Financial Inclusion & Infrastructure Global Practice

Market Conduct Supervision in Small Countries: The Case of Armenia

KEY MESSAGES

- *In many small and low-income economies capacity and resource constraints require a flexible and practical approach in developing market conduct capacity and oversight.*
- *While a twin-peak model[1] has the advantage of clearly defined objectives and mandates of the respective agencies an integrated model might be more feasible for small and low income economies.*
- *However, conflicts of interest need to be addressed: Market conduct supervision policy must be developed independently from prudential supervision.*
- *Market conduct supervision functions may be carried out by prudential supervisors on the basis of detailed market conduct manuals and adequate training.*
- *Market conduct supervision should assess both the existing business practices of financial institutions in dealing with their clients and the internal controls related to market conduct.*
- *With an ever-growing complexity of financial products and the utilization of new sales channels, adequate resources must be available to train supervisors accordingly.*

INTRODUCTION

The institutional arrangements for market conduct regulation and supervision vary across countries. In some countries the same supervisory agency is in charge of prudential and market conduct supervision. Others have established a specialized financial consumer protection/ market conduct agency (so called 'twin-peak' structure). A third approach is for a general consumer protection agency to also deal with financial products and services.

There are advantages and disadvantages to each model: Placing consumer protection in the same agency as prudential supervision typically ensures good flow of information and supervisory coordination while creating potential conflicts with the traditional and long-standing prudential supervisory roles. The twin-peak model has the advantage of clearly defined objectives and mandates of the respective agencies. On the other hand, in particular, small countries often lack resources to establish a specialized market conduct authority with the required knowledge and expertise. The challenge of the general consumer protection agency approach is to provide sufficient resources in order to handle financial services issues properly since technical aspects of financial services require specialized staff with sector-specific knowledge and expertise.

The optimal model in any given country will depend on country-specific characteristics such as the size and structure of the financial system, its stage of development, specific regulatory and supervisory activities, skills and institutional capacity, and prevailing political traditions. In many small and low-income countries capacity and resource constraints

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[1] Twin peak model refers to a structure where a separate authority (outside prudential supervision) is responsible for market conduct supervision.

THE WORLD BANK

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Departement of Economic Affairs, Education and Research EAER
State Secretariat for Economic Affairs SECO

CENTRAL BANK OF ARMENIA

require a flexible and practical approach in developing consumer protection capacity and oversight.

DEFINITION OF MARKET CONDUCT AND CONSUMER PROTECTION SUPERVISION

In broad terms, both market conduct and consumer protection are the elements of financial regulation and supervision focusing on financial institutions' behavior, including non-distortive and non-abusive business practices and information disclosure in providing services to the retail consumers.[2] For the sake of simplicity, market conduct supervision here includes financial consumer protection supervision, and this term will be used as an integrating concept throughout the technical note.

WHICH INSTITUTION IS RESPONSIBLE FOR MARKET CONDUCT SUPERVISION IN ARMENIA?

The Armenian financial market is regulated by the Central Bank of Armenia (CBA). The CBA is also the integrated supervisor, thus combining the regulatory role of developing financial market rules with the supervisory role of enforcing these rules. The supervisory mandate of the CBA covers both the prudential supervision as well as the supervision of market conduct of financial institutions. Both the prudential supervision and market conduct mandate of the CBA stem from the Law on the Central Bank, defining the objective of the CBA in these areas to "ensure necessary conditions for the stability, solvency, liquidity and normal activities of the banking system of the Republic of Armenia" and to "ensure essential conditions for protection of rights and lawful interests of the financial system consumers."

The effectiveness of the consumer protection regime is also supported by the well operating Financial System Mediator (a financial ombudsman) that addresses consumer complaints and contributes to the comprehensive financial consumer protection framework.

HOW IS MARKET CONDUCT SUPERVISION ORGANIZED WITHIN THE CBA?

