

Comparison of Banking Regulation and Supervision in Azerbaijan and the EU

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Introduction

A central bank is at the heart of the banking system. It is because the central bank is the “banks’ bank” and the government’s bank. Most countries have some form of central bank serving for the nation’s financial matters. Legal mechanism and the mandate of central banks depend on some features such as economic considerations, social preferences, political environments etc. The central banks are the main part of banking system in all countries. The legal status, goals, specific functions and duties of central banks’ are regulated with certain countries’ banking legislation. The central bank of the Old World type was a bank of banks. “Its primary function was to rediscount bills of exchange which have their origin in various parts of the country and which pass through inferior banks whose endorsement they bear”. After many years the other functions mentioned below were transferred to the central banks.

There are several characteristic and general functions and duties of central banks with regardless to in which country it is situated. But every country’s banking system has its specific functions and duties besides those general functions and duties. The specific functions and duties of it are stated in certain countries’ banking legislation. Generally, central banks perform three essential general functions while fulfilling their purposes and essential duties. These functions are regulatory, supervisory and information-research functions as it is emphasized in the legal literature. But it can be differed country by country. It is tried to research in this article banking regulation and supervision in Azerbaijan and banking regulation and supervision in Euro-

pean Union. Comparative analysis of both of Azerbaijan and EU experience, the roles of central banks in banking regulation and supervision process, advantages and disadvantages of both of these systems are researched in this article. As it is emphasized the research object of this article is comparative analysis of banking regulation and supervision within Azerbaijan and the European Union and there is a need to answer several questions for clarifying this issue: How banking regulation and supervision is realized in Azerbaijan? How it is realized in EU? Which models are used? Generally, is there a need to regulate or supervise banking activity? Why? etc. It is tried to answer such questions in this article too.

Is there a need to regulate of supervise banking activity?

Banks play a crucial role in the efficient allocation of savings and investments in a market economy and are important for the stability of the whole financial system. As it is mentioned, there are essential general functions of the central banks within banking activity. These functions are regulatory and supervisory functions as it is emphasized in the legal literature. Regulatory function includes several very significant issues. Generally this function is implemented by two ways. The first one is the regulation of money circulation which has great importance in the countries’ economy. The second aspect of regulation powers is reflected adopting banking regulations, establishing prudential ratios, determining procedures etc. This is legal side of regulation powers. As it seems, regulatory powers of central banks are reflected from financial and

economic aspects.

The other main function of central banks' is supervisory function. Supervisory function is the logical continuation of the regulatory function. Namely the related state body, mainly central banks supervise banking activity, realizing of rules, prudential ratios by different ways which established in the certain countries legislation.

The question is – “is there a need to regulate or supervise banking activity?” There is such need because of importance and necessity of banking system as the essential ring of economic system. Besides its importance banking activity is an area of business activity which demands high risk. Generally there are four of the main risk categories (credit risk, market risk, liquidity risk and operational risk) which can make clear the importance of regulation and supervision on banking activity. Principle-13 of the Core Principles for Effective Banking Supervision states that: “Banking supervisors must be satisfied that banks have in place a comprehensive risk management process to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks”.

Some authors emphasize that to establish prudential ratios, rules for regulation of banking activity is violation of right of ownership, because the Central Bank restricts banks' rights to order and to use their property by establishing prudential ratios. But I think, regulation of banking activity never can be deemed as restriction of right of ownership. Because banking activity is very significant ring of both financial system and economy of the certain country, namely it has necessity because of public interests. So it needs strict regulation by certain state body. It may be argued that whether the Central Bank can be subject of banking regulation powers or not, but necessity of such regulation is out of question. On the other hand if the Central Bank should not realize this power, then there is need existing of other state body instead of the Central Bank for regulating banking system. I think, it is out of question that whether there is need to regulate banking activity or not.

On the other hand, there are such norms - rules, prudential ratios for banking being and every bank “knows” its liability and obligation before its existing. Namely to be bank is

chosen knowing obligations for banking being.

Banking regulation and supervision in Azerbaijan

First of all there is a need to emphasize that the banking legislation of the Azerbaijan Republic was amended substantially in the March of the 2016. According to the amendments to the legislation dated 09 March, 2016, (hereinafter “amendments”) the subject of banking regulation and supervision was changed and this was a notable event in the administrative history of the Azerbaijan Republic, because these reforms resulted creating of new state body.

Till the amendments the subject of the banking regulation and supervision was the Central Bank of Azerbaijan Republic. According to the previous legislation one of the functions of the Central Bank was licensing and regulating banking activities and providing banking supervision.

