial capital and other company data necessary for the assessment of the company’s creditworthiness.
37. Court procedures often last several years and the appeal courts tend to decide on the legal issues, but not on the core of the matter.
39. Another issue of concern is that the secured bankrupt’s creditor (mostly a bank) is allowed to receive only 70 per cent from the collateral selling price, the other 30 per cent is included in the bankrupt’s estate to cover the unsecured creditors.
40. Garančí fond obchodníků s cennými papíry.
41. This project is financed by Phare 2002 facilities.
42. The Solvency II Directive should be adopted in 2007.
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Kazakhstan takes further steps to improve regulation of its financial markets

A number of new legislative acts relating to financial markets have been adopted in Kazakhstan over the past years. It is hoped that these laws will mark the beginning of a new stage of development, which will see greater credit resources and investment opportunities available to the general public and small businesses, as well as the expansion of the financial markets due to new inflows of foreign capital.

On 4 July 2003 the President of Kazakhstan signed a new benchmark Law on State Regulation and Supervision of the Financial Market and Financial Institutions. It became effective in January 2004 and was amended in June that year (the Regulation and Supervision Law). This law significantly changed the system of state regulation and supervision in the country’s financial sector by reorganising the National Bank and establishing an Agency for Regulation and Supervision of the Financial Market and Financial Institutions (the Agency). Numerous amendments to various laws governing Kazakhstani financial markets and institutions were also introduced to establish a unified system of state control and to help improve state regulation (which also became effective at that time).

On 6 July 2004 a number of new laws were signed that established the legal grounds for increasing the role of investment funds as institutional investors in the real economy and created credit bureaux responsible for the formation and maintenance of credit histories. These laws were designed to further stimulate the development of the banking sector. Namely, these laws were the:

- Law on Investment Funds (the Investment Funds Law)
- Law on Credit Bureaux and the Formation of Credit Histories in Kazakhstan (the Credit Bureaux Law)
- Law on Amending Certain Legislative Acts in Kazakhstan Concerning the Operation of Credit Bureaux and the Formation of Credit Histories (the Amendments Law).

The Concept of Development of the Financial Sector in Kazakhstan, approved by the government on 28 July 2003, provides for both the creation of credit bureaux and the development of investment funds (“the Concept”). Pursuant to the Concept, the aim of credit bureaux is to create conditions for financial institutions engaged in lending (i.e., banks, loan partnerships, pawn-shops, etc.) to exchange information on the solvency of borrowers on a permanent basis. Under the Concept, the creation of credit bureaux will improve the quality of banking services, enhance customers’ confidence in banks and other financial institutions, protect the interest of borrowers and lenders, and reduce risks in the loan facilities market.

With regards investment funds, the Concept focuses on the development of home institutional investors, rather than investment funds. The major objective of the reform implemented by the Investment Funds Law is “to develop and implement the potential of home institutional investors as key subjects of mobilisation and redistribution of free resources to the real sector of the economy”.

Furthermore, on 13 June 2005 a new Law on Foreign Exchange Regulation and Control (the Foreign Exchange Law) was signed. This law had been adopted from the Exchange Regulations Liberalisation Programme 2005-07, approved by the government on 25 June
2004. The law is aimed at liberalising the Kazakhstani foreign exchange market and relaxing foreign exchange regulation and control. The Foreign Exchange Law shall be effective as of 1 January 2007.

**Regulation and Supervision Law**

As set out in the Regulation and Supervision Law, the Agency performs major state control and supervisory functions in relation to banks, insurance companies, pension and investment funds, and the securities market. The Regulation and Supervision Law provides that the Agency is responsible for monitoring the financial market and financial organisations, protecting the rights of financial market participants, and promoting fair competition on the financial market. The Agency is also in charge of improving the standards and methods of regulation and setting up standards and requirements for the operation of financial institutions. The Agency is not a part of the government, but reports directly to the President of Kazakhstan.

In order to achieve these purposes, the Agency is vested by the Regulation and Supervision Law with vast functions and authorities. Most of these were previously held by the National Bank and include:

- issue and termination of licenses to banks, insurance companies, pension and investment funds, securities brokers, registrars, asset managers, custodian, etc.
- set up of prudential standards and other norms and limits, including capital requirements
- establishment of procedures and rules for activities and operations of financial institutions
- registration of issues of securities
- establishment of procedures for the issue, trading, circulation and redemption of securities
- regulation of the stock exchange.

It should also be noted that the Regulation and Supervision Law introduced the concept of anti-monopoly regulation in the financial markets. The Agency for the Regulation of Natural Monopolies, Protection of Competition and Support of Small Business was established and is authorised to enforce anti-monopoly regulation within the financial markets.

