

15-th International Banking Congress

“The Basle Recommendations: Approaches and Realization”

**“Banking Supervision: Generator or Hindrance in
Development of the Banking System”**

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Ladies and Gentlemen!

Let me express my thanks to the organizers of the Congress for this opportunity to take the floor and share my thoughts on some issues which the banking communities of our countries are concerned about.

Today I will speak about the role of banking supervision in the development of the banking system.

1. Methodological notes

The key word for determining the topic is ‘Development’ and therefore we need to look into this conception.

Just a little methodological digression from the theme! Recently Messrs. Alexei Ulukaev, Aftandil Babaev and myself were discussing in relation to Caucasus. From the review I presented it turned out that Armenia had been the most successful in development. This aroused some discontent with the interlocutors. But my response was that no one disturbed them to make their own review.

What does it mean – from the methodological point of view? In order to understand whether or not there is development, we have to identify who’s the subject, what goals it pursues, and who evaluates the results of the action.

Development is the change of an object's qualitative characteristics being the result of one or several accomplished projects with definitely set goals realized by the subject/subjects of the development.

Project is a technological process of a purposeful change of qualitative parameters of the object.

Development often, without going into the matter of qualitative characteristics of the object, is being replaced by the growth. Since when the discussion is development of the banking system, the indicators such as growth of assets, share of assets in GDP, level of capitalization, etc. are the ones that are most referred to. In our opinion, never attempting to underestimate the importance of these indicators, there should however be some other approaches to evaluating the development. Namely, to watch the obtained results in correlation with the set goal.

That is, where we see the reformer and the goals set by that reformer, it will be no difficult to evaluate the obtained results in terms of the change of qualitative characteristics. Here, the question is: who may give the evaluation? Answer – firstly, the subject that fulfils the project, and, secondly, an independent subject that is familiar with the project.

Actually, the mess really comes about because there is great deal of evaluators of development of the banking system, and each of them, with their own perception of the development, issues inadequate evaluations. The conclusion is if you fail to know the reformer's goals it'll be impossible to evaluate whether or not the banking supervision is generator or hindrance to the development of the banking system.

2. Three phases of development of the banking system

We might distinguish three phases of development of the banking systems of our countries:

1. Phase of depuration

2. Phase of regulation (establishment)

3. Phase of development

The basic characteristics of the first phase include chaotic emergence of banks, a great number of bankruptcies, frequent change in ownership, formation of legislation, establishment of banking supervision. At this stage, the goal of development of the banking system has been apparent – that's depuration of the system. Also apparent was the subject of the development (banking supervision) and the projects accomplished pursuant to the goals set. In Armenia, we have implemented a project of improvement of the bankruptcy legislation whereby the banking supervision was empowered adequately in order to exercise bankruptcy with as minimum social consequences as possible. The legislation clearly stipulated quite tough criteria pertaining to insolvency, including the Central Bank's subjective judgment of the activities of the bank. The fulfillment of this project helped us liquidate around 30 percent of the banks and, over a year, quantitative indicators of the banking system recovered. Russia accomplished a project on the introduction of all-known individual deposit insurance scheme.

The second phase has peculiarities as follows: enlargement (consolidation) of banking institutions, identification of a level playing field, formation of core elements of an institutional environment of the banking sector, adherence by the banking supervision and regulation to international standards and practices, and practices of corporate governance. What comes forward also at the stage of establishment is the goal of development of the banking system – that's stabilization, and banking supervision appears to be the main subject of the development. International rules of banking supervision and banking regulation clearly set a vector around which banking supervision authorities of practically all CIS countries take their measures. Generally, these are Recommendations of the Basle Committee and other regulatory papers for the banking business. Without introducing these, the international banking

activities are not possible. How successful has the banking supervision been in realizing projects at the second phase is generally the business of international organizations which launch various investigations to evaluate compliance to international practices. And, as we read and learn these documents, we could see whether the banking supervision is generator or hindrance to the development. So, the problem of evaluators at the first and second phases does not emerge as the goals are visible.

