AMERICAN UNIVERSITY OF ARMENIA

LL.M. Program

TITLE

Regulatory Powers of Financial Oversight Authorities

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Introduction

One of the principal functions of financial oversight authorities in achieving a safer, more flexible, and more stable monetary and financial system is to regulate and supervise various financial entities. But following the global financial crisis of 2007-2009, regulatory authorities in the whole world were engaged in a fundamental reconsideration of how they approach financial regulation and supervision. Many authorities of the world are convinced that performing these functions through micro-prudential regulation and supervision of banks, holding companies, their affiliates and other entities, including nonbank financial companies, proved to be insufficient to ensure and maintain financial stability of a country, union or the world as a whole. Hence, macro-prudential supervision and regulation that looks beyond the safety and soundness of individual institutions became crucial to the stability of the financial system as a whole. Moreover, some governments began considering a more stringent and more precise regulation schemes to avoid deregulation

that may lead to excessive risk taking by financial institutions which is the main reason of market failures and crises in the whole world.
This research paper will try to find the best methods and structures of financial regulation by analyzing different aspects of regulation referred to below.

To really capture the problem, one needs to understand who regulates and whether the structure of a particular regulator, like unified as the cases are in Armenia (the Central Bank of Armenia), Singapore (the Monetary authority of Singapore), Georgia (the National Bank of Georgia) etc., twin-peaked like in the United Kingdom, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), Australia, Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC), or multiple specialized regulators for each financial sector as in the USA, matters. This paper will refer to the aforementioned structural differences and distinctions trying to assess their advantages and disadvantages.

In addition the question arises on what to regulate and how; whether only banks, bank holdings, insuring companies, other financial institutions or the so called shadow banking companies like hedge funds must be regulated as well, and whether prudential regulation is enough or conduct of business rules are necessary to achieve a safer and more sound financial system. The distinction must be drawn between the aimed results of regulations.

The thesis will also study the new financial architecture by referring to recent proposals and acts adopted by developed countries such as the United States of America or the United Kingdom. This will include the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule also known as section 619 of the Dodd-Frank Act and ring-fencing approach, which was recommended by the UK Independent Commission on Banking and is rather similar to the Volcker Rule.

The need for a stricter consumer oriented regulation and supervision must be analyzed to understand if stricter consumer protection regulation and supervision can help decrease the risk of failures of financial institutions and thus avoid crises, for instance, such as the U.S. subprime mortgage crisis that was a nationwide banking emergency and contributed to the U.S. recession of 2007-2009 and to enhance the protection of investors especially the unsophisticated ones.

Chapter 1

Who Regulates?

A key feature of a regulatory regime is the establishment of semi-governmental regulators, which have wide powers.

Regulators need to have legislative powers, to make rules by adopting acts, subsidiary legislation, directives, guidelines etc., executive powers to implement policy and judicial powers to make and enforce decisions by imposing different fines and sanctions. Often the latter is backed by private enforcement by investors of civil claims.

In short, regulation involves the combination of legislative, executive and judicial powers in one entity.
The regulatory practices in different countries vary according to institutional characteristics. Some countries have single regulators regulating all major segments of the financial sector, banking, securities and insurance. Some other countries have two regulators for the banking sector and the securities market. Finally, some others, including the United States of America, go for separate regulators for each of the segments.

In the face of blurring of activities among financial service providers and emergence of financial conglomerates (i.e. financial institutions undertaking a combination of activities), the institutional structure of supervision has become a major issue of policy debate in several countries. Besides having certain powers, regulators also have a regulatory structure, which depends generally on a country’s particular circumstances and the types of industries that need to be regulated.

Having decided on the above-mentioned aspects a unified, twin-peaked or multiple specialised financial regulatory authorities may be established.
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Unified:

Unified financial sector regulation and supervision agency is an agency in which banking, insurance, securities and other regulations are combined. That is the case in Armenia, the Central bank of Armenia; Georgia, the National bank of Georgia; Singapore, the Monetary Authority of Singapore.
The most important point to consider is the appropriateness of merging the core financial sector regulatory and supervisory functions into a dedicated agency or commission. And, in doing so it is not sufficient to consider the advantages and disadvantages of such a change, but it is also important to take into account whether alternative approaches can come up with the same outcome in a more efficient and possibly safer manner.

Advantages

A variety of arguments have been advanced in favour of unification. The most persuasive ones are based on efficiency grains, in particular the economies of scale that is undoubtedly offered by unification of financial regulatory and supervisory agencies.
The unification of financial sector regulation and supervision can improve efficiency and effectiveness of regulation in some circumstances, for instance, an integrated regulatory agency may be better able to monitor the activities of integrated financial firms and markets than separate agencies. Thus, it may be an appropriate response to the regulation of financial conglomerates.
[1]

Financial conglomerates, which operate diverse financial institutions domestically and even internationally, emerged the need for financial regulators to seek to identify more efficient and effective ways to oversee their operations. Moreover, fragmented supervision may impair the ability of financial sector supervisors to form an overall risk assessment of a particular financial institution on a consolidated basis. Furthermore, there are also risks that cannot be addressed by specialist regulators, which have oversight jurisdiction over only part of a diversified conglomerate, due to the risks being group-wide. These risks include whether the group as a whole has adequate capital and adequate systems and controls to manage risks occurred. Regulators must also be able to ensure that they can respond on an institution-wide basis should serious problems arise in any part of a conglomerate. Though such financial conglomerates claim to have financial walls, they are often proven illusory once serious difficulties arise.
To ensure effective supervision and regulation of diversified financial conglomerate groups, places such requirements on the different financial supervisory bodies that are not placed in cases of supervision of more simple corporate structures. A fast, effective and efficient system of sharing information with each other on matters of each particular institution must be one of the major tasks of financial regulatory and supervisory bodies; while also ensuring the appropriate degree of confidentiality. Besides, the supervisory bodies must have a close and on-going working relationship to be able to effectively and promptly share suspicions and findings to identify and fill regulatory gaps.
Institutions also need their regulators to minimize the burden (cost) of supervision by demanding that supervision of their operations be carried out as efficiently and with as little duplication as possible.

