Formalization of Banking Supervision

19th–20th Centuries

Eiji Hotori · Mikael Wendschlag · Thibaud Giddey

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Preface

This book has been many, many years in the making. Eiji Hotori and Mikael Wendschlag presented a crude first draft, including the conceptualization of the formalization process, at the 17th World Economic History Congress in Kyoto, Japan in August 2015 (WEHC 2015). At a session organized by Hotori entitled "Banking supervision in comparative perspective: Europe, America and East Asia," several of the world's leading researchers on banking supervision history presented new research and engaged in discussions about the similarities and differences between various countries, and the book's third author, Thibaud Giddey, presented some of his work on the cases of Switzerland and Belgium. Inspired by the conference and the positive feedback on the early draft, work on the book continued. With Giddey agreeing to join the project, the number of country cases increased, enabling deeper scrutiny of why banking supervision became formalized as it did, and why various countries' histories differ so much.

Today, it is well known that countries vary considerably in terms of the institutional setup of financial supervision. These differences have been regarded as potential problems in relation to financial stability, level regulatory playing fields, and market efficiency. Regarding banking in particular, the differences in how regulation is implemented and enforced by national banking supervisors have been a source of policy concern at least since the global financial crisis. In Europe, the creation of the banking union in 2014 can be seen as an attempt to overcome these

differences and increase international harmonization under the European Central Bank banking supervision framework.

Despite broad acknowledgment of the differences between countries in terms of banking supervision, little consideration has been given to investigating *why* these differences exist. In essence, a historical perspective has been lacking.

As was evident in the research presented at the WEHC in 2015, as well as in other research on banking supervision history, the origins of many of today's institutional structures can be traced back a long way. Therefore, without an understanding of how the various distinct national structures came to exist in the first place, it is difficult to design sound institutional reforms. The power of institutional "incremental change" seems strong in relation to banking supervision, and hence reforms of various national arrangements for greater international harmonization should benefit from greater knowledge of how the existing differences arose. This is a key motive behind this book, to focus on the formalization of banking supervision in a range of countries and identify the "drivers" of the various processes.

To address these issues, the book focuses on the formalizing phase of banking supervision, that is, the formalization process rather than banking supervision itself. While it is clear that the history of banking supervision in each country differs, it is more difficult to identify the underlying principles of the formalization process itself. As we will see, banking supervision was formalized at different times in various countries. For example, the UK underwent the process about a century later than the US. However, we believe that our approach of focusing on the drivers of the formalization process provides a means of comparing various cases in a meaningful way. Of course, in the context of our comparative analysis, an explanation of the concept of "formalization" is critical, and this is provided in the first chapter. The final chapter compares the drivers of the formalization of banking supervision in the countries examined. The other chapters are essentially "empirical" in nature, providing an account of each country's historical particulars. Our analysis reveals that there were four main drivers of banking supervision formalization in the eight countries examined (the US, Japan, Sweden, Germany, Switzerland, Belgium, France, and the UK): governmental necessity, social and economic development, financial crises, and financial globalization. Additionally, the outbreak of war was often the trigger for the introduction of

formal banking regulation and supervision. It is noteworthy that financial crises, which are generally considered to be a primary driver of major regulatory and supervisory reforms, were not the sole driver of the formalization of banking supervision.

We hope that this book establishes a standard for research on banking supervision. In future research, the effectiveness and outcomes of banking supervision *after* formalization should be examined, and thus a new explanation of the global financial crisis of 2008 should emerge. This book is highly recommended to not only financial/economic historians, but also readers who are currently or will in the future be involved in banking supervision, that is, students, bankers, supervisors, and international officials.

Yokohama, Japan — Eiji Hotori
Stockholm, Sweden — Mikael Wendschlag
Lausanne, Switzerland — Thibaud Giddey

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At the WEHC 2015, we were blessed to have productive comments by our session participants and audiences. In addition to being presented at the WEHC in 2015, earlier versions of the concept and outline of this book were presented at the Högre Seminariet entitled "Explaining the formalization of banking supervision: An international comparison" at Uppsala University on 31 March 2015, a pre-conference of the WEHC entitled "Diversity in development of the banking supervision: Toward a comparative analysis" at Yokohama National University in Japan on 25 October 2014, the European Business History Association Annual Congress 2013 entitled "Research on the history of banking supervision: A comparative analysis" at Uppsala University on 23 August 2013, and an international conference entitled "New Perspectives on Financial Supervision" at the Stockholm School of Economics on 5–6 June 2012. Although we are responsible for any remaining errors, we are grateful to Charles A. E. Goodhart, Niels Krieghoff, Jean-Luc Mastin, Emmanuel Mourlon-Druol, Jan Ottosson, Catherine R. Schenk, Masato Shizume, Sean Vanatta, Eugene N. White, Kazuhiko Yago, and anonymous reviewers for their invaluable suggestions.

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CHAPTER 1

Motivation and Framework

1.1 Introduction

Today, banking supervision is a common feature of the financial system in all developed countries. However, the history of formalized banking supervision differs substantially between countries in terms of both timeframe and character, and despite its importance, very few attempts have been made to compare the history of banking supervision in various countries.

Major changes in the institutional setup of banking systems, including the regulation and supervision of banks, have often been attributed to political reactions to financial crises (Grossman 2010a). The logic behind this view is that financial crises discredit the existing order of things, and politicians often respond to changed public sentiment by implementing measures aimed at ensuring that these crises will not occur again (Goodhart 2010).

While financial crises have played a key role in the formalization of banking supervision in many countries, other factors have been important in the United States (US) and the United Kingdom (UK). The emergence of formal banking supervision in the US was closely linked to the note-issuing privileges given to the national banks by the Office of the Comptroller of the Currency (Robertson 1968). In the UK, banking

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supervision was formalized as a result of the development of, among other things, new international financial institutions, markets, and centers in the 1970s (Capie 2010).

As Streeck and Thelen (2005) noted in the context of institutional economics, institutions tend to evolve slowly and incrementally, while rapid and overwhelming change is rare. Change is incremental because of the “bargaining” nature of stakeholders. The actions and positions of various interest groups tend to be mutually neutralizing, lessening the impact of various groups’ attempts to either introduce change or retain the current institutional setup. Thus, the emergence of financial regulation and supervision should be observed over a long period of time, rather than immediately following a specific event such as a financial crisis.

The purpose of this study is to explain why the formalization of banking supervision took place at different times in different ways by identifying the drivers of formalization in the following developed countries: the US, Japan, Sweden, Germany, Switzerland, Belgium, France, and the UK. These countries display a rich variety in terms of the history of the formalization of banking supervision. The US, which was the first country to formalize banking supervision, commenced the formalization process at the state level in the 1820s and basically completed the process at the federal level in 1863–1864, providing the national banks with banknote issuing rights in relation to the newly created national currency. In Sweden and Japan, the formalization process occurred in the second half of the nineteenth century during a period of rapid economic growth, and was finalized in 1907 in Sweden and 1916 in Japan. Germany, Switzerland, and Belgium instituted a formalization process in response to the financial crisis in the early 1930s, and the effectiveness of formalized banking supervision was strengthened by different drivers over several decades in the three countries. France provides an example of a formalization process in response to the nationalization that occurred in the 1940s. In the UK, the trend toward financial globalization that commenced in the 1970s was the driver of the formalization of banking supervision.

The choice of these eight countries was motivated by several factors.[1] One of our main objectives was to present a variety of cases in terms of (a) the chronology of the formalization process (ranging from 1820 to 1970), (b) the size of the country and its banking sector, (c) the type of financial system (bank- vs. market-oriented), (d) the variety of capitalism (liberal vs. coordinated market economy), and (e) the legal system. This diverse selection enables meaningful international comparisons from an historical perspective (see Table 1.1). Furthermore, in this book, we examine the process of "formalization of banking supervision," and thus it is a necessary condition that the chosen country has important commercial banks, as well as influential government interventions, albeit to varying degrees. The US and the UK are categorized as having market-oriented systems wherein economic development has mainly been financed via the stock markets. However, the role of the commercial banks remains important in both countries, and the impact of institutional design by both governments is important in understanding the development of the national economy (Allen and Gale 2000: 30–34). The other six countries are categorized as having a bank-oriented system, with close and enduring relationships between industry and the banks with either the implicit or explicit consent of the government (Allen and Gale 2000: 34–42).

Hall and Soskice (2001: 17–21) categorized both the US and the UK as "liberal market economies," while they categorized five other countries (Japan, Sweden, Germany, Switzerland, and Belgium) as "coordinated market economies." Although France was categorized as "ambiguous," it has a "non-market coordination" system in the corporate finance sector.

[1] These include economic importance in terms of magnitude (e.g., gross domestic product) and quality (e.g., the Human Development Index score). Additionally, the choice of these eight countries is based on an historical perspective. The US and the UK are regarded as representing the Anglo-Saxon system and have traditionally been viewed as important countries, especially since the second half of the nineteenth century. Germany and France are regarded as representing the Continental system and have been influential in the financial sector since the late nineteenth century. Japan and Sweden were the earliest adopters of formal banking supervision among Asian and European countries, respectively, while Switzerland and Belgium represent smaller continental European economies and developed a highly formalized banking sector in the early twentieth century. As open economies subject to numerous European cultural and institutional influences, they provide interesting examples of the influence of various international dimensions on the process of formalization of banking supervision.

Table 1.1 Summary of the eight countries examined

Country	*GDP world rank 2018*	*GDP per capita world rank 2018*	*HDI world rank 2019*	*Type of financial system*	*Variety of capitalism*	*Legal origin*	*Supervisory authority (primary) as of 2019*	*Year formalization commenced*
US	1	9	15	Market-oriented	Liberal market economy	Common law (English origin)	FRB, OCC, FDIC, SEC	1863
Japan	3	26	19	Bank-oriented	Coordinated market economy	Civil law (German origin)	Kin'yū-cho (Japanese FSA)	1872
Sweden	23	12	8	Bank-oriented	Coordinated market economy	Civil law (Scandinavian origin)	Finansinspektionen (Swedish FSA)	1868
Germany	4	18	4	Bank-oriented	Coordinated market economy	Civil law (German origin)	BaFin	1931
Switzerland	20	2	2	Bank-oriented	Coordinated market economy	Civil law (German origin)	FINMA	1934
Belgium	24	19	17	Bank-oriented	Coordinated market economy	Civil law (French origin)	FSMA, National Bank of Belgium	1935
France	6	21	26	Bank-oriented	"Ambiguous position"	Civil law (French origin)	Banque de France	1941

Country	*GDP world rank 2018*	*GDP per capita world rank 2018*	*HDI world rank 2019*	*Type of financial system*	*Variety of capitalism*	*Legal origin*	*Supervisory authority (primary) as of 2019*	*Year formalization commenced*
UK	5	22	15	Market-oriented	Liberal market economy	Common law (English origin)	PRA (a part of the Bank of England)	1979

Sources GDP and GDP per capita: International Monetary Fund, World Economic Outlook Database October 2019, https://www.imf.org/en/Data, accessed on 8 June 2020; HDI: United Nations Development Programme, 2019 Human Development Index Ranking, http://hdr.undp.org/en/content/2019-human-development-index-ranking, accessed on 8 June 2020; Type of financial system: Allen and Gale (2000); Variety of capitalism: Hall and Soskice (2001); Legal origin: La Porta et al. (1998)
Note GDP ranking is based on nominal GDP in US dollars

Regarding the US and the UK, Hall and Soskice (2001: 27–31) emphasized the role of the stock market (including its function in relation to valuation and disclosure) in corporate finance in the liberal market economy, although they did not entirely discount the roles of bank lending[2] and the government in terms of macroeconomic policy.

From a legal perspective, the US and the UK are included in the "common-law tradition" ("English origin") category, while the other six countries are included in the "civil-law tradition" category. Within the "civil-law tradition" category, France and Belgium are included in the "French origin" category, Germany, Japan, and Switzerland are included in the "German origin" category, and Sweden is included in the "Scandinavian origin" category. As La Porta et al. (1998: 1151–1152) noted, law enforcement is stronger in the German- and Scandinavian-origin countries, whereas it is weaker in the French-origin countries. We will examine the applicability of this categorization to banking supervision at the time of formalization in each country.

With the aforementioned institutional economics context in mind, we focus on three dimensions in relation to the formalization of the supervision of commercial banks: (1) the legal framework (bank regulation), (2) the banking supervisory agency, and (3) bank supervisory activities. A narrative approach is adopted based on both primary and secondary sources.

Our primary data sources are collections of historical documents and archival materials. Notably, Söderlund (1976) included the confidential notes of the two directors who headed the Swedish Bank Inspection Board, while a publication by the Bank of Japan contained the minutes of the Financial System Research Committee, including arguments for the reform of the banking supervision system in the 1920s. Regarding Switzerland, we accessed a large collection of unpublished documents including the minutes of the Federal Banking Commission deposited in the Swiss federal archives. Our analysis of Belgium is also based on primary sources including the archives of the Banking Commission kept by the National Bank of Belgium and the State Archives. Regarding the other four countries, ample secondary sources in relation to the formalization of banking supervision were available.

[2] See notes 25 and 26 in Hall and Soskice (2001).

The rest of this book is organized as follows. The remainder of Chapter 1 explains several key concepts, presents a definition of "formalization," and summarizes relevant previous studies, including comparative studies. Chapters 2 to 9 trace the development of the commercial banking system and outline the history of banking supervision, mainly focusing on the formalization phase, in each of the countries studied. The countries are compared in Chapter 10 and the various drivers of the process of formalization of banking supervision are identified.

As is evident in this book, formalization of banking supervision took place in response to the shifting needs of the time, and the formalization process was incremental in many cases. In the US, formalization began in relation to the Civil War financing, while in Japan and Sweden it was closely linked to the organic development of the banking sector and the general public's increasing exposure to commercial banks as both depositors and borrowers. In Germany, Switzerland, and Belgium, the formalization process was triggered by the Great Depression in the early 1930s, although the specific forms of the crisis varied considerably among the three countries. In France, the formalization was linked to the Second World War and the subsequent control of the economy, while in the UK, progress toward financial globalization prompted a shift from informal to formal banking supervision.

Notably, although financial crises are generally considered to have been the primary drivers of major regulatory and supervisory reforms, they did not always play a key role in the process of formalization of banking supervision. In addition, it is noteworthy that from a historical perspective, regulation, and supervision have not always been "natural" responses to dysfunction in the banking system. The formalization of banking supervision was rather the product of complex political actions negotiated by relevant stakeholders with divergent interests in a specific social, political, and economic environment.

These findings are applicable not only to the design of future banking supervision system but also in the field of development economics. For example, even if a developing country experiences a financial crisis, the timing of the formalization/enhancement of banking supervision should be determined by the conditions, namely, whether there is an increasing trend in the number of depositors and whether the commercial bankers are sufficiently mature to understand the need for formalized banking supervision. Simultaneously, the country's history should be carefully considered with using the incremental change approach.

1.2 Concepts and Definition

Our theoretical approach is inspired by the terminology, definitions, and theory developed by institutional economists such as North (1990), who made an important distinction between informal and formal institutions. Informal institutions operate under socially enforced "rules" such as norms, while formal institutions are based on laws and regulations. Our interest lies in the process whereby an informal institution receives recognition, support, and active endorsement from formal institutions and organizations (e.g., government agencies).

In this book, we define informal supervision as having a discretionary, undisclosed, case-by-case, and irregular characteristic with undefined motives, targets, means, and responsibilities. Conversely, formal supervision is an arrangement whereby banking supervision is rules-based (Bank Law/Act/Decree) and sanctioned and authorized by the government, with basically the same treatment of all cases on a regular basis under formally stated objectives, powers, and responsibilities.

An important concept is that of "formalization," which is developed from a largely theoretical institutional perspective and is particularly inspired by the incremental change approach described and exemplified by Streeck and Thelen (2005).[3] This approach emphasizes the often slow and piecemeal change in institutions and the relatively rare occurrence of rapid and overwhelming institutional change. Change is incremental because of the often mutually neutralizing pushes and pulls of various interest groups aimed at either altering or retaining the current institutional arrangements. As illustrated later in this book, the formalization process is more or less incremental in every country. Additionally, in a seminal study of the literature on the history of banking supervision and regulation, White (1983) emphasized the struggle by various stakeholders to either change or retain the existing banking regulations in the US in the late nineteenth and early twentieth centuries. In this book, the main stakeholders are assumed to be the supervisor (the government), those subject to supervision (commercial banks), and those who supposedly benefit from banking supervision (e.g., small depositors). Instead of detailing the negotiation process, we deem it sufficient to outline the bargaining process among stakeholders. We assume that the interests of the general public are generally recognized by political leaders. Hence, to

[3] See also Mahoney and Thelen (2010).

attract as many votes as possible, political leaders are careful to safeguard the interests of small customers and depositors.

In contrast to other studies regarding the history of bank regulation, we go beyond merely chronicling the enactment of new or reformed banking acts. While these events are important, in many instances they are misleading in relation to identifying actual institutional change. New or reformed institutions often need active and deliberate enforcement to come into effect, which implies the need for an enforcer. As will be demonstrated later, the cases examined in this book illustrate the merits of looking at three dimensions, namely, rules, enforcers, and enforcement, in relation to the study of institutional formalization. In most of the cases covered in this book, banking supervision experienced periods when either one or two of these dimensions existed. Hence, the formalization of banking supervision involves not only the formalization of institutions (including expressing the norms, rules, and conventions of sound banking in legal form), but also the implementation and enforcement of banking regulations by regular supervisory activities executed by an organization that is formally empowered to do so. In terms of banking supervision, the state of being "formalized" is realized when (1) a legal framework, (2) a banking supervisor, and (3) bank supervisory activities are in place on a permanent basis.

Specifically, in this book, we operationalize the idea of institutional formalization in the context of the history of banking supervision by attempting to empirically capture and analyze the process that leads to the lasting condition whereby:

1) the legal basis for banking and its supervision is enacted, verified by bank acts and acts that regulate the supervision process;
2) a legitimate and empowered supervisory agency has been established, as verified by legal documents and political decisions, as well as the appointment of permanent staff and the establishment of a permanent office for in-house operations; and
3) the latter has started to enforce/implement the former on a regular basis, as evidenced by on- and off-site examinations and enforcement actions.

This book focuses on bank regulations regarding specific rules for commercial banks including the conditions for licensing (entry barrier and liability rules), the definition of banking and the scope of the banking

business (commercial/investment), capital adequacy, disclosure rules, and restrictions on interlocking directorates/insider loans (large loans). We also examine legislation in relation to banking supervision, which formally defines the objectives, powers, and resources of the supervisor. Although some forms of banking regulation such as liability rules are more or less self-enforcing, we assume that regulation requires active implementation and enforcement. As a result of this broad definition and the historical perspective adopted, we consider formalization as a long-term process, starting when one of the conditions is met and ending when all of the conditions are fulfilled.

The banking supervisor is defined as an organizational entity specifically assigned and empowered to enforce banking regulations and to engage in banking supervision as defined above. This can be an independent agency or a specific department within the Ministry of Finance (or Central Bank).

Banking supervisory activities are defined as regular on- and off-site examinations to check the health of a bank in terms of its ability to achieve one or more objectives. Depending on the objective(s), the main items to be checked will differ. Banking supervision also involves the enforcement of banking regulations through a range of disciplinary actions such as moral persuasion, fines (and/or imprisonment), or even the revocation of a bank's license.

1.3 Theory of Banking Supervision

Proper banking supervision is generally based on "principles of prudence." The Oxford English Dictionary defines the word "prudent" as "acting with or showing care and thought for the future"; its origin is the late Middle-English word "provident." In the eighteenth century, Adam Smith introduced the concept of "the virtue of prudence" as "a remedy for the vices," which is not merely a reorientation of self-interest but a reconsideration of the proper ends of a human being. Smith further introduced "magnanimity" as a complement to "the virtue of prudence" (Hanley 2009: 100–132).[4] Conventionally, the "principles of prudence"

[4] There is a guide on how to "read" Smith's *The Theory of Moral Sentiments*.

suggested that bankers should have full knowledge of the means and business of borrowers (Rae 1886).[5]

In the East, the concept of prudence existed as a philosophical tradition in relation to the "Zhongyong" (the doctrine of the average), which is one of the virtues of Confucianism, stating that one should never act in excess. In Japan, the Confucian philosopher Ogyu Sorai (1666–1728) interpreted Confucian doctrine as promoting sobriety and saving. In his well-known book "Seidan," he described sobriety and saving as essential virtues for both the sovereign (samurai) and the merchant. The noun "prudence" appeared in the earliest official English–Japanese dictionary, published in 1814. However, the concept of the "principles of prudence" for bankers was not widely recognized in Japan until the early twentieth century (Hotori et al. 2018).

Regarding prudential supervision, recent economic theory outlines why banking supervision is necessary. One key concept in explaining the need for prudential supervision is that of "externality," which developed in the field of public economics. The financial industry is closely connected through the payments system, which carries the systemic risk of "contagion." Theoretically, private costs (the costs incurred as a result of the failure of a specific bank) are lower than social costs (the costs incurred as a result of a chain of bank failures). This is called "market failure"—similar to the result of underinvestment in public goods, sound banks can fail as a result of contagion triggered by the failure of a bad bank. Additionally, the field of information economics introduced the concept of "asymmetric information" to explain the "rationality" of an excessive risk-taking strategy. Basically, information asymmetry exists between banks and customers. Although a disclosure system reduces the information gap, banks/customers are unable to access all of the internal documents or accounts of the customers/banks. Thus, information asymmetry results in "adverse selection": Good borrowers are excluded as a result of their ability to demand lower interest rates, with risk-taking banks preferring to lend to customers who accept higher interest rates and engage in high-risk business practices, while sound banks are forced to limit their lending as a result of their conservative strategy. The financial authority can impose certain regulations aimed at reducing excessive risk taking by banks. However, without proper banking supervision, the authority has

[5] Ross (1998) examined the adoption of the "principles of prudence" in the UK.

insufficient information about the banks' assets, risk status, and regulatory compliance. Hence, one of the aims of on-site bank examinations is to narrow this information gap (Goodhart and Illing 2002: 1–19; Mishkin 2001: 1–29; Goodhart et al. 1998: 1–15; Freixas and Rochet 1997: 257–279; Freixas et al. 2000: 63–84).

Another important concept in relation to banking supervision is that of "moral hazard." To lessen systemic risk and protect small depositors, a "safety net" has been introduced in relation to the modern banking system. The official deposit insurance scheme operated by the government and the "too big to fail" approach (whereby the central bank acts as the lender of last resort in the event of a bank bailout) provide a safety net. In addition to systemic risk, the mismatch in maturity dates between depositors and banks can cause a run on banks that has been likened to "sunspots," even if the banks are sound (Diamond and Dybvig 1983: 408–410). However, the existence of a safety net increases the risk of bankers' moral hazard because the depositors' level of scrutiny will decline in response to the guaranteed safety of their deposits. This is another reason for the financial authority to intervene in the financial sector. The supervisory authority constantly conducts examinations and supervision of banks to monitor the banks' performance. Imposing penalties such as fines reduces the risk of bankers' moral hazard.