Quite a few banking systems of the CIS countries entered the phase of development. The fundamentals of this phase are building of a single model of financial market, and creating of an institutional environment, pursuant to an alternative goal of development.

3. Goals of development at the current phase (alternatives)

What goal could be set for the banking system of our countries at the third phase?

Let us review three basic alternatives. Naturally, these are not mutually exclusive, however the priorities should be set out primordially.

Alternative 1 suggests a supportive ground for stability of the banking system. The key function of banks in the context of this model lies in performing the role of intermediation in the payments and settlements area. The accumulation of resources and lending to economy is the key source for creation of value, and the funding of the real sector comes from non-bank sources.

Alternative 2 characterizes building by the banking system of the function of intermediation, connected with the accumulation of resources and lending to economy. In this model, the function of investment is not intrinsic to banks, as non-bank institutions are there for this function.

Alternative 3 points out the banking system as performer of a role of locomotive for the development of the economy on the whole. In this model, an investment component of the bank comes forward, and banks mostly position themselves as management institutions, bringing considerable influence upon the decisions taken in other sectors of economy.

So, in the third phase the goal is not apparent. In order to understand whether or not supervision authorities are generator or hindrance to the development, we first need to look into the projects of development and, therefore, goals and then to evaluate how far a banking system today is from the one we would like to set up.

This means that all participants of the market – banks, consumers, regulators – should hold a single vision of the future of the banking system.

A relevant question here is – who shapes that vision and stands as the subject of development on a phase when goals are not that visible.

The answer is simple – the one who will take a responsibility and fulfill the project of development of the banking system. That could be the government on behalf of the ministry of finance, or that could be the central bank, and a group of banks (in a form of association of banks).

There could be no development unless purposeful activities, open declaration, transparent measures are in place. The subject that implements a project activity shall have adequate capacities, resources and methods.

It is obvious that all the participants of the market should discuss the project in question, and once it is adopted, the parties of the discussion will automatically become participants of the project. Within its framework it'll

be quite easy to judge whether the banking supervision is a generator or a hindrance.

Some of you in the lecture-room may have a new question, like ‘How *you* accomplish the approaches in your country, which you are proposing?’ To us, the answer is already evident – we are for the third alternative providing that banks come out as driver of the development of economy. At present, much effort is being spent on re-writing the legislation and other regulatory papers which would give banks an access onto the investment market. Banks in Armenia – that’s a vital sector that accumulates the experience of management, including corporate governance, risk management, and financial flows management. In reality, banks are the very entities which could push ahead corporate governance to the enterprises of the real sector. This would both downsize the underground economy, and increase the number of solvent, transparent enterprises. After all, indeed, the principal problem on the way of economic development today is corruption and ‘shadow’ economy. While we had success in resolving the issue in our banking system, there comes then a necessity to use the potential of the banks as subjects interested in resolution of such problems in other sectors of the economy as well.

We need to realize this project in close cooperation with the banking community.

4. Significance of Basle II for the development of banking system

The topic of the Congress reads “The Basle Recommendations: Approaches and Realization”.

We would rightfully ask a question to ourselves: Could Basle II become a development project for the banking system?

Our answer is: No, it could not. Inasmuch as we fail to set up clear goals of development, we will not be able to answer questions like these: “How to

introduce the Basle II?”, “What would be the phases for its introduction?”, “What realities of the current situation do we need to consider, what to ignore?”, and the introduction of new standards would always meet with resistance.

To us, Basle II is a new instrument for both banks and banking supervision, and a competent usage of that instrument within the framework of the set goals might enable accomplishment of the project.

5. Main conclusions

To sum up, I would like to formulate the basic theses of my address.

First – a development may only be if it is designed;

Second – there should emerge a subject which would take a responsibility for the accomplishment of the development project;

Third – evaluating the activity of a regulator is not possible without a design position.

At the phase of depuration and establishment, the banking supervision will act as a generator for the development of the banking system, since both goals and reformers are visible. At the new phase of development, the banking supervision may be a hindrance, as goals are not obvious, vision of the future of the banking system varies, and there is at least three alternatives to choice.

For today, the main challenge we face is clear delineation of the desired goal of development.

Thank you