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[1]Richard K Abrams and Michael W. Taylor 2000 (Issues in the Unification of Financial Sector Supervision); Rosa M. Lastra 2000, Legal and Regulatory Responses to the Financial Crisis Queen Mary University of London, School of Law Legal Studies Research Paper No.100/2012

The latter can be achieved by minimizing overlap and duplication in reporting and oversight, by having a single contact point for all requests on regulatory issues that will allow regulators to respond flexibly and in a fast manner, while decreasing the risk of regulatory gaps developing.
A unified approach seems to offer a better prospect of coordination and exchange of information than would occur between separate agencies, even though, the latter may use the lead regulator arrangement.
In addition the unified approach of supervision can more easily and rapidly respond to financial innovations due to its interconnectedness and efficient information sharing ability. In short, it is more flexible in terms of development of new regulatory arrangements than separate specialist agencies are.
A larger size of a regulatory organization permits a finer specialization of labour, consequently unification may permit cost saving on the basis of shared infrastructure, administration and support systems. In contrast, the existence of multiple specialized regulatory bodies has mostly resulted in the duplication of support infrastructures, for example, in personnel administration, data collection and processing etc. Unification may also permit acquisition of information technologies, which become cost effective only beyond a certain scale of operations and will let the regulator avoid wasteful duplication of research and information gathering efforts.
Furthermore, the existence of multiple regulatory agencies, especially with overlapping responsibilities and areas of jurisdiction, makes it harder to hold any of them accountable due to possible blame disbursement strategy among the regulators.

Disadvantages

The disadvantages of unification are the advantages of the other two structures represented further and are almost as long as the advantages. They include claims that the unification of financial regulatory sector may result in unclear objectives for the regulatory agency; as banking, securities and insurance businesses are subject to different regulations, economies of scope will prove hard to achieve. The agency may suffer economies of scale, thus, it will pose concerns across the whole financial services sector.
The difficulty to strike an appropriate balance between the different objectives of regulation is one of the most powerful arguments advanced against unified regulatory agencies. The objectives range from guarding against systemic risk to protecting an individual consumer from being subjected to fraud.
[2]

Being a multifunctional regulatory agency is similar to a person trying to cope with several problems simultaneously, multitasking, which may make it a rather difficult task for a single regulator to have a clear focus on the objectives and rationale of regulation. As a consequence, the statutory responsibilities of a unified regulator may be vague and ill defined, which in turn will entail problems of holding the regulatory agency accountable for its activities. However, one knows who to turn to in case there is an issue of accountability. Vague objectives can also make them come into conflict with each other. Unlike unified agencies, specialist agencies with a clear focus on a specific regulatory objective may more easily cope with issues encountered and be held to account for their activities. In spite of the strong arguments of the economies of scale in favour of a unified regulation presented above, one should always take into consideration that a unified agency is effectively a regulatory monopoly, which may give rise to inefficiencies associated with monopolies. For example, in countries, as Armenia, Georgia and Singapore, with a single regulatory authority the issue of accountability is regulated very vaguely or even not regulated at all. The laws prescribing their duties give them a myriad of discretionary powers and;
the way the chairpersons of unified regulatory authorities are appointed or elected may raise serious issues of independence. For instance, the chairperson of the MAS is appointed by the president and the latter acting in

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[2]See Charles Goodhart and Rosa Lastra, 'Border Problems', *Journal of International Economic Law*, Vol. 13, No. 3, September 2010, pp. 705-718. See Andrew Crocket, 'Rebuilding the Financial Architecture', (2009) 46(3) *Finance & Development* 18-19, at 18. See Charles Goodhart and Rosa Lastra, 'Border Problems', *Journal of International Economic Law*, Vol. 13, No. 3, September 2010, pp. 705-718. Luis Garicano and Rosa Lastra, 'Towards a new Architecture for Financial Stability: Seven Principles', *Journal of International Economic Law,* Vol. 13, No. 3, September 2010, pp. 597-621

his discretion, may refuse to appoint any person as chairman, deputy chairman, director or managing director or to revoke any such appointment if the President does not concur with the advice or recommendation of the Minister, the Cabinet, a Minister acting under the general authority of the Cabinet or the Public Service Commission, as the case may be, and may refuse to concur with an appointment by the minister*.

A particular concern about a monopoly regulator is that it can be more rigid and bureaucratic than separate specialist agencies. The above-mentioned bureaucracy is mainly due to unified agency's operations being so broad-based and the mangers, staff being unable to fully understand the range of operations of the organization. However, if the particular unified financial regulatory and supervisory body is poorly managed, staffed and organized, it is more likely to be inflexible and bureaucratic despite its being large or small. Moreover, one needs to take into account that a unified function in a small country like Armenia may still be smaller than each of the specialized supervisory bodies in a large country like the U.S.A. both in terms of functions performed and staff engaged.

Another disadvantage that a unified regulatory agency may face is the ever-increasing range of functions that are assigned to the agency, for instance, due to financial market innovations. For example, attempts were made to assign the U.K.'s Financial Services Authority more and more new responsibilities, which were beyond its already broad scope. These included encouraging competition or regulation of mortgages in terms of consumer protection.

Finally, one of the most worrisome of all the criticisms of unified financial regulation and supervision is the moral hazard argument. The argument is based on the premise that the public, in case of a failure of one financial institution, will tend to think that other financial institutions under the regulation and supervision of the same unified regulator will fail as well. Morrison and White (2010) describe how regulation can be a source of systemic failure. When a common regulator regulates banks, the failure of one bank can be interpreted as informative about the ability of the regulator to evaluate the quality of others. Consequently, this may lead to bank runs, withdrawal of funds by public and finally the melt down of the whole financial market.