**Credit Bureaux Law**

The Credit Bureaux Law defines credit bureaux as commercial entities for two types of groups: individuals and legal entities. The Credit Bureaux Law provides that operations of credit bureaux are subject to licensing. The Agency is designated as a licensor. The Credit Bureaux Law defines, amongst others, consent of the person who is the subject of a credit history (the borrower), the confidentiality of information contained in the credit history and the proper use of this information in forming a credit history. All of these elements are essential for improving lending relations in Kazakhstan.

With regards the consent of the borrower, this is required for the submission of information on the borrower to the credit bureau, and for obtaining a credit report on the borrower by the receiver concerned. While the Credit Bureaux Law defines the granting of consent by the borrower for filing information with the credit bureaux, the Amendments Law makes it a requirement within banking legislation for consent to be granted in writing when entering into a loan agreement. Under the Credit Bureaux Law, banks and institutions engaged in individual banking operations (banking institutions), and entrepreneurs and businesses selling goods and services on credit or deferred payment, are obligated to present information on the credit history of entities to credit bureaux. As a result, the newly adopted laws will ensure a guaranteed flow of credit information from the borrower to the banking institutions and from the banking institutions to credit bureaux, making it possible to form credit histories immediately after the enactment of the new laws.

As for the suppliers of information, apart from the banking institutions, the Credit Bureaux Law defines these as individual entrepreneurs and legal entities selling goods and providing services on credit or providing deferral of payments, whose characteristics shall be defined by the government’s Resolution. Unlike banking institutions and legal entities that sell goods and services on credit, state entities engaged in registration of titles to real estate and transactions therewith are not obligated to provide information on credit histories. Instead, they provide such information on the terms and conditions defined by the Ministry of Justice.

**New Investment Funds Law**

The newly adopted Investment Funds Law has replaced the 1997 Investment Funds Law (the 1997 law), which failed to produce the expected results in the securities market. The new Investment Funds Law regulates investment funds only and does not cover asset management relations in the case of managers other than trust companies. Also the new Investment Fund Law is not applicable to the Kazakhstan Investment Fund, which was founded by the government to implement state policy on support of domestic producers and to carry out state investment in innovative technologies.

The new law describes a multitude of investment fund types and provides a more comprehensive regulation of their formation and operation. For instance, instead of a mutual fund and investment company, which were provided for by the 1997 law, the new law provides for a joint-stock fund and a unit investment fund. The unit
investment fund may be established in the following forms: open, interval, and closed. The main differences between the joint-stock fund and the unit investment fund, and the open, interval and closed unit funds are mostly in the right of security holders (holders of stock or unit, respectively). These security holders have the right to ask that their stock or unit be bought out by the investment fund or the management company.

It should be noted that the unit fund is not a legal entity and constitutes nothing but an aggregate of monetary and other assets resulting from investment. A unit fund is co-owned by unit holders and managed by a management company. A risk investment fund is a distinct category, which can exist only as a joint-stock investment fund or a closed investment fund. Less rigid requirements are applied to the risk investment fund in terms of asset management. At the same time the shares and units of risk investment funds may not be traded on organised securities market (for example, the Kazakhstan Stock Exchange, which is a self-regulated organisation).

The Investment Funds Law specifies the composition and value of assets in investment funds. Notably, investments outside Kazakhstan may be included into the investment fund assets on the conditions and according to the procedure determined by the Agency.

Under the Investment Funds Law, the assets of investment funds are managed differently in joint-stock funds and unit funds. For instance, in joint-stock funds assets are managed by a management company or by the fund itself. Meanwhile, in a unit fund (which is not a legal entity) the assets can be managed by a management company only. For a joint-stock fund to manage its assets it should have a license, granted at the same time as the state registration of the investment fund share issue.

The law also describes in detail disclosure of information on an investment fund, which ensures non-professional investors can make informed investment decisions. It is noteworthy that the Investment Funds Law generally does not impose restraints on the ability of foreign companies or individuals to act as founders of investment funds in Kazakhstan. The only limitation is that offshore (tax haven) registered companies listed by the Agency are not eligible to become shareholders of the investment funds. Prior to the adoption of the new Foreign Exchange Law, Kazakhstani foreign exchange regulations required certain types of foreign exchange transactions to be licensed. The new Foreign Exchange Law has shortened the list of foreign exchange transactions to be licensed, thereby fostering the full liberalisation of the Kazakhstani foreign exchange market. The new law also provides that licensing of foreign exchange transactions shall be a ‘temporary’ regime to be in existence until 31 December 2006, following which the temporary provisions of the Law shall become ineffective.

