

The Central Bank as a Financial Mega-regulator (Russian Experience)

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Abstract

This contribution deals with the models of institutional regulation of financial markets. The main aim of the contribution is to confirm or disprove the hypothesis that the model of the Central Bank as a mega-regulator of financial markets is not optimal for the developing countries and particularly for Russia. The author highlights main arguments *pro et contra* Central Bank as a financial mega-regulator. The author supposes that before and during financial regulation reforms, it is necessary to answer the question: Is the financial market in the country sufficiently developed and extensive to abandon the functional (sectoral) regulation and move to mega-regulation? For Russia the answer is negative.

Keywords

Central Bank; Russia, financial markets; governance, mega-regulator; supervision

1 Introduction

This contribution deals with the models of institutional regulation of financial markets. The research purpose of the article is to confirm or disprove the hypothesis that the model of the Central Bank as a mega-regulator of financial markets is not optimal for the developing countries and particularly for Russia. The methodology of the study includes general scientific methods (analysis, synthesis, induction, deduction,

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comparison and description) as well as particular legal academic methods (interpretation of legal acts and formal-legal method).

Issues of efficiency of regulation of financial markets by a single authority (the so-called mega-regulator) combining all management powers in this area is the subject of scientific and practical analysis in various countries for many years.²

The first to decide on the formation of such a structure were the small countries of Northern Europe: Norway (1986), Iceland and Denmark (1988), Sweden (1991).

Among the major countries of Western Europe, the first on the way to create mega-regulators was the United Kingdom, when it announced the reform of the banking supervision and the establishment of the Financial Services Agency in 1997. In 2002, a single mega-regulator was established in Germany.

The creation of the mega-regulator did not save them from a banking crisis neither Norway in 1988, nor Sweden in 1992. The British Financial Services Agency was reorganised and divided in 2011–2012.

2 The History of the Financial Market Regulation in Russia

The idea of creating a mega-regulator has been the subject of active discussions among scientists and politicians over the past twenty years in Russia.

This idea was first proposed by the British company Cadogan Financial at the end of 1999. The first step in the implementation of this initiative was the creation of the Federal Service for Financial Markets (FSFR). It was assumed that the mega-regulator would be formed on its basis as a collegial and independent authority. At the same time, this authority would combine not only the regulation of the insurance and stock markets, but also banking supervision.

Consideration of the possibility of combining the functions of regulation of all segments of the financial market (stock, insurance, banking, non-state pension funds) and the creation of a mega-regulator, as well as the possibility of combining supervision of various institutions of the financial market in one federal body was provided for in the program of socio-economic development of the Russian Federation in the medium term (2006–2008).

By May 2007, due to contradictions in the government and the resignation of the FSFR Head O. Vyugin, who was an active supporter of the creation of the mega-regulator, the discussion process was almost stopped.

In mid-December 2010, the Ministry of Finance published a draft presidential decree providing for the creation of a mega-regulator on the basis of the Federal Service for Insurance Supervision (Rosstrakhnadzor) controlled by the Head of State by joining the Federal Service for Financial Markets. At the end of the month, after the meeting

² See Goodhart et al., 2003; Goodhart and Tsomokos, 2011; Moloney, 2014; Moloney et al., 2015; Stolyarenko, 2001; Jurkowska-Zeidler, 2017; Jurkowska-Zeidler, 2015.

with President Dmitry Medvedev, the concept changed – it was proposed to abolish Rosstrakhnadzor and transfer its functions to the FSFR.

On 4 March 2011, the Russian President signed the decree *About Measures on Perfection of State Regulation in the Sphere of the Financial Market*, providing for the creation of a prototype of a mega-regulator on the basis of the Federal Service for Financial Markets.

The long-term discussion on the creation of a financial mega-regulator in Russia ended in January 2013 with the decision of the President of Russia on the integration of the FSFR into the Central Bank of Russia.