Twin-Peaks:

The twin peaks model of financial regulation is comprised of two specialized financial regulatory and supervisory agencies, each of which have their specific role in the oversight of a particular country's financial sector. According to many specialists in financial sphere, this model is designed to cover any known gaps existing in a unified regulation.[3]

The two regulatory bodies are mainly the prudential regulatory authority and the conduct of business authority. The former always tends to create a resilient and stable financial system through promoting and enhancing the safety and soundness of regulated financial institutions; while the latter is tasked with protecting financial customers through regulating and supervising financial market conduct.

Regarding Australia's twin peaks system, Georgia State University's Professor Elizabeth Brown echoes the many voices in academic literature that have argued Australia's twin peaks regulatory model helped it during the global financial crisis of 2007-2009. Many specialists in this field are determined that Australia was able to avoid many of the problems that arose in the United States and the United Kingdom during the global financial crisis at least partly due to its twin peaks regulatory structure. In an interview with Reuters in 2009, Hans Hugervorst, the then chairman of the Netherlands Authority commented that the twin peaks model worked very effectively in his country and outperformed many other European nations that had single authorities for regulating the financial sector. Subsequently, several jurisdictions have implemented a twin-peaked regulatory structure that mainly aims to separate the market conduct and consumer protection functions from prudential regulation functions. For example, in the United Kingdom, a review of the

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[3] Andrew Godwin, Steve Kourabas and Ian Ramsay 2016 Twin Peaks and Financial Regulation: The Challenges of Increasing Regulatory Overlap and Expanding Responsibilities

Financial Services Authority's (FSA) pre-global financial crisis light approach led the United Kingdom Government to adopt a twin-peaks regulatory structure by splitting the Financial Services Authority into Prudential Regulation Authority and Financial Conduct Authority. The Financial Conduct Authority (FCA) exists to make sure markets work well so that consumers get a fair deal.

The FCA has three statutory objectives:

- To protect consumers
- To enhance the integrity of the UK financial system
- To help maintain competitive markets and promote effective competition in the interests of consumers

The Prudential Regulation Authority (PRA), as the FCA, was created by the Financial Services Act (2012) and is part of the Bank of England. It will have close working relationships with other parts of the Bank, including the Financial Policy Committee and the Special Resolution Unit.
The PRA role is defined in terms of two statutory objectives:

- To promote the safety and soundness of financial firms and,
- Specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders.

The PRA's approach to regulation and supervision has three characteristics:

A judgment-based approach: The PRA will use judgment in determining whether financial firms are safe and sound, whether insurers provide appropriate protection for policyholders and whether firms continue to meet the Threshold Conditions.

A forward-looking approach: The PRA will assess firms not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage.

A focused approach: The PRA will focus on those issues and those firms that pose the greatest risk to the stability of the UK financial system and policyholders.[4]

Advantages

As I previously mentioned in this report, the disadvantages of the unified structure are the advantages of the other two approaches including the twin peaks approach.
One of the strongest arguments in favor of the twin peaks approach is its capacity of a rather broad scope of supervision mainly due to its structure. Such a structure allows the two specialized agencies to have a clear focus and objectives that allow them to overcome issues connected both with systemic risks and with consumer protection. These may be achieved through setting capital requirements against risk weighted assets by a prudential regulation and overseeing the conduct of business of individual financial institutions and between them. The implementation of the twin peaks regulator's more thorough, stricter and forward-looking method of regulation and supervision is undoubtedly an advantage. Ensuring the appropriate degree of confidentiality may be easier through the fragmented approach than it may via unified and the main reason of this are the blurring lines between the range of objectives of a unified agency.

Disadvantages

The economies of scale and scope may be harder to achieve through the twin peaks approach that is offered by unification of financial regulatory and supervisory agencies. The regulation of financial conglomerates may appear to be a tougher task for a fragmented financial regulatory structure, due to their less efficient cooperation in terms of information sharing. In addition there is a risk of overlap and duplications in performing oversight functions. The two regulators' functions are often not so clear and distinct from each other, which may sometimes lead to confusion and accountability issues.

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[4] Financial services (Twin Peaks Regulation: Key Changes and Challenges) November 2012 https://home.kpmg.com/uk/en/home/industries/financial-services.html

Furthermore, this structure imposes more costs on regulated financial institutions, for instance, in terms of labour force duplication or infrastructure duplication.
For example the FCA is funded entirely by the financial services firms it regulates. The FCA is accountable to the Treasury, which is responsible for the UK's financial system, and Parliament. However it is an independent body and does not receive any Government funding. This definitely means that more burden is imposed on financial institutions regulated by the FCA.

Multiple Regulators:

This approach is even more fragmented than the twin peak approach because it fragments the whole financial market according to financial market participants' scope of activity by offering specialized agencies for each scope. The many regulators structure is common in rather large countries that cannot be regulated by a single financial regulatory system, because it will definitely make the regulatory authority be burdened with a plethora of functions that may be an arduous task to perform for a single agency. These countries are, for example, the USA, the Peoples Republic of China etc., which have very large and diverse financial markets in terms of financial functions performed. Such countries apply a function-specific regulation, in which the regulatory domain is defined by functions performed by financial institutions. The United States, for example, has adopted a model, which blends functional regulation with lead supervisor.
I will present the outline of the U.S. financial regulatory system as it currently stands, delineating the different regulatory bodies and their respective roles below for a better illustration of multiple regulators approach. [5]

Federal Reserve System

The Federal Reserve (the Fed), is the central bank of the United States. The Fed is responsible for regulating the U.S. monetary system (i.e. how much money is printed, and how it is distributed), as well as monitoring the operations of holding companies, including traditional banks and banking groups. Broadly speaking, its mandate is to promote stable prices and economic growth.

The Federal Reserve exerts regulatory oversight in a few different ways:

Board of Governors:

Its main responsibility is to guide monetary policy by coordinating with the Federal Open Markets Committee (FOMC) and regional reserve banks. The Board is also responsible for the financial services industry supervision, including approving bank presidents and setting requirements for the amount of cash banks must hold in reserve; and coordination and oversight of the actions of regional reserve banks.