Accordingly, prior to the adoption of the new law certain types of foreign exchange transactions were to be registered. With the adoption of the new Foreign Exchange Law, however, the list of such transactions subject to registration has changed. In particular, some types of foreign exchange transactions that previously had to be licensed now will have to be only registered. This will make conducting foreign exchange transactions much easier and less bureaucratic as registration of a foreign currency transaction does not require the consent of the National Bank, as is the case with licensing a transactions.

The law introduced a new form of foreign exchange regulation, a notification of a foreign exchange transaction to an authorised agency (i.e., the National Bank). This notification is used for certain foreign exchange transactions - for example, transactions between residents and non-residents involving investment in derivatives - some of which were to be licensed or registered before the adoption of the law. The introduction of the notification regime is also another step forward in liberalising the Kazakhstani foreign currency legislation. The National Bank of Kazakhstan will now be notified of a particular foreign exchange transaction after parties to a particular transaction have been involved, as opposed to the transactions having to be licensed or registered and can only be conducted after a license or certificate of registration has been issued.

Also as a result of liberalisation of the currency legislation following the adoption of the law, direct investments3 made by residents outside of Kazakhstan shall be registered, while now such direct investments are subject to licensing.

Under the current Foreign Exchange Law any loans (including credits, financial aid), extended by residents to non-residents for over 180 days shall be licensed (except where the same are extended by resident banks to non-residents). Following the adoption the Foreign Exchange Law any loans extended by residents to non-residents in monetary form shall be registered. The Foreign Exchange Law, however, makes no exceptions for the registration of resident banks extending loans to non-residents, which worsens the position of banks...
as compared to the current Foreign Exchange Law. (It seems likely that exceptions will be made for banks in a specific regulation of the National Bank of Kazakhstan.)

Loans extended by non-residents to residents for over 180 days shall be registered as before. In likelihood, the amount of loans extended without registration with the National Bank will be established by a specific regulation set by the National Bank of Kazakhstan. (Currently, loans extended for the amount less than US$ 100,000 are not subject to registration.)

Finally, the Foreign Exchange Law lifts restrictions for the export of foreign currency in cash from Kazakhstan. For an individual, whether resident or non-resident, to take in excess of US$ 10,000 of foreign currency out of Kazakhstan they are required to present to Kazakhstani customs authorities a document proving its legitimate origin. The list of such documents is to be defined by the National Bank of Kazakhstan. Currently, the export of foreign currency in cash is restricted by the amount equivalent to US$ 10,000 for resident individuals and US$ 3,000 for non-resident individuals.

End notes
1. These forms are comparable to the US forms of investment companies, i.e. a joint-stock investment fund and closed unit investment fund are similar to the closed-end fund. The securities (shares and units, respectively) in this type of fund are not generally redeemable and trade on a secondary market. An open unit investment fund is similar to a unit investment trust (UIT) in that its securities (units) are redeemable and trade on a secondary market. An interval unit investment fund is similar to an interval fund, which is a type of a closed-end fund, in that its securities (units) are redeemable at specified intervals.

2. Pursuant to the Investment Funds Law, a unit is recognised now as a registered, issued security in a paperless form. Therefore, unit is a novel type of legally recognised security in Kazakhstan.

3. Direct investments refer to investments in money, securities, intellectual property rights, or other property assets in payment for shares (participatory interest) in a company. As a result of the investment, the investor becomes the owner of ten or more per cent of voting shares (ten or more per cent of votes of the total votes of shareholders) in the said company.
This paper examines the history, current status and likely future development of Russian banking legislation. It outlines the key laws regulating banking activities in Russia and sets out the opinion of the Bank of Russia and the government on the main tasks that need to be accomplished in the area of banking legislation.

The history of banking legislation in Russia

Russia’s modern banking system, like the banking systems of most of the transition countries, is relatively young. It came into force on December 1990, when the Supreme Soviet of the Russian Soviet Federal Socialist Republic (RSFSR), the then Russian parliament, adopted the laws on the Central Bank of the RSFSR (Bank of Russia) and on banks and banking in the RSFSR. Over the past 15 years, both the banking system and banking legislation have evolved through several stages.

The first stage was the period of rapid growth under the conditions of quasi-liberal regulation. This resulted in the adoption of the new versions of the laws on the Bank of Russia in 1995 and on banks and banking in 1996. A number of other laws also vital for the functioning of the banking system were adopted during this period, including the Civil Code (Part One) in 1995 and the Law on the Securities Market in 1996. In 1992, the Law on Currency Regulation and Currency Control in the RSFSR, which was based on a rigid currency regulation model, was also adopted.