In 2007, the CBA established the Consumer Protection and Market Conduct (CPMC) Division within the Financial

KEY FACTS: ARMENIA

- Population: 3.1 million
- GNI per capita: 3,200 USD
- Lower middle income country
- Adult population with account at a formal financial institution: 17.5 % (compared to 44.9 % in Europe & Central Asia)
- Financial sector: dominated by 21 banks that account for 91.1 percent of the private financial system's assets, with the share of non-bank credit organizations at 4.8 percent, and insurance and capital market at 2.3 percent of the private financial system's assets.
- Financial penetration remains low: banking sector assets and loans to GDP in 2011 were 54.1 percent and 31.6 percent respectively. Financial depth is one of the lowest in ECA region, with deposits to GDP accounting for 24.5 percent at the end of 2011
- Credit to private sector/GDP: 26 percent (compared to about 33 percent in Georgia and Moldova, or 44 and 62 percent in Russia and Ukraine, respectively)
- Household debt: In the first half of 2012 the household debt burden (total sum of liabilities of households to credit institutions) has slightly increased with the debt to GDP ratio and debt to deposits ratio amounting to 17.0 percent and 102.2 percent, respectively. Nevertheless, it remains lower than respective figures reported in Eastern European countries.
- Pension reform in 2014: the financial sector should expand further in 2014 with the introduction of a mandatory defined-contribution second pillar pension system for citizens under 40 years of age as well as voluntary schemes.

Sources: CBA, Global Findex 2012

[2] The World Bank's Good Practices for Financial Consumer Protection use the terms "consumer protection," "business conduct," and "market conduct" supervision interchangeably.

CASE STUDY 1 – MISLEADING ADVERTISING

As part of the regular monthly monitoring of all TV ads aired by financial institutions, a TV ad for a mortgage claimed that the loan is granted without any downpayment, leading the consumers to believe that there are no additional requirements for getting a loan. However, according to the bank's website, additional collateral was needed to obtain the loan. According to Regulation 8/03 an advertisement should not influence consumers' attitudes towards an advertised service by inaccuracies, overstatements and misrepresentations.

- The advertisement was found in breach of the regulation and the Licensing & Supervision Committee imposed a fine on the financial institution.

System Stability and Development Department. The CPMC Division is currently staffed with six full-time employees, including the head of the division.[3] The responsibilities of this division include the creation and improvement of the legal framework for market conduct regulation and supervision, establishment of consumer rights protection infrastructure, improvement of financial literacy of the population and establishment of the necessary market conduct supervision framework. The supervisory activities of the CBA, as well as general consumer protection and financial education activities are funded from the CBA's budget.

REGULATORY RESONPSIBILITIES OF THE CPMC DIVISION?

The CPMC Division is responsible for developing all legislation (laws and CBA regulations) related to consumer protection and market conduct supervision.

Any proposals for new regulatory requirements or for the update of the existing rules are prepared by the CPMC Division in close cooperation with the Financial System Regulation Department and the Legal Department, which provides legal opinions to both prepared regulations and conducted inspections as well as being responsible for licensing of financial institutions in Armenia.

The CPMC Division is also responsible for the development of rules in the form of the market conduct supervision manual that guides CBA activities in this area. This manual forms an integral part of the general on-site inspection manual.

WHICH SUPERVISORY TOOLS ARE BEING USED?

The available supervisory tools for the CBA include:

- on-site examinations of financial sector providers,
- monitoring of the content of websites of financial service providers,
- monitoring of advertising by financial service providers, including TV advertisements,
- monitoring and analysis of published information, including annual reports, financial statements, and other documents published by the financial institution,
- testing and verifying of disclosure and advertising materials made publicly available by financial institutions, and
- specific on-demand supervision actions (e.g. monitoring of radio advertising during the launch of the motor third party liability insurance, supervisory actions based on received complaints or media coverage, etc).

CASE STUDY 2 – MISCALCULATION OF THE ANNUAL PERCENTAGE RATE FOR CONSUMER CREDIT

As part of an on-site inspection, the inspectors verified the calculation of the Annual Percentage Rate (APR) of consumer loans, finding that some of the fees charged were omitted from the calculation by the bank, thus lowering the presented APR from 32.41% to 30.51%.

- As the miscalculation was based on an improper calculation methodology of the bank, the Licensing & Supervision Committee imposed a fine on the financial institution.