Federal Open Markets Committee:

The FOMC is the Fed's primary monetary policymaking body. The FOMC is charged with assessing the economic and financial landscape and setting the "federal funds rate," the benchmark interest rate at which the Fed loans money to banks.

Reserve banks:

The federal reserve banking system encompasses twelve regional banks with twenty-five total branches. They store and distribute reserves, process checks and other forms of interbank payments, and generally supervise the operations of commercial banks in their region.

Department of the Treasury

The U.S. Department of the Treasury has evolved to encompass several different duties. It recommends and influences fiscal policy; regulates U.S. imports and exports; collects all U.S. revenues, including taxes; and designs and mints all U.S. currency.
In terms of financial regulation, the Treasury Department functions primarily through the operations of two agencies it oversees, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, which regulate savings and loans:

[5] The UK Financial Conduct Authority https://www.fca.org.uk;
Prudential Regulation Authority http://www.bankofengland.co.uk/pra/Pages/default.aspx

Office of the Comptroller of the Currency: The Office of the Comptroller of the Currency (OCC) is responsible for chartering all U.S. banks and, more broadly, for ensuring the stability of the banking system. It attempts the latter task by monitoring: "a bank's loan and investment portfolios, funds management, capital, earnings, liquidity, sensitivity to market risk, and compliance with consumer banking laws." Its responsibilities thus overlap, to a degree, with those of the Federal Deposit Insurance Corporation (FDIC), which must also monitor banks' capital reserves and sensitivity to risk.

Office of Thrift Supervision: The Office of Thrift Supervision (OTS) is tasked with supervising federally chartered savings and loan associations, also known as "thrifts." The OTS regulates the formation and management of thrifts. It is also responsible for regulating savings and loan-holding companies-firms that buy up rights to all the loans held by various thrifts-which gives it purview over several major U.S. banks and financial firms.

Treasury Secretary Henry M. Paulson has taken a very active role amidst the financial turmoil of 2008. He has pressed the need for a plan aimed at stimulating liquidity in financial markets and has made Treasury money available to some failing U.S. financial institutions on the grounds that their failure would severely damage the U.S. economy. However, this approach created a moral hazard issue.

Securities and Exchange Commission

The Securities and Exchange Commission (SEC) is an independent government agency tasked with overseeing the U.S. securities markets, enforcing securities law, and monitoring exchanges for stocks, options, and other securities. The commission is also responsible for overseeing corporate takeovers. One of the primary tasks assigned to the commission is the promotion of transparency in securities markets and thus the protection of investors from fraud or corporate malfeasance, in part through requiring that firms file quarterly and annual financial reports. The SEC is tasked with providing guidance to corporations regarding U.S. accounting rules, and Congress authorizes the commission to bring civil charges against firms thought to have committed fraud or other accounting wrongdoings. The commission has subdivisions focused on regulating: corporate finance, trading and markets, investment management, and enforcement.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC), was intended as a financial backstop to provide the broader U.S. population a guarantee that individual savings will not evaporate when a bank does.

The FDIC exerts regulatory authority in that, to qualify for FDIC insurance, member banks must meet certain requirements. Banks are categorized based on the extent of their reserves and liquidity. Typically, a U.S. bank holding less than the percentage of the assets set it is managing in reserves is considered "undercapitalized."

Commodities Futures Trading Commission

The Commodities Futures Trading Commission, or CFTC, provides a regulatory framework for the increasingly complex market in futures contracts (through which traders agree to buy or sell a good at a specific time in the future for a specific price). Traders now speculate on the future prices of any number of financial entities from currencies, to government securities like Treasury bonds, to the valuation of different stock indices-and the CFTC has come to regulate all futures contracts, not just those involving commodities. [6]

National Credit Union Administration

[6] Edward V. Murphy Specialist in Financial Economics January 30, 2015 (Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets);

The US Regulation and Supervision https://www.federalreserve.gov/supervisionreg.htm

The National Credit Union Administration, or NCUA, in some ways functions both like the FDIC and the OCC, though it regulates credit unions rather than banks. The NCUA is responsible for chartering and supervising U.S. credit unions. It also insures savings in all federal- and most state-chartered unions through a fund called the National Credit Union Share Insurance Fund.

As we can see from the above example of a multiple regulator structure, it is very hard to avoid overlap and duplications in performing oversight functions. Thus, it is very costly and sometimes even unfounded to implement and maintain such a structure of financial regulation and oversight. Fragmented supervision may raise concerns about the ability of the financial sector supervisors to form an overall risk assessment. Moreover, it proves to be very complicated which may result in unclear objectives. Different regulators very often set different regulations for the same activity for different players. However, if their functions are clear-cut and distinct from each other there will be no risk of overlap or duplication, so the regulated institutions will have a clear understanding of correct market behavior.

[illegible] conclude the regulators part, it should be stressed that changing the structure cannot of itself guarantee effective regulation and supervision. After all, all national ‘architectures’, whether one authority, twin-peak, or many regulators, failed to prevent the global crisis. Consequently, institutional structure is of second order issue, to be considered once the various conditions and methods for effective regulation are in place. Changing the structure cannot by itself address the root causes of weaknesses of financial regulation and supervision that have contributed to market failures known to the world. Hence, strengthening regulatory capacity needs to be given attention ahead of issues of the structure of regulation. The core idea is that the structure of a regulatory system needs to reflect the structure of the markets that are regulated.

Chapter 2

What Needs To Be Regulated And How?

This question refers both to the type of financial institutions that should fall under the regulatory perimeter and the measures or rules that will limit risks with regard to the lending or investment decisions institutions make and with regard to the lines of defenses that the institution should implement, for instance in terms of capital and liquidity requirements, to be able to absorb losses and withstand a crisis and to minimize the risk of moral hazard to society and to taxpayers.