Fundamentally, a regulatory system should include incentives encouraging banks to comply, otherwise banks relinquish their right to self-manage risk and must depend on the supervision of the regulatory authority. Hence, formal regulation should provide incentives for the bankers themselves that encourages voluntary risk management. Mishkin (2001: 13–15) pointed out the shift from a conventional "regulatory approach" to a prudential "supervisory approach" after "financial innovations" had facilitated the placing of "huge bets" by the banks, with the focus shifting from detecting financial crimes or breaches to maintaining sound banking business practices and proper operations. Thus, discretionary financial supervision is considered important in minimizing regulatory evasion by banks.

The economic theory underlying banking supervision lacks an historical perspective, which we address in this book.[6] Bankers' skills and knowledge of the banking business have increased over time, but banking

[6] We do not intend to criticize existing economic theory. Rather, we apply the theory from an historical perspective.

supervision cannot be effective until bankers have sufficient knowledge about the principles of prudence and banking operations. Similarly, a disclosure system only works when neither accounting fraud nor bookkeeping mistakes exist. Thus, not only moral hazard but also the maturity of bankers in terms of their knowledge and experience should be considered. In this respect, legislation regarding the formalization of banking supervision (as well as bankers' opinions in relation to the process) provides information that can be used to assess the stage of the process of formalization of banking supervision.

The emergence of ordinary customers/depositors is also an important factor. Until countries reached a certain stage in their economic development, commercial banks mostly catered for monarchs and privileged merchants. However, as the economy developed, commercial banks were increasingly used by small customers (both borrowers and depositors). As the degree of information asymmetry between banks and their customers increased, the introduction of formal banking supervision was sought by various stakeholders including bankers, customers, depositors, and stockholders. Thus, the level of social and economic development should be examined as one of the barometers of the formalization of banking supervision. The relationship between the commercial banks and the government is another important factor. Historically, commercial banks were permitted to issue their own banknotes, underwrote huge amounts of national bonds, and were deeply committed to national development projects. Thus, the soundness of these banks was crucial for the government's credibility, which more or less provided the rationale for the formalization of banking supervision.

1.4 Scope

This book focuses on identifying and explaining the formalization of banking supervision from an institutional perspective and places less emphasis on the effects and quality of the supervision itself. Additionally, we are mainly concerned with the shift away from an informal system of banking supervision, and thus we do not address informal banking supervision in detail. Of course, in every country in which a banking sector has developed, some form and level of informal banking supervision developed simultaneously. The creation and operation of a bank automatically attract stakeholders with various incentives in relation to

monitoring such things as proper conduct, fair treatment, and remuneration. This informal supervision still prevails today, being undertaken by shareholders, employees, analysts, the media, depositors, and customers, although the development of a formal regulation system has reduced these stakeholders' incentives. Even formal supervisors make use of informal supervision to complement the laws that regulate financial companies. Similarly, the process whereby individual banks/banking associations monitor their own/members' legal compliance, namely, self-regulation, is not examined despite its importance in several countries.

This book deals specifically with the supervisory system in the commercial banking sector. Despite its significance in some countries, the supervision of financial intermediaries other than commercial banks is not systematically addressed. Several elements, such as the inspection of finance companies, are not included, even if they were established before the process of formalization of commercial banking supervision began. For example, in the case of Germany, we do not include the supervision of mortgage lending institutes (Hypothekbanken) that commenced in 1899 at the national level.

Because banking supervision was formalized at different times in the eight countries we examine, the periods covered differ in relation to the various countries. Regarding the US, we focus on the supervision of commercial banks at the state and federal levels for about 80 years from the mid-nineteenth century.[7] In relation to Japan and Sweden, we mainly examine the period from the late nineteenth century to the early twentieth century, while for Germany, we focus on the period commencing with the Great Depression in 1929. In relation to Switzerland and Belgium, we mainly study the period from the 1930s to the 1970s, which witnessed the enactment and progressive enforcement of commercial banking laws. In the case of France, we examine the period following the implementation of the Banking Act of 1941, while regarding the UK, we mostly examine the formalization process following the secondary banking crisis in 1973–1974. Overall, the period studied extends from the early nineteenth century to the late twentieth century. We do not deal with the Basel Committee on Banking Supervision (except for the UK chapter), since the influence of international institutions over national banking supervisory arrangements increased from the 1970s, in particular.

[7] We note that the multi-agency and multi-level arrangements for commercial banking supervision in the US present a challenging case in terms of both comparisons with the other cases and our concept of formalization.

1.5 Previous Research

The growing body of literature on this topic suggests that the formalization of banking supervision has been triggered by different factors in various countries. The existing literature on each of the eight countries we examine is discussed in the Introduction to each country's chapter. However, the following paragraphs provide an overview of the literature on the formalization of banking supervision, with a special emphasis on comparative and internationally oriented studies.

Banking supervision in the US has been the subject of numerous academic studies (e.g., Mitchener 2005, 2007; White 1992, 2009, 2011). It is well known that formal banking supervision has existed for nearly 200 years in the US. Mitchener and Jaremski (2014: 7–13) confirmed that the state of New York introduced formal banking supervision in 1826, while Robertson (1968: 33–86) detailed the beginning of banking supervision at the federal level via the Office of the Comptroller of the Currency in 1863–1864.

In contrast to the long history of banking supervision in the US, formalized banking supervision in the UK only commenced in 1979 with the enactment of the new Banking Act (Norton 1991: 7–17; Capie 2010: 587–631). As Schenk (2014) and Mourlon-Druol (2015) noted, the formalization process in the UK was accelerated primarily by the need for international banking supervision that was triggered by the Herstatt Bank crisis in 1974, and the secondary banking crisis in London in 1974 revealed that the domestic system was vulnerable as a result of lax supervision. Thus, the US and the UK are polar opposites in terms of the history of banking supervision.

Previous studies have reported that formal banking supervision was introduced to other European countries during the Great Depression. For example, Germany began the process of formalization of banking supervision in response to the banking crisis during the Great Depression, with the emergency arrangements of 1931 being formalized in 1934 (Bähre 1984). Similarly, the Netherlands commenced the formalization process in 1932 (Mooji and Prast 2003), while Switzerland and Belgium did so in 1934 and 1935, respectively (Giddey 2014), and Italy introduced a new banking law in 1936 (Barbiellini and Giordano 2014). Furthermore, previous studies involving multiple countries (Zahn 1937; Allen et al. 1938; Smits 1940; Gigliobianco and Toniolo 2009) have found that many developed countries introduced, enhanced, or at least considered formal

banking supervision during the Great Depression. The 1930s represent a watershed in the institutional and administrative history of many developed countries, in particular regarding state intervention in the economy (Cassese 1984). Thus, it appears that the triggering of the formalization process by a financial crisis is a familiar pattern.

The history of banking supervision in Japan and Sweden has also been the subject of several studies. Hotori (2006) first focused on the history of banking regulation and supervision in Japan and identified various objectives and functions. However, while that study described the role of formalized banking supervision in the 1920s and 1930s, the formalization process itself was not examined. The history of financial regulation in Sweden has been examined in studies of the regulatory changes that occurred around 1900 (Fritz et al. 1989; Larsson 2010). However, these studies provided few details on the nature of the supervisor and the banking supervision process. Wendschlag (2012) examined the institutional and organizational development of the banking and securities supervision process up until the early 1990s, although the payoff structure behind the formalization of banking supervision was not presented. Recently, Hotori and Wendschlag (2019) compared the early histories of commercial banking supervision in Japan and Sweden.

Few other comparative studies have been conducted in relation to the history of banking supervision in various countries. Drawing on cross-country compilations of banking laws (Zahn 1937; Allen et al. 1938), Ortino (1981) provided the first descriptive account of the differences and similarities between four countries' decrees on banking from a legal perspective. Grossman (2010a: 128–168; 2010b: 131–136) attempted to identify new criteria to classify financial supervision systems in various countries by surveying the temporal sequence of central bank creation and banking supervision. While that study is clearly thematically related to our study, only a fairly brief narrative account is provided as a result of the focus on the introduction of various legal acts as an indicator of change. Grossman's approach differs from ours in that the enforcement of financial regulations and the supervisory activities themselves are not scrutinized. Goodhart (2007) had a similar motivation to ours, albeit mainly focusing on the role of the central bank and limiting his enquiry to the macro level, while Hall (1993: 175–187) analyzed the differences among the Japanese, UK, and US banking supervision systems in the 1980s. Busch (2009), drawing on four case studies (the US, the UK, Germany, and Switzerland), explored the political processes that led to changes

in banking regulation during the last three decades of the twentieth century. Haber (2008) compared the development of banking regulation in the US around 1800 and Mexico in the decades around 1900, linking the chartering of banks (as a way of promoting or preventing market entry) to the political institutions in each country at the time from the perspective of promoting or preventing political competition. That study is highly relevant because it identifies multiple problems regarding the use of informal rules and gatekeepers (political cronies in the case of the US) and the gradual acceptance of formal institutional solutions to enable market development.

This book is also an attempt to fill the gap that exists between previous studies based on a domestic perspective and those based on a comparative perspective.

* * *

Commencing with Chapter 2, we trace the process of formalization of banking supervision in each of the eight countries examined with an emphasis on the stages passed through and the timing of the "full" formalization of banking supervision based on the three aforementioned criteria: (1) commercial banking regulation as the legal basis for supervision, (2) the creation of an agency/organization empowered to enforce the banking regulations, and (3) the enforcement power or actual enforcement activities of the agency/organization. The latter is assumed to have occurred when the supervisory agency exercises regular on-/off-site examinations and is empowered to impose formal sanctions in the case of a breach of the regulations.[8]

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CHAPTER 2

The United States: The First Formalization of Banking Supervision

2.1 Introduction

The federal political structure in the United States (US) has influenced the character of the country's banking system ever since independence. The dual-banking system whereby state and federal chartered banks have coexisted under somewhat different regulations and supervision is a product of the reforms that formalized banking supervision during the Civil War. Whereas the US financial sector is broadly categorized as a liberal market-oriented system in which market discipline (rather than regulatory enforcement) works well (Allen and Gale 2000; Hall and Soskice 2001), it has also been characterized by formal regulation and supervision for much longer than the systems in most other countries. As we will see, many US states introduced state-level banking supervisory systems in the early nineteenth century, and with the creation of the Office of the Comptroller of the Currency (OCC) and the enactment of the National Bank Act of 1864, the US became the first country to introduce formal banking supervision at the federal level. Previous studies have found that state banking supervision before 1864 and national banking supervision before the New Deal were both characterized by a "light touch," and were thus imperfect in terms of their effectiveness (White 2011; Mitchener and Jaremski 2014). White found that the relatively small losses caused by a series of financial crises in the late nineteenth century were the result of the double liability rule under which shareholders were compelled to pay double the amount of their investment, and that banking supervision was seen as a

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E. Hotori et al., *Formalization of Banking Supervision*,
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"complementary factor" supporting the self-discipline and governance of the commercial banks (White 2015: 22–23).

Basically, this chapter draws on the findings of important previous studies. In particular, White's (2015)[1] novel study covered the key elements of banking supervision by the OCC based on archival materials from related institutions and is therefore highly relevant. In addition to examining such studies, this chapter also challenges the common perspective regarding the driver of formalization of banking supervision. In our view, previous studies have assumed a close link between financial crises and the introduction of bank regulation/supervision.[2] However, as Hotori and Wendschlag (2019) showed, a financial crisis has not always been the sole driver of the formalization of banking supervision.

Drawing on two historical studies (Knox [1900] and Allen et al. [1938]), this chapter examines the formalization of banking supervision in the US, in particular banking supervision by the OCC. Based on the criteria introduced in the previous chapter, the OCC supervisory system was the first and most important banking supervisory system during the period in question.[3] Regarding banking supervision at the state level, we focus on New York State (NY) because its supervisory system provided the foundation for the system of banking supervision introduced by the OCC.

2.2 Early Development of Commercial Banking in the US

Commercial banking first emerged at the state level in the US and hence developed somewhat differently in different parts of the country.[4] Following the Declaration of Independence in 1776, commercial (state) banks were established in Philadelphia in 1782 (The Bank of North America), Boston in 1784 (Massachusetts Bank), and New York in 1784 (The Bank of New York). The First Bank of the US was chartered by

[1] See also Stiller (2017).

[2] For example, Gigliobianco and Toniolo (2009).

[3] As illustrated in the next chapter, the OCC system was the model for the formalization of banking supervision in Japan.

[4] Besides state banks and national banks, the US banking system comprises savings banks and trust companies.

the federal government in 1791.[5] During the 30-year period from 1800 to 1830, the number of state banks in the US increased from 28 to 330 (Knox 1900: 307–310).

An early feature of commercial banking in the US was the right to issue notes with official (state) approval. Approximately 9,000 different banknotes issued by more than 1,500 state banks were in circulation by 1860 (Robertson 1968: 29–32). Noteholders suffered losses if the issuing bank failed, and yet the number of people who suffered losses was relatively small (Rockoff 1974, 1975).

From the late 1830s until the introduction of the National Bank Act of 1864, the "free banking era" has been perceived as one of the most distinctive features of the financial history of the US (Hammond 1957: 572–604). The term "free" meant that anyone who so desired could create a bank without obtaining a charter from any authority. Except for an initial failure in Michigan (as a result of the well-known "wild-cat" banking problem), the free banking system was successful (Rockoff 1974: 141–143, 163). Notably, chartered banks existed alongside these free banks, which led to fierce competition in many states (Knox 1900: 414–418). Although a number of banks failed during the free banking era, the number of state banks increased from 901 in 1840 to 1,562 in 1860 (Knox 1900: 312).

It is considered that in NY, "some of the 'soundest' banking of the era was accomplished" around the period when the Free Banking Act was enacted in 1838 (Rockoff 1974: 163). In 1839, under the Free Banking Act, 71 free banks were in operation with a total banknote circulation of five million USD (Knox 1900: 416), while there were also 96 chartered state banks with a circulation of 19 million USD. Generally, the chartered state banks (e.g., the Bank of New York, the Bank of America, and the City Bank) were larger than the free banks (Knox 1900: 422, 427–429). The chartered state banks were under the "careful" supervision of the NY State Banking Department, and from 1840 the free banks were also subject to inspections by the Bank Commissioners (Knox 1900: 416–418, 422).[6] In several states, the free banking system failed to attract investors willing to incorporate free banks. In Philadelphia, Pennsylvania, the free

[5] The Second Bank of the United States, one-fifth of whose capital was subscribed by the government, was liquidated in 1841 as a result of bad management.

[6] From 1843, the Comptroller of the State succeeded the Bank Commissioners.

Table 2.1 Development of State and National banks in the US, 1834–1883 (10-year intervals)

Year	*1834*	*1843*	*1853*	*1863*	*1873*	*1883*
Number of state banks	506	691	750	1,466	277	788
Total deposits of state banks ('000 USD)	75,667	56,169	145,554	393,686	110,800	335,000
Number of national banks	–	–	–	–	1,976	2,529
Total deposits of national banks ('000 USD)	–	–	–	–	540,511	1,106,453
Population per state and national bank	29,476	27,900	34,876	23,435	19,163	16,374
Total deposits of state and national banks per capita (USD)	5.1	2.9	5.6	11.5	15.1	26.5

Sources Knox (1900: 295–312); Robertson (1968: 67); Maddison Historical Statistics, Maddison Database 2010, https://www.rug.nl/ggdc/historicaldevelopment/maddison/releases/maddison-database-2010, accessed on 18 April 2020
Note Because of data unavailability, figures for 1834 (rather than 1833) are shown

banking system was introduced in 1861, and yet only nine banks were incorporated under the system (Knox 1900: 460–461).

Between 1853 and 1863, the population per state bank fell from 35,000 to 23,000, while the aggregate per capita deposits of the state banks increased from 5.6 USD to 11.5 USD (see Table 2.1). This suggests that by 1863, the commercial banks were no longer mainly used by professional merchants. The advent of ordinary people as bank customers provided the background for the formalization of banking supervision.

2.3 Progress of Commercial Banking and the National Bank Act

Neither the crisis of 1837 nor that of 1857 led to the formalization of bank regulation and supervision at the federal level.[7] Triggered by the suspension of specie payments by New York banks, the crisis of 1837

[7] The bank obligation insurance program, which was similar to the deposit insurance system, was first adopted in NY in 1829, prior to the 1837 crisis (Federal Deposit Insurance Corporation 1998: 3–7).

forced 25% of all banks to close (Rousseau 2002: 457–459, 486–487). Regarding the crisis of 1857, one important factor was the enactment of a regulation in New York in 1857 limiting the amount of notes that could be returned to peripheral banks, which resulted in a "flood of peripheral banks' notes into the city for redemption" (Calomiris and Schweikart 1991: 818–819). However, the scale and duration of the crisis were less than those of the 1837 crisis, with only five percent of banks failing, and some of those being able to resume operations soon after. Thus, recovery from the crisis of 1857 was "rapid" in New York (Calomiris and Schweikart 1991: 824–826).

Prior to the Civil War, both the North and the South needed large amounts of capital to finance their war efforts. When Salmon Portland Chase became Secretary of the Treasury in 1861, the fiscal disbursement required for war-related financing was huge. Chase preferred note issuing rather than an increase in taxation, and thus bonds were issued and sold, mainly to the general US population and companies, but also to speculators in Europe (e.g., in London and Amsterdam).[8] From 1862, the Union government in the north issued a new paper currency, not fully backed by gold or other specie, as another source of financing.[9] Thus, as much as 450 million dollars of legal tender known as "greenbacks" had been issued by the end of the Civil War.

Furthermore, as an element of wartime fiscal policy, Chase introduced a national bank organization plan that required banks to hold sufficient bond-secured banknotes because the market for government bonds was depressed at the time (Robertson 1968: 33–36). Following a period of discussion from December 1861 to February 1863, the use of a national currency backed by government bonds was incorporated into the National Currency Act of 1863 (Robertson 1968: 36–45).

In February 1863, the OCC was created under the general direction of the Secretary of the Treasury. The Comptroller was able to submit an annual report directly to Congress (i.e., not through the Secretary of the Treasury), and thus the OCC became basically an independent agency. Hugh McCulloch, who had previously been the president of the State Bank of Indiana, was appointed the first Comptroller (Robertson

[8] See Sexton (2005) for further details.

[9] The Confederacy government in the south also issued notes, some of which paid interest, but because of their less developed banking system and more limited access to the bond market, the Confederacy government's efforts were much less successful.

1968: 45–47). Confronted with a disappointing start[10] to the process of organizing national banks in place of the state banks during the period 1863–1864, McCulloch suggested a complete rewrite of the National Currency Act. Thus, the National Bank Act of 1864[11] was passed by Congress on 3 June 1864 (Robertson 1968: 49).

Furthermore, the Act of 3 March 1865 imposing a ten percent tax on state banknotes created a significant incentive for state banks to join the national banking system. Consequently, 922 state banks were converted to national banks by 1865 (Knox 1900: 101). In Philadelphia, Pennsylvania, where the first national bank, The First National Bank of Philadelphia, was established, almost all of the state banks converted to national banks with the expectation of tax exemptions from the state government (Knox 1900: 461). Conversion from state to national also generated extra profits for the banks: National banks were no longer required to retain specie, and the converted banks could sell gold at the current price plus a premium. For example, the Philadelphia National Bank declared an extra dividend of 25% in 1866 (Wainwright 1953: 122–123).

From the 1870s, both the national and state banking systems developed significantly (see Table 2.1). The number of national banks increased from 1,976 in 1873 to 2,529 in 1883 (and to 3,787 in 1893), while aggregate deposits increased from 540 million USD in 1873 to 1,539 million USD in 1893 (Knox 1900: 295–304). Meanwhile, the rise of state banking was even more rapid, with the number of state banks increasing from 277 in 1873 to 3,579 in 1893, and aggregate deposits increasing from 110 million USD in 1873 to 709 million USD in 1893 (Knox 1900: 311–312). This state banking revival was related to the reduced profitability of the banks' note-issuing business from the 1870s onward (Robertson 1968: 62–68).

[10] McCulloch identified four reasons for the disappointing start, especially the low rate of conversion from state banks to national banks. Among them, the rule whereby the word "national" should be included was an obstacle to conversion by state banks with their existing tradition and history (Robertson 1968: 47–49).

[11] The National Bank Act of 1864 was in part prompted by previous instances of bank misconduct (e.g., illegal note-issuing, speculation, excessive risk-taking, and fraudulent accounting).

2.4 Dissemination of Commercial Banking Regulation

US commercial banking regulation developed at both the national and state levels.[12] The characteristic "dual banking system" of the US remains significant even today and was more or less predetermined by the signing of the US Constitution in 1787. The constitution granted the states considerable rights in terms of regulating business within their jurisdiction, which of course included commercial banking. Consequently, federal banking regulation before the creation of the national banking system in the 1860s was concerned with the near-central banks, namely, the First and Second Banks of the US, while private commercial banks were regulated by state authorities (Komai and Richardson 2011: 3).

Among early bank regulations in the US, a common feature was the charter requirement that provided state authorities with an opportunity to survey the prospects of a bank's owners, funding, and business model, both at incorporation and afterward (Mitchener and Jaremski 2014: 8–9).[13] Demand for banking services grew rapidly from the 1830s onward in response to the rapid development of the US economy (see Table 2.1), and there were only loose constraints on the commercial banking sector. The formal requirements for obtaining a bank charter were undermined by political and commercial cronyism, whereby those with the right connections easily obtained a charter, while those without such ties found it much harder (Robertson 1968: 21–23).

During the free banking era, the number of state banks in the US increased from 788 in 1837 to 1,601 in 1861 (Robertson 1968: 16). During this period, the commercial banking sector experienced turbulence, with the average lifespan of a bank being approximately 5 years (Komai and Richardson 2011: 3). However, depositors' losses were relatively small because the banks were generally liquidated before their financial health had significantly deteriorated. Knox (1900: 315–316) estimated that total losses by noteholders were approximately five percent per annum, which was not particularly high given the rate of inflation at the

[12] See, for example, White (1983).

[13] Moreover, banks had to purchase government bonds or lend money to the state.

time. Although 57 state banks failed during the free banking era in NY, 23 fully redeemed their circulating notes (Knox 1900: 322–323).