3 The Content of the Modern Stage of Regulation of Financial Markets

In July 2013, the Federal Assembly of the Russian Federation adopted the federal law No. 251-FZ of 23.07.2013 *On Amendments to Certain Legislative Acts of the Russian Federation in Connection with the Empowerment of the Central Bank of the Russian Federation of Powers to Regulate, Control and Supervise Financial Markets*. The law provides the transfer of the powers of the Federal Service for Financial Markets to the Bank of Russia regarding legal regulation, control and supervision in the field of financial markets, including insurance, credit cooperation and microfinance activities, the activities of commodity exchanges, exchange intermediaries and stock brokers, the formation and investment of pension savings and other powers.

Due to the transformation of the Bank of Russia into a mega-regulator of the financial market, the goals, functions and powers of the Bank have undergone significant changes. Let us note the main changes.

Firstly, the Bank of Russia, although retaining all its functions and powers, but some of them were changed and clarified.

Secondly, the Bank of Russia inherited all the main powers of the abolished Federal Service for Financial Markets of Russia, and therefore its powers have been qualitatively expanded.

Thirdly, the Bank of Russia in its new quality received new functions, belonged neither to the FSFR nor the Bank of Russia.

The Bank of Russia began to make decisions on the official registration of non-state pension funds; to regulate, control and supervise the activities of the non-credit financial organisations (NCFO), i.e. to make decisions that were within the competence of the FSFR: to carry out inspection of the activities of the NCFO, to send them binding regulations, and to apply coercive measures to the NCFO.

He began to set terms and procedure for the preparation and submission of reports by the NCFO, as well as other information provided by federal laws.

In addition, the Bank of Russia began to register issues of issuance securities and reports on the results of issues of issuance securities. The Bank of Russia had

the relevant powers before, but only in relation to the securities of credit institutions, and now its competence has extended to the securities of all issuers. Moreover, in its new capacity, the Bank of Russia began to monitor and supervise compliance by issuers with the requirements of the Russian Federation legislation on joint stock companies and securities, as well as to regulate, control and supervise corporate relations in joint stock companies.

In its new capacity, the Bank of Russia has the right to adopt regulations on a much larger number of issues, including those related to the activities of the NCFO.

In connection with the new goals and functions of the Bank of Russia, its competencies have been expanded, which led to appropriate changes in the organisational structure and management bodies of the Bank of Russia, as follows.

1. The collegial body of the Bank of Russia – the National Banking Council – was renamed as the National Financial Council.

2. The Bank of Russia's Chairman is appointed not for four years (as before), but for five years and the list of grounds on his dismissal was expanded.

3. The number of the Board of Directors of the Bank of Russia has changed. In addition to the Chairman of the Bank of Russia, it includes 14 (not 12, as before) members of the Board of Directors.

4. A new permanent body, the Financial Supervision Committee, has been established. It brings together the heads of the structural units of the Bank of Russia, ensuring the implementation of its regulatory, control and supervisory functions in the field of financial markets.

Thus, the Central Bank of the Russian Federation became a single structure that provides end-to-end regulation, control and supervision of all banking and almost all financial sectors in Russia, including insurers, non-state pension funds, exchanges, microfinance institutions, etc.

4 The Positive Side of the Regulatory Reform of the Financial Markets on the Basis of a Mega-regulator

As the analysis of the position of the supporters of the Central Bank as the financial markets' mega-regulator shows, they put forward the following arguments in favour of such a decision.

1. The possibility to regulate financial conglomerates (organisations, each of which provides a variety of financial services) and to supervise them on a consolidated basis with the application of uniform rules; exclusion of abuses of market participants, who used contradictions in regulation and supervisory approaches of different authorities. The Central Bank supervised the banking system before, and the banking system is

closely linked to the securities market. Banks hold a significant share as bondholders in the debt securities market.

2. The unified approach to the different types of financial service providers eliminates discrimination in the regulation of relations with a similar legal nature and the resolution of disputes arising from such relations.

3. Reducing the administrative burden on the participants of the financial market by eliminating the need for coordination of actions and decisions with several authorities.