Financial intermediaries always incur financial instability, intertwined with macroeconomic policy, because of excessive risk-taking. For a long time, it was believed that as long as financial regulators guarantee price stability through policies, the financial infrastructure would also remain stable. The crisis of 2007-2009 proved that this view was unfounded. The regulation of banking and financial markets has become the major challenge for public authorities. Due to increased competition, the borders between financial institutions are fading; consequently, the authorities must thoroughly examine and define the financial institutions that need that need to be regulated.

What must be regulated is a question that has triggered a multiplicity of strict conduct of business rules and prudential requirements; capital, liquidity and other indicators of banking and financial soundness as well as proper corporate governance rules are required. After the global financial crisis, it became clear that banks had too little capital, too thin a buffer to absorb losses and that therefore both prudential and conduct of business rules were inadequate. Basel III is an attempt to respond to the limitations of Basel I and II. As an international standard it should contribute towards establishing a level playing field. The remarkable thing about the amount of minimum capital which is required under the Basel rules is that the headline figure of 8% of risk weighted assets (RWA) that was set in Basel I and has remained the same ever since. However, Basel III has done two significant things. It has changed what counts as ‘capital’ and it has introduced capital ‘buffers’ to supplement the minimum capital requirements. However, it depends on a particular country to set its own best-suited capital requirements. Furthermore, capital regulation is no panacea. Good banking and finance also rest upon asset quality, management, adequate earnings and risk controls that can be achieved through more stringent prudential and conduct rules.

It will be rather fair to infer that banks have already influenced the Basel III rules given the long implementation period for the new capital regime. And we may even think that the Basel Committee will introduce Basel 4 even before the financial authorities can implement the Basel 3 rules.

The focus of the Basel rules is on the capital requirements for individual banks. It can be argued that this

approach gives insufficient recognition to the systemic consequences of bank failures. The failure of a single bank is probably neither here nor there, provided the consequences of its failure do not extend to other financial institutions and, through them, to the real economy. On the other hand, making individual banks more resilient to stress is a way of providing systemic protection if one bank's failure will impact on other institutions in the system.

There is a very important question to be answered, which is why capital requirements should be strictly imposed upon commercial banks, credit and depositary institutions when the 'shadow banking system', like Hedge Funds, is engaged in similar types of risky activities. Emphasis on capital is important as it is an indicator of soundness, but, nevertheless, it should not be the sole tool in the regulators' armory. Financial regulators focus too much upon capital requirements, however, it is difficult to assess and control the quality of the asset portfolio, and, of course, potential mismatches between the duration of liabilities and assets provides a cause for concern about liquidity management and controls.

In addition to the capital rule requirements, the Basel Committee issued new soft- law rules, for example, the new 'Core Principles for Effective Banking Supervision' addressing issues such as corporate governance, the treatment of systemically important banks, recovery and resolution plans etc. For its part, the Financial Stability Board has also been publishing a number of principles and documents, the most relevant being the

'Key Attributes of Effective Resolution Regimes for Financial Institutions'. These key attributes, which are the result of work undertaken by the Financial Stability Board (FSB) jointly with its members including the International Monetary Fund, World Bank and the standard-setting bodies, are considered new internationally-agreed standards that lay out the responsibilities, instruments and powers that national resolution regimes should have to resolve a failing systemically important financial institutions (SIFI). They also establish the requirements for resolvability assessments and recovery and resolution planning for global SIFIs, as well as for the development of institution-specific cooperation agreements between home and host authorities. They are aimed at solving the too-big- to-fail problem by making it possible to resolve any financial institution in an orderly manner and without exposing the taxpayer to the risk of loss, protecting essential economic functions through mechanisms for losses to be allocated between shareholders and unsecured and uninsured creditors. Taking into consideration the attempts of the afore-mentioned international financial authorities to find post crisis schemes for resolution of financial institutions, one may infer that there is very little or even no chance to prevent market meltdowns by devising tougher pre crises regulations. Whether these legal and regulatory changes will help prevent the next crisis remains to be seen. Historical experience suggests that regulation is not a natural product, but a by-product or reaction to crises or conflicts. Regulation is most needed in good times, when rapid credit expansion and exuberant optimism cloud the sound exercise of judgment in risk management, yet regulation is typically designed in bad times, in response to a crisis. We need appropriate counter-cyclical* regulation, bearing in mind the biblical story

of Joseph in which provisions were gathered in good times to be used in bad times.

With regard to the scope of institutions that should be regulated, there is an apparent need to widen the scope beyond the three pillars upon which financial regulation has traditionally rested, i.e. banking, securities and insurance. Hence, the financial regulation authorities must devise strict rules for a wider range of institutions that are now central to the safeguarding of financial stability, such as clearing and settlement systems, credit rating agencies and auditing firms, and private pools of capital such as hedge funds and private equity funds. Perhaps the answer in some cases with regard to derivatives markets is not more regulation, but more transparency and accountability, a well functioning clearing system, and on balance sheet accounting treatment, which must be very attentively supervised. In some other cases, the answer will be litigation.

To improve accountability and transparency in the financial system, to end the too big to fail financial institution approach, to protect the taxpayers in the United States by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes the Dodd–Frank Wall Street Reform and Consumer Protection Act or the Dodd-Frank Act was signed into federal law of the U.S.A.

Due to the Dodd-Frank Act a number of new agencies were created while others were made to merge or were removed in an effort to streamline the regulatory process, and increase oversight of systematically

important institutions. However, as already mentioned in this paper, changing the structure of financial authorities cannot by itself guarantee an effective and efficient regulation and supervision. Even the Federal Reserve Act was amended. The Act's intentions are to provide for an advanced warning system on the stability of the economy; create new rules on corporate governance; and of course, eliminate certain gaps that led to the 2008 economic recession. All of the agencies are compelled to report to Congress, to present the results of current plans and explain future goals. This accountability technique may be quite efficient in terms of the improvement of strict regulation and supervision and will leave almost no space for lighter approach of regulation.