Federal bank regulation arose from the need for a common currency that had been recognized by most in the highest echelons of politics and business by the mid-1850s, and the creation of the national banking system was mainly aimed at improving the government's ability to cover the federal deficit caused by the Civil War. While the war was in progress, it had been less difficult for Congress to pass regulatory reforms because many of the strongest opponents of centralized authority were the southern states (Komai & Richardson 2011: 3–4). Supported by the National Currency Act of 1863 and the National Bank Act of 1864, the US federal authority commenced its program aimed at regulating the commercial banks.[14]

Under the National Bank Act, national banks were regulated by the federal government based on a uniform set of rules. White (2015: 3–7) summarized the major regulations applicable to the national banks as follows.[15]

a) Minimum capital requirement (Sect. 7: $50,000 for banks in towns with populations under 6,000; $100,000 for those in larger towns with populations between 6,000 and 50,000; and $250,000 for those in cities with populations greater than 50,000)
b) Minimum reserve ratio (Sect. 31: 15% of the total deposits and circulation for country banks, and 25% of the deposits for reserve city banks).
c) Circumscribed lending (Sects. 28–29: for example, no loan could exceed ten percent of the bank's capital stock)
d) Codified good corporate governance (Sects. 8–11: a minimum of five persons were required to form an organization; Sect. 40: banks were required to keep a list of names and residences of all of the shareholders available during business hours for inspection by any shareholder, creditor, and so on)
e) Double liability imposed on shareholders (Sect. 12)
f) Licensing and revocation power held by the Comptroller (Sects. 17–18, 50)
g) Quarterly disclosure requirements (Sect. 34).

[14] Notably, the national banking system did not replace the state-based banking systems.

[15] We have made some minor corrections and added section numbers based on Robertson (1968: 195–212).

The national banks were required by law to purchase and hold government bonds as collateral for the issuance of notes (new currency) almost equal to their value (White 2015: 3–4). Depending on the amount of collateral the bank had deposited with the US Treasury, the new currency was printed by the Treasury and then issued by the national banks. Thus, the US government guaranteed reimbursement of national banks' notes at par value via government bonds,[16] while NY, for example, did not guarantee full payment of the notes of any state bank (Knox 1900: 95–96).

In an attempt to induce state banks to join the new national banking system, taxes on note issuing by state banks were introduced in 1865.[17] This taxation was sufficiently effective to attract many state banks to become national banks, while state authorities responded by lowering the regulatory requirements (e.g., the minimum capital requirement) for obtaining a bank charter to attract small commercial banks. Over the following decades, the regulators and supervisors of both systems competed to attract commercial banks to join their system, leading to a form of "regulatory arbitrage" (White 2011: 6–9; White 2015: 4).

The banking crisis of 1907 led to another substantial reform of the US banking system, eventually resulting in the creation of the Federal Reserve System (FRS) in December 1913. The Fed, as the Federal Reserve was colloquially known, through its 12 Reserve Banks in various districts, was assigned a supervisory role in the sense that it had the authority to request financial information from the banks that joined the FRS with the aim of accessing the central bank's discount window. However, the Fed faced two dilemmas. First, it had to manage the conflict between price stability and financial stability. The US economy experienced high rates of inflation during the period 1914–1920, which forced the Fed to raise interest rates, which in turn induced the commercial banks to take greater risks (White 2011: 42–45). Second, the reforms created competition between the Fed and the OCC. The Fed attempted to attract both national and state banks to join the FRS by not imposing strict regulation

[16] If government bonds were in short supply, the US government simply increased the printing of its own bonds.

[17] However, a tax on state banknote issues in 1865 led the state banks to gradually shift their business model toward deposit-taking, while the federal currency-based national banks continued under the conventional business model until 1900 (Robertson 1968: 52–54, 62–66).

and supervision. The Fed basically depended on the bank examination reports provided by the OCC, but only limited reports were provided to the Fed. Later, the authority to request reports from the Fed's member banks was transferred from the OCC to the Fed, and the frequency of calls for reports halved following the introduction of the revised Federal Reserve Act of 1917 (White 2011: 34–40).

By the 1920s, the rise of branch banking had become a topic of debate. While only six percent of all commercial banks operated branches, those banks accounted for 15% of all commercial banking resources. Following a 3-year debate on whether unit banks should be protected from competition, the McFadden Act was introduced in 1927. This limited national banks to opening branches only within cities, towns, or villages where state banks were permitted to open new branches under state law (Robertson 1968: 100–105).

After the stock market crash of 1929 and the banking crises of the early 1930s, the liberal attitude of the US regulatory agencies toward the commercial banks was significantly transformed from a market-based discipline to a supervisory regime. The Federal Deposit Insurance Corporation (FDIC) was created in June 1933, and all of the Fed's member banks were required to join. By 1935, 43% of the nation's deposits were insured by the mutual guarantee fund of the FDIC (White 2009: 25–26). Additionally, the FDIC was empowered to conduct bank examinations, albeit with considerable discretion. The Banking Act of 1933, widely known as the Glass–Steagall Act, included further restrictions on commercial banks, both state and national. The Glass–Steagall Act required the complete separation of investment banking and deposit taking, as investment banking was considered to carry higher risk. Based on the hard lessons of the preceding years, combining those businesses was considered inappropriate for individual depositors (White 2009: 27). The Fed's renowned Regulation Q of 1933 set interest rate ceilings for bank deposits, including term deposits (Allen et al. 1938: 418–419). Finally, under the Banking Act of 1935, the federal authorities were given the power to grant a bank charter. Specifically, the OCC stressed that a bank charter would not be granted unless the necessity for a new bank in the location and reasonable prospects of success were clearly evident (White 2009: 26).

2.5 Organization of the US Banking Supervisor

Preceding the creation of the OCC, as Mitchener and Jaremski (2014: 11–13) noted, a separate authority for state bank supervision was created in several US states. By 1863, 15 states had an agency (generally state bank commissioners) with the stated objective of banking supervision. In many states, the creation of these supervisors was associated with the fact that the state government was either the sole or a partial shareholder in the commercial banks (Robertson 1968: 24–27). However, the overall quality of state banking supervision (e.g., publishing detailed standardized bank balance sheets for public examination) had not significantly improved by 1863 (Mitchener and Jaremski 2014: 24–25).

As part of the US Treasury, the OCC had its headquarters in the Treasury building. The Comptroller was appointed by the president based on the recommendation of the Treasury Secretary, with the Senate's approval. However, the operation of the OCC was reasonably independent (White 2011: 4–5). The OCC's Washington facilities (in the Treasury building) were funded by the federal government with US Congress approval, while the costs of on-site examinations were covered by examination fees charged to the examined banks.[18]

The first four heads of the OCC shaped the institution by establishing various priorities (Knox 1900: 97–105). The attitude of successive Comptrollers in the early years was one of caution in relation to risky (or illegal) behavior by the banks.[19] The first Comptroller, Hugh McCulloch, maintained a conservative attitude and felt that it was his "duty" to discourage the organization of new banks to prevent "so much increase in the aggregate banking capital of the country." In 1865, McCulloch was appointed Secretary of the Treasury, and Freeman Clark became the second Comptroller. Because the national banknotes were printed by companies in New York, he recommended relocating the Comptroller's office from Washington DC to New York to enable prompt redemption of national banknotes, but this did not happen. In 1867, Hiland R. Hulburd succeeded Clark to become the third Comptroller. During his tenure,

[18] The examination fee was based on the examined bank's total capital (Robertson 1968: 78).

[19] This description of the first three comptrollers is based on the account of their successor Knox (1900). Thus, there might be some doubt regarding the veracity of his description. See also Kane (1922) for further details.

Table 2.2 Burden of OCC bank examiners, 1889–1911

Year	*1889*	*1896*	*1903*	*1907*	*1911*
Number of OCC examiners	30	34	74	100	113
Number of national banks	3,239	3,689	4,935	6,422	7,270
Number of banks per OCC examiner	108.0	108.5	66.7	64.2	64.3

Source White (2015: 11)

which ended in 1872, two important pieces of legislation were passed by Congress in 1869. First, instead of requiring reports from banks on the first day of January, April, July, and October each year, the OCC was permitted to call for a report on a bank's condition on any five days during the year to prevent the bank from taking measures to prepare a favorable report. Second, it became illegal for any person to support national banks in engaging in misconduct by any illegal measure.

In April 1872, John Jay Knox succeeded Hulburd to become the fourth Comptroller, a position he held until 1884. Although the national banking system was in fierce competition with the state banking system, and gradually adopted lax regulation and supervision practices, no formal deregulation process was implemented during the first decade of the dual-banking system. Legislation passed in 1876 authorized the appointment of receivers by the Comptroller to take charge in the case of insolvency or voluntary liquidation of a national bank. This also served as a means of law enforcement in cases involving the mismanagement of a national bank and/or violations of the law (Knox 1900: 110–111, 124–131; Robertson 1968: 72). The OCC now had the power to revoke a bank's charter and to place it in receivership if the bank was found to be insolvent.

White (2015: 11) noted that data on the number of examiners were available but incomplete (see Table 2.2). In 1889, the numbers of OCC bank examiners and national banks were 30 and 3,239, respectively, while in 1896 the numbers were 34 and 3,689, respectively. Because of the heavier than expected burden placed on bank examiners, various bank examination procedures, for example, submitting monthly bank examination reports, were often behind schedule (White 2015: 13–15). The number of banks per examiner[20] was 108 in 1889 and 109 in 1896.

[20] Allen et al. (1938: 397–398) noted that each bank examiner was expected to carry out on-site examinations of 70 banks annually on average.

The Federal Reserve System that was created in 1913 was assigned a supervisory role, with the main aim of scrutinizing the financial status of member banks for the purposes of the central bank's lending activities. However, the Fed was not empowered to access the complete examination reports sent by the OCC. The Fed's bank examiners were deployed to examine state-chartered member banks. There were six Fed examiners in 1915, which increased to 20 by 1920 (White 2011: 41–42). However, overlapping areas of authority led to tension between the Treasury (including the OCC) and the Fed, as the latter found it difficult to obtain complete independence from the former. In addition to the Fed being housed in the Treasury building, two of the Fed's board seats were held by the Comptroller and the Treasury Secretary, and hence those institutions had both insight into and influence over what the central bank was doing, and should be doing (White 2011: 35–40; Robertson 1968: 107–110).

The reforms of the post-Great Depression banking system led to stricter banking regulation, as well as the creation of several new organizations with supervisory objectives. Specifically, the FDIC undertook the task of bank examination. The FDIC was created in 1933 to administer the new deposit insurance scheme that would guarantee the repayment of deposits up to certain amount in the case of a bank failure. National banks were required to participate in this new deposit insurance system, and state banks were given the opportunity to join. However, prior to 1950, the FDIC was required to obtain written consent from either the Comptroller, the Board of Governors, or state supervisors, before it was permitted to conduct a bank examination (White 2009: 29).

Finally, the role of banking supervision was formally divided among the OCC, the Fed, and the FDIC in 1938 (Robertson 1968: 127). Moreover, the three agencies began to cooperate in relation to examination policies. For example, loans and investments were uniformly classified as Category I, II, III, or IV, replacing the previous approach to asset valuation that relied on the examiners' discretion (White 2009: 30). The bank examination procedures were made uniform among the three federal supervisory authorities (the OCC, the Fed, and the FDIC) and the state bank supervisory agencies in September 1938 (Suto 2003: 49–51).

2.6 Banking Supervision and Characteristics of the OCC

Before the emergence of the national banking system in 1863, state banks were subject to a certain level of supervision. The degree, frequency, and power of enforcement of this supervision varied from state to state but was generally characterized by a “light touch.” As mentioned earlier, the double liability rule imposed on the banks’ shareholders served to induce prudential operation. Thus, state bank examination “appears to have originated in those states where a stockholder relationship existed between the state and the bank” (Robertson 1968: 24). Information about the banks was reported sporadically to state officials, often following rumors about a bank being in financial distress. Several state supervisors even lacked the authority to force banks to provide even the most basic information about their business activities. If a bank was suspected of being close to bankruptcy, the governor would appoint one or more citizens who were held in high esteem to conduct an on-site examination (Robertson 1968: 23–27). This arrangement fits with most of the indicators of our definition of informal supervision including being sporadic, case-by-case, and discretionary (see Chapter 1).

The OCC was founded in 1863 and authorized to conduct regular on-site examinations of each national bank at least once a year and later twice yearly following a series of recessions in the early 1890s. On-site examinations took three days on average, or more precisely, one day for small country banks and five days for large city banks. The relatively low pay made it difficult to hire examiners’ assistants, and the OCC’s examiners also had to cover the travel expenses incurred in conducting on-site examinations (White 2015: 7–13).

The bank examination process can be summarized as follows. First, an examiner visited a bank with a bank examiners’ book provided by the OCC containing pre-printed forms to record key information such as significant loans. Second, the examiner met with the board of directors and the president of the bank. Third, the examiner completed the official forms relating to the examination, and these were sent to the OCC office in Washington DC each month. Fourth, recommendations and suggestions were made to the bank if necessary, and the Comptroller persuaded the bank’s board of directors to rectify any violations (White 2015: 15–17; Allen et al. 1938: 397–398; Robertson 1968: 71).

The OCC was empowered to revoke a bank charter and to place it in receivership if the bank was found to be insolvent. The power to approve, reject, or revoke bank charters was an important function

of the Comptroller, who had few other disciplinary instruments (other than moral suasion) at his disposal. If an examiner discovered that loans had been granted in excess of the legal limits, the Comptroller had no means of addressing such a breach. Additionally, shortfalls in the reserve banks were required to hold were often treated as "random fluctuations." Examiners often found it difficult to estimate the value of collateral (especially real estate) for loans because they were required to exercise discretion in establishing values by referring to market prices. Some, but not all, commercial bankers viewed the OCC examinations as "a reasonably-priced nationally standardized audit" aimed at reducing the risk of contagion leading to runs on banks, and thus the relatively sound banks cooperated with the OCC in relation to examinations (White 2015: 17–19).

The main objective of the OCC's banking supervisory activities was restraining the abuse of privileges granted to banks under the federal charter. However, the evaluation of the banks' governance played another important role. The examiner's report considered the characteristics of the shareholders, directors, cashier, and the president of the bank, including a description of the internal auditing system. Loans to directors and officers of a bank received special attention from the bank examiners (White 2015: 20–21). Thus, over time, the OCC's supervisory function was transformed from the mere inspection of ledgers to close scrutiny of the operational status of the bank (Robertson 1968: 71–73).

Additionally, the OCC examiners occasionally endeavored to support a bank in severe financial distress. For example, the bank examiner's report regarding the Eighth National Bank of New York in December 1868 documented that the examiner had provided managerial advice to the bank's president aimed at improving the bank's fund-raising capability.[21] The OCC was interested in the aftermath of bank failures, and the OCC annual reports included a list of failed banks, including the name of the receiver and dividends paid to shareholders.[22]

* * *

[21] Examiner's Report on the Eighth National Bank of New York, 19 December 1868, *Failure in December 1871 of Three Banks in New York City*, Committee on Banking and Currency, HR42A-F4.2, RG233, The US National Archives and Records Administration (NARA): Washington DC.

[22] For example, the OCC (1872, 1873) documented the problems identified in relation to the Eighth National Bank of New York.

The formalization of banking supervision in the US occurred in incremental steps. In response to the state authorities' experiences of banking supervision during the free banking era, a national banking supervision system was established against a background of rapid social and economic development from the 1850s onward. The National Bank Act of 1864 was enacted to address the fiscal deficit incurred by the Federal government as a result of the Civil War, as well as to provide a uniform national currency. Thus, financial crises (e.g., the bank crisis of 1857) did not trigger this major step toward the formalization of banking supervision. However, following financial crises from the 1870s onward, even though these crises did not result in significant losses by either noteholders or depositors, the formal banking supervision system was strengthened incrementally. Specifically, the crisis of 1907 led to the creation of the Fed, which was empowered to examine member banks, and the Great Depression of 1929–1931 led to the creation of the FDIC, which was authorized to examine all national banks and state banks that participated in the federal insurance scheme. Further changes in relation to formal banking supervision by the OCC, the Fed, and the FDIC occurred in 1938, although the OCC continued to conduct on-site examinations on behalf of the FDIC until 1950.

Therefore, against the background of economic development the formalization of banking supervision in the US was triggered by the Civil War (i.e., for fiscal reasons) as well as the need to establish a national currency, while the formalization process was completed through measures introduced in response to a series of financial crises in the early twentieth century.

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CHAPTER 3

Japan: Formalization of Banking Supervision Including a Reversal

3.1 Introduction

Japan introduced formal banking supervision earlier than most other developed countries. As detailed later, the first modern banking system in Japan was basically a copy of the United States (US) national banking system. The US National Bank Act included provisions for formal banking supervision, and thus the Japanese government also included provisions for a formal banking supervisory system when it created the banking system with the National Bank Decree in 1872. During the Edo period (1603–1868), before the introduction of the modern banking system, *Ryōgae* (financial merchants) provided several financial services including remittance, exchange, and loans. The issuance of remittance bills to reduce the cost of carrying gold/silver coins between Tokyo and Osaka and significant lending to feudal lords (*Daimyō-gashi*) provided most of the business of the financial merchants. However, their activity differed from that of the modern banking sector in that the financial merchants did not operate proper deposit-taking businesses including elements such as term deposits and current deposits.

While the history of Japanese banking supervision is highly relevant for developed countries, few studies have been published in English and

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Table 3.1 Japan's population and gross domestic product, 1885–1920 (5-year intervals)

Year	*1885*	*1890*	*1895*	*1900*	*1905*	*1910*	*1915*	*1920*
Population ('000s)	38,313	39,902	41,557	43,847	46,620	49,184	52,752	55,473
GDP (million USD)	33,052	40,556	46,933	52,020	54,170	64,599	75,952	94,654
Per capita GDP	863	1,016	1,129	1,186	1,162	1,313	1,440	1,706

Source Population: Bank of Japan (1966); GDP: Maddison Historical Statistics, Maddison Database 2010, https://www.rug.nl/ggdc/historicaldevelopment/maddison/releases/maddison-database-2010, accessed on 18 April 2020

limited information is available.[1] The purpose of this chapter is to identify the driver of the formalization of banking supervision in Japan by tracing the formalization process that began with the introduction of the national banking system and that was completed with the enactment of the Banking Act of 1927. Additionally, this chapter focuses on the creation of an independent agency for banking supervision within the Ministry of Finance.

Because the formalization of banking supervision in Japan included a reversal, this chapter also examines the cause of this reversal and how the reversal transformed formal banking supervision after its reintroduction in 1915–1916.

3.2 Development of Commercial Banks

In Japan, a significant increase in the number of commercial banks, the enhanced position of commercial banking in the national economy by the early twentieth century, and a policy of rapid industrialization facilitated by the Industrial Revolution provided the background for the formalization of banking supervision (see Table 3.1).

As Tamaki (1995: 21–45) noted, a modern banking system was introduced to Japan following the Meiji Restoration in 1868 and quickly

[1] See, for example, Allen et al. (1938: 279–300), Ehrlich and Tamagna (1954: 532–545), Hotori (2011), and Hotori and Wendschlag (2019).

developed via multiple paths. Commercial banks, exchange companies, lending companies, savings associations, and regional development companies were the main financial institutions before the banking system was formalized and integrated in the 1890s. The commercial banks were especially important in relation to the emergence of the modern Japanese banking system. The commercial banks (officially known as *ordinary banks*) were derived from two streams—*Kokuritsu Ginkō* and *Shiritsu Ginkō*.[2] The former was basically modeled on the US national banking system, whereby each bank took deposits, provided loans, and issuing its own banknotes. The number of banks (*Kokuritsu Ginkō*) increased to 150 during the boom of 1877–1879; to maintain the value of their banknotes, the establishment of new banks was no longer permitted after 1879. Furthermore, the creation of the Bank of Japan in 1882 saw the centralization of note-issuing.[3] Each *Kokuristu Ginkō* was transformed into a commercial bank by 1899, and these constituted a significant share of the commercial banking sector. The *Shiritsu Ginkō*, which were mostly the successors to the financial merchants who operated in the Edo period (1603–1868), provided deposit and loan services. The number of banks increased from 1880 onwards, especially during the first industrial boom (1886–1889) and the Sino–Japanese War boom (1894–1896). Under the Bank Decree of 1890, each *Shiritsu Ginkō* was formally categorized as a commercial bank.

The number of commercial banks (*ordinary banks*) peaked at 1,890 in 1901 (Goto 1970: 56–57), and by 1910 there were 1,600 commercial banks operating a total of 3,300 offices, which meant that the average population per office was approximately 15,000 (see Table 3.2). This meant that even the general public could access commercial banking services (deposits and loans) within their community (town or city) from around 1910.[4] Most importantly, the total deposits of the commercial banks increased more than 14-fold from 1895 to 1910 (Bank of Japan 1966: 198–199) as the Japanese commercial banks were gradually transformed into deposit-taking banks during the 1900s.

[2] The main founders of *Kokuritsu Ginkō* were feudal lords and *samurai*, while the main founders of *Shiritsu Ginkō* were wealthy merchants and farmers (Tamaki 1995: 36–45).

[3] See Schiltz (2006) for further details.

[4] By 1920, the population of every city in Japan exceeded 20,000 (Bank of Japan 1966: 14–15).

Table 3.2 Development of ordinary banks, 1895–1910 (5-year intervals)

Year	*1895*	*1900*	*1905*	*1910*
Number of banks	792	1,802	1,697	1,604
Number of bank offices	1,069	3,176	3,112	3,301
Population per bank office	38,875	13,806	14,981	14,900
Aggregate assets of banks (million yen)	140	715	1,009	1,561

Source Ministry of Finance (1896, 1901, 1906, 1911)

Around the turn of the century, *zaibatsu* banks rose to prominence in the Japanese economy, especially in the commercial banking sector. Five major *zaibatsu* banks (Mitsui, Mitsubishi, Sumitomo, Yasuda, and Daiichi) accounted for 17.2% of all loans and 21.5% of all deposits in 1910 and accounted for more than 25% of both loans and deposits by the 1920s (Goto 1970: 86–93). The main activities of the *zaibatsu* banks varied. While Mitsui Bank and Mitsubishi Bank provided loans to their group companies (e.g., trading, mining, cotton spinning, and shipping companies), Yasuda Bank focused on business activities involving national and state governments such as underwriting public bonds. This strategy eventually enabled Yasuda Bank to expand its market share by amalgamating failed country banks following an informal rescue request from the government (Kato 1970).

Following the Taisho bubble economy period (1915–1919), the banking sector suffered a series of financial crises in 1920, 1922, 1923, 1927, and 1930. Many banks were either bankrupted or purchased by larger banks, and the number of commercial banks decreased from 1,794 in 1922 to 680 in 1931 (Kato 1957: 278–279). The Showa financial crisis of 1927 was particularly serious and led to a run on banks throughout the country, and not only small banks but also several large banks (Jūgo Ginkō, Oumi Ginkō, Fujita Ginkō, and Kajima Ginkō) were forced to suspend their business. Following these crises, the surviving banks were forced to become more conservative in line with the prudential recommendations of the bank supervisors (Ministry of Finance), and thus the Japanese banking system did not experience any further serious financial crises until 1997.

While the banking sector has been a major component of the Japanese financial system since 1872, the stock market (especially the formal

market) remained inactive until the financial “Big Bang” (1996–2001).[5] Although the Tokyo Stock Exchange was created in 1878, the trading volume was dominated by futures transactions. Shimura (1969: 38–42) noted that the volume of futures transactions was much larger than that of physical-delivery (spot) transactions.[6] The defectiveness of the formal stock exchange and lack of related institutions such as reliable investment banks meant that many companies (e.g., textile, mining, and trading companies) preferred to do business with commercial banks (particularly when seeking loans). Even railway and electricity companies partially depended on loans from commercial banks to avoid the high cash dividend payments that accompanied increases in capital through the stock market. The aggregate assets of the commercial banks increased tenfold from 1895 to 1910, reaching 1,600 million yen in 1910, while the ratio of aggregate assets to GNP increased from 11 to 54% during the same period (Bank of Japan 1966: 32, 198–199). In the early twentieth century, the interests of the commercial banks became increasingly intertwined with the development of modern industries and with middle-class people’s daily business.