As it is mentioned banking regulation powers are reflected from two aspects, first one is financial and second one is legal aspect. Functions of CB established in the Article 5 of the Law on Central Bank mainly related to the regulatory role of it in the general financial system. Namely by establishing and implementing the monetary and foreign exchange policy, organizing cash circulation, issuing banknotes, maintaining and managing international gold and foreign exchange reserves, organizing and coordinating activities of payment systems Central Bank regulates the whole financial system and implements its main purposes. So the enumerated functions derive from the goal of CB, with the other word from the historical nature of it. The second aspect of regulation powers of CB was reflected adopting banking regulations, establishing prudential ratios, determining procedures etc. This was legal side of regulation powers and the main issue within this part of our research. According to the legislation the Central Bank implemented the following regulatory activities:

- adopting banking regulations;
- establishing prudential ratios, as well as methods for their calculation and application;
- determining procedures for calculation and creation of loan loss provisioning and other assets established by banks, domestic branches

of foreign banks and non-bank credit institutions;

- setting forth corporate governance standards for banks and domestic branches of foreign banks;

- establishing special conditions of fulfillment of credit commitments before the Central Bank under financial rehabilitation measures for banks.

As it seems banking regulation powers of Central Bank of Azerbaijan Republic covered making rules for functioning of banks and it is an essential issue for banking system. For being efficient and legal banking system such regulation is necessary and without this regulation to provide such efficiency and legality is difficult. The other main function of central banks' is supervisory function. Generally, there are following approaches on subject of supervising functions within banking activity in the different countries: 1) body of banking supervision is the central bank; 2) functions of body of banking supervision are fulfilled by the central bank in interaction with corresponding state structures, always Ministries of Finance or Economy; 3) body of banking supervision is the corresponding state structure. According to the statistics of International Monetary Fund supervisory powers are realized by central banks in the 76% of the countries, by ministries of finance in the 4% of the countries and the by mixed state bodies in the 20% of the countries. This variety derives from different factors such as degree of institutional, administrative and cultural development of the country, economic conditions etc.

In Azerbaijan Republic, the first model of banking supervision was applied. According to the Law on Central Bank of Azerbaijan Republic and the Law on Banks the exclusive body of banking supervision was Central Bank. Central Bank was the only supervisory body within banking system in Azerbaijan. With regard to the Article 5 of Law on Central Banks one of the functions of the CB was licensing and regulating banking activities and providing banking supervision. According to the Article 46 of Law on Central Bank "the Central Bank provided bank licensing, regulation and supervision in order to ensure stable operation of the banking system and protected interests of bank creditors and depositors in the Republic of Azerbaijan in accordance with Law on Cen-

tral Bank, Laws of the Republic of Azerbaijan on Banks, and on Post Offices, on Non-bank Credit Institutions and Regulations of the Central Bank on Credit Unions, and by-rules of the Central Bank". As it is mentioned, three main functions – bank licensing, regulation and supervision were established in the Law. The Central Bank had the exclusive right to grant and revoke special permissions (licenses) to credit institutions and permits to their branches and departments, as well as representative offices of domestic and foreign banks to provide representative capacity, special permit (license) to the national operator of postal communication to deliver financial services in the Republic of Azerbaijan. The Central Bank determined the format and contents of banking licenses and permits. Namely CB defined the rules of admission in the banking system and supervises this activity by licensing mechanism.

But how is the position of the banking regulation and supervision powers today in Azerbaijan? New public legal entity was established according to the Decree of the President of the Azerbaijan Republic dated 03 February, 2016. The name of this public legal entity is Supervisory Chamber on Financial Markets. Establishing such public legal entity all the regulatory and supervisory powers on banking system were transferred to this body. So today banking regulation and supervision powers are executed by Supervisory Chamber on Financial Markets. One of the main purposes of the Chamber is licensing, regulating and supervising of securities market, insurance and credit organizations (both banks and non-banks) activity. As it is clear Central Bank of Azerbaijan Republic implemented both of banking supervision and regulation powers. I think, this was not right way in government management and establishing of new body is advisable, because in that case the Central Bank was regulator and supervisor of realizing of its rules at the same time. With regard to separation of powers it is not reliable. In the most countries' experience shows that one of these functions should be executed by Central Bank, but not both of them at the same time. Why? - Because this situation can be resulted abuse of powers and in some cases such abuse will be inescapable. On the other hand, gathering both of these functions in one hand can be considered monopoly of the state authority.

Assembling both of these functions in one hand is not expedient due to reasons mentioned above. Chamber was established and both of the mentioned functions were transferred to this Chamber. But it has to be emphasized that this shall not make any difference from the practical aspect, because in this case only the body executing certain functions will be changed and it shall not result any advantages. Because I think problem is not due to Central Bank being, problem is implementing of both of these functions by the same body. So transferring of both of these functions will not solve any problem. On the other hand, the Central Bank is the most related state body to banks, so it should know better what sphere of banking activity needs to be regulated and how it should be regulated. So the Central Bank should be the subject of regulatory function. From this aspect, regulatory function has to be one of the main functions of Central Bank.

Generally, we can evaluate banking supervision and regulation body in its transition period in Azerbaijan nowadays.