[3] Compared to around 80 staff in the Financial Supervision Department.

HOW ARE THE SUPERVISORY TOOLS APPLIED?

On-site inspections focusing on both prudential and market conduct supervision are conducted by the staff of the Financial Supervision Department based on an annual workplan that takes into account key risk factors such as the size of the financial institution, complaints against the institution as well as inspection and monitoring results. When limited resources allow, a staff member of the CPMC Division joins on-site inspections based on the consumer protection team's risk assessment of the inspected institution. Otherwise prudential supervisors conduct both the general on-site inspection, as well as the market conduct supervision, in line with the guidelines of the market conduct supervision manual. In this case an informal exchange of information with the CPMC Division takes place to discuss the inspection findings and possible further actions.

Results of the market conduct assessment are reflected in the Market Conduct Assessment Matrix (see box below) which provides a classification of a financial institution's market practices, internal controls, procedures and compliance. This allows supervisors to take a more comprehensive view in analyzing the financial institutions in terms of focusing on mitigation of key risks and taking supervisory actions.

Off-site supervisory actions regarding market conduct – on the other hand - are initiated by the CPMC Division. Some of the activities are more formalized and conducted regularly on a monthly and quarterly basis (e.g. the monitoring of the websites of financial institutions and their compliance with the rules) while others are more ad-hoc, based on the requests of the CBA Board or feedback from the market that may point out to a significant market conduct issue.

Market Conduct Examination Manual

The onsite supervision manual defines four key areas of interest for complex on-site market conduct inspections:

- Financial services rendered (terms and conditions, content of contracts, fees, etc.)
- Interaction with consumers (conduct of the sales process, information disclosure, staff qualifications, etc.)
- Internal redress mechanism
- Advertisements and other published information

The examination includes two types of inspection and generates, accordingly, two types of assessments:

1. Inspection and assessment of the existing (actual) situation: A 5-score system of assessment (5 for fully satisfactory; 4 for mostly satisfactory; 3 for satisfactory; 2 for partly satisfactory; and 1 for unsatisfactory) is used to describe the compliance of the policy of financial institutions, how properly they carry out their activity, maintain their records, which risks they are exposed to, and legal compliance.

2. Inspection and assessment of risk management: The same 5-score system of assessment is used to assess the compliance of the internal control policy of financial institutions, how properly they carry out that policy, maintain their records, which risks they are exposed to, and the legal compliance.

TEMPLATE MARKET CODUCT ASSESSMENT MATRIX

	PROPER POLICY	PROPER IMPLEMENTATION	PROPER RECORDS	EXPOSURE ASSESSMENT	LEGAL COMPLIANCE	AVERAGE ESTIMATE
FINANCIAL SERVICES	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5
CONSUMER CONGRUENCE*	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5
REDRESS MECHANISM	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5
ADVERTISEMENT AND OTHER PUBLISHED INFORMATION	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5
AVERAGE ESTIMATE	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5	1-5/1-5

*Interaction with consumers

CASE STUDY 3 - WEBSITE CONTENT

As part of its off-site supervision activities, the CPMC Division monitors the content of websites of financial institutions each quarter to ensure their compliance with Regulation 8/03, defining the procedures and minimum requirements for publication of information by financial institutions. They are required to comply with the following general principles:

1. Information is presented in font type and size easily legible for a representative consumer and in visible form; and
2. Information is presented in a way that allows a consumer to easily find information in which he/she is interested.