3.3 The Development of Commercial Banking Regulation

Commercial banking regulation was gradually introduced to Japan in the second half of the nineteenth century. With the National Bank Decree of 1872, the organization of the Japanese banking system (*Kokuritsu Ginkō*) was modeled on the US national banking system. Similar to the US guidelines, the National Bank Decree of 1872 set out the terms in relation to the issuance of national bank notes, limited large loans to

[5] In Japan, the informal stock market was presumed to be larger than the formal stock market. However, it remains unclear whether the banking sector or the informal stock market was more important in relation to the Japanese financial system (Bank of Japan 2012).

[6] In 1920, there were 152,312 futures transactions and 17,464 spot transactions (Shimura 1969: 39). When the Tokyo Stock Exchange resumed operations in 1949, the US General Headquarters of the Allied Forces prohibited futures transactions with the aim of developing the formal stock market.

certain borrowers,[7] and included specific provisions for bank examinations (Articles 73 and 74). Under the Decree, the national banks were also required to obtain a bank license.

Following the establishment of the Bank of Japan in 1882,[8] the issuance of banknotes was finally centralized with the establishment of a national currency, although regulatory power was not granted to the Bank of Japan. Following the creation of a central bank, the national banking system was abolished and the existing national banks were incentivized to convert to ordinary banks[9] that essentially engaged in commercial banking. The most critical incentives to undertake this conversion was the deregulation of large loans to certain borrowers and much looser banking supervision, including the suspension of on-site examinations. During this period of lax bank regulation and supervision (1893–1914), the number of Japanese banks increased threefold, and this expansion was accompanied by a significant increase in problems related to insider lending (the "*Kikan Ginkō*" problem). Kasuya (2000: 8–28) detailed the transition of the Bank Decree from 1890 to 1916 and noted that Japanese bankers were slow to recognize the importance of systemic risk, even after the spectacular failure of the Hyaku-Sanjū Ginkō in 1904.

This historical journey provides an interesting example of the reversal of the institutionalization process. Similarities are apparent between this period in Japan and the antebellum period in the US that featured "free-banking." The US Free Banking era coincided with the Industrial Revolution in the US, wherein the railway, shipbuilding, and telegraph industries developed rapidly. In the US, the Civil War was the trigger for introducing national banking. In Japan, the period of lax bank regulation and supervision coincided with the Meiji Industrial Revolution. Following this period of social and economic development and the advent of well-educated bankers, the outbreak of the First World War was the trigger for reintroducing prudential regulation and supervision.

The Ministry of Finance issued an official notice on 31 August 1901 stating that the government would no longer grant banking licenses to

[7] A large loan was limited to no more than 10% of the total capital of a national bank (Article 56).

[8] The Belgian central bank inspired the institutional setup of the Bank of Japan (Bank of Japan 1982: 119–120; Schiltz 2006).

[9] Commercial banks, which were established under the Bank Decree of 1893, were defined as "ordinary banks" by the government (Bank of Japan 1966).

newcomers. In addition to this administrative entry barrier, banking regulation was incrementally reintroduced from 1916 to 1927. For commercial banks, special disclosure rules, including a distinction between various types of loans, and the use of balance sheet and profit-and-loss statement templates were prescribed under the Bank Decree of 1916. Together with the Bank of Japan, the Ministry of Finance supported the existence of cartels among the commercial banks in each region in relation to deposit interest rates from December 1918.[10] In 1923, the Ministry of Finance issued an official notice stating that commercial banks were no longer permitted to open a new branch office or agency except in the case of a merger. On 25 December 1924 (and each year thereafter until 1934), the Ministry of Finance issued an official notice recommending a reduction in the stock dividends paid by the commercial banks.

On 28 September 1926, the Financial System Research Committee was established to discuss the reform of bank regulation in Japan.[11] The committee was chaired by the Minister of Finance and comprised approximately 40 members including government officers from the Ministry of Finance, Ministry of Commerce, and Ministry of Agriculture, *zaibatsu* bankers, stockbrokers, members of the Diet (Parliament), and financial experts (academics). The top priority among many items on the agenda was the reform of the ordinary (commercial) banking system, and the committee's recommendations presented in November 1926 were mostly embodied in a new bank bill, *Ginkōhō* (the Banking Act), which was passed on 30 March 1927 (Bank of Japan 1956: 1–16). The banking crisis occurred in April 1927, and hence the Banking Act of 1927 was not the "product" of a financial crisis.

Under the Banking Act of 1927, the scope of the commercial banking business was basically limited to "proper" kinds of business—loans, deposits, and exchange services (i.e., there was a separation of the banking and securities businesses). With regard to multiple directorships, every bank director was required to obtain permission from the government

[10] Following the financial crisis of 1900, the deposit interest rate cartels began as a gentlemen's agreement among members of the bankers' association during the period of lax regulation and supervision. Following this period, the government "recommended," that is, effectively forced, all commercial banks to establish deposit interest rate cartels (Okada 1987).

[11] The committee, which was created by the government, discussed fundamental revisions of the Bank Decree of 1916 and significant enhancement of the banking supervisory system (Bank of Japan 1956).

(Article 13). Notably, the minimum capital requirement was increased from half a million yen to one million yen (Article 3), and the commercial banks were forced to comply with this regulation. Furthermore, the commercial banks were now obliged to submit their financial statements to the Minister of Finance for inspection. If an error was found, the government issued an official guidance to correct the error. Legal sanctions, including fines and imprisonment, were applicable in relation to breaches including accounting fraud and window dressing.

A bank consolidation policy was also implemented under the Banking Act of 1927, and the Ministry of Finance dispatched its officers (bank examiners) to commercial banks to provide "constructive advice" together with officers of the Bank of Japan as well as officers of the financial division of the local government in the area where negotiations regarding bank mergers were taking place. There were more than 600 amalgamations between 1927 and 1932.[12]

The formalization of the regulatory system for commercial banks in Japan was completed in 1927 (see Table 3.3).[13] Entry barriers, branch opening restrictions, regulation of the services provided through the banking business, and special disclosure rules remained the main banking regulatory measures until the next major revision of the Banking Act in 1981.[14]

3.4 Formalization of the Banking Supervisory System

The formalization of banking supervision in Japan began in the second half of the nineteenth century (see Table 3.4). The Ministry of Finance had been responsible for licensing banks under the national or ordinary banking system since 1872. The first official on-site examination of the First National Bank of Tokyo was conducted in 1875. However, neither a specific organization nor a specialized post for banking supervision was created within the Ministry of Finance until 1915. Officers

[12] Okazaki and Sawada (2007) empirically identified a positive effect of the bank consolidation policy in the form of increased deposits from the public, while the banks' return on assets deteriorated in several cases following amalgamation.

[13] See Hotori (2006: 46–87) for further details.

[14] Financial deregulation in Japan mainly occurred in the 1980s and 1990s (Hotori 2016b).

Table 3.3 List of major bank regulations (up to December 1927)

Type of bank regulation	*Content of regulation*	*Year introduced*
Bank entry regulations	New entry was not allowed under the bank licensing system operated by the Ministry of Finance	1901
Special disclosure rules	Special balance sheet and profit-and-loss statement templates were prescribed	1916
Arrangements for deposit interest rate cartels	The Ministry of Finance "recommended," that is, effectively ordered, ordinary banks to organize deposit interest rate cartels	1918
Bank branch regulations	Opening of new branches was rigidly regulated by the Ministry of Finance	1923
Limitations on stock dividends	The Ministry of Finance recommended that ordinary banks reduce their stock dividends	1924
Restrictions on multiple directorships	Every bank director was required to obtain permission to serve as a director of another company	1927

Source See the text

from the Ministry of Finance engaged in multiple tasks such as taxation-related activities, and hence were not properly trained to act as examiners or supervisors.[15] These multiple roles in relation to fiscal and monetary policy strengthened the Ministry of Finance's influence over the banking sector and eventually led to abuses of power and corrupt behavior by officers (especially in the 1990s).[16] The commercial banks were not charged any examination fee because the costs of banking supervision such as travel expenses for on-site examinations were covered by tax revenue, unlike the situation in the US and Sweden.

In August 1915, a specialized bank inspection position was established, and in April 1916, the Banking Bureau was recreated within the

[15] There is no archival evidence explaining why the Japanese government did not create the independent supervisory authority similar to the OCC in the US.

[16] Notably, most of the former bank examiners were not corrupt (Hotori 2016a).

Table 3.4 Timeline of the formalization of banking supervision in Japan

Year	*Contents*
1872	Enactment of the National Bank Decree and creation of the modern banking system in Japan
1875	First official on-site bank examination by the Ministry of Finance
1893	Implementation of the Bank Decree and introduction of the formal ordinary (commercial) banking system
1893–1914	Lax bank regulation and supervision (e.g., no regular on-site examinations)
1915	Creation of a specialized bank inspection role and recommencement of regular official on-site bank examinations
1916	Creation of the Banking Bureau, enactment of the revised Bank Decree of 1916, and introduction of legal power of enforcement for bank examiners
1927	Enactment of the Banking Act of 1927, which strengthened the enforcement power, increased staff and budget for banking supervision, and increased the frequency of examinations (every 2 years), and creation of the Bank Inspection Section as part of the Banking Bureau

Source See the text

Table 3.5 Burden on Ministry of Finance Bank examiners (1915–1940, 5-year intervals)

Year	*1915*	*1920*	*1925*	*1930*	*1935*	*1940*
Number of examiners	6	6	22	72	63	59
Number of ordinary banks	1,442	1,326	1,537	782	466	286
Number of ordinary banks per examiner	240.3	221.0	69.9	10.9	7.4	4.8

Source Number of examiners: Hotori (2006: 99, 186); Number of ordinary banks: Ministry of Finance (1916, 1921, 1926, 1931, 1936, 1941)

Ministry of Finance, including the bank inspection position (Hotori 2006: 48, 54). Initially, there were only two examiners and four assistants, but these numbers gradually increased to eight and 22, respectively, by 1922 (Hotori 2011: 34). Accordingly, the number of ordinary banks per examiner decreased from 221 in 1920 to 70 in 1925 (see Table 3.5). However, the burden on the bank examiners remained heavy as the number of banks per examiner was almost the same as that of the US OCC examiners about twenty years before (in the 1900s). The number of banks per OCC examiner was 64 in 1907 (see Chapter 2 for further details).

Following discussions among the Financial System Research Committee in 1926,[17] the Bank Inspection Section was created as part of the Banking Bureau in May 1927. Subsequently, the numbers of examiners and assistants increased to 18 and 54, respectively (see Table 3.5), which allowed the frequency of on-site examinations to increase to at least once every 2 years (see Table 3.6). Newly recruited officers were expected to have spent part of their career in a private company after having been educated at a commercial college (Hotori 2006: 94), and in 1927 these newly recruited officers received numerous lectures on subjects including banking and bookkeeping at the Ministry of Finance. Additionally, in 1928 the Bank Examination Division was created within the Bank of Japan, with the main aim of supporting the on-site examination activities of the Ministry of Finance.

Following a series of financial crises in the 1920s, most Japanese bankers came to understand the high cost of systemic risk, and thus *zaibatsu* bankers did not oppose the implementation of the new Banking Act of 1927, which contained much stricter regulations including a restriction on multiple directorships (Hotori 2006: 76–77). *Zaibatsu* banks were already well-capitalized and pursuing a relatively conservative strategy by 1927; therefore, the regulations introduced under the new Banking Act were initially aimed at smaller banks. The examiners were appointed from among high-ranking officers in the Ministry of Finance until 1942, when on-site examinations were suspended because of the Second World War.[18]

3.5 The Purpose and Practice of Banking Supervision

The Meiji Restoration in 1868 paved the way for the Japanese people's first experience with modern banking. Strange as it might seem to contemporary readers, the main purpose of a bank examination was the "education" of bankers,[19] that is, training the bankers in relation to

[17] See Bank of Japan (1956: 375–397) for further details.

[18] Hotori (2016a) elaborated the profiles of bank examiners from 1927 to 1998.

[19] Who educated the supervisors? A Scottish banker, Alexander Shand, was hired by the government to teach and demonstrate the process of bank examination. The textbook "On banking" (1877), which was edited by Shand, was translated into Japanese, and knowledge regarding prudential practice was shared among officers of the Ministry of Finance. In

Table 3.6 Frequency of on-site bank examinations by the Ministry of Finance in Japan (1915–1934)

Year	*1915*	*1916*	*1917*	*1918*	*1919*	*1920*	*1921*	*1922*	*1923*	*1924*
Number of exams	38	80	69	44	36	5	70	118	65	105
Number of banks	2,099	2,091	2,062	2,039	2,001	1,987	2,001	1,945	1,840	1,765
Frequency (years)	55.2	26.1	29.9	46.3	55.6	397.4	28.6	16.5	28.3	16.8
Year	*1925*	*1926*	*1927*	*1928*	*1929*	*1930*	*1931*	*1932*	*1933*	*1934*
Number of exams	93	53	20	421	461	96	205	154	204	135
Number of banks	1,670	1,544	1,396	1,131	976	872	771	625	601	563
Frequency (years)	18.0	29.1	69.8	2.7	2.1	9.1	3.8	4.1	2.9	4.2

Notes Frequency refers to the expected interval between on-site examinations of a particular bank. The number of banks includes both savings and ordinary banks

Source Hotori (2011: 34)

practices such as double-entry bookkeeping, risk management, and distinguishing between deposits and capital. Thus, the banking supervisor was initially engaged in providing organizational learning for the commercial banks rather than banking supervision. Daiichi Bank (1957: 214–235) documented the earliest bank examiner's report of their examination of the First National Bank of Tokyo in 1875.[20] The on-site examination was directed by Alexander Shand, who was the Secretary for the Ministry of Finance at the time.[21] Many of the points made in his examination report concerned the proper and prudent management of the bank's affairs. As could be expected, Japanese banks experienced numerous problems in relation to their banking business and operations in the early stages, and examiners primarily endeavored to detail the problems of each bank as clearly as possible, and provide instructions on how to address these problems. The priority for on-site bank examinations was the inspection of ledgers and the provision of instructions on correct bookkeeping practice, which was a crucial part of the British principles of prudence as taught by Shand and his staff. For example, bank examiners visited the 26th National Bank of Osaka and found evidence of fraudulent accounting in relation to the capital account involving the inclusion of some large deposits from ex-feudal lords.[22] The bank was required to correct the ledger based on "advice" (which was nearly a threat) from the chief bank examiner and was also recommended to dismiss the director in charge.

If necessary, the Ministry of Finance appointed an officer to the board of a problem bank. For example, Shuzo Toyama, a former bank examiner of the Ministry of Finance, was appointed as the president of the 32nd

1882, the Ministry of Finance created the College of Banking and Commerce, where prudence was taught. See Hotori et al. (2018: 115) for further details.

[20] Alexander Shand, Report on the First National Bank of Tokyo, 5 February 1875, *Documents on Bank Examination of the First National Bank of Tokyo*, Ministry of Finance, Okuma Shigenobu Collection, A1126-1, Waseda University Library: Tokyo.

[21] Although the model for the national banking system was that of the US, Shand was a Scottish banker who had never worked for a US bank. Later, he became a director of Parr's Bank in the UK (Tsuchiya 1966).

[22] Nagaaki Tsutsumi and Shuzo Toyama, Examiners' Letter regarding the 26th National Bank of Osaka, 24 October 1878, *Documents on Bank Examination of the Three Banks (The 16th National Bank of Gifu, The 32nd National Bank of Osaka, and the 26th National Bank of Osaka)*, Ministry of Finance, Okuma Shigenobu Collection, A1167, Waseda University Library: Tokyo.

National Bank of Osaka under an informal order from the Minister of Finance in January 1879 to supervise the reconstruction of the bank.

The examination trip in the early period was quite tough, since there was no nationwide railway network until the 1890s. Harada Sekizen-kai (1938) documented a diary of one examination trip schedule from April to May 1875 directed by Jiro Harada (Table 3.7). This material indicated that on-site examination was carried out during two or three days per national bank, and the main focusing points were inspection of ledgers, instruction on bookkeeping, and check of large loans and/or insider lending. If an error or a fault was identified through the examination, bank examiners instructed the bank how to correct. Examiners spent more time in headquarters than in branches, and on branch visit examiners often found the old fashion Japanese ledgers—single bookkeeping with secrecy (*Dai Fuku-chō*). These bank examinations were to be unannounced, yet bankers could predict an approximate visit date, once they had arrived at their first destination.

Following the aforementioned period of lax or no on- and off-site examinations in the late nineteenth century and early twentieth century, the financial crises of 1900 and 1907 led more bankers to understand the importance of systemic risk. Shibuya (1975) documented a series of special bank investigation reports of the Ministry of Finance that covered failed or badly performing banks. These reports illustrated the seriousness of the financial crises that occurred during the period 1907–1914. It was subsequently reported (Anonymous 1914: 6–8) that a number of bankers had called for the resumption of the on-site examination system. The period of lax supervision led to some hard-earned lessons for Japanese bankers in relation to identifying systemic risk in the financial markets, and the gradual maturing process that occurred around the turn of the century brought about a positive transformation in the supervisor's role in relation to the banking system. In addition to the financial crisis of 1914, the outbreak of the First World War prompted a return to the banking supervisory system by the Ministry of Finance (Hotori 2006: 48).

At this point, the nature of the supervision changed from the education of bankers to proper prudential supervision. In 1915, the Ministry of Finance recommenced on-site examinations, and the Banking Bureau was created in 1916. Strict sanctions were also introduced in an effort to force bankers to comply with the examiners' orders. These sanctions were reinforced by the enactment of the Banking Act of 1927, which included provisions for the forcible replacement of bank directors and possible

Table 3.7 Bank examination trip of Harada's group (April–May 1878)

Date	*Name of examined banks*	*Contents of examination*
1 April	The 13th National Bank of Osaka	*Inspection:* cash, loan, time deposit, and current deposit
2 April		*Inspection:* dairy ledger and general ledger *Instruction:* correct bookkeeping
4 April	The 32nd National Bank of Osaka	*Inspection:* cash, time deposit, and current deposit
5 April		*Inspection:* loan and collateral, warehouse
6 April		*Inspection:* ledgers *Instruction:* correct bookkeeping
15 April	The 1st National Bank of Tokyo (Osaka branch)	*Inspection:* cash, loan and collateral, time deposit
16 April		*Inspection:* current deposit, accommodation bill, and commercial bill
17 April	The 17th National Bank of Fukuoka (Osaka branch)	*Inspection:* old fashion Japanese ledgers (*Dai Fuku-chō*) *Vigilance:* large loan (10,000 yen)
18 April	The 3rd National Bank of Tokyo (Osaka branch)	*Inspection:* cash, loan, time deposit *Probe:* main business of the bank manager
19 April	The 34th National Bank of Osaka	*Probe:* main business of the bank president and director *Instruction:* correct bookkeeping
20 April	The 32nd National Bank of Osaka (Sakai branch)	*Inspection:* old fashion Japanese ledgers (*Dai Fuku-chō*)
22 April	The 5th National Bank of Tokyo (Osaka branch)	*Inspection:* cash, time deposit, current deposit, ledgers
25 April	The 1st National Bank of Tokyo (Kobe branch)	*Inspection:* cash, national bond, loan, time deposit, and current deposit *Probe:* contents of special loans at the open port of Kobe
4 May	The 26th National Bank of Osaka	*Inspection:* ledgers
7 May		*Interview:* with the general manager and chief clerk of the bank
12 May	The 25th National Bank of Obama (Fukui)	*Inspection:* cash, loan, time deposit, and current deposit *Vigilance:* large loan (22,000 yen)

(continued)

Table 3.7 (continued)

Date	*Name of examined banks*	*Contents of examination*
15 May	The 21st National Bank of Nagahama (Shiga)	*Vigilance:* substance of collateral and loan-to-value ratio *Inspection:* cash, loan, ledgers *Vigilance:* unsecured large loan (17,000 yen) and insider lending

Notes In addition to bank examination, Harada visited four rice market companies in Dojima (8–13 April), Hyogo (26–27 April), Shichijo (2 May), and Oumi (10 May) for inspection of ledgers, clearing margin, etc.
Source Jiro Harada, The Diary of Bank Examination Trip to Kyoto, Osaka, Hyogo and Shiga, contained in Harada Sekizen-kai (1938: 499–544)

imprisonment for a period of up to one year. An important suggestion, that a summary of the bank examination report should be made available to the public each year to discourage banks from engaging in excessive risk-taking, was also discussed in the Financial System Research Committee on 19 November 1926. However, the suggestion, which was designed to promote banks' self-disciplinary behavior, was not pursued because of the perceived risk of the public mistakenly assuming that the Ministry of Finance guaranteed the soundness of banks that had been examined (Bank of Japan 1956: 380–384). This meant that the bank examination system in Japan differed from the private auditing system typically adopted in Continental Europe, such as in Switzerland. Instead, commencing in 1935, the commercial banks were required to submit confidential reports including an explanation of the banks' risk management measures (Hotori 2011: 37–38).

The main objective of bank examinations during the period 1915–1934 was to ensure the soundness of banks by minimizing the incidence of bad loans and insider lending (Hotori 2011: 36–37). To achieve this objective, the conduct of an on-site bank examination was fully detailed through 42 provisions in the bank examination manual. The focal points of an on-site examination were summarized as follows:

a. to identify any violation of laws, guidelines, or articles of incorporation
b. to evaluate management and business performance

c. to confirm the details of the bank's assets
d. to investigate any close relationships between the bank and companies or individuals.

Specifically, bank examiners were required to look for evidence of insider lending with any special conditions such as low-interest loans. For example, bank examiner of the Ministry of Finance, Makoto Okada, pointed out much amounts of insider transactions (borrowing) between the vice-president, Kahichi Yamazaki, of the Daihachijū-go Bank in Kawagoe (25 km northwest of Tokyo). In response, the president of the bank directed to reduce such transactions, and the rest of insider transactions should be audited by the internal auditors.[23]

Due to the financial crises in the 1920s, the Ministry of Finance got more cautious about bad loans and insider lending. There are many examples to show this—we just introduce a case of medium-sized regional bank, Seibu Bank in Chichibu (50 km northwest of Tokyo).[24] Through bank examination on Seibu Bank taking place in October 1931, bank examiners classified the bank's doubtful loans by uniformed category as: (1) uncollectible, (2) delayed repayment, or (3) need early collection. In addition, examiners identified huge amount loan (one-fourth of all loans) with applying special lower interest rate to the president of the bank, Manzo Kakihara. On 18 June 1932, the business improvement order was issued to Seibu Bank, and the bank was obliged to submit a monthly report on the disposal of those problem loans to the Ministry of Finance.