The next stage was the period of transition to new methods of banking regulation, based on the principles of the Basel Committee on Banking Supervision. At about this time, inconsistency of banking legislation reforms contributed to the 1998 banking crisis, which led to drastic measures aimed at tightening banking regulation. As a consequence, the Law on Insolvency (Bankruptcy) of Credit Organisations (1999, with subsequent amendments) was passed and a number of amendments to the laws on the Bank of Russia and on banks and banking were made.

By 2001, when the Russian banking system had stabilised, new banking legislation was primarily focused on increasing the efficiency of the banking business and on strengthening depositors’ trust in the banking system.

The following important laws were passed during this period: the Law on Currency Regulation and Currency Control, which was aimed at completely liberalising currency regulation by 2007; the Law on Insuring Natural Person’s Deposits made with Banks in Russia; the Laws on Mortgage and the Issue of Mortgage Securities; the Law on Credit Histories; and the Law on Counteracting Laundering of Illegal Proceeds and Financing Terrorism. In addition, bank bankruptcy legislation was subjected to a large-scale revision.

The current banking system

In accordance with Article 2 of the Law on Banks, the banking system of Russia consists of the Bank of Russia, credit organisations and the branches and representative offices of foreign banks. The Bank of Russia is the institution in charge of implementing both monetary and credit policy and banking supervision.

The Bank of Russia supervises activities carried out by credit organisations, which include banks and non-banking credit organisations (NCO). As of 1 January 2005, there were 1,299 credit organisations in Russia (1,249 banks and 50 non-banking credit organisations). The current
banking supervision policy results in the absence of foreign banks’ branches from the Russian banking system. However, the number of banks with foreign participation, and sometimes 100 per cent foreign capital, is significant amounting to 131 as of 1 January 2005.1

Sources of banking legislation

There are several levels of regulation on banking activities. The main principles are set out in the Constitution which was adopted in 1993. These include, in particular, the principle of referring banking regulation to the jurisdiction of Russia,2 the principle of the Bank of Russia’s independence and the basic framework for the formation of its management bodies, as well as some other principles (Article 71, paragraphs g and h; Article 74; Article 75; Article 83, paragraph d; Article 103, part 1, paragraph c; Article 104, part 3; Article 106, paragraph c; Article 114, part 1, paragraph b).

The legal opinions of the Constitutional Court are particularly important for applying the Constitution. They are recognised as “general legal representations (conclusions) of the Constitutional Court that result from the interpretation of the Constitution by the Constitutional Court and its comprehension of the constitutional sense of legislative and regulatory provisions within the jurisdiction of the Constitutional Court; they remove constitutional and legal uncertainties and provide a legal foundation for the final conclusions (rulings) of the Constitutional Court”.3

Legal opinions of the Constitutional Court are deemed to be legal sources. Legal principles that the Constitutional Court has formulated in some of its acts are significant for both the development of banking legislation and its enforcement. In particular, the Constitutional Court considered it necessary to strengthen the protection provided to an individual citizen-depositor, as the weaker party to a bank deposit contract. The Court also extended the principle of the Bank of Russia’s independence to the area of banking supervision, and determined the limits to the possible interference in banks’ activities on the part of the supervision authorities.

Federal laws, including the main ones mentioned above, are of critical importance for regulating banking activities.

In accordance with Article 2 of the Law on Banks, banking activity in Russia is also regulated by the Bank of Russia’s normative acts. Pursuant to Article 7 of the Law on the Bank of Russia, the Bank shall issue normative acts which are obligatory for the federal bodies of state power, the bodies of state power governing Russian subjects and local government bodies, as well as for all juridical and natural persons. These acts shall refer to issues on the Bank of Russia’s jurisdiction set out in the Law on the Bank of Russia and other laws, such as monetary and credit policy, banking supervision, settlements and currency regulation.

The main provisions of acts issued by the Basel Committee on Banking Supervision were implemented by means of the Bank of Russia’s normative acts.

The Law on the Bank of Russia

The current Law on the Bank of Russia was adopted in 2003. It amounts to the third significant revision of norms regulating activities carried out by the Central Bank of Russia. The law determines the Bank of Russia’s status, aims, functions and authorities.