Banking regulation and supervision in European Union

Central banks in a single country may be established as a single institution or as multiple institutions that are joined together in a federated system. The European Central Bank (hereinafter referred as ECB) is the central bank of the several European Union countries which have adopted the euro. First of all, there is a need to clarify briefly the basis of the monetary system in European Union. The main purpose of ECB is to maintain price stability in the euro and to provide the purchasing power of the single currency. The ECB is an official EU institution at the heart of the eurosystem. Establishing of the European Central Bank and the European system of central banks (hereinafter referred as ESCB) in the June 1, 1998 brought two essential results with it. Firstly, uniform monetary unit – Euro was issued by establishing of such organization, which executives currency politic of the Union. Secondly, establishing of European system of central banks eliminates dependence of member states' central banks from the both political influence and the other currency

regulation bodies. Legal basis of the ECB was established in the Rome Statue on Creating European Union dated 1957, and was made additions and amendments afterwards. The ESCB is consists of the ECB and the National Central Banks (hereinafter referred as NCB) of the 25 EU Member States. ECB and NCBs are independent bodies which have legal personality decision-making powers, but ESCB has no legal personality and capacity as ECB and NCBs. It is just a whole system which is consists of ECB and NCBs. Not all the EU member states are user of the euro, but this system includes national central banks of all the member states even those which has not adopted euro as unit currency. There are two reasons of it, first one is their special status and the second one is derogation. But why there was a need to adopt a term “Eurosysteem”? As it is mentioned some of the member states maintained their monetary sovereignty and their central banks are not involved in realizing the System's core functions. It makes this system complex and for helping to understand the complex structure of the European central banking system more easily, the Governing Council of the ECB decided in November 1998 to adopt the term “Eurosysteem”.

So not a single central bank, but the whole system was established for realizing central banks functions for the euro in EU. To answer the question “why?”, three main reasons are emphasized in the ECB's official publications:

1. The establishment of a single central bank for the whole euro area (possibly concentrating central bank business in one single place) would not have been acceptable on political grounds.

2. The Eurosysteem approach builds on the experience of the NCBs, preserves their institutional set up, infrastructure and operational capabilities and expertise; moreover, NCBs continue to perform some non-Eurosysteem-related tasks.

3. Given the large geographic area of the euro area, it was deemed appropriate to give credit institutions an access point to central banking in each participating Member State. Given the large number of nations and cultures in the euro area, domestic institutions (rather than a supranational one) were considered best placed to serve as points of access to the Eurosysteem.

From this aspect, functional structure of the European system of the central banking is similar to the structure of the system of the Federal Reserve of the USA. The system of the Federal Reserve does not appear as independent legal entity. Board of Governors and Federal Open Market Committee are federal representatives and public legal entities within the system of the Federal Reserve, as well as twelve Federal Reserve banks are private legal entities within this system. As it seems the banks within the system of the Federal Reserve are under the private ownership. If it is compared with European system of central banks, twelve countries' national banks (from fifteen member countries') are in the governments' ownership and the rest of the national banks are in the private companies' ownership. This compare between the system of the Federal Reserve and European system of the central banking helps us to understand bilateral character of the functions of the national central banks. National central banks execute their functions both within the European system of the central banks depending on the ECB and as independent body not depending on ECB. "However, in contrast to the NCBs, which are typically public legal persons (publicly managed and, for the most part, publicly owned), the Federal Reserve Banks have private legal personality, with private ownership (100% owned by the member banks in each district) and private management."

The main issues researched within this part of the article are banking regulatory and supervisory powers in EU. The ECB may also adopt legal acts which are mandatory norms and they have a direct effect. These legal acts which are the instruments of the ECB for regulating certain relations are ECB's Regulations and ECB's Decisions. There is also a need to notify that all measures taken by the ECB are open to review or interpretation by the Court of Justice. The decision-maker body of the ECB is the Governing Council of the ECB. ECB may decide to delegate its regulation power to the Executive Board of the ECB, but in that case it must specify the limits and scope of certain powers. Official Journal of the EU is the official publication and the regulations are binding and enter into force only after publishing in this journal.

Besides its mandatory regulations ECB realizes advisory activity too. As advisor the

ECB may adopt opinions and recommendations within its competence. These acts are not binding legal act. The ESCB Draft Statute included supervision as one of the basic tasks of the ESCB. However, the opposition of some countries (notably Germany) to such an inclusion meant that the final version of the ESCB Statute and of the Treaty of EU only referred to supervision in a limited way, as a non-basic task. So banking supervision issue differs from country to country within EU. For instance, while some central banks have exclusive responsibility for banking supervision, such as in Spain or Italy, others either share supervisory responsibilities with other bodies, such as in France or do not have formal supervisory responsibilities, such as Germany.

While the regulating function is usually split between two or more institutions, the supervision function for a specific sector is typically given solely to the supervisory body. Banking supervision is realized within Single Supervisory Mechanism (hereinafter as SSM) in EU. It includes the national competent authorities of member states and ECB. SSM realize supervision on prudential requirements. It is emphasized in the official publications of the ECB that the SSM's three main objectives are to:

- ensure the safety and soundness of the European banking system;
- increase financial integration and stability;
- ensure consistent supervision.

The activity of this mechanism is based on some principles such as, integrity and decentralization, usage of the best practices, homogeneity within the SSM, consistency with the single market, independence and accountability, risk-based approach, proportionality, adequate levels of supervisory activity for all credit institutions and effective and timely corrective measures.

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