The bank examination manual also contained the sequence to be followed during the on-site examination: (1) cash and securities, (2) bills, notes, and paper, and (3) books and records. Moreover, the Ministry of Finance provided every examiner with official pre-printed forms on which they were required to record the bank's assets, liabilities, and other key information (e.g., insider lending lists).

Kiyoji Hoshino (1893–1979), whose father was a merchant of a Sake brewing company, and a graduate of the University of Tokyo, entered the

[23] Daihachijū-go Bank, Response Report on Bank Examination, 25 November 1916, *Documents on Bank Examination of the Daihachijū-go Bank*, Prefectural Bureau of Banking and Industry, Administrative Materials, Tai970G, Saitama Prefectural Archives: Saitama.

[24] Seibu Bank, Response Report on Bank Examination, 23 October 1932, *Documents on Bank Examination of Seibu Bank*, October 1931–February 1935, Materials Collection of Saitama Bank, No. 78, Saitama Prefectural Archives: Saitama.

Ministry of Finance in 1918. After working initially as a bank examiner, he was promoted to the Director of the Bank Inspection Section. In October 1937, he made a speech on bank examination to country bankers, which provides details of bank examination and its philosophy at that time.[25]

First, the "protection of depositors" was de novo emphasized as the main purpose of bank examination. This reflected the increase of middle-class depositors as the result of the economic growth. *Second*, the main role of bank examiners shifted from education to consultation with bankers regarding their management. On this issue Hoshino stated that:

> Cooperation between bankers and examiners was indeed important. Without hesitation bankers should ask examiners the ways of improvement. Examiners shared similar 'mindset' with banks which enabled improvement… A bank examiner was just like a 'doctor'. Although 'a good medicine sometimes tastes bitter', bankers should follow the examiners' advices after on-site examination.[26]

Third, Hoshino stressed the following lending items should be examined carefully: bad loans, large loans, and insider loans. Especially, insider loans were the most "troublesome" because the directors were tempted to break the rules of sound banking. In his view, bank failures had been caused by such bad insider loans. To make matter worse, if a bank had already given insider loans, non-insider borrowers blamed such bank management to avoid collection.

Hoshino's speech represented the shift in the nature of bank examination. The priority of bank examination changed to reflect growing concerns over the insider loans (and large loans at the same time). The enhanced stricter sanctions introduced in 1927 made it simpler for examiners to instruct bankers for improvement of the bank management.

The on-site examination took approximately 1 week for an average-sized bank, and the arrival of the examiners was supposed to be a surprise, although some bankers were able to receive early warning of an impending visit through their community network, such as a call from

[25] Hoshino gave the speech for two days (11–12 October 1937). See Hoshino (1967: 1–64).

[26] Hoshino (1937: 15–20, 62–63).

a hotel or railway station.[27] A typical on-site examination proceeded as follows. The first day was spent checking cash and securities held in the bank's safe, and the relevant pre-printed forms were required to be completed by the chief examiner. The second day was dedicated to examining the books, records, and forms kept by the bank's head office. The third and fourth days were spent conducting interviews with the managers of the bank's major branch offices. The fifth day was dedicated to interviews with the president and directors of the bank, wherein they were presented with any formal queries generated by the bank examination. On the sixth day, the bank submitted their response to the aforementioned queries (Hotori 2006: 102).

* * *

The main driver of the formalization of banking supervision in Japan was not a financial crisis. The gradual development of the banking sector and better-educated bankers in the early twentieth century provided the background for the positive transformation of the supervisor's role.[28] The major trigger for the introduction of formal banking supervision was the outbreak of the First World War, which made it necessary to minimize confusion among depositors.[29] The costs of banking supervision such as travel expenses for on-site examinations were covered by tax revenues. The political rationale for formalizing and enhancing banking supervision was the government's desire to protect small depositors at a time when the universal suffrage movement was becoming widespread.[30] Notably, the Japanese case shows that not only the supervisors' but also the bankers' good understanding of systemic risk enabled the implementation of supervision because it included a reversal of the formalization process[31] that was in place in the decades prior to the First World War.

[27] The frequency of on-site examinations was approximately once every 2 years (see Table 3.5). This interval also helped the bankers to predict the likely date of arrival of the examiners.

[28] Hotori and Wendschlag (2019: 216–217) detailed this aspect of the development of the Japanese economy.

[29] Transcript of a speech by Minister of Finance Reijiro Wakatsuki in April 1915.

[30] Universal suffrage was introduced in Japan in 1925 (Takeda 1992: 241–245).

[31] The suspension of on-site bank examinations from 1893 to 1914 and the bank deregulation implemented in 1895 represented a reversal of the process of formalization of banking supervision.

Essentially, the formalization of banking supervision in Japan was largely a process of maturation, including a reversal, which aligned with the incremental change approach.

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CHAPTER 4

Sweden: Early Adopter of Formal Banking Supervision with Incremental Steps

4.1 Modernization of the Swedish Banking System in the Nineteenth Century

Sweden industrialized over the course of the nineteenth century. In tandem with this development, a "financial revolution" occurred that modernized the ways in which saving, lending, and investments were generated (Ögren 2010). The gradual economic growth itself became an important driver of the banking system's development (Table 4.1), as an ever-larger share of the population became able to set aside some of their earnings for productive investment and/or save for future needs. The population's growing ability to save was promoted by the savings bank movement, established in Sweden in the 1820s. They increased in numbers quickly, especially in the rural parts of the country where the private bankers and the commercial arm of the parliament-owned Riksbank had limited presence. By the 1830s partnership commercial banks were created in the commercial centers to offer short-term funding for trade and investments of the commercial elites, and by the 1850s the first joint-stock banks with limited liability were created (Larsson 1998). The partnership banks were funded by note issuing and guaranteed by the personal liability of the partners who, as in many other countries, were part of the same local elites that the banks serviced. Business prudence was monitored by these social networks.

With the joint-stock banks, the possibilities to fund larger industrial investments and to mitigate risks in the commercialization of innovations

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Table 4.1 Commercial banks (Joint stock and partnership), 1870–1920 (10-year intervals)

Year	*1870*	*1880*	*1890*	*1900*	*1910*	*1920*
Number of banks	27	43	43	66	80	31
Deposits (million SEK)	74	247	352	772	1,465	4,968
Loans (million SEK)	110	287	457	1,045	2,085	6,210

Source Häggqvist et al. (2019) and Schön and Krantz (2015)

were greatly improved, and by the end of the century the joint-stock banks were beginning to dominate commercial banking. The general success of the joint-stock company was supported by the creation of the Stockholm stock exchange in the 1860s, which eased the funding of new joint-stock companies and the buying and selling of shares in the companies of the industrialized age. Despite periodical economic recessions and a few financial crises (1850s and 1870s), the commercial banking sector grew without pause over the second half of the nineteenth century, from eight banks in 1850 to more than 60 by 1900. In the same period, total bank deposits grew from less than ten percent of GDP to about 50% (Häggqvist et al. 2019).

In addition to the mutually enforcing processes of industrial and financial modernization also came the reforms of the Swedish political system, as well as the development of the public administration and bureaucracy. With the constitution of 1809, the powers of the king's government were reduced in favor of the parliament, and with abolition of the parliament of the estates in 1866 the legislating power received a broader public representation. The parliamentary process gradually increased the demand on the state to guard and promote the rights and wellbeing of the general population (Kahn and Wendschlag 2020). As the banking sector grew and more individuals became bank customers, the soundness of the banks would become a matter of political concern.

4.2 Nineteenth-Century Commercial Banking Regulation

The regulation of Swedish commercial banks originated from the requirement to gain the King's permission to open a bank. This charter requirement first employed in the 1650s in the case of Stockholm Banco—the

first bank in Sweden—remained in force even with the general policy shift toward free enterprise that also occurred in the nineteenth century. While most types of commercial enterprises did not require a royal permission by the mid-nineteenth century, the enterprises engaging in banking business did. The poor experience of the first bank—it failed within a decade and was taken over by the parliament and renamed Riksens Ständers Bank (later renamed Sveriges Riksbank)—can explain why the regulation of banks developed separately from the general corporate acts. In this sense, bank specific regulations developed earlier in Sweden compared to many other countries.

In order to obtain a charter, the bank's owners had to be approved as well as its business plan, including the bank's rules for dividend payouts and reserve funds. The charters were for ten years, when a new charter application had to be approved. The administration and scrutinizing of these applications were done by the Ministry of Finance, and these administrative activities associated with bank charters and regulatory reforms were implemented almost annually during the second half of the nineteenth century.

However, once a charter had been obtained, the commercial banks were not subject to day-to-day supervision. Nor did the banking regulations of the early and mid-nineteenth century imposed much constraint on the business practices of banks. Notably, the partnership banks' note issuing began in the 1830s—the royal decree of 1824 had not accounted for note-issuing business nor explicitly prohibited such business.[1] The issuing of private notes became the most important measure for funding for the partnership banks, and with the 1846 Partnership Banking Act, this note-issuing business came under formal regulation.

The 1846 Partnership Banking Act tasked the local County Administration to appoint civil servants to monitor locally established banks. The representative's powers was limited however, concerned mainly to ensure that the bank did not violate its note-issuing privileges. The representatives did not perform supervisory activities in any standardized or regular fashion during the first half of the nineteenth century (Wendschlag 2012). The personal liability of the partners and the monitoring within the local social networks remained the main form of supervision.

[1] Kungliga kungörelsen den 14 januari 1824 angående inrättande av enskilda banker (The Royal Decree on 14 January 1824 regarding establishment of individual banks).

The first Joint-Stock Bank Act was adopted in 1848. Similar to the Partnership Bank Act, the County Administrations were to appoint a "King's representative" to oversee the joint stock banks. The Act gave the County Administration the right to participate in the bank's board meetings, the obligation to appoint an external auditor of the annual report, and, on behalf of the government in Stockholm, the power to request the information about the bank it deemed necessary to verify compliance. As for the partnership banks however, the supervisory activities of the County Administrations was very limited, irregular, and without common standards of practice between counties. Conversely, social forms of discipline were important for the early joint-stock banks, since those banks operated locally and were dependent on the good faith of local commercial interests both for funding and business.

None of the banking acts implemented in the 1840s provided much provisions in the form of supervisory power for the County Administration. According to the acts, the only enforcement action available for the County Administration was to recommend the Ministry of Finance to revoke or not renew the bank's charter. This option was too drastic for most discrepancies observed in the banks, and the lack of range in disciplining tools prevented proper supervision to develop at the time. Moreover, local politicians or civil servants were mostly the board members of banks and/or significant customers of banks, which further undermined the counties' credibility as supervisors.

By the late nineteenth century, the joint-stock commercial banks came to dominate over the partnership banks in financing the new industry.

The joint-stock banks were more adapted to the times with the new industries of electricity, telephone, hydropower, and chemicals. Due to unlimited liability, partnership banks could not enlarge their business scale sufficiently to satisfy the financial needs of these new industries. Most important to the demise of partnership banks was however, the 1897 Riksbank Act that granted the central bank a monopoly on note issuing (Larsson 1998). This ended the partnership bank's funding model, and more or less forced them to incorporate as joint-stock banks and to base their funding on deposits (and bond issues to some extent). Both types of commercial banks remained in operation however, but practically all differences in legal treatment were erased with the 1903 Banking Reform Act.

While the market and the regulators favored the joint-stock bank, it was regarded as a less reliable form of incorporation. Most important was

the fact that the owners' liability was limited, which could lead to too risky or disengaged operations. Another problem came with the overall trend of commercial banks branching out of their home regions. In 1885, 44 commercial banks operated 156 offices, and fifteen years later 66 banks were running 270 offices.[2] With this development the disciplining power of local social networks declined. For external stakeholders, it was becoming difficult to oversee the bank's full operations. The County Administrations shared the problem caused by the branching out, not the least due to the lack of coordination between counties for the supervision of banks operating in multiple counties. As with the state apparatus in general, the banking supervision developed toward further formalization and centralization (Wendschlag 2018).

4.3 The Bank Inspector Profession

Although the banking acts implemented in the 1840s did not introduce day-to-day standardized supervision, the acts required the commercial banks to submit several financial reports per year (frequency depending on size) to the Ministry of Finance. By 1868 the workload in relation to these reports, the administration of charter applications, and dealing with bank regulation reforms were quite demanding. The Minister appointed a civil servant to work exclusively with these matters. The civil servant commenced to develop specialized understanding both of the regulatory requirements and of all the commercial banks in the country. By 1876 this civil servant was given the title of Bank Inspector, and an assistant was hired by the Bank Inspector.[3]

Thus, the formalization and centralization of banking supervision had begun incrementally in Sweden. Indeed, the banking acts identified the County Administrations' responsibility for performing monitoring activities. Yet, those activities were practiced irregularly with weak mandates. The Bank Inspector performed on-site examinations, but quite infrequently. From 1870 to 1889 just 4–6 examinations were conducted per

[2] These figures are drawn from *Statistik om bankerna* (Statistics on the banks).

[3] Kungligt beslut den 15 december 1876 (The Royal Decree of 15 December 1876).

year with little systematization, while the frequency was higher around the 1878–1879 railway bond market crash.[4]

With the 1889 appointment of former banker and head of the Stockholm Stock Exchange, Robert Benckert, as the Bank Inspector, the number of on-site and off-site examinations increased drastically. By then a Bank Bureau had been formed within the Ministry of Finance, which was headed by the Bank Inspector.[5] However, the arrangement required that all executive decisions had to be made by the Minister of Finance. This was an inefficient process, especially since the Minister had to rely on the Bank Inspector's expert advice in most cases (Wendschlag 2012). The special skills developed by the Bank Inspector were also in high demand in the political sphere as the banking acts frequently came up for reform. The political leadership in parliament was in favor of promoting the banking sector's expansion. At the same time the industry's and the general population's growing dependence on banking services (for saving, borrowing, payments, and investing) called for the state to ensure that banks were reliable and prudent in their businesses.

The continued growth of the banking sector called for new reforms. In 1905, the parliament appointed a committee, headed by Bank Inspector Benckert, to investigate a suitable new organization for the banking supervision. The report, published in 1906, argued for the establishment of an independent banking supervisory agency. The agency was still to be organized under the Ministry of Finance but with a board given executive powers, more resources and a clearer mandate to supervise and discipline the commercial banks. Although the growth of the banking sector was an important motive for the reform, the inefficient decision-making process of going via the Minister of Finance was a strong argument for creating an independent agency. The fact that the Insurance Inspectorate had been established in 1904 for the supervision of commercial banks was another argument—the soundness of commercial banks being at least as important as that of insurance companies. The proposed agency would be fully funded by fees paid by the supervised banks, and its board was to be appointed by the Minister of Finance. The board would take over all

[4] Unfortunately, the archives are limited in detail of the work of the banking supervisor during the crisis.

[5] K Maj:t:s beslut den 31 maj 1889 angående inrättandet av en bankbyrå (May's decision on 31 May 1889 regarding establishment of a bank branch).

the supervisory duties of the County Administrations.[6] The board would have the power to grant and revoke bank charters, and could also require the banks to submit all data and information on request.

The supervisory agency was also authorized to conduct on-site inspections of any bank office under its supervision. It could call upon the bank's board of directors not to execute board decisions or to reverse decisions already put in force. If corrections were not made, the Inspection Board could "issue written reprimands or take the measures, which were deemed required."[7] These measures included publishing reprimands in the press and calling an extra meeting of the bank's board. If a bank had made losses equal to the reserve fund plus ten percent of the basic fund, the Inspection had the duty to require the bank's board of directors to bring in external accountants to make a financial statement without delay. New owner capital would then be necessary to rescue the banks from liquidation. The County Administrations still held the power to appoint the King's local representative who took part in preparation of the commercial banks' accounting reports, but these appointments now required the Bank Inspection Board's approval which in effect led to raised competence requirements for these representatives.

The 1906 investigation did not propose substantial alternatives to its main proposal.[8] Allocating the banking supervisory power to the central bank—a solution that was later favored in many other countries (Grossman 2010)—was never discussed. While the 1897 Riksbank act had initiated the dismantling of the central bank's commercial banking arm, the Riksbank was still a competitor to the commercial banks in many respects (Barvell et al. 2019).

In the fall of 1906, the parliament voted in favor of the proposal, and on the first of January 1907 the new agency, the Royal Bank Inspection

[6] The County Administrations still were supposed to monitor savings banks.

[7] SFS 1906:104 § 2.2 Kungl. Maj:ts nådiga instruktion för dess bankinspektion och för dess finansdepartements bankbyrå (May's gracious instruction for the bank inspection and for the finance department in the bank bureau).

[8] Betänkande med förslag till förändrade bestämmelser angående bankkontrollen, afgifvet den 15 november 1905 (Report of proposed changes to the banking control, issued on 15 November 1905).

Board commenced its operations.[9] At the beginning, the new agency coexisted with the Bank Bureau (still headed by the Bank Inspector) which maintained several functions—collecting reports from the banks, producing bank sector statistics, and work related to regulatory affairs. By 1910, these duties were fully transferred to the Bank Inspection Board.

Initially, the number of staffs of the supervisory agency was quite small. It consisted of the Bank Inspector, his two assistants, one secretary, and two external members of the executive board. The Inspector and the secretary were trained in law, while most of the staff hired in the next few decades would be persons with some ten years of work experience at banks and/or other private financial institutes.[10] The agency expanded in the coming years with 15 examiners (and a handful of administrative staff) in total in 1920, and the budget for the Bank Inspection Board increased tenfold between 1907 and 1920 (Fig. 4.1).

4.4 Supervisory Activities of the Bank Inspection Board

With the new agency, the supervisory activities, i.e., on- and off-site examinations, increased drastically compared to earlier. An important reason for this was the banking crisis that began in the summer of 1907 which keep the supervisors busy until the end of the following year. While triggered by the international stock market and credit crisis, excessive domestic lending as well as rapid branch-network expansion were observed among most of Swedish banks that got into trouble (Grodecka et al. 2018).

The Bank Inspection Board was greatly involved in the crisis management. About 20 on-site examinations were conducted in 1906. In 1907 and 1908, the number rose to over 80 per year, and such high level of supervisory activity was maintained for the rest of the decade more or less (Ottosson and Wendschlag 2019). Although the Bank Inspection Board Act of 1906 had no specific guidance on the agency's mandate or role in a banking crisis, Bank Inspector Benckert personally made interventions

[9] SFS 1906:104 § 2.2 Kungl. Maj:ts nådiga instruktion för dess bankinspektion och för dess finansdepartements bankbyrå (May's gracious instruction for the bank inspection and for the finance department in the bank bureau).

[10] SFS 1906:104; Bankinspektionens arkiv, tjänstematriklar (The Archives of the Bank Inspection Board, materials).

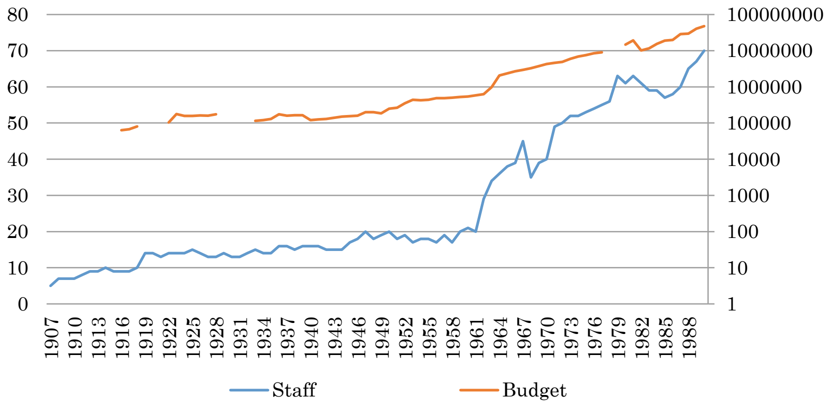

Fig. 4.1 The Royal Bank Inspection Board: Staff and Budget, 1907–1990. *Note* Number of staff: left line. Budget (SEK, not adjusted for inflation): right line. The Bank Inspection Board merged with the Savings bank Inspectorate in 1962. In 1991 it merged with the Insurance Inspectorate to form the Swedish Financial Supervisory Agency (*Sources* Bankinspektionen, *Tjänstematriklar*, and Svensk Bankmatrikel, 1906–1944)

in problem banks. Many bank boards were persuaded to replace incompetent managers, in many cases with persons proposed by Benckert himself. The agency also acted as a broker in cases when weak banks were taken over by or merged with larger banks (Söderlund 1976).

* * *

The process of banking supervision formalization in Sweden was finalized with the creation of the Bank Inspection Board in December 1906. The commercial banking regulation development from the 1840s but did not enhance supervisory duties/activities of the County Administrations. The supervisory powers of the County Administrations were not exercised in a day-to-day, uniform or transparent way. With the creation of the Bank Bureau and the development of the Bank Inspector profession in the 1860s and 1870s, banking supervisory activities such as on- and off-site examinations became marginally more frequent, but began the process of centralization of the banking supervison. Still the lack of independence (dependent on political decision makers) was still problem for

effectiveness of the supervisory system. The creation of the Bank Inspection Board in 1906 and the transfer of supervisory executive powers from the Ministry of Finance to this new supervisory agency were the final step of the formalization process. Already in its first year of existence, the agency was forced to test the limits of its mandate with its involvement in the banking crisis of 1907–1908.

The main driver in the formalization process was the development of the banking sector itself and the initial and kept treatment of banks as the "special" type of businesses—manifested by the charter requirement. The centralization of the banking monitoring from the local County Administrations to the government in Stockholm was in part driven by the success of the joint-stock bank incorporation that reduced the disciplining powers of local social networks of elites.

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CHAPTER 5

Germany: Financial Crises and Formalization of Banking Supervision

5.1 A Brief History of German Commercial Banking

The German banking system is commonly characterized as comprising of three sectors, or “pillars”: the credit cooperatives, the commercial banks (private and joint-stock banks), and the savings banks (Sparkassen). The credit cooperatives developed in the eighteenth century as providers of bank services to members of local guild- or workplace-based cooperatives. Sparkassen, with origins in the early nineteenth century, were often owned or with close ties to local municipality authorities. The private bankers, some with roots back to the seventeenth century, were run by families or a small group of partners, servicing merchants and local businesses. The joint-stock banks emerged in the middle of the nineteenth century but grew in numbers and market share throughout the rest of the century (Krieghoff 2013). The banking system took form over the nineteenth century alongside the German industrialization, which took off during the second half of the century. The stepwise unification was naturally a key factor to Germany’s economic and financial development. The toll-free “inner-market” created with the 1834 customs union boosted more trade in goods and services, and also provided considerable opportunities for cross-state investments in the new industries (Guinnane 2002). However, until the unification of 1871, most private banks remained local in their operations—servicing local merchants, business men, and the wealthy upper classes. They were organized as partnership firms, often

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under the control of one or a network of families. Branch networks were basically limited to the banks' home cities. Several new banks, established in the 1850s, became the large and significant commercial banks by the early twentieth century. These banks, including the Darmstädter, Disconto-gesellschaft, and Berliner Handelsgesellschaft, would build their success on forming close and lasting ties to companies of the industrializing economy. A common denominator of the commercial banks that would become the "Big Five" was that they developed into universal banks. Universal banks were able to provide their company clients with all the banking services in need. Several of these banks were founded as partnership banks, but with the enactment of the first joint-stock company act in 1868, many banks, including the Big Five, shifted to the joint-stock company form. Deutsche Bank and Dresdner Bank, created in 1870, became joint-stock banks and soon proved themselves better suited to grow with their customers in the industrializing economy of the time (Tilly 1986).