In accordance with Article 75 of the Russian Constitution, the Law on the Bank of Russia determines that the Bank exercises its functions independently from other bodies of state power. The Bank of Russia’s independence is apparent in the following areas: financing (the Bank uses its own resources to finance its activities and is not funded from the budget); jurisdiction (issues referred to under the jurisdiction of the Bank are the issues of its exclusive jurisdiction by law); management (the principal management bodies include the Chairman of the Bank and the Board of Directors of the Bank of Russia, who are appointed by the State Duma); the special status of the Bank’s officers (Bank employees are not categorised as public servants and have a special pension provision system stipulated by law).

The Bank of Russia’s jurisdiction covers the issues of monetary and credit policy, banking regulation and supervision, and the functioning of Russia’s payment system. In accordance with Article 4 of the Law on the Bank of Russia, the main functions of the Bank are:

- to elaborate and carry out a single state monetary and credit policy, in conjunction with the government
- to have the monopoly on issuing money in cash and organising its circulation
- to supervise the activity of the credit organisations and banking groups, as well as to make decisions on the state registration of credit organisations, and the granting and revoking of credit organisations’ banking licences
- to exercise currency regulation and currency control.

The Bank of Russia is entitled to conduct transactions related to monetary and credit policy independently, to issue normative acts, and to license the activities of credit organisations and to ensure their compliance. Such specific areas of authority result from the Bank’s individual organisational and legal status, as determined by the Law on the Bank of Russia. The Bank of Russia does not fall under any organisational and legal form known to the Russian civil law. Furthermore, the property of the Bank, as federal property, is inviolable: in accordance with Article 2 of the Law on the Bank of Russia, the Bank exercises the powers to own, use and
dispose of the property of the Bank, including the Bank's gold and currency reserves. Any seizure of the indicated property without the Bank's consent is not permissible unless otherwise stipulated by federal legislation.

The Bank of Russia is governed by a number of bodies. In 2002, in accordance with the Law on the Bank of Russia, the management bodies were supplemented with the National Banking Board (NBB).

The NBB was conceived as an instrument to enhance the transparency of the Bank's activities. The Law on the Bank of Russia calls the NBB "a collegiate body of the Bank of Russia" (Article 12) and identifies it as a form of the Bank's accountability to the State Duma. NBB members are appointed by the State Duma, the Federation Council, the Russian President and the government. The Chairman of the Bank of Russia is an NBB member by virtue of his position.

The NBB makes decisions on a wide range of the Bank's activities, such as approving the total cost of the Bank's staff, the total volume of its capital investments and its total administrative and maintenance costs. The NBB also examines the implementation of the main areas of state monetary and credit policy, banking regulation and banking supervision, and the execution of the currency regulation and currency control policies (Article 13).

The Bank of Russia's Chairman and Board of Directors are the supreme governance bodies of the Bank. In accordance with Article 83 of the Constitution and Article 14 of the Law on the Bank of Russia, the Bank's Chairman is nominated by the Russian President and appointed by the State Duma. In accordance with Article 20 of the Law on the Bank of Russia, the Bank's Chairman shall:

- take full responsibility for the activities of the Bank of Russia
- ensure that the Bank fulfils its functions in compliance with this federal law, and take decisions on all issues assigned by federal laws to the competence of the Bank, except those on which decisions are taken under this federal law by the NBB or the Board of Directors
- chair the meetings of the Board of Directors
- sign Bank of Russia normative acts.

The Bank's Board of Directors consists of the Chairman and 12 full-time Board members. The Board of Directors has significant power in areas such as the Bank's inhouse activities, the development and implementation of a monetary and credit policy and banking supervision.

Article 56 of the Law on the Bank of Russia also defines the Banking Supervision Committee as a permanent body to implement the Bank of Russia's regulatory and supervisory functions.

The Bank of Russia's first key task is to implement a monetary and credit policy aimed at ensuring the stability of the rouble. The Bank develops this policy in accordance with the guidelines for the single state monetary and credit policy. These guidelines are developed on an annual basis and represent current year monetary policy targets.

In accordance with Article 45 of the Law on the Bank of Russia, guidelines for the single state monetary policy for the coming year cover: the underlying principles of the monetary and credit policy pursued by the Bank; a brief description of the state of the Russian economy; and a forecast for the expected fulfillment of the main parameters of the monetary and credit policy in the current year. The guidelines are drafted by the Bank's Board of Directors in collaboration with the government (Article 18). They are then considered by the NBB (Article 13) and by the State Duma, which makes a corresponding decision before it passes the Federal Budget Law for the coming year (Articles 5 and 45).