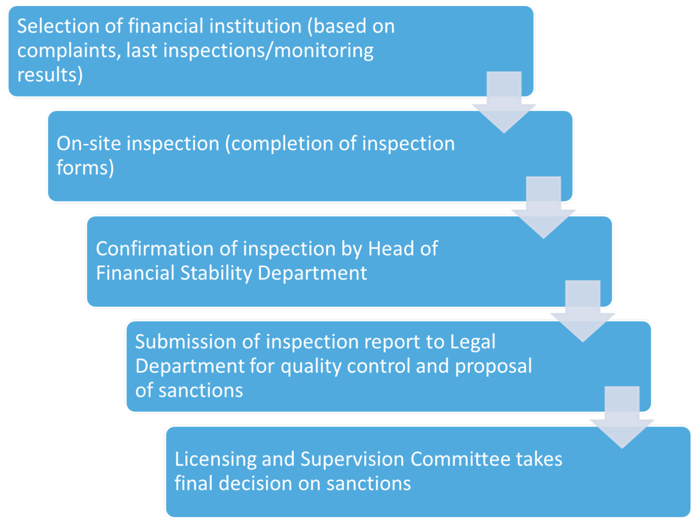
During the regular monitoring, one of the websites was found to have the following links placed in a hardly visible part of the homepage and in a small font: 1) Regulations, 2) Contact & Feedback, 3) Rights of consumers, and 4) Office of the financial ombudsman.

- As the setup of the homepage was in clear breach of the requirements of the relevant regulation, the Licensing & Supervision Committee imposed a fine on the financial institution and the homepage had to be changed.

ASSESSMENT OF SUPERVISION RESULTS AND ENFORCEMENT ACTIONS

After confirmation of the inspection results by the Head of the Financial Supervision Department, the on-site inspection report is shared by the Financial Supervision Department with the Financial Stability and Development Department and the Legal Department. The supervisory actions, as proposed by the Legal Department, are then discussed at the so-called "Licensing and Supervision Committee" which is the primary CBA forum for discussing supervision results and deciding on penalties. The Committee consists of 7 members: 1) Chairman. 2) Deputy Chairman, 3) Head of Financial Supervision Department, 4) Deputy Head of Financial Supervision Department, 5) Head of Financial System Regulation Department, 6) Head of Financial Stability and Development Department, and 7) Head of Legal Department.

Core on- site supervisory process



The off-site supervisory actions follow a similar process. After confirmation of the inspections by the Head of the CPMC Division and the Head of the Financial Stability and Development Department[4] the inspection forms are submitted to the Legal and Supervisory Departments for quality control and the Licensing and Supervison Committee then decides on sanctions.

CHALLENGES AND LESSONS LEARNED

Armenia has strong insights to offer as a model for market conduct supervision in small countries. Lessons learned and challenges include:

- In many small and low-income countries capacity and resource constraints require a flexible and practical approach in developing consumer protection capacity and oversight.
- While a twin-peak model has the advantage of clearly defined objectives and mandates of the respective agencies, an integrated model might be more feasible for small and low income economies.

[4] If the CPMC Division participates in on-site inspections the Head of CPMC Division signs the market conduct section of the report.

- In the case of Armenia, an integrated central bank supervision of all financial institutions provides for the implementation of a holistic financial sector development and regulation framework.
- However, conflicts of interest need to be addressed: In Armenia, market conduct supervision policy is developed independently from prudential supervision.
- As effectiveness of market conduct supervision and timeliness in response is constrained by limited resources, market conduct supervision functions are carried out by prudential supervisors on the basis of detailed market conduct manuals and adequate training.
- Going forward, organization and staffing of the CPMC Division will need to be strengthened to further develop and enforce sound and efficient market conduct supervision.
- Market conduct supervision in Armenia assesses both the existing business practices of financial institutions in dealing with their clients and the internal controls related to market conduct.
- There are two key challenges faced by the current market conduct system in Armenia: lack of thematic market practices investigations and mystery shopping power.
- While the supervisors have extensive powers in off-site supervision and on-site inspections, some supervisory tools which are especially useful for market conduct supervision such as mystery shopping or market practices investigations are not allowed by the Armenian legislation. As a result the supervisory enforcement on the basis of non-documentable requirements (one-on-one sales practices, oral communication with clients, etc.) cannot be effectively imposed.
- With an ever-growing complexity of financial products and the utilization of new sales channels, adequate resources must be available to train the supervisors accordingly.

MORE INFORMATION AND RESOURCES

Consumer Protection and Financial Capability:
http://www.worldbank.org/responsiblefinance

Financial Literacy & Education Russia Trust Fund:
http://www.finlitedu.org/

Financial Inclusion:
www.worldbank.org/financialinclusion

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