In contrast to the UK banks at the time, funding by note issuing was not common among German commercial banks of the nineteenth century. Nor did German banks depend on retail deposits, while the individual deposits taking was the savings banks' and the credit cooperatives' key source of funding. The three-pillar division of German banking remained fairly intact after the unification. The commercial banks instead relied on funding from the partners or shareholders (in the case of the private banks and the joint-stock banks, respectively). From the 1870s, commercial banks also issued bonds for funding. With the creation of the German central bank, the Reichsbank, in 1876, the option of funding by note issuing was removed from the commercial banks (Guinnane 2002).

The overall strong economic development after the unification in the 1870s contributed to the strong development of the German banking sector. By the turn of the century the banking sector comprised of 118 joint-stock banks, 1,386 private banks, 39 mortgage banks, 2,685 savings banks (Sparkassen), and 12,140 credit cooperatives (Krieghoff 2013). In addition to these banks, there were also a number of state-owned niche-banks: Staatsbanken, Landesbanken, Girozentralen as well as the commercial bank Reichs-Kredit-Gesellschaft—one of the six largest banks (Schnabel 2004: 828).

Germany experienced a banking crisis in 1907–1908, and many of the large universal banks encountered difficulties due to failures of large customers of the banks and tight liquidity in the international capital

market for the banks to borrow. However, the German commercial banking sector recovered rapidly after the crash. The recovery in part came by a greater market concentration when comparatively sound banks took over weaker ones (Tilly 1986).

From the start of the First World War until the reforms in 1924 that put an end to the post-war hyperinflation, the joint-stock banks decreased in numbers but grew in terms of branch offices and market share. The number of provincial credit banks dropped from over 100 in 1913 to less than 70 in 1925. By the end of the decade, the total assets of "the big six" commercial banks amounted to 50% of all banks' assets (Krieghoff 2013; Schnabel 2004). During the same period the 9 largest banks grew from operating 550 offices to more than 1230. Many new private banks and niche joint-stock banks were created during the hyperinflation-period to act on the business opportunities that the market volatility offered. As soon as the hyperinflation ended in 1924, many were closed (Krieghoff 2013).

While the reforms in 1924 brought greater stability to the German banking system, it also spurred on competition within and between the different banking segments. The merger trend continued as competition for depositors and business clients was intensified (Bebenroth et al. 2009). The commercial banks complained to the regulators about unfair competition from the publicly owned Sparkassen. At the same time, the largest commercial banks had the advantage of a renewed access to the international capital market, albeit only for short-term foreign credit. Of course, the large banks' dependence on international funding and its short-term nature would be one of the causes of the severe German banking crisis in the early 1930s (Schnabel 2009).

The German banking crisis was triggered by the collapse of the Austrian bank Creditanstalt in May 1931, after which several German commercial and savings banks were subject to runs by depositors. At the same time, the large commercial banks were no longer able to roll over their international funding as investors sought to reduce their exposure to the German economy. In June 1931, the stock exchange was closed to stop a fire sale of shares, and in the same month the Danatbank, the second largest bank in the country, closed its offices to stop the deposit withdrawals of worried depositors. However, the runs on banks continued and forced the government to intervene. After a country-wide bank two-day holiday, the government announced that it had taken over

the Danatbank and bought a controlling stake in the near-failed Dresdner bank (Bitz and Matzke 2011).

Before the year was over the German federal government had become a major shareholder of three largest commercial banks, as well as a key creditor. While the government control of the commercial banks was intended to be temporary, many managers were replaced by "caretakers" appointed by the government (Krieghoff 2013). When the Nazi-government came in power in 1933, the government's control over the German banking sector was kept. In practice the commercial banking sector would remain under political control until after the Second World War (Nathan 1944).

5.2 Commercial Banking Regulation in Germany

The regulation of commercial activity underwent significant changes in connection to the unification of the German states in 1871, with the freedom of establishing a joint-stock company embodied in the "Gewerbeordnung" of the same year. Before 1871, many German states and cities were quite restrictive in permitting joint-stock companies in general, since the owners' limited liability could open up for irresponsible businesses. In some states, such as Prussia, the local government granted more joint-stock companies from the 1850s and onwards. Yet, this was exceptional, and the major shift came after the unification, when all German joint-stock companies, including joint-stock banks, came under the same regulation (Fohlin 2002; Büschgen 1998: 253). Under the 1870 Company Act, neither the private banks nor the joint-stock banks were subject to charter requirements.[1] Other banks, such as the Preussian publicly owned Sparkassen and the mortgage banks, were subject to regulatory requirements under the supervision of the local authorities. For private and joint-stock commercial banks, the "free enterprise" character of the 1870 Company Act meant no specific regulation or supervision (Bitz and Matzke 2011). Although the Act permitted companies to start branches around the country, few banks created large branch networks. Instead, commercial banks preferred to cooperate in groups formed under one of the largest Berlin banks (Bebenroth et al. 2009).

After the 1907–1908 banking crisis a committee was formed to investigate the need for banking regulation. However, the committee, supported

[1] Notably, all banks were still required to have the state or city authority's approval to start business.

by the Reichsbank, argued for maintaining control via banks' self-regulation and "gentleman's agreements" to maintain sufficient liquidity and to operate with prudence. The large joint-stock banks volunteered to publish their balance sheets every other month, and in 1910, this practice was mandatory by law for all joint-stock banks listed on the stock exchange. Yet, the requirement to publish balance sheets was suspended with the start of the First World War (Krieghoff 2013).

The deep recession after the war was accompanied by hyperinflation as the German government used the printing press to pay for fiscal expenses as well as for the war reparation funds set out in the Versailles treaty. Commercial banks mostly remained profitable thanks to business opportunities offered from the market volatility throughout the hyperinflation period, although the size of the banking sector shrunk considerably. Even after the reconstruction of the Reichsbank in 1924 and the accompanying currency reform and credit controls, the commercial banks remained unregulated. The issue was subject to parliamentary debate, but with the recovery in the last half of the 1920s the matter fell off the agenda until the banking crisis in 1931 (Nathan 1944).

The banking crisis of 1931 led to the introduction of banking regulation in Germany. A number of moratorium laws were enacted to facilitate the government's intervention in the failing banks, including the 1931 "Verordnung über Aktienrecht, Bankenaufsicht und über Steueramnestie" for the first time to be bound commercial banks to bank-specific requirements as well as the provisions for banking supervision by the federal government. With this ordinance the formalization of banking supervision began in Germany. However, it would take several more years until this process was finalized. During the crisis, which lasted between 1931 and 1933, many of the major commercial banks were brought under government control, and banking supervision in the modern sense was not conducted on a day-to-day basis during this period. With the Nazi-party in power from 1933, and under their direct control of the banking system, this stage of incomplete formalization remained even after the re-privatization of the rescued banks in 1934.

Nevertheless, the moratorium laws signified the introduction of regulations specific for commercial banks. In December 1934, these moratorium laws were replaced by the Credit Act of 1934, the Reichsgesetz über das Kreditwesen (Bitz and Matzke 2011). A license requirement was introduced as well as minimum capital- and liquidity provisions. The bank's major owners and managers should meet fit-and-proper criteria.

The Act also introduced standardized credit procedures and documentation, as well as regular, standardized reports on the business and financial standing of the bank (Bruckhoff 2009; Bitz and Matzke 2011).

The crisis also led to the credit cooperatives to form an association that offered deposit insurance in case a member bank failed. For the savings and commercial banks, similar industry-organized deposit insurance schemes were introduced in the 1960s and 1970s, respectively (Bebenroth et al. 2009).

Under the Nazi-regime the banking sector came to focus on activities that were in line with the economic policies of the government. By invoking the "leadership principle", Hitler had the power to appoint all board members since coming to power in 1933. The formal independence of the central bank gradually disappeared over the 1930s, culminating with the 1939 Reichsbank Act that made it a part of the government (Krieghoff 2013).

5.3 Creation of the German Banking Supervisors

As mentioned above, the 1931 moratorium act established the legal basis for introducing banking supervision in Germany. However, the question of who should supervise the banks became a matter of political debate. While the Reichsbank was recognized as the supervisor based on competence and experience in banking matters at the federal level, the idea also received criticism after the crisis for being too closely allied with the banking sector (Krieghoff 2013).

The organization of the supervision was clarified with the 1934 Credit Act. Two government entities were created to regulate and supervise the banking sector. The Supervisory Board for the Credit System[2] was created within the Reichsbank to set the overall rules for the banking sector, and the federal Commissioner of the Credit System (Reichskommissar) was in charge of the rule implementation and day-to-day supervision (Bitz and Matzke 2011).

In September 1939, the government closed the Supervisory Board and transferred its powers to the Ministry of the Economy. At the same time, the Office of the Commissioner was renamed the Reich Supervisory Office for the Credit System, and organized under the Ministry of

[2] The 1934 Act gave considerable room for discretion to the Board.

Economics and its President appointed by Hitler himself. In 1944 the banking supervision was transferred to the Minister of the Economy. The Reichsbank, a part of the government at that time, carried out the operational supervision (Krieghoff 2013).

After the Second World War, the allied countries decentralized the banking supervision to the level of the new Länder-governments. The local authorities regularly met in a special committee for banking supervision, namely "Sonderausschuss Bankenaufsicht," which included the reformed German central bank (Bank deutscher Länder) as well as (from 1949) ministers of the federal government. The new central bank was also organized with branches in each of the Länder, and conducted the day-to-day supervision (Bitz and Matzke 2011). The decentralized structure of the central bank and the banking supervision was promoted by the Americans who had a similar state-level arrangement. And just as in the US, one motive behind the decentralization was to prevent the concentration of the government power (Bruckhoff 2009).

After the occupation years, the supervision was centralized once again. Although the work to reform the 1934 Credit Act commenced soon after the end of the war, it was not until 1961 that the new act was fully implemented. This meant that the differences between Länder in terms of regulation and supervision were removed. The central bank, now called the Bundesbank, remained responsible for the day-to-day examination of banks as well as the collection of banking data. However, a new federal agency responsible for implementation and enforcement was created with the 1961-decisions. The agency was called the Bundesaufsichtamt für das Kreditwesen, or BAKred for short, and became ultimately responsible for the supervision of some 13,000 credit institutions.[3] The 1961 Act also defined the purpose of the regulation and supervision—to ensure the public's trust over the banking system as well as to ensure that banks were commercially viable in line with the interest of its shareholders and employees. While the 1961 act did not change the overall supervisory or regulatory regime, it ended the decentralized system implemented under the US occupation (Krieghoff 2013).

[3] BaFin (Federal Financial Supervisory Authority), History of Banking Supervision. https://www.bafin.de/EN/DieBaFin/AufgabenGeschichte/Bankenaufsicht/bankenaufsicht_node_en.html#doc7859652bodyText2. Accessed 25 May 2020.

5.4 German Banking Supervisors' Functions

The Office of the Commissioner established in 1934 was responsible for the implementation and enactment of the Credit Act of 1934, as interpreted by the Supervisory Board (see above). The Office received monthly reports from all credit institutions. The reports were to include information about new loans and to list all borrowers with liabilities exceeding one million Reichsmarks. Disciplinary actions would be taken against a bank if the bank's individual exposures were too large. The Commissioner could request for any information from the banks and could issue fines. Moreover, the Commissioner was empowered to close a bank or a bank office with considerable discretion (Nathan 1944).

The 1934 Act gave the Reichsbank and the Supervisory Board for the Credit System mandate to set interest rates and fees for the banks as well as other business conditions. Banks were required to report monthly on their business, and large exposures to individual clients were limited. All requirements imposed on banks by the Reichsbank and the Supervisory board aimed to reinforce the impact of the central bank's monetary policy. In addition, they focused on limiting credit expansion as well as maintaining the foreign exchange control introduced in 1931 (Krieghoff 2013).

While the 1934 Act introduced a set of banking regulation, a supervisory authority and the provisions for day-to-day supervision, de facto government control over the most of the banking sector under the Nazi-regime makes it problematic to date the formalization of banking supervision. In our view, it is more correct to date the introduction of centralized uniformed supervision with proper prudential purpose until after the Second World War—that is, enactment of the 1961 Act with creation of the supervisory agency, BAKred.

After that, the Banking Act was reformed several times between the 1970s–1990s. Especially after the Herstatt Crisis in 1974, the reformed acts clarified and expanded the jurisdiction, responsibilities, and powers of the bank supervisor (Mourlon-Druol 2015; Bitz and Matzke 2011).

* * *

In summary, the German case was triggered by a financial crisis at the turn of the 1930s. However, the formalization process was prolonged due to the political control over the banking sector under the Nazi-regime. Thus, while our criteria for formalized banking supervision (with banking act,

a supervisory agency, and day-to-day supervision) were introduced in the mid-1930s, the fact that the banking sector did not operate on market-term until after the Second World War—we date the full formalization of German banking supervision until this time. Day-to-day banking supervision work commenced under the US occupation, but the banks operated under public control as well as the decentralized banking supervision system lasted until 1961.

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CHAPTER 6

Switzerland: Formalizing Banking Supervision in the Aftermath of a Crisis, Better Late Than Never

6.1 Introduction

Banking has long been identified as a key sector in Swiss economy. The Swiss financial center grew extensively during the twentieth century, and it became a turntable for international capital. The rapid growing significance of the international activities of Swiss banks was disproportionate to the size of the country, its demographic importance, or its economic and industrial power. Despite the international reputation of Swiss banking (both in positive and negative aspects), only few studies have addressed the historical development of banking regulation and financial supervision specifically: following Bänziger's pioneering study of the development of banking supervision (Bänziger 1986), post-2008 contributions have largely renewed the historical research on Swiss financial regulation (Giddey 2012, 2019; Mazbouri and Schaufelbuehl 2015; Straumann and Gabathuler 2018).

This chapter will focus on the process that led to the introduction and successful implementation of banking supervision during the twentieth century. As shown below, banking supervision was introduced rather late in the aftermath of a severe crisis due to the strong resistance of bankers. During a long period, at least until the 1980s, official banking supervision merely consisted in de jure controls of commercial banks. The effectiveness of the supervisory activities of the federal agency in charge of supervision was improved progressively, thus leading to the completion of the formalization process.

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6.2 Development of Swiss Banking System

At the turn of the twentieth century, Switzerland gradually developed into an international financial center (Mazbouri 2005). The Swiss banking system rested on two main types of banks: the cantonal banks and the so-called big banks (Mazbouri et al. 2012). The cantonal banks are mostly government-owned commercial banks, whose assets are guaranteed by the cantons. Established in successive waves during the nineteenth century, their business area stretched from mortgage credit (and savings deposits) to commercial lending. The "big banks," on the other hand, were founded in the second half of the nineteenth century, on the model of the French *Credit mobilier*. They were meant to finance large investment projects, such as railway construction or manufacturing industry. In 1933, on the eve of the formalization of banking regulation, there were eight big banks: the *Schweizerische Kreditanstalt* (Zurich, established in 1856), the *Schweizerischer Bankverein* (Basel, 1872), the *Schweizerische Bankgesellschaft* (Zurich, result of a merger in 1912), the *Schweizerische Volksbank* (Berne, 1869), the *Eidgenössische Bank* (Zurich, 1863), the *Basler Handelsbank* (Basel, 1862), the *Banque d'Escompte Suisse* (Geneva, founded 1855, merger in 1931), and the *Leu & Co* (Zurich, founded in 1755, joint-stock company in 1854).[1]

In addition to the cantonal and big banks, other secondary banking categories also shaped the Swiss financial center: local and regional banks, savings banks, or private banks. Private banking houses, frequently originating from 18th century trading companies, specialized in wealth management, but also participated in other activities such as bond issuing, thanks to their international network of contacts (Mazbouri 2020). All in all, despite the division between different types of financial companies, the Swiss banking system has been marked by a great versatility and a strong tendency toward mixed "universal" banking. Commercial credits, collection of savings, mortgage credits, and even the issuing of state bonds were not restricted to one specific category of banks. Another outstanding feature was the comparatively low degree of concentration of the Swiss banking sector, at least between the end of the nineteenth century and the 1960s (Ritzmann 1973: 108–115; Cassis 2001). The low market concentration was also fostered by the coexistence of three financial centers within Switzerland. At the turn of the twentieth century,

[1] Regarding the Swiss big banks, see Mazbouri (2016) for further details.

Geneva, Basel, and increasingly Zurich emerged as the main financial centers of the country thanks to their respective specialization, their own stock exchange, and close international linkages.

The Swiss financial center, as it developed at the beginning of the twentieth century, was made of a polycentric territory—distributed between Zurich, Geneva, and Basel—based on the growth of two main actors: the big banks and the cantonal banks (Mazbouri et al. 2012: 472). When compared internationally, Swiss banking, from a very early stage, succeeded in keeping a strong position in the niche market of cross-border capital management (Farquet 2018: 15–46). Swiss banking position as a hub for international transactions and a safe haven for foreign capital during the First World War strengthened this underlying feature, and laid the foundations for the tremendous growth of the second part of the twentieth century. However, recent research suggests that the transformation of Switzerland into an international tax haven, which, in turn, contributed to the establishment of an international financial center, dates back to the nineteenth century (Guex 2021).

A distinctive feature of the Swiss financial center was the late creation of a central bank. The establishment of the Swiss National Bank in 1907 was the result of a 15-years-long political process, and put an end to a decentralized monetary regime, with a large number of issuing banks. The Swiss National Bank was shaped as a semi-public institution: it is a joint-stock company, but some of the governing bodies are elected by the federal government and its monetary policy is confined within the framework of the National Bank Act of 1905 (Guex 1993; Bordo and James 2007). As noted by Grossmann, the Swiss National Bank does not fit the general conclusion that younger central banks were more likely to become banking supervisors than their older counterparts (Grossman 2010a, b: 162–167). The absence of a supervising function within the competence of the central bank established in 1907 left a vacuum that would not be filled before the start of formalization of banking supervision in 1934.

6.3 Financial Crisis and Enactment of the Banking Act of 1934

Although the first Banking Act at the federal level was only enacted in November 1934, the first attempt to pass a law on commercial banking

dates back to 1914.[2] Previously, the only form of regulation on banking in effect were cantonal decrees on savings banks and on the establishment of cantonal banks, introduced in the second half of the nineteenth century.[3] In 1914, following a severe crisis resulting in the failure of a share of 10–15 percent of Switzerland banking institutions (50–69 out of 449 banks were deleted from the company register in 1910–1914), the federal government delegated the drafting of a bill on the supervision of banking companies (Wetter 1918; Ritzmann 1973: 105). The legislative proposal, known as "Landmann bill" after its author, Julius Landmann, professor of economics in Basel, met with considerable opposition from the banking community when confidentially discussed in 1916. Among bankers, the prospect of the state control over financial activity awakened fears of tarnishing the international role of the Swiss financial center as a safe haven for capital, since during the period of the war a lot of capital poured into Switzerland from the belligerent countries (Farquet 2012). Although the main provisions of the Landmann bill did not involve a radical change in banking activities, but only included basic regulatory provisions, such as a licensing system and the setting up of a federal Office for Banks, the draft bill was abandoned in 1917 due to joint action on the part of the Swiss Bankers Association and the Swiss National Bank (Mazbouri and Schaufelbuehl 2015).

In 1931 the European banking crisis hit the major Swiss banks hard. The introduction of exchange controls as well as the freezing of Swiss assets in Germany and central Europe created serious problems for the financial institutions that were heavily involved in the countries concerned (Perrenoud et al. 2002: 81–82; Halbeisen 2001). Swiss banks held a large share of German external debt, and the freezing of those assets caused a considerable devaluation of the invested funds. Overall, the strategy of the affected banks was to reduce their assets in countries with transfer restrictions. The governmental efforts to try to enact a Banking law resumed soon after the outbreak of the financial crisis in Switzerland. Yet, during a first phase (1931–1933), the discussions between financial, political, and administrative elites moved slowly. The banking representatives tried to avoid a law on commercial banking, by insisting on two alternatives solutions: first was an informal and private agreement with the central bank,

[2] For further details on the history of Swiss banking supervision, see Giddey (2019).

[3] These regulations remain outside the scope of this book.

for example on balance sheets' publications. Second was the insertion of a few provisions on banking supervision within the general corporate law.

Indeed, the first specific bill on commercial banking appeared to be doomed to suffer the same fate as the previous Landmann bill. In December 1933 the near-failures of two big banks, which were forced to ask for Confederation support in order to avoid bankruptcy, led to a change of course. Two large banks (the *Banque d'Escompte Suisse* and the *Schweizerische Volksbank*), which were suffering from the 1931 banking crisis and had invested a large share of assets in countries with transfer restrictions, had to ask for external bailout plans in order to avoid bankruptcy (Baumann 2007). On both occasions, the governmental rescue plan for the failing banks generated a rising political pressure in favor of banking legislation, since the plan involved the federal state acquiring of a stake equivalent to roughly a quarter of its expenditure for that year. The bailout plans had to be approved by the federal parliament, which compelled the banking representatives to make concessions. The Swiss bankers considered the passing of a law inevitable, and they participated actively in its preparation. The law-making process was marked, both in the pre-parliamentary committees and in the parliament, by the decisive influence of certain bank managers, such as the chief executive of Credit Suisse Adolf Jöhr. At the end of a rather short legislative process for Swiss habits, the Federal Law on Banks and Savings Banks was adopted in November 1934.

The enactment of the 1934 Banking Act represented the first step toward the formalization of banking supervision in Switzerland. For the first time, almost all commercial banks were subject to the same rules at the federal level. However, some financial intermediaries such as finance companies, private banks, and cantonal banks obtained a specific status, allowing them not to be subject to certain provisions. Entry conditions were not very strict: a bank could open its counters after fulfilling technical and administrative requirements. A licensing system—that is, allowing a supervisor to grant and revoke banking licenses or charters according to the compliance with regulation—was not provided for. Some prudential measures were implemented in the 1934 Banking Act: banks had to comply with an equity ratio and a liquidity ratio, but the minimal levels were low and the enforcement of the ratios did not involve a change in credit policy. Notably, bank secrecy—one of the most important competitive advantages for the Swiss financial center—was strengthened, given that Article 47 afforded it protection under criminal law (Guex

2000). Preserving and even consolidating the secrecy of banking activities concomitantly with the passing of a law on banking supervision was also a message to foreign bank customers who might have feared state intervention. Overall, the banking regulation introduced in 1934 was more of a generalization of existing practices than a questioning of the system. No separation of commercial and investment banking was introduced, and the model of the mixed universal commercial bank remained untouched.[4]

6.4 Organization of Swiss Banking Supervision Agency

The 1934 Banking Act set up the first nationwide supervision agency: the Federal Banking Commission (FBC), "eidgenössische Bankenkommission." Its main task was to ensure the effective application of the Banking Act. Among the more precise missions of the new organism, it had to give a ruling on which companies were subject to the law, recognize auditing bodies, agree on restructuring procedures for failing banks, verify compliance with liquidity and equity ratios, confirm the yearly audit of every bank, and establish regulations of limited scope.