In accordance with Article 35 of the Law on the Bank of Russia, the principal tools and methods of the Bank's monetary and credit policy are as follows:

- interest rates on Bank of Russia operations
- ratios of mandatory reserves deposited with the Bank (reserve requirements)
- open market operations
- the refinancing of credit institutions
- currency interventions
- setting targets for money supply growth
- direct quantitative restrictions
- issuing bonds on its own behalf.

The second principal task of the Bank of Russia is to develop and strengthen Russia's banking system. In accordance with Article 56 of the Law on the Bank of Russia, the Bank is the body in charge of banking regulation and banking supervision. The Bank supervises the actions of credit institutions and banking groups to ensure that they comply with banking legislation, Bank of Russia normative acts and the compulsory standards set by the Bank. The principal objectives of banking regulation and banking supervision are to maintain the stability of the Russian banking system and to protect the interests of depositors and creditors.

In the area of supervision, the Bank of Russia:

- sets mandatory rules in compliance with current legislation for credit organisations, including rules for licensing credit organisations’ activities, requirements regarding financial stability, management quality requirements, rules to conduct banking operations,
and reporting requirements for preparation and submission, as well as third party notification

- carries out off-site and on-site supervision of credit organisations’ activities, and consolidated supervision of banking groups and bank holding companies
- makes decisions on granting and revoking banking licences, and applies corrective measures
- participates in some liquidation proceedings, including bankruptcy proceedings.

The Law on Banks

The Law on banks defines the following:

- the notion of a credit organisation
- the structure of banking operations
- requirements for the management structure of a credit organisation
- requirements for licensing credit organisations’ activities
- requirements for purchasing major shares in the capital of credit organisations
- requirements arising from the necessity to exercise supervision over credit organisations’ activities
- provisions on the protection of information
- requirements to disclose information about credit organisations’ activities to the supervisory authority and third persons.

A credit organisation is defined as a legal entity entitled to carry out banking operations to make profit on the basis of a special licence from the Bank of Russia (Article 1 of the Law on Banks). The law determines the possible organisational and legal forms of credit organisations as follows: a joint stock company, or a limited or double liability company. As mentioned above, credit organisations are subdivided into banks and non-bank credit organisations.

The Law on Banks determines the list of banking operations as follows:

- attracting the monetary resources of natural persons and legal entities in the form of deposits (demand or fixed-term deposits)
- investing those resources in its own name and for its own account
- opening and maintaining banking accounts for natural persons and legal entities
- clearing payments ordered by natural persons and legal entities, including those of correspondent banks, within their bank accounts
- collecting cash, bills, payment and settlement documents and providing cash services to natural persons and legal entities
- buying and selling foreign currencies in cash and non-cash forms
- attracting precious metals in the form of deposits and investing them
- providing bank guarantees
- the remittance of monies on the instruction of natural persons without opening bank account (excluding postal remittance).

In accordance with paragraph 5 in Article 4 of the Law on the Bank of Russia, the Bank of Russia sets the rules to conduct banking operations.

A credit organisation is obliged to have a management structure that corresponds to the nature of its activities. The management structure of a credit organisation must include a general meeting, a board of directors, and a collective and a single executive management body. The law determines the mandatory professional competence and standards of conduct required from a credit organisation’s management. The appointment of senior managers is subject to the Bank of Russia’s approval. A credit organisation must have an internal control system that conforms to both the Bank of Russia’s requirements and the credit organisation’s scope of activities.

Major acquisitions of a credit organisation’s capital (20 per cent and over) are subject to the Bank of Russia’s approval. Minor acquisitions (5 per cent and over) are subject to notification. The Bank conducts approval procedures to verify the acquirers’ financial stability and business reputation. A draft law currently under consideration would reduce the threshold subject to Bank approval from 20 per cent to 10 per cent. It would also impose financial stability and standards of conduct requirements on the “actual owners” of credit organisations, and also contains other requirements that would ensure the complete disclosure of information about the ownership structure of credit organisations.

The Law on Banks contains a number of additional requirements for non-resident acquirers of shares in Russian credit organisations. In particular, any acquisition of shares in a Russian bank by a non-resident is subject to approval. The law also determines requirements relating to the acquirer’s financial status. A draft law presently being prepared would give equal rights to resident and non-resident acquirers. There are no quotas limiting non-resident participation in the Russian banking system.