Furthermore, the Act eliminates any exemptions, thereby rendering numerous additional investment advisers, hedge funds, and private equity firms subject to new registration requirements. For instance, prior to the passage of Dodd–Frank Act, investment advisers were not required to register with the Securities Exchange Commission (SEC) if the investment adviser had fewer than 15 clients during the previous 12 months and did not hold itself out generally to the public as an investment adviser. In addition to this, the Federal Reserve supervises certain non-bank financial institutions and their subsidiaries in the same manner and to the same extent as if they were a bank holding company.

In addition, there is the Volcker Rule, formally known as section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a federal regulation that prohibits banks from conducting certain investment activities with their own accounts, and limits their ownership of and relationship with hedge funds and private equity funds, also called covered funds. The Volcker Rule's purpose is to prevent banks from making certain types of speculative investments that contributed to the global financial crisis.
Named after former Federal Reserve Chairman Paul Volcker, the Volcker Rule disallows short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for banks' own accounts under the premise that these activities do not benefit banks' customers. In other words, banks cannot use their own funds to make these types of investments to increase their profits. For example, engaging in proprietary trading gave banks a competitive advantage as they had the tools and information needed, however, it definitely created conflict of interests. To avoid conflict of interests, the institutions had to give up either acting on behalf of their clients and earn fees and commission dollars, or the activity of engaging in proprietary trading on their own behalf. Furthermore, besides the probability of earning excess returns such trading could expose proprietary traders to the potential for large losses and, thus, have a negative impact on the overall financial market.
The rule allows banks to continue market making, underwriting, hedging, trading of government securities, insurance company activities, offering hedge funds and private equity funds, and acting as agents, brokers or custodians. Banks may continue to offer these services to their customers and generate profits from providing these services. However, banks cannot engage in these activities if doing so would create a material conflict of interest, expose the institution to high-risk assets or trading strategies, or generate instability within the bank or within the overall U.S. financial system.
Depending on their size, banks must meet varying levels of reporting requirements to disclose details of their covered trading activities to the government. Larger institutions must implement a program to ensure compliance with the new rules, and their programs will be subject to independent testing and analysis. Smaller institutions are subject to lesser compliance and reporting requirements, as they do not really pose so much risk to the overall financial market stability. However, the question arises concerning the number of small institutions present in the market, which can definitely change the whole picture. What if only ten percent of the financial market consists of large institutions? The ring-fencing approach, which was recommended by the UK Independent Commission on Banking is similar to the Volcker Rule as it proposes the separation of domestic retail banking divisions from their investment banking arms to safeguard against riskier banking activities. There is a prohibition on ring-fenced banks from conducting the regulated activity of "dealing in investments as principal" in the UK or elsewhere. In contrast to the Volcker Rule, British law does not prohibit ring-fenced bodies from being part of a group that engages in excluded activities. They must however be sufficiently independent from this group. This is where the ring-fence becomes important.

It serves as a shield between the deposit-taking entity and the other groups. Moreover, it has to be able to carry out its own activities in the event that one of the other members becomes insolvent.
As demonstrated by the above-mentioned regulatory approaches, there is a need both for prudential and conduct of business regulations.[7]

Chapter 2.1

Prudential Regulation

As we already know the aim of prudential regulation is to promote safety and soundness of financial institutions. There are micro-prudential and macro-prudential regulation rules; the former is designed to enhance the stability of individual financial institutions and the latter is a regulation required to protect the financial system as a whole, the macro-prudential being fundamentally different in nature from micro-prudential regulation. A too-narrow focus on the safety and soundness of individual banking organizations makes it harder to assess the broader financial landscape, and to detect and mitigate potential threats to financial stability that cut across many firms and markets.
Macro-prudential regulation seeks to identify, immunize, isolate and intervene in financial failures and, in contrast to micro-prudential regulation; it requires international harmonization across countries. The focus of harmonization to date has therefore been precisely the opposite of that which is required to protect the financial system. However, to achieve the desired harmonization mentioned above, financial authorities should also pay attention to the regulation of individual institutions, which are an inalienable part of the financial system as a whole.
A central instrument of prudential control for banks consists in capital adequacy rules, for instance, provided in the Basel rules. Equity capital provides the necessary cushion against losses, since shareholders may want to benefit from the leverage effect and to increase their return on equity by providing as little capital as necessary. According to Dirk Heremans and Alessio M. Pacces, only in well-capitalized institutions, however, do the shareholders have enough incentives to monitor their financial health. There is a perception that when financial institutions hold a large amount of equity capital, they have more to lose in case of failure so that they will pursue less risky activities. From a prudential point of view the incentive effects of capital requirements are more important than the mere buffer function of capital against losses. In particular the imposition of capital requirements on banks is deemed to be necessary to limit their high leverage ratios.[8]

In addition, the cost of capital is to be reflected in the risk adjusted pricing of loans affecting their competitive position in credit markets. As banks are in the business of providing risky services, the high leverage, however, may easily induce excessive risk-taking and possibly huge losses undermining individual

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[7] Matthias Lehmann 2014 Volcker Rule, Ring-Fencing or Separation of Bank Activities: Comparison of Structural Reform Acts Around the World
See *UK Independent Commission on Banking*, Final Report, September 2011 (henceforth: Vickers Report), p. 3.
Pacces, Alessio M. and Heremans, Dirk, Regulation of Banking and Financial Markets (May 1, 2011). Encyclopedia of Law and Economics: Regulation and Economics, 2nd Edition, A.M. Pacces and R.J. Van den Bergh, eds., Elgar, 2012
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1914461&rec=1&srcabs=2027921&alg=1&pos=9
[8]Basel Committee on Banking Supervision http://www.un.org/esa/ffd/events/2010GAWGFC/5/Coen.pdf
Islam, Md. Nahidul, Comparison among the Basel Accords (July 5, 2012)
Central Bank of the Republic of Armenia Board Resolution No. 39
https://www.cba.am/EN/laregulations/Regulation_2.pdf

solvency and systemic stability. Hence, capital regulation is seen as necessary to limit the high leverage ratios and to provide the necessary cushion against losses in order to protect creditors.