4. The threats of systemic risks are identified more quickly due to the monitoring of the whole financial system.

5. The creation of a mega-regulator allows to improve the quality of risk management in financial institutions through the use of best practices of the Central Bank.

6. The combination of the a legal creation and law enforcement functions in mega-regulator's activity makes the process of preparation and implementation of new rules more flexible, fast and meets the interests of the market.

7. The single regulator was expected to give impetus to the development of existing areas and formation of new areas of the financial market in Russia, as well as to promote the creation of financial conglomerates when the holding company or otherwise consolidated owner owns several financial institutions and provide financial products related to different sectors of the financial market; cross-offers of financial products.

8. The mega-regulator was expected to respond quickly to unforeseen circumstances, external and internal risks. It is able to combine the activities of various participants of the financial market, quickly and efficiently allocate resources to resolve problems and timely monitor the results of such activities.

9. The activity of the mega-regulator allows to solve the problems of competition of powers and competence of numerous financial control bodies.

10. The mega-regulator is able better to ensure the confidentiality of the flow of information as the turnover of information occurs within a single organisation.

11. The existence of a single authority allows to stimulate cooperation and establishment of contacts with business and international organisations, as well as with state bodies of foreign countries.

12. Optimisation of costs for the implementation of management functions by reducing the cost of interaction.

13. The creation of a mega-regulator on the basis of the Central Bank allows to improve the quality and quantity of management resources without attracting budget funding through the use of Central Bank funds.

14. The Central Bank had a successful experience in supervision in one of the sectors of financial markets. The activities of the Central Bank of Russia are credible among the population. Russians have no culture of investing in non-bank financial instruments, and therefore no long-term money. After the creation of the Deposit Insurance System, we have increased deposits in banks by 10 trillion Rubles, but

cumulative life insurances – decreased. The reason is that the Central Bank created an industry in the banking sector that is being trusted by the population.

15. The FSFR failed to build deep supervision over financial markets, so it is logical to make the mega-regulator on the basis of the most powerful supervisory authority in the financial sector – the Central Bank of Russia.

Thus, the absolute majority of arguments do not connect the usefulness of the mega-regulator with its formation in the structure of the Bank of Russia. The last three arguments, which support this, are largely subjective and momentary.

5 The Negative Aspects of Creating a Mega-regulator

As the analysis of the positions of the opponents of the Central Bank as the financial markets' mega-regulator shows, they put forward the following arguments against such a decision.

1. They feared that could lead to losses in the efficiency of supervision in the transition period. Reorganisation would inevitably take at least 3–5 years and would cause excessive mobility of personnel, weakening of governance, instability of staff, structures and powers, the prevalence of current organisational tasks over promising ones. This may slow down the development of the market, lead to increased regulatory costs and the build-up of systemic risk. The experience of Norway, Sweden and Japan shows the inevitability of losses during the transition period. Meanwhile, the costs were not so great in reality.

2. The consolidation of all functions of the financial market regulation in the Central Bank will lead to ignoring the specifics of certain sectors of the financial market, reducing flexibility in regulation. Financial markets are a narrow field of activity, and there are few who are truly professionals. A number of functions of the FSFR are qualitatively different from what the Central Bank was currently engaged in. For example, the identification of market manipulation, insider trading, registration of microfinance institutions and depositories.

3. The consolidation of all functions on the regulation of financial markets for the Central Bank of the Russian Federation could lead to the mechanical extension of strict rules of banking regulation and banking supervision in this area of activity.

4. The creation of a mega-regulator based on the Central Bank of the Russian Federation, which is already the largest Central Bank in the world, would lead to bureaucratisation of decision-making and “delayed feedback”.

5. The creation of a mega-regulator on the basis of the Central Bank causes a certain conflict of interests arising from the concentration of many different functions in the Bank of Russia, as well as the participation of the Central Bank in the capital and management of some major players in the Russian financial market.

6. The creation of a mega-regulator based on the Central Bank would cause a sharp increase in the supervisory workload (the number of supervised organisations will increase by about 9 times) as well as in the supervisory burden on supervised organisations (according to estimates, by about 5 times).