Set up and financed by the federal government, the FBC was an executive body of public law enjoying considerable autonomy. Its broad independence was only nuanced by the fact that it had to submit an annual report to the federal government and that some of its decisions could be subject to administrative appeal to the Federal Supreme Court. The FBC formed an administrative novelty in Swiss institutions. Whereas the supervision of insurance companies had been carried out since 1885 by a federal office directly embedded in state administration, the FBC was a more independent agency, with regard to both the government and the central bank. Quite interestingly, the strong institutional separation between the FBC and the Swiss National Bank was also due to the fact that the latter was reluctant to being involved in the supervision, for fear that it would damage its relationship of trust with commercial banks. The first FBC board members in 1935 were a former Federal Councillor—i.e. Swiss head of state—(as chairman), a former director of the Swiss National Bank, a member of parliament, and two retired bank managers from the

[4] In 1971 the Banking Act was revised in the wake of the development of foreign banks in Switzerland. Yet the revision met with strong resistance, and thus only minor adjustments were made (Giddey 2013).

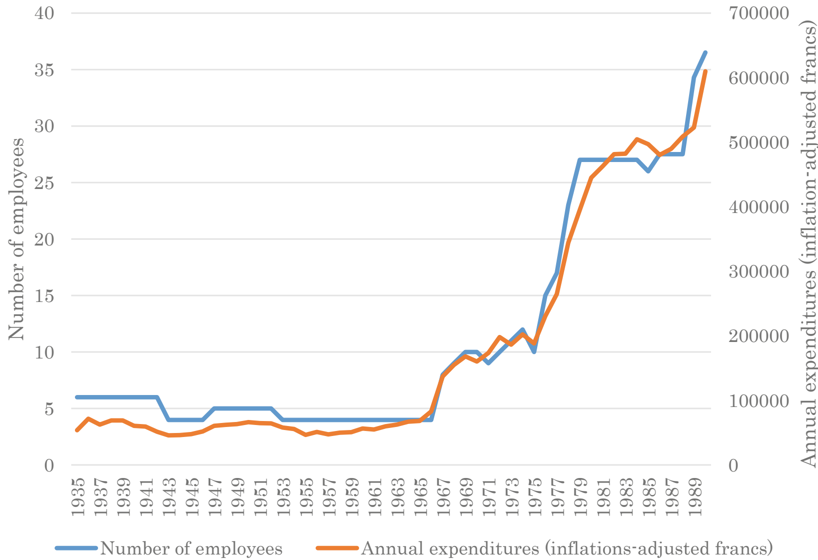

Fig. 6.1 Swiss Federal Banking Commission: staff and resources, 1935–1990 (*Sources* Giddey [2019: 250–251])

two biggest banks of the day. The composition of the commission did not change significantly over time (1935–1991). Out of five or seven members, there were former or active politicians (liberal and conservative), law or economics professors, former governors of the central bank, and former commercial bank managers. Most of the Swiss banking supervisors (71%), exclusively university-educated men with an average age of 58 at appointment and 66 at retirement, had strong ties with the banking sector—board members, former managers of commercial banks, cantonal banks, Swiss national bank, auditing companies (Giddey 2019: 247).[5]

In addition to the members who only met on a part-time basis—on average once a month, the FBC had a permanent secretariat in charge of the day-to-day management of the supervision agency. The Banking Commission was poorly staffed and under-resourced (Fig. 6.1). The total number of employees of the Swiss banking supervision agency (including

[5] Biographical statistics are based on the 42 first members of the Federal Banking Commission (1935–1991).

subordinate staff) ranged from 4 to 6 between 1935 and 1966. An increase occurred in the late 1960s, when the Commission was entrusted the supervision of investment funds; the late 1970s witnessed a second employee growth as a result of a governmental decision. The development of the financial resources of the FBC follows the same path, as staff salaries were the largest expense. It should be noted that the staff was very limited, even when compared nationally. In 1966, while the banking supervision agency employed only 6 persons, the Federal Bureau of Private Insurance had 29 employees and the Swiss National Bank employed over 400. Whereas the Swiss financial center enjoyed tremendous growth during the post-Second World War economic expansion, the administrative body in charge of its supervision lagged behind.

6.5 Activities of Banking Supervision

As a consequence of the structural weakness of the Swiss banking supervision agency, its actual activities were also limited. As a matter of fact, the 1934 Banking Act introduced a regulatory regime which made auditing companies as the cornerstone of the financial supervision. The private auditing firms were in charge of the on-site primary examination of the annual accounts and balance sheets. This examination consisted in the monitoring of the compliance of the bank's bookkeeping with banking regulation. This supervisory regime was indirect, since the main monitoring tasks were executed by private auditors. The state agency could only intervene in a second phase. In the view of the bankers who favored this solution, this system had the advantage of keeping the civil servants at bay in order to maintain a high level of secrecy. However, the indirect supervisory regime also highlighted the lack of independence between the supervised banks and the supervising auditing companies. Indeed, the main auditing companies who dominated the market of official banking auditing were established or taken over by the big banks, such as the *Gesellschaft für Bankrevisionen*, jointly created in 1934 by Credit Suisse and Schweizerischer Bankverein. Consequently, the reports produced by the auditing companies on the regulatory conformity were rather lenient. Applying great diligence sometimes meant losing a client/customer, since the banks were free to choose any approved auditing company.

The Federal Banking Commission's activities did not involve on-site examinations. The supervisory activities were restricted to repetitive administrative routine: registration of new banks, accounting reports

collection, authorizing auditing companies, and discussing the management of failing banks. As a result of the indirect supervisory regime, the Banking Commission is kept informed of only a narrow part of the Swiss financial center's activities. The audit reports annually produced by the auditing companies were only transmitted to the FBC if the clarified breaches could not be resolved amicably by the bank and the auditing company. Between 1937 and 1970, the FBC dealt with auditing reports which concerned a share of banks varying between four and 22% (Giddey 2019: 357). The vast majority of financially sound banks were completely off the radar. In the same vein, disciplinary measures were very rarely part of the regulatory framework of the Banking Commission. During its first 30 years of existence (1935–1965), the FBC filed only 16 complaints against non-compliant banks and refrained from using this disciplinary measure more often, as this step was seen as too drastic and prone to threaten the financial viability of the concerned bank. Legal complaints by the agency were thus considered measures of last resort.

In light of the very limited capacity of the Federal Banking Commission to grasp the supervision of the Swiss financial center, one might expect that the supervisors would redouble their efforts to change the regulatory framework in order to improve their resources and competences. During a first phase, between 1935 and 1965, it was not the case at all. Conversely, the Swiss banking supervisors, in line with the Bankers Association, opposed all the bills and plans that implied a formal amendment of the 1934 Act. They feared that opening up a public discussion on banking regulation could produce damaging or ineffective results. This strong defense of the status quo, both by the supervisors and the supervised, and despite established legal loopholes, explains why the first legislative revision of the Banking Act occurred as late as 1971.[6]

As a consequence, Switzerland provides an interesting case of an incomplete formalization of banking supervision during a long first phase. Indeed, even after the introduction of a federal law on commercial banking in 1934, only two of the three conditions, i.e., the enactment of a legal basis and the establishment of a supervisory agency, had been met. The effective enforcement activities by the supervision agency were still practically non-existent for a long time. During its first fifty years of existence, the Banking Commission was an empty shell which merely

[6] Yet, this amendment only consisted in minor changes.

carried out administrative duties. It was not until the early 1980s, with the stepping up of the resources of the Banking Commission, that an actual implementation of state banking supervision could be achieved.

* * *

In summary, Swiss banking supervision was formalized with the enactment of the Banking Act in 1934. Considering the early development and international activities of Swiss banks, the adoption of a law on commercial banking was rather late in comparative perspective. This delay was partly due to the marked reluctance of Swiss leading bankers to state intervention in the sector as well as their successful dismissal of previous regulatory attempts.

The passage of the 1934 law was the result of the heavy banking crisis that affected Swiss banks in the early 1930s. The losses suffered and the governmental bailout plans adopted undermined the resistance of banking representatives to a specific Banking Act. However, previous self-regulatory arrangements persisted mainly between the central bank and the bankers' association. The 1934 law established a new supervisory actor, the Federal Banking Commission. Yet, this agency was not given adequate supervisory capacities in terms of resources and competences. Instead, the private auditing firms undertook the on-site primary examination of banks—the main auditing companies were under the influence of large banks. It was not until the 1980s that the resources of the supervisors were significantly improved to complete the formalization of banking supervision.

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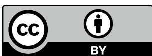

CHAPTER 7

Belgium: Formalization and Incremental Development of a Supervisor with Increasing Powers and Authority

7.1 Introduction

As a small continental Europe country, Belgium ranks among those states, alongside Germany, Italy, Switzerland, or the US, which introduced or strengthened formal banking supervision in the aftermath of the 1930s financial crisis. Until 1934, the general company law—requiring the submission to shareholders of a balance sheet, a profit-and-loss statement and an auditor's report—was the only control imposed over Belgian banks. There were no restrictions whatsoever on the establishment of new banks. The central bank, established in 1850, had no statutory and formal supervision over the banking system. The severe financial crisis stemming from the global economic crisis of the 1930s triggered a significant reform, and Belgium changed from one of the least restricted commercial banking systems to one where control was far-reaching.

While Belgian financial history, as an early developer of mixed and universal commercial banking, has been well researched, the specific aspect of banking supervision has not been scrutinized as closely. Early studies in the 1980s (Vanthemsche 1980a, b) have paved the way for more extensive analysis of the impact of supervision on two major institutions: the central bank and the main commercial bank, the Société Générale (Van Der Wee and Tavernier 1975: 278–299; Van Der Wee 1997). More recent research has produced more in-depth studies of the development of banking supervision in Belgium (Cassiers et al. 1998;

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Kurgan-van Hentenryk 2001; Maes and Buyst 2009; Moreau 2010; Giddey 2017a, b).

Relying on this existing literature, as well as on unpublished archival material, this chapter examines the formalization process of banking supervision in Belgium, with a special focus on the period from the 1930s to the 1970s, which coincides with the introduction and completion of formal banking control.

7.2 Transition of Belgian Commercial Banking, 1830–1930: An Overview

Belgium is widely considered the birthplace of mixed universal banking (Chlepner 1943: 3–17). The very early foundation of the *Société générale de Belgique* in 1822, even before the creation of the Belgian federal state in 1830, made it traditionally the world's oldest universal bank. It operated different activities: paper money issuing, commercial credit, collecting savings and investing in the share capital of manufacturing companies (Buyst and Maes 2012: 1–25). A rival and similar institution, the *Banque de Belgique* was set up in 1835. The Banque Nationale (later called Banque Nationale de Belgique), a central institution of national discounting and issuing banknotes was established as a joint-stock company in 1850, two years after a severe crisis (Kurgan-van Hentenryk 2003). The universal banks renounced their issuing rights and most of their discounting activities (Buyst and Maes 2008). In 1860 and 1865, respectively, additional state-owned financial institutions were set up: the *Credit Communal* provided loans to local authorities and the *Caisse Générale d'Epargne et de Retraite* (CGER), a public savings bank. With those new developments, the former universal banks limited themselves to industrial investment activities.

During the Belgian economic boom between 1895 and 1914, the participation of banks in industrial financing grew considerably: while they held 12% of the capital of public limited companies in 1892, this proportion rose to 41% in 1911 (Kurgan-van Hentenryk 1992: 318). Thirty universal banks dominated the market, but only Société Générale had a network of branches throughout the country. Société Générale also dominated the banking system, controlling nearly half of its total assets (Kurgan-van Hentenryk 1992: 320).

The First World War marks a watershed in the Belgian banking history, as in the economic history of the country in general (Kurgan-van Hentenryk 1997: 209–212). Due to infrastructure destruction and increased public spending, banking activities were redirected to public sector financing. During the interwar period Belgian banks focused on national and colonial economy, and they underwent a period of consolidation and concentration. This trend was marked by the constitution of three major financial groups who controlled many subsidiary companies and a network of agencies: the *Société Générale* (55% of total assets in 1930), the *Banque de Bruxelles* (16.5%), and the *Algemeene Bankvereeniging* (10.1%).[1] On the eve of the crisis of the 1930s, the highly concentrated Belgian banking system was structured around a handful of large groups operating on the model of mixed universal banking. Those groups played a vital role in the dynamism of the Belgian economy. In this sense, Société Générale and the Banque de Bruxelles were at their peak in the late 1920s, when they extended their grip on large parts of the national economy.

In addition to the Credit Communal and the CGER (public savings banks) mentioned above, the "parastatal" or semi-public banking sector also developed during the interwar period. The *Société nationale de crédit à l'industrie* (SNCI) and the *Caisse centrale du petit crédit professionnel* was created in 1919, 1929, respectively. The two financial institutions specialized in credit allowance and mobilization to small industrial companies and the middle class (Vanthemsche 1997). Further state-owned financial institutions were established during the 1930s, such as the *Institut de réescompte et de garantie* (IRG, 1935), the *Office central de credit hypothécaire* (OCCH, 1936), and the *Institut national de crédit agricole* (INCA, 1937). Besides the large commercial banks and the semi-public institutions, the Belgian banking sector also featured private bankers (Brion and Moreau 2016), as well as private savings banks and cooperatives (Vanthemsche 1986).

[1] These figures are based on Kurgan-van Hentenryk (1992: 320).

7.3 Commercial Banking Regulation: The Great Depression as the Main Driver

Prior to the enactment of formal banking regulation in 1935, the Belgian banking sector developed significantly in the absence of formal control of commercial banks. The business environment for banking activities remained very liberal: there was no specific legal supervision over private financial institutions (Chlepner 1943: 82). Banks were only subject to the general company law (*loi sur les sociétés commerciales*), passed in 1873. Same as other corporations, banks were required to submit to shareholders an annual balance sheet, a profit-and-loss account, and an auditor's report. Standardized accounting practices and prescribed form of documents were missing (Maes and Buyst 2009; Allen et al. 1938: 83). There were no entry requirements, which meant anybody was able to set up a new bank. The central bank had no statutory control over financial institutions, but only exercised a form of supervision and control over interest rates through its discount policy. The absence of specific banking regulation did not mean the inexistence of financial and banking crises. The Belgian financial system witnessed severe crises during the nineteenth century, for instance in 1838–1839, as well as during the 1870s and the 1880s, but those difficulties did not lead to a formalized regulation of banking activities (Chlepner 1943: 18–21; Grossman 2010: 89; Maes and Buyst 2009: 99). In the second half of the nineteenth century, the policy response was rather rescue operations coordinated by the central bank and the finance ministry.

The severe economic and banking crisis of the early 1930s led to an important reform of the banking system in 1934–1935. The difficulties of the banks mainly originated in the depth of the economic crisis. As a small open economy, highly dependent on external markets, Belgium was particularly affected by the collapse of its exports, caused both by the fall in international demand and by protectionist measures. The banks were unable to realize their investments, except with heavy losses, and tried to recover their debts from industrialists (Kurgan-van Hentenryk 1992: 327). Major financial groups such as Société Générale and the Banque de Bruxelles, which had significant shareholdings in the industry, were forced to extend credit lines in a risky way (Maes and Buyst 2009: 101). Industrial business failures had a devastating effect on the liquidity of large banks (Cassiers et al. 1998: 127): deposits fell from 4,774 million gold francs in 1930 to 3,636 in 1933 (Vanthemsche 1991: 110).

The crisis worsened in 1934 due to the difficulties of two popular deposit banks, the *Banque belge du travail* and the *Algemeene Bankvereeniging*, backed by the Belgian Worker's party and the Flemish Christian Democrats respectively. Because of their close links with the political parties, the issue of a governmental bailout raised a furious political polemic (Mommen 1994: 22–23).

A first reform was adopted by the government in August 1934, as a result of the crisis. Two decrees were passed. The first one was aimed at protecting banks from collapse: it authorized banks to exchange sound but frozen claims on industry for bonds issued by a state-backed institution, the *Société nationale de crédit à l'industrie* (SNCI). The second decree was a more far-reaching measure: it compelled the mixed universal banks to operate as deposit banks, separating their functions from investment banks. This edict meant the end of mixed universal banking in Belgium. The existing institutions had to split into deposit banks on the one hand and holding companies on the other hand. Deposit banks were forbidden to hold industrial and commercial companies' securities, and they had to publish standardized balance sheet and to provide a minimum capital (Vanthemsche 1980a: 37–40; 1991: 111). This radical reform resulted from negotiations between influential bankers and government representatives, since the trend toward specialization was already adopted by the large financial groups during the 1920s. The idea of separating banking businesses was inspired by the British model; the separation of deposit and investment banking had already been decided in the US and in Italy (Barbiellini and Giordano 2014).

However, the reforms of August 1934 did not restore the public's confidence in Belgian banks, and the crisis deepened and reached its peak between October 1934 and March 1935. A new three-party government—including socialist ministers and headed by the former vice-governor of the central bank Paul van Zeeland—was formed in March 1935, whose program entailed an immediate devaluation of the Belgian franc, as well as the introduction of a control (or supervision) over banking.

The Royal Decree of 9 July 1935 on banking control was the result of this process and remains a major milestone in the history of financial supervision in Belgium (Vanthemsche 1980b; Giddey 2014). The 1935 decree provided a comprehensive legislative framework for banking operations. Entry requirements were imposed, and the notion of "bank"

became restricted to institutions supervised by the new law. Regulations on liquidity and solvency ratios were introduced. The role of private banking auditors was formalized: they had to guarantee the yearly accounting control, and to work as an intermediary between the banks and the state supervisor. Notably, the 1935 decree on banking established a formal banking supervisor: the *Commission bancaire* (in Dutch *Bankcommissie*).[2]

All of those provisions were explicitly inspired by the recent Swiss banking regulation, adopted a few months earlier (Giddey 2014). This foreign influence also meant that the liberal version of banking supervision had prevailed within the Belgian government, as opposed to the more interventionist approach favored by the socialist representatives (Vanthemsche 1980b). In addition to the aforementioned Swiss-inspired features, the 1935 decree on banking control confirmed the separation of deposit and investment banking. More precisely, the portfolio holding companies created by the banks to comply with the 1934 reform were also excluded from the scope of the supervision decree of 1935. Only deposit banks were supervised by the new regulation: finance companies were not controlled. Finally, private bankers, organized as a partnership rather than a corporation, acquired a privileged status that private bankers were not obliged to separate deposit and investment banking business (Brion and Moreau 2016: 215–216).

In 1935, the start of formalizing the banking supervision in Belgium occurred in the context of a severe financial crisis. A new governmental political majority, including technocratic elements, preferred a detailed but light regulation. Thus, the central bank was sidelined, and a new body of banking supervisors was established. Unlike the Swiss case, but similarly to the situation in the US and in Italy, the formalization of supervision coincided with the confirmation of the separation of deposit and investment banking, decided one year earlier in 1934.

7.4 The Belgian Banking Commission: Limited Legal Powers and Resources

The Royal Decree no. 185 of 9 July 1935 established a new institution in charge of the supervision of commercial deposit banks: the Banking Commission (*Commission bancaire/Bankcommissie*). Its legal position was marked by great autonomy vis-à-vis the state apparatus: it

[2] This supervisory authority is described in more detail in the next section.

was largely independent from the governmental ministries, which were not represented as such within the Commission, and also from the central bank (Bruyneel 1978).[3] The Commission decided independently and bore full responsibility for its decisions, except in a few cases which required governmental approval.[4] The supervisors were entrusted with the enforcement of the 1935 Royal Decree on the control of banks. More precise tasks resulted from this overall purpose.

The Banking Commission was in charge of drawing up the list of registered banks including approval for merger projects between banks; it could require and set, with governmental approval, liquidity ratios (between readily realized assets and short-term deposits), and solvency ratios (between equity capital and the total deposits); it even received the power—but never enforced it—to define maximum interest rates on certain credit operations. The micro-prudential supervision of the individual deposit banks was initially based on the yearly examinations made by private auditors. Until the reform of 1975, the Banking Commission did not conduct inspections directly on supervised banks. This outsourcing of actual supervision was inspired by the Swiss model and induced the smallness of the staff of the Banking Commission during a large part of the twentieth century (Fig. 7.1).

The Banking Commission consisted of a board of seven members, chaired by a president. The six ordinary members were not hired professionals but were only compensated by fees for the meetings' attendance (on average, 2.4 meetings per month between 1935 and 1975). In addition to the board the institution hired permanent administrative staff to deal with daily operations. Out of the seven board members: three, including the president, were appointed without restrictions by the government, two were chosen from a list drawn up by the central bank, and the rest of two were selected from a list drawn up by the Association of banks. This designation of the board members explicitly increased influence of the regulated banks and the central bank in appointment of supervisors. A study of the first 25 members appointed as Banking Commission members (1935–1975) shows that the profile of the supervisors did not evolve significantly over time (Giddey 2017a:

[3] The central bank had an official appointed to the board of the Commission and contributed to the funding of the new agency.

[4] However, as explained below, the government was involved in the selection of board members.

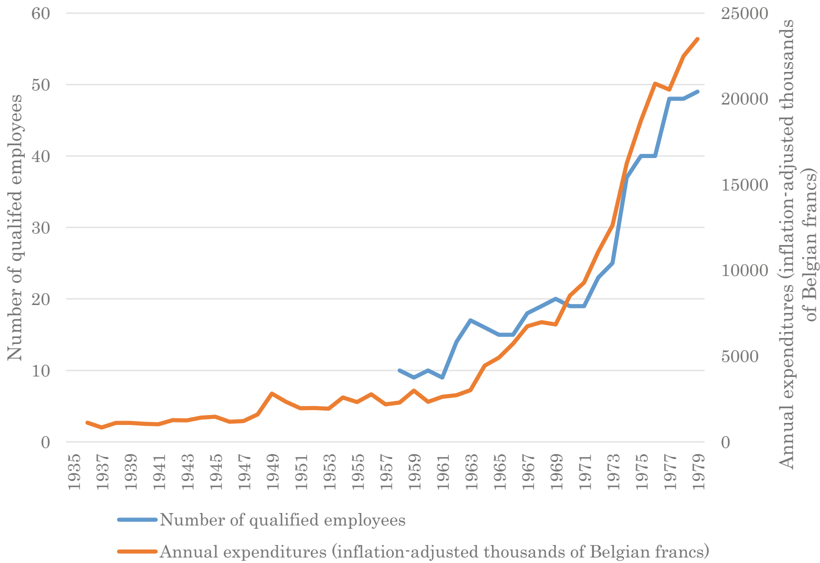

Fig. 7.1 Belgian Banking Commission: staff and resources, 1936–1980 (*Source* Banking Commission annual reports, for more detail: Giddey [2017a: 47–49])

31–38). The composition of the commission reflected a delicate balance of political, social, and linguistic criteria. The president was a banking specialist, three members were industrial or trade employers' representatives, two members were coming from socialist credit cooperatives, and one member was a senior official of the central bank. Active commercial bankers were excluded from the Banking Commission, and even direct "revolving doors" transfers from the private banking sector, for example a former bank executive joining the Banking Commission, did not occur before 1975. The composition of the Banking Commission was rather characterized by the current political balance of power.