The Law on Banks contains an exhaustive list of grounds for revoking a credit organisation’s banking licence. Some of the grounds for licence revocation depend on
the decision of the Bank of Russia’s authorities, while other conditions are obligatory. The situations where the decision is up to the Bank of Russia are as follows:

- ascertaining the facts where the reported data is obviously invalid
- failure to observe federal laws regulating banking activities
- failure to observe the Bank of Russia’s normative acts if the measures envisaged in the Law on the Bank of Russia were applied to the credit organisation more than once within one year
- multiple violations within one year of the requirements determined in Articles 6 and 7 (with the exception of paragraph 3 in Article 7) of the Law on Counteracting Laundering of illegal Proceeds and Financing Terrorism*, and some others.

The obligatory grounds for licence revocation are as follows:

- if the capital adequacy falls below 2 per cent and if the amount of own funds of a credit organisation is less than the minimum amount of the charter capital
- if a credit organisation within the time determined by law does not comply with the Bank of Russia’s order to bring the amount of the charter capital and the amount of own funds (capital) up to the required amount
- if a credit organisation is insolvent.

To safeguard the interests of creditors, the Law on Banks sets out the legal and organisational consequences of licence revocation. In particular, the Bank of Russia is obliged to appoint a temporary administration to manage a credit organisation. Creditors’ claims after a licence revocation must be settled in liquidation proceedings, including bankruptcy proceedings.

**The Law on Deposit Insurance**

The Law on Deposit Insurance took effect in late December 2003. By clarifying the legal position, it ended ten years of debate about the acceptability and feasibility of the deposit insurance system in Russia.

Under the law, deposits of up to 100,000 roubles (€2,900) made with Russian banks are insured. If a bank’s licence is revoked, compensation will be paid from the compulsory deposit insurance fund managed by the Deposit Insurance Agency (DIA). The fund consists of contributions from the state, as well as insurance premiums payable by banks involved in the deposit insurance system. Insurance premiums payable by banks are determined as the average chronological value within the accounting period (quarterly) of daily balances on accounts for recording deposits. The current rate of insurance premiums accounts for 0.15 per cent of the accounting base.

The compulsory deposit fund is independent from budgetary funds as well as from funds of other persons, and the fund’s resources cannot be collected to satisfy state or DIA liabilities. If the fund lacks the resources for making payment, the deficit can be made up from federal budgetary funds or the introduction of a higher insurance premium rate.

The deposit insurance system is managed by the DIA, which is organised as a state corporation. The main goal of the DIA is to ensure a high level of public trust in the banking system, and its main function is to make prompt payments of compensation for insured deposits. The DIA is independent from the state, the Bank of Russia and banks, and DIA employees are not public servants. The DIA is not a supervisory body, but it does have some “quasi-supervisory” authority within the framework of the deposit insurance system (for example, it participates in the Bank of Russia’s inspections of banks’ activities).

One of the reasons for the delay in adopting the Law on Deposit Insurance was concern that the weakness of the Russian banking system might lead to a collapse of the deposit insurance system, resulting in the growth of public mistrust in the banking system and the state. Under the law, banks which want to participate in the system are subject to special supervision arrangements. Eventually, all banks will have to be part of the system in order to attract individual deposits. Of the 1,182 banks that were licensed to attract monetary funds at the time when the law came into force, 1,143 applied to join the system. At the same time, following supervision, 290 banks were denied entry to the deposit insurance system.

**The law on the Bank of Russia’s payments for deposits made by natural persons in bankrupt banks, which do not participate in the system of mandatory insurance of physical persons’ deposits made with Russian banks**

This federal law was adopted in summer 2004 to ensure the smooth transition of the Russian banking system to the deposit insurance system. Introducing mandatory insurance for physical persons’ bank deposits necessitated adoption of the law, because some banks will lose the right to attract individuals’ deposits under the new system. It was decided that to strengthen trust in the banking system as a whole, similar guarantees should be extended to depositors of the banks that were not included in the deposit insurance system.

Under the law, the Bank of Russia’s funds will be used to compensate depositors of banks that are not included in the deposit insurance system. With regard to the unpaid
amounts, in the course of preliminary payments made in accordance with the Law on Insolvency (Bankruptcy) of Credit Organisations, the Bank of Russia will pay 100 per cent of the recognised claim to the first priority creditors, up to a total amount of 100,000 roubles (less preliminary payments made by the receiver). The Bank of Russia makes the payments through the authorised agent banks, which are determined on a competitive basis. Despite the efforts to adopt the same mechanism determined by the law on deposit insurance, there are some differences in the Bank of Russia’s payment procedures. The key difference is in the Bank of Russia’s terms of payments, which will obviously be longer.

The Law on Insolvency (Bankruptcy) of Credit Organisations

The Law on Bank Bankruptcy took effect in May 1999 and has been amended significantly over the last six years. The changes were partly related to the changes in general bankruptcy legislation, and partly related to the changes in bank bankruptcy ideology. The most significant amendments came into force in November 2004.