7. The financial market is mobile and unstable, and the Central Bank is conservative. This conservatism could restrain the development of the securities market.

8. In Russia there is no developed multi-sectoral financial market that requires a unification of management efforts in the framework of the mega-regulator for being more effective (through the harmonisation of such rules and management decisions in different sectors).

9. In our opinion, one of the most important obstacles (not allocated by analysts) to the Central Bank's empowerment as a mega-regulator is the uncertainty with the legal status of the Bank of Russia in the system of authorities. According to the position stated on the official website of the Central Bank of the Russian Federation, the Bank of Russia acts as a special public-legal institution with the exclusive right of monetary issue and organisation of monetary circulation, it is not a public authority, but its powers by their legal nature belong to the functions of state power, since their implementation involves the use of measures of state coercion. The uncertainty of the legal status of the Central Bank of Russia affects the regulation of its relations with public authorities. Thus, the procedures of coordination with the Government of the Russian Federation in creation of the main directions of the unified state monetary policy are not regulated by any of the relevant laws.

The allocation of functions of the mega-regulator of the structure with a legal status, which is not fully defined in science or in practice, formally independent from public authorities, is fraught with the loss of control over financial markets, the inability to adequately regulate the processes taking place on them in coordination with national management trends.

The legislation provides the adoption of many management decisions in the field of financial markets by the Government of the Russian Federation in coordination with the Central Bank. Meanwhile, the mechanism of such coordination is not only not written in the law, there is no clear idea of it neither on the scientists' nor practitioners' side.

6 The Optimal Regulation of Financial Markets in Developing Countries

The idea of creating a mega-regulator is in the trend of world reforms in this sector: the gradual consolidation of financial, banking and insurance supervision since 2008 is insisted by international organisations, the relevant recommendations were adopted within the G8 and G20. However, this idea is hardly effective for Russia with relatively isolated banking and financial sectors, as well as less influencing macroeconomic

indicators by the financial and stock markets. A single regulator is effective where there is a large share of organisations working simultaneously in all financial markets.

International experience does not give a clear answer to the question of moving to the mega-regulator.

In today's world, many financial markets live without a mega-regulator – it is enough to recall the two most powerful national markets, the US and China, who, moreover, as a result, overcame the consequences of the crisis of 2008–2009 faster than others. Currently, among the 115 full members of the International Organization for Securities Commissions (IOSCO), the concept of a mega-regulator has been implemented in 50 countries. At the same time, 33 countries have a single independent mega-regulator (with a combination of regulation and supervision), which is not a Central Bank. The functions of the mega-regulator are carried out by national (Central) banks in 13 countries, and another 4 countries use the “twin peaks” model, when the powers of prudential regulation and supervision of systemically important organisations (non-bank financial companies with sufficiently large consolidated balances) are assigned to the Central Bank, and the second regulator is responsible for the regulation and control of non-bank financial organisations.

If you take the largest financial markets, only one country out of 25 has the National Bank as mega-regulator – Singapore. All other cases of choosing a Central Bank as a mega-regulator are countries with very small markets where foreign banks are dominated.

The political task of the creation of civilised rules for the preservation of the capital of people and companies, as well as other above-described positive aspects of the mega-regulator are achievable by the other ways, minimising the above-mentioned risks.

7 Conclusion

Like any management activity, the effectiveness of the regulatory reform depends on the state of the object of management (regulation), so it is necessary to answer the question: is the financial market in the country sufficiently developed and extensive to abandon functional (sectoral) regulation and move to mega-regulation? For Russia, the answer to this question is obvious and five years of experience of the Central Bank of Russia as a mega-regulator confirmed the prematurity of giving it such a wide competence. The creation of an effective mega-regulator should be the final stage of a complex period of reform, including the unification of regulation and supervision in various segments of the financial market and taking, as the world practice, at least 10–12 years.

So the purpose of the research was reached. It is approved that the model of the Central Bank as a mega-regulator of financial markets is not optimal for the developing countries and particularly for Russia.

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