According to the CENTRAL BANK OF THE REPUBLIC OF ARMENIA BOARD RESOLUTION No. 39 articles 24, 24.1 the minimum reserve requirement with the Central Bank of Armenia (CBA) on resources attracted in Armenian Dram for banks and foreign bank branches operating in the Republic of Armenia shall be 8 percent; while the minimum reserve requirement with the CBA on resources attracted in foreign currency, as well as in dematerialized metal accounts for banks and foreign bank branches operating in the Republic of Armenia shall be 12 percent which shall be reserved in Armenian Dram. This means that there is an anticipated inflation rate of 50 percent in case of foreign currency, which in turn suggests a tougher regulation in providing loans in foreign currency. More stringent regulation in such a case is very crucial especially in small countries such as Armenia, because 50 percent devaluation of Armenian dram is more likely to lead the borrowers to the inability to repay their loans and, thus, create financial market instability and even failure. There are more aspects to be considered in addition to inflation, the most prominent being the fact that Armenia is rather an importing than an exporting country, which means that Armenians in general use foreign currency for international transactions and need to set higher prices at home in case of inflation.
As Armenia is considered risky in terms of giving out loans, mainly due to drams devaluation probability, banks and other financial institutions give out high percentage loans to compensate the risk of non-repayment. However, due to the same afore-mentioned devaluation in addition to high percentage repayment creates much more risk of non-repayment by borrowers, which in turn may lead to failure of a large number of individual consumers and the crush of the whole financial market. This is really harmful for both the consumers and the investors.

The Basel III rules reflected the proposition or, perhaps, assumption that the negative externalities of bank failure are linearly related to the size of the bank's assets. If that relationship is non-linear or if matters other than the size of the bank's assets are relevant in determining the likely negative effects of the failure of a bank, then it might be appropriate to impose a higher capital requirement on certain banks because the consequences of failure are more extensive.

Though prudential regulation and capital adequacy rules may seem sufficient to make financial institutions monitor their own financial health and soundness, we definitely need strict conduct of business rules to curb the flaws of prudential regulation and to further enhance the safety and soundness of financial institutions without the reliance on the presumption that shareholders will.

Chapter 2.2

Conduct of Business

Conduct of business (COB) regulation governs conduct of financial intermediaries towards their clients, towards the individuals or institutions, with whom they transact in providing products and services. Under ordinary agency law, agents have general duties to act in the best interests of their principles, to be fiduciaries. Being a fiduciary means to be entrusted to manage the property of others in an honest and faithful manner. Hence, financial institutions may be considered fiduciaries of their investors and need to demonstrate good faith in acting on behalf of the latters while deciding on the risk aspects connected with the consumer, for instance, the borrower. In addition, in the first place the fiduciary duties (duty of care and duty of loyalty) arise inside a financial institution itself. For instance, the duties arising in relation of the managers towards their shareholders need to be performed in an honest manner. So, conduct of business regulation is of crucial importance as it may curb the excessive risk taking by financial institutions, their

staff, and acting in bad faith. Moreover, outside the regulatory regime, courts are ineffective to be considered an alternative way of regulation in cases of fraudulent conduct of business. COB regulation serves the objectives of protecting investors from harm, preserving and enhancing the integrity and orderly operation of financial markets, and otherwise serving the public interests. Various forms of conduct of business regulation such as requirements for registration or licensing; rules governing sales, marketing and other business practices; and mechanisms of enforcement are known.

Conduct of business regulation is considered distinct from general law or private law, because financial regulations are legal instruments such as statutes and the rules and regulations of agencies etc. In general, both COB regulation and the general law apply to regulate the business conduct of financial intermediaries.

COB regulation has theoretical justification in economics and related disciplines; and standard neoclassical economic analysis has proved the importance of regulatory intervention when the risk of market failures exists. For example, some financial intermediaries set higher prices than their competitors, because of costs such as information obtaining costs and these circumstances justify mandatory disclosure and direct price regulation. So, failures stemming from the 'public good' nature of information can be addressed via disclosure requirements and anti-fraud rules.

The need for COB regulation also stems from a discretion delegated by a client (investor) to a financial intermediary to act on the former's behalf; and principal-agent theory counsels for mechanisms to help align the intermediary's interests with those of the clients and, thus, reduce agency costs. The above-mentioned justifies rules requiring duty of loyalty. And the possibility of the harm by a financial intermediary imposed to another through carelessness justifies the imposition of the duty of care. These various justifications are much more needed with regard to regulation to protect individual investors rather than institutional ones, because institutional investors are considered sophisticated and are able to protect themselves. As may be inferred from the context presented, the regulation we are talking about concerns the financial intermediaries of the securities market.

Though at first sight it may seem that the COB regulation is mostly needed for the financial intermediaries that are engaged in securities trading, as the protection of investors, in particular unsophisticated ones, are of crucial importance, I assume that other financial lines, such as banks, need conduct of business rules not less than the securities sphere does, because, for instance, the investors who deposit money for a fixed percentage rate need to be maximally secured as well from bank failures. In some cases insurance may be the answer to failures and will protect the investors (lenders), however, insurance promotes excessive risk taking by financial intermediaries. But provided that maturity transformation* is done in a safe manner will definitely decrease the high risk of financial markets meltdowns. That is whenever banks give out loans (relend) to borrowers they need to follow certain requirements to assess the ability of a particular consumer (borrower) to repay by gaining profits. However, even where regulatory intervention finds theoretical justification, determining the best form of such regulation poses difficult challenges. As it is evident that any failures are connected both with the market and the rules of regulation, regulatory reforms must be assessed for their likely effect on people and markets. This exercise needs to involve both expert judgments, for instance anti-trust expert judgments, and historical evidence.