Under the Law on Bank Bankruptcy, a “problem” bank can be subjected to two sets of measures. First, measures to avert bankruptcy. These are supplementary to the supervision system and are conducted by banks’ shareholders on a voluntary basis or on the Bank of Russia’s request. One of the key actions set out in the Law on Bank Bankruptcy is the appointment of a temporary administration for managing a credit organisation. The law determines the grounds for the temporary administration’s appointment, its powers, the time limit to its activities, and imposes restrictions on the powers of bank’s shareholders and bodies established by the shareholders during the period of temporary administration.

Second, the Law on Bank Bankruptcy sets out arrangements in the case of a credit organisation’s bankruptcy. These arrangements can be carried out only after the revocation of the credit organisation’s banking licence. The decision on formalising a credit organisation’s bankruptcy and the appointment of a temporary administration is made by the courts.

Under bank bankruptcy legislation, the DIA is obliged to implement bankruptcy proceedings in those banks that attract individuals’ deposits (the overwhelming majority of banks). This is to enlarge the bank’s property share directed to creditors and to avoid decisions being made in favour of certain creditors to the detriment of others. Bank’s creditors participate in the bankruptcy proceedings through the general meeting and creditor committee mechanisms.

The Law on Credit Histories

The Law on Credit Histories was adopted in late 2004 and took effect on 1 June 2005. The law determines the notion and the contents of a credit history; the grounds and procedures for filing, keeping and using credit histories; the regulation of bureaux of credit histories; the characteristic features of creating, liquidising and reorganising bureaux of credit histories; and the principles of their interaction with the sources of credit history formation, borrowers, public authorities, local governments and the Bank of Russia.

Bureaux of credit histories are an element of banking infrastructure that is common to many countries worldwide. A system of credit history provides lenders (creditors) with a cheap and efficient means of collecting and using information about borrowers. Credit histories also make borrowers more disciplined in meeting their liabilities. This reduces the creditor’s risk level, and therefore interest rates.

The Law on Credit Histories assumes that credit history bureaux will be established as commercial organisations that receive and provide information on a commercial basis. Credit organisations have the responsibility of providing information about borrowers to at least one of the credit history bureaux. The borrower must consent to the bureau receiving and providing information. A borrower is also entitled to receive free information about itself once a year from a bureau with a view to verifying the information’s validity.

Under the law, a unified information centre must be established to enhance the overall performance of the credit history system. This function will be fulfilled by the central catalogue of credit histories to be established by the Bank of Russia. The central catalogue will provide information to interested persons free of charge.

The central catalogue will also have the task of keeping (on a temporary basis) the data from a credit history bureau if the bureau’s activities are discontinued (due to liquidation, reorganisation or de-licensing) if such a database is not purchased by other bureaux. The central catalogue will subsequently pass this database over to other credit history bureaux.

The outlook for the development of banking legislation in Russia

The future development of Russia’s banking legislation forms a key part of the Strategy of Banking Sector Development in the Russian Federation to 2008, which was adopted by the government and the Bank of Russia earlier this year. The banking community took part in preparing the strategy document.
The strategy proposes draft laws aimed at strengthening banking supervision and tightening the requirements imposed on credit organisations, as well as maximising market opportunities for them.

According to the strategy, to improve banking supervision there should be legislative amendments aimed at enhancing the transparency of credit organisations’ ownership structure, as well as clarifying requirements imposed on the “actual owners” of credit organisations, in terms of their financial status and business reputation. In addition, the business reputation evaluation criteria that are applied to the senior managers and founders of credit organisations must also be clarified. A key, if controversial, requirement is that from 1 January 2007 credit organisations will have to have a mandatory 10 per cent capital adequacy ratio and own funds of €5 million (subject to the “grandfather clause” applicable to the functioning credit organisations). Market mechanisms will be developed by improving pledge institutions, creating the derivative utilisation framework, setting conditions for asset securitisation and streamlining the application of other financial instruments.

End notes
2. In accordance with the Constitution, there are three areas of constitutional and legal regulation: the Russia’s exclusive jurisdiction, the joint jurisdiction of Russia and its subjects and the jurisdiction of the subjects of Russia.
5. See about mechanisms of transition to the deposit insurance system: Гузнов А. Некоторые вопросы, связанные с переходом к системе страхования вкладов. «Законодательство», 2004, №№3,4.5,6.
6. Hereinafter the “Law on Bank Bankruptcy”.