Financial institutions need to be examined for compliance with a broad range of laws, regulations, and other legal requirements to ensure their safe and sound functioning. Though consumer oriented regulation and supervision is not widely employed in many jurisdictions or are just illusory, it is of great importance, because it may indirectly lead to both investor and, consequently, market harm. [9]

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[9]Calomiris, C.W. and Powell A. (2001), "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-99", in Mishkin, F.S. (ed.), *Prudential Supervision. What Works and What Doesn't*, NBER Conference Report, The University of Chicago Press: Chicago.

Giordano, Claire, Prudential Regulation and Supervision Instruments and Aims: A General Framework (April 16, 2009). Financial Market Regulation in the Wake of Financial Crises: The Historical Experience Conference p. 243, 2009. Chapter 2,3 Tuch, Andrew F., Conduct of Business Regulation (June 30, 2014).

Chapter 2.3

Consumer Oriented Regulation and Supervision

Financial consumer protection laws, regulations, supervisory and oversight structures constitute an essential element of the modern financial system. As recent financial crisis demonstrated, adequate financial consumer protection is an important contributor to financial stability. Moreover, responsible behavior by financial service providers and ability for the users of financial services to protect their interests contribute to economic empowerment of the population. The majority of financial agencies responsible for prudential regulation and supervision also have a responsibility for financial consumer protection. However, the importance of consumer protection function has created the need of a separate unit from prudential regulation. Some financial authorities have employed a broader range of monitoring tools such as monitoring consumer complaints, which is less costly than monitoring the financial institution itself.

Legal framework in most countries provides broad provisions on fair treatment such as protection for client confidentiality and restrictions on deceptive advertising. However, fewer economies have provisions specific to financial industry such as restrictions on predatory lending, bundling and tying of services etc. Predatory lending strategy may have a very negative impact both for consumers and investors as well as for the whole economy, because it ignores some critical fair treatment rules that need to be followed. Even collateralized loans may prove insufficient to avoid crises, as was the case of subprime mortgage crisis in the United States, which was the higher percentage of lower quality mortgages partly encouraged by the United states government. Predatory lending can also cause the emergence of economic bubbles, when prices grow beyond their true value. And the problem arises when a sufficient number of consumers become insolvent and cannot repay their debts, because the financial institutions engaged in predatory lending ignored the rules of fair treatment regulation (proper lending rules). Such scenario forces financial institutions to sell and fire sell the collateral and thus deflate the bubbles and the deflation will most probably lead to market failure.

Though some financial experts argue that too much regulation may have a negative influence on competition, I strongly believe that this field of financial sphere is able to find other efficient ways for competition such as costumer service.

Protecting investors is very closely connected to consumer-oriented regulation and supervision, because investors indirectly lend their money to consumers and they need to be sure that the money are invested in the right place. But excessive risk taking such as predatory lending by financial institutions will put the investors in a vulnerable position.

"Conduct of Business Regulation," in Oxford Handbook of Financial Regulation 537 (Niamh Moloney, Eilis Ferran, & Jennifer Payne eds., 2015); Washington University in St. Louis Legal Studies Research Paper No. 14-06-04.

Chapter 22 Conduct of Business Philip Wood 2008 (Law and Practice of International Finance)

Consequently, consumer-focused regulation and supervision may limit the ability of risk-insulated bodies to take excessive risks and thus pose a moral hazard issue.[10]

Conclusion

We have reviewed the economic rationale for regulating banking and financial markets. Intermediaries emerge in financial markets in order to cope with risk and uncertainty of financial exchange. These problems are shifted, mitigated, but not eliminated by financial intermediation. Hence, regulation and supervision of banking and the financial infrastructure in general are necessary to improve the efficiency of financial markets, which have direct impact on economic growth. However, even regulation and supervision are not sufficient to exclude the possible negative outcomes, because the discretion given both to regulators and the financial intermediaries cannot be efficiently regulated and supervised. Moreover, the evidence showed that the structure of a regulatory system cannot by itself guarantee effective and efficient results. Market failures in finance are mainly due to problems of information asymmetries and externalities. Regulation addresses these problems through conduct of business rules, consumer rights protection and prudential requirements. However, in Armenia the CBA has both market conduct rules and consumer rights protection mechanisms that are, unfortunately not so clearly set and are rather blurry. The main reason being the contradicting ideas laid between the discretionary powers (rights) of financial institutions and the rules set by the Consumer Protection and Market conduct Division of the Central Bank of Armenia. For example, banks in Armenia may give out loans to final consumers based solely on their own risk management techniques, which have often proved to be wrong, and even caused crises, similar to the subprime mortgage crisis occurred in the United States. The blurring line might be eliminated if the rules of market conduct and consumer rights protection are more precisely prescribed leaving no or very little space for discretionary powers that are most probable to lead to the failure of one or more financial institutions due to the latters being not competent to assess the overall financial situation and the risk of crises. The above-mentioned will also insure more legal predictability for banks and other financial institutions without much harm to regulatory flexibility that is important in the light of adapting to changing environment.

I also suggest devising new and easier ways of piercing the corporate veil of financial organizations in Armenia not to let their staffs act in bad faith based solely on personal motives, for instance, give out loans to non-competent borrowers. Moreover, there is no regulation and liability set for financial institutions, as creditors, acting as shadow directors by making the borrowers do business in a way the creditor prescribes. Now such a behavior often leads the borrowers to insolvency and no one can be held liable, which is, in my opinion, a gap in the regulation and should be paid a thorough consideration.

To sum up, the right combination of the regulatory structure, which must reflect the particular financial market structure, and the regulation through conduct of business and prudential rules, complemented with good faith, care and loyalty in all aspects of the financial architecture may make it easier to avoid crises and/or resolve financial institutions in a more efficient manner, eliminating the high risk of moral hazard.

[10] The board of Governors of the Federal Reserve System Promoting Consumer Protection and Community Development https://www.federalreserve.gov/aboutthefed/files/pf_7.pdf

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