The president of the Banking Commission was effectively the head of its management. He was assisted by a very limited staff. Prior to 1959, the archival sources are insufficient to provide reliable and comprehensive information on the number of employees of the Banking Commission. It is safe to say that the number of "qualified" employees—i.e., senior

managers, advisers, and secretaries—did not exceed 10.[5] Figure 7.1 provides the number of the senior staffs and the budget of the supervision agency. A tremendous growth is noticeable in the human and financial resources available starting in 1963 and accelerating during the 1970s.

The qualified staff doubled between 1962 (9) and 1968 (18), and reached 40 persons by 1976 and 49 by 1980.[6] The increase during the 1960s and 1970s was mainly due to new supervision tasks that the Banking Commission was gradually entrusted with investment funds, private saving banks, and holding companies. In 1976 for example, the Banking Commission took over the supervisory duties on the private savings banks, which had previously been undertaken by another state agency, the Office central de la petite épargne.[7] Unlike its Swiss counterpart, the Belgian Banking Commission was able to cope with those new tasks by hiring additional staff, because a large part of its budget was funded by fees paid by the supervised financial institutions. The agency funding, mainly relying on fees collected from the supervised companies, allowed for an incremental increase in staff.

7.5 Banking Supervision and Supervisory Activities: A Significant Extension After the Second World War

Because of the limited means of the Belgian agency, its effective (on-site) supervisory manners were not very developed. The reason of both the limited scope of the operations and resources of the Banking Commission is mainly explained by the fact that it relied on the private auditors (or chartered accountants) for the yearly auditing. Moreover, the private auditors were selected by the banks on a list of auditors which had been certified by the Banking Commission. With the 1975 reform of banking regulation, the selection mode of auditors changed, and the supervisors

[5] The total number of staff, including auxiliary and unqualified staff amounted to approximately 30 employees in 1960.

[6] According to the Annual reports of the Banking Commission, this trend continued during the following period—159 employees in 1985, 231 in 1992, 244 in 1997, and 273 in 2003. The current Financial Services and Market Authority, established in 2011 as a successor of the Banking Commission, had 348 employees in 2017.

[7] Established in 1934, this body de facto functioned as a department of the central bank (Welch 1981: 1–2).

were able to appoint the auditors unilaterally. Until 1975 the Banking Commission did not perform any on-site examinations or inspections—the direct supervision was outsourced to private entities. Only in very specific and exceptional circumstances could the Banking Commission ask the National Bank of Belgium to conduct inquiries and inspections of an individual bank. This procedure—i.e., delegating an inquiry to central bank's agents—was administratively onerous and time-consuming (Bruyneel 1972: 215). The role of the agency was merely to coordinate the network of certified auditors.

However, the Banking Commission, despite the scarcity of its legal powers, used different means to enforce regulatory compliance. It should be noted that the agency compensated the lack of intervention measures and explicit legal powers by an approach based on moral suasion. Especially during the long presidency of Eugène de Barsy (1944–1973), the Banking Commission favored a method of regular informal meetings with influent bank managers. Cooperation and discussion with the regulated institutions were preferred to disciplinary action (Bruyneel 1978). This "governor's eyebrow" approach gave the supervision agency a large discretionary authority. In Belgium a formalization process of financial supervision does not entirely exclude informal methods of enforcement.

In addition to this specific feature of strong cooperative attitude between the supervisor and the supervised, the Belgian Banking Commission also witnessed two major developments during the post-Second World War era. The first important activity of the supervision agency was its significant role in the use of liquidity and solvency ratios (*coefficients bancaires*). While the instrument of the ratios was established by the 1935 Royal decree, it was not enforced by the Banking Commission before 1946. In the post-war period, the Banking Commission—hand in hand with the central bank and the Treasury—decided to apply the provisions of the banking control regulation related to ratios. In the new context, the ratios were used as a means to stabilize the massive public debt inherited from wartime, rather than as a tool to ensure the stability of the financial institutions and the security of their depositors. A large share of bank credits was channeled toward the public sector. The ratios introduced by the Banking Commission were seen as a way to restructure the massive floating debt caused by the war (Cassiers and Ledent 2008). Banks were obliged or actively encouraged to hold considerable stocks of state paper. Those mandatory ratios were gradually relaxed between 1949 and 1965. By the mid-1970s, the constraining ratios that compelled

the banks to finance the public sector had been transformed into more standard equity ratios. Through the supervisory activities (negotiations) to enforce those ratios, the Banking Commission established itself as a significant player, alongside the central bank and the Treasury, not only in banking supervision, but also in monetary and state financing policy.

The second development also occurred during the post-war economic boom. In the context of growing internationalization and despecialization of the financial system, the role of the Banking Commission was gradually extended. Financial innovation, for example the success of new forms of financial intermediation such as investment funds, was another driver of this process. In 1957 the Banking Commission became in charge of the supervision of investment trusts; in 1964 it was entrusted the supervision of all the institutions that received deposits from the public such as consumer credit and mortgage companies; in 1967 holding companies were partly submitted to its control; in 1975 the Banking Commission was also responsible for the supervision of private saving banks (Giddey 2017b). This considerable extension of the supervisory tasks of the Banking Commission was accompanied by a dynamic process of deregulation and despecialization of the financial institutions. The more financial establishments offered full banking services, the more centralized their supervision became within the Banking Commission.

In the post-war era, financial innovation, monetary and state financing policy, and an increasing role of market forces were the main drivers of the regulatory reforms. Banking crises, which were at the heart of the formalization process during the 1930s, were not relevant. Furthermore, the significant increase of the supervisory tasks and powers of the Banking Commission that occurred with the 1975 revision of the law on banking is to be considered as the final completion of the formalization process that started in 1935.

* * *

The formalization process of Belgian banking supervision began in the middle of the 1930s as a consequence of the economic and financial crises at the beginning of the decade. However, based on our understanding of “formalization,” the process was not completed until the mid-1970s. While banking regulation and a banking supervisor was introduced with two acts in 1934 and 1935, the day-to-day supervisory activities remained quite limited until the next major regulatory reform in 1975. The banking

supervisor established in 1935 mainly consisted of a committee, and the supervisory activities performed were conducted by external auditors in connection to the regular auditing or at multi-year intervals, which we consider to be somewhat off from our understanding of formal banking supervision. Similar to countries such as Switzerland and the UK, the Belgian commercial banks had been subject to informal supervision enforced by moral suasion as well as social and political networks. The launching trigger of the Belgian formalization process was the financial crisis of the early 1930s, and the process was completed as a product of the Belgian financial system's development, deregulation and despecialization of the banking, and the increased jurisdiction of the Banking Committee.

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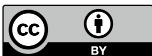

CHAPTER 8

France: Credit Control and Formalization of Banking Supervision

8.1 Introduction

The character of the French financial system during 1945–1984 was seen as (semi-)publicness. Large financial institutions have been nationalized by the government, and official control power was relatively strong over the activities of commercial banks. Banking supervision was not regarded as a mere prudential measure but also as an indirect control tool of the economy (economic growth, inflation rate, etc.), an essential policy field in the post-war era. Indeed, the role of French supervisory agencies—the Banking Control Commission (Commission de contrôle des banques, CCB), which was part of the central bank (Banque de France)—was submitted to larger objectives: to mitigate and stabilize the inflation rate and, more importantly, to steer credit to priority economic activities. Previous literature (in English) which detailed the prudential aspect of the Banking Control Commission is very scarce at the moment. A stronger focus has been recently placed on the monetary and credit policy of the Banque de France and its role in stabilizing inflation (Monnet 2018).

By focusing in this chapter on the micro-prudential aspect of Banking Control Commission, which changed its name to Banking Commission (Commission Bancaire) in 1984, we traced the formalization of banking supervision with the following questions in mind: was the formalization process caused by necessity of control or by coping with a financial crisis; what was the role of the CCB in the purpose of financial stability or mere

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credit control; how come France adopted a formalized supervisory regime only in the 1940s?

In addition, this chapter includes an account of the supervisory regime before the Act of 1941, since recent research suggests that the financial crisis of the 1930s had a much more significant impact on French banks than the literature had so far acknowledged (Baubeau et al. 2021).

8.2 Overview of French Banking System

The French banking system, as it developed during the twentieth century, takes its roots in the evolution of the nineteenth century, and has been a mixture of "liberal moods" and public ownership. From the mid-nineteenth century onwards, systemically important banks were established in France in conjunction with public paid-in capital (Des Essars 1896). In 1848, Discount Bank of Paris (Comptoir d'Escompte de Paris) was established with two-thirds capital paid by the State and the city of Paris. It is considered one of the earliest bank created as a joint-stock company. However, the Discount Bank of Paris, as well as other Comptoirs d'escompte were soon fully privatized, by an imperial decree in 1853. Later, in 1889, the bank changed its name to Comptoir National d'Escompte de Paris after a severe crisis and a liquidation. Other large joint-stock banks were established during the same period: the Crédit Industriel et Commercial in 1859, the Crédit Lyonnais in 1863, and the Société Générale in 1864 (Germain-Martin 1954). Those three institutions eventually developed into the main pillars of French deposit banking. During the second half of the nineteenth century, deposit banks also became more and more active on the stock exchange—issuing bonds, underwriting securities, etc. (Quennouëlle-Corre 2011). As opposed to those successful enterprises, the nineteenth century also witnessed significant setbacks in the evolution of commercial banking: the failures of the Credit mobilier (1852–1867), the Union Générale (1875–1882) are well-known examples.

In addition to the large commercial banks who gradually specialized in deposit banking, the French financial system featured significant *banques d'affaires* (investment banks or merchant banks). The Banque de Paris et des Pays-Bas (founded in 1872), the Banque de l'Union parisienne (founded in 1904) were its most famous representatives (Cassis 2010: 103–104). They specialized in long-term investments as well as bond issuance, and were very active on foreign markets. Asides from the

large commercial banks and the merchants banks, the French financial system also included other actors, such as banks specialized in agricultural credit (the 1852 established Mortgage Bank of France—Crédit Foncier de France—a central agency for land credit businesses with a subvention from the State), and the *Haute Banque* (private bankers). The private banking houses, in particular the Rothschild Frères, despite the growing development of joint-stock banks, remained major stakeholders on the French financial market.

By the early twentieth century, the French banking system was composed of the private banks, i.e., so-called haute banque (private bankers—e.g., Rothschild), joint-stock banks (banques d'affaires—investment banks—and deposit banks)—e.g., Paribas and the Crédit Lyonnais—savings banks, cooperative specialized banks (e.g., Banques populaires, Crédit Agricole) and long- and medium-term credit banks (e.g., Crédit National, Crédit Foncier). A few foreign institutions were also present in Paris: banks from the UK, Germany, and the US (Bonin 2005).

From 1913 to 1938, the French banking industry was influenced by the growth of a semi-public sector (Quennouëlle-Corre and Straus 2010: 103–105). However, the large commercial banks continued to dominate the French financial market during the 1920s. In the early 1930s, during the Great Depression, several large deposit banks were close to failure, and those were rescued and merged with other banks. Indeed, the global financial crisis had a significant impact on French banks (Baubeau et al. 2021). A severe credit crunch affected them, with a movement of deposits away from banks toward savings institutions and the central bank. Between October 1930 and early 1932, France witnessed two waves of banking failures, which only affected the large commercial banks indirectly. The second largest investment bank, Banque de l'Union Parisienne was on the edge of the collapse in 1932–1934, yet the bank was rescued by the central bank (Banque de France).

Although France experienced a severe financial crisis during the early 1930s, neither financial regulation nor equity control was in a first phase introduced into French banking system. The reason is presumed that the four large commercial banks with approximately 50% share of total deposits did not suffer serious damage from the crises. Especially, Crédit Lyonnais increased amount of deposits and replaced the role of failed banks in lending business (Baubeau et al. 2021: 244). Despite the massive credit crunch that resulted from a series of major banking panics, it was not until 1941 that state interventionism prevailed under

the Vichy regime. The incorrect narrative that France had not been affected by a banking crisis during the early 1930s, was even used in 1936 as an argument in the political debate to avoid implementing banking regulations.

Thus, the French banking system adopted specialized lines: deposit banks and investment banks on one side, and more specialized institutions (agriculture banks, savings banks, and long-term lending banks) on the other side.

8.3 Emergence of Rigid Commercial Banking Regulation

Although France experienced financial crises during the second half of the nineteenth century and during the Great Depression of the early 1930s, formal regulation on commercial banking was not adopted before 1941 (Creel et al. 2012: 12–13).

The development of the 1941 Banking Act has been studied in depth by historian Claire Andrieu. The law that was adopted in 1941 was actually endorsed by the same groups who had successfully opposed it in 1936–1938. This remarkable turnaround is most emblematically personified by Henri Ardant (1892–1959), CEO of the Société Générale, who opposed the regulation of banks before the war, but was elected in 1941 at the head of the Committee representing the banks in the newly organized system. This historic turn of events was due to the change of regime. The establishment of an authoritarian State, combined with foreign occupation, made this remarkable turnaround possible. Banking, as other sectors of the economy, was affected by significant structural changes in the wake of Vichy *dirigisme* and the ideology of national revolution (Margairaz 2009). The reform was rather radical and marked a break in the history of French banking, because it fueled the banks under the more or less direct control of the state and a corporatist organization. The interests of the banks were grouped and represented by the *Comité d'organisation des banques*; this committee, in which the major banks were prominent, had significant powers. It could for example refuse the membership of a company to the list of official banks (Andrieu 1990: chap. 7). In a few years (1940–1945) a full-fledged reform was achieved, in two directions: the control of the entire banking sector was established, and the nationalization of four commercial banks and the Banque de France was carried out (Andrieu 1990: 38–119).

Indeed, the first Banking Act (Vichy Act) was enacted on 13 June 1941, yet the main intention of the Act was to control credit after abolishment of the gold standard. The following two banking agencies, in a dualist system, were organized under the Act of 1941 (Andrieu 1990: 207–208). The Standing Committee of Banks (Comité d'Organisation permanent des Banques) consisted of six bankers and a government representative was the agency to regulate the whole banking system. It was designed as a corporatist commission, with a direct representation of the supervised sector, had regulatory powers and set entry requirements. The Banking Control Commission (Commission de Contrôle des Banques), on the other hand, was the agency for enforcement of the bank regulations (Beduc et al. 1992: 256–257). It was dominated by the central bank (Banque de France), and its main activity was to check the accounting of banks. The Act of 1941 contained several provisions of prudential regulation—minimum capital of banks, standard formulas of periodic situations and of profit and loss accounts. What is more, in 1941, the concept of registered bank was introduced. For the first time in French history, a legal definition of banking was introduced, and the first census of banks was conducted.

After the Second World War, on 2 December 1945, the second banking Act was implemented. In terms of supervision, it endorsed the same principles as the 1941 law, yet in a different spirit. Its main innovation was the nationalization of banks (Chambost and Touchelay 2021). Under the Act, the four largest commercial banks (Crédit Lyonnais, Société Générale, Comptoir National d'Escompte de Paris, and the Banque nationale pour le commerce et l'industrie) and Banque de France were nationalized to control lending and support a quick recovery of economy (Plessis 2003: 6–7). Furthermore, financial institutions were compartmentalized into four categories: deposit banks, investment banks and medium- and long-term lending banks, and banks with special legal status (such as Crédit Agricole) (Thiveaud 1997). This separation of banking business was similar to that of the Glass-Steagall Act of 1933 in the US. At the same time, the Act of 1945 upheld the essential elements of regulation in the Act of 1941. Minimum capital regulation was set at 5,000,000 francs for joint-stock banks and at 1,000,000 francs for partnership/personal banks. The standard formulas of periodic situations, balance sheets, and profit and loss accounts were established.

The Standing Committee of Banks (Comité d'organisation professionelle des banques), which was ideologically marked by the authoritarian

and corporatist Vichy regime, was replaced by the National Credit Council (Conseil National du Crédit). The professional representation lost its official powers for the benefit of Finance Ministry and central bank's delegates. The National Credit Council's essential role was to approve the Ministry's and central bank's decisions (Andrieu 1990: 242). However, a professional organization of bankers, the *Association professionnelle des banques*, now renamed *Association française des banques*, remained.

Despite those institutional differences, there was a strong continuity between the 1941 and 1945 Acts. French banking regulation switched the character of banking system from semi-corporatism to state interventionism (Margairaz 2016). Under the Act of 1945, competition among banks reduced significantly. The major concern of the government was to separate the banks from the risk of instability stemming from competition and to ensure financing for reconstruction. Thus, the banks hardly increased their number of branches from 1945 to 1959. From 1948 on, a quantitative credit control was established: the credit system became an administered system by the Banque de France rather than regulated by the market (Margairaz 1991).

The "Debré laws" of 1966/1967 reduced the distinction between the investment banks and the deposit banks. The banks began to offer various sorts of financial instruments—personal loans, mutual funds, etc. The deposit banks were also authorized to open a new branch at will, which led to an increased number of branches. Michel Debré arranged the amalgamation between the C.N.E.P. and B.N.C.I, which resulted in the birth of the largest French Bank, B.N.P. (Banque Nationale de Paris), achieved in 1969. During the 1970s, the large national deposit banks witnessed a return of tighter credit restrictions, which became both a monetary and supervisory policy instrument (Mastin 2020a). Since the 1960s, credit restrictions which limited the growth of volume of loans for each bank had been implemented, notably to fight inflation. Yet, commercial banks reacted to the renewed constraints by engaging in window dressing and illicit credit transfers. This market of unrestricted loans occurred partly beyond the control of the monetary authorities, which tried to regulate it (Monnet 2018).

However, the banking sector was still regulated and compartmentalized. It was not until the Banking Law of 1984 that all banks were subject to the same set of rules under waves of financial deregulation. In addition, privatization of major banks took place in 1987 for Société

Générale, Crédit Commercial de France, Paribas and Suez, in 1988 for Caisse Nationale de Crédit Agricole, and in 1993 for B.N.P. (Plessis 2003: 7–8). The banking reforms of the 1980s, which included a gradual removal of the credit restrictions, initiated by socialist leaders, paved the way for future financial deregulation and less state interventionism that would prevail in the 1990s (Cassou 2016; Quennouëlle-Corre 2018; Kaspereit 2020).

8.4 Banking Control Commission as a Supervisory Agency

As aforementioned, the banking supervisory agency, the Banking Control Commission, was organized in 1941 in France. The Commission was mainly[1] composed of the Governor of the Banque de France (as chairman), the Director of the Treasury, and the Chairman of the Committee Permanent Professional Organization of Banks. The Commission was empowered to implement supervision and to control banks together with regulatory powers, jurisdictional powers, and special powers concerning the verification of nationalized deposit banks—which, moreover, were under the direct control of the Minister of Finance. However, the semi-public or cooperative banks (e.g., Crédit Agricole and savings banks) were directly supervised by the Ministry of Finance and remained outside of the scope of the BCC. Following the Act of 1945, the members of the Commission were expanded to the President, the President of the Finance Section of the State Council, the director in charge of credit matters at the Ministry of National Economy, a bank representative appointed by the Ministry of Finance (nominated by the Professional Association of Banks), and a representative of the bank staff appointed by the Minister of Finance (Fournier 1951: 591–599; Quennouëlle-Corre and Straus 2010: 107–108). This change was a simple reflection of the demise and exclusion of the Standing Committee of Banks, whose delegates were replaced by the Ministry of Finance and Banque de France representatives.

Enforcement activities came to be fully effective after the Act of 1945, together with the decision on 19 January 1944. For its own use, the

[1] In this chapter, banking supervision for colonial countries (e.g., Algeria) is excluded.

Commission was empowered to require more detailed quarterly situations of a bank in addition to standard forms of annual balance sheet and profit and loss accounts. In response to the proposal of the Banque de France, the Decrees of 28 May 1946 provided that the Commission was given a discretionary power to amend regulation regarding bank management manner to ensure/maintain banks' solvency and liquidity. Beyond their formal adoption, it is uncertain whether the ratios were enforced. In addition to liquidity ratio and solvency ratio, total amount of credits to the same person/company should be reported in the risk division report to another department of the Banque de France, the *Centrale des risques*. By the decision on 11 February 1948, the Commission imposed 60% of minimum liquidity ratio on the deposit banks.[2] During a first period (1945–1957), the liquidity supervision was exercised indirectly through liquidity control (Treasury bill floor and rediscount ceiling); this was followed by a period of direct quantitative control (credit restrictions, first temporary, then permanent from 1972 onwards) (Mastin 2020b). Furthermore, the liquidity requirements were de facto met with the almost automatic refinancing by the Banque de France.

The Commission—constituting a Tribunal Administratif—was given a strong power to charge the following penalties without prejudice; warning, censure, prohibition/limitation of certain operations (for example, the lowering of the rediscount ceiling until 1972), suspension of responsible managers (with nomination of a provisional administrator), and revocation of bank license (the last power has "never been exercised"). In addition, the Commission (and/or the Association Française des Banques) organized a Tribunal Repressif, and it could impose punitive sanctions (e.g., fines and imprisonment) for breaches of the articles of the Act of 1941 (Welch 1981: 78–79).

Until the Banking Act of 1984, the role of the Commission (supervisory agency) was primarily to prevent any failures of banks and to enforce credit regulations. In the post-war French setup focused on the domestic national banking system, the credit restrictions also served the purposes of the exchange control. In this perspective, the administered system primarily sought to meet the objectives designed by the governmental Plan commission: investments, exports, and housing were targeted as preferential sectors that benefitted from privileged credit conditions.

[2] Due to the post-war rapid inflation, the Commission suspended solvency ratio regulation and risk division ratio regulation.

With regard to its disciplinary toolbox, the Commission shared the power, together with the National Credit Council or the Professional Association of Banks, to prosecute the offenses in common law courts. Especially, the power of qualifying a bank, a credit institution, or a banker in a public document was an effective "weapon" to prevent breaches of the laws in force. In addition, the Commission was empowered to appoint a provisional administrator with all the powers of administration, management, and direction whenever misconduct of a director of a bank or a financial institution was found (Fournier 1951: 597–599). Despite those formally significant powers, several obstacles to an effective enforcement of the supervisory measures remained. For example, the growing size of the networks (branches, subsidiaries, etc.) and the heterogeneity of the accounting systems impeded a thorough audit by the Banque de France inspectors (who audited on behalf of the BCC).

Apparently, authorities over bank personnel issues and powers of licensing were essential source for actual enforcement activities of banking supervisor. In practice, the Commission conducted about 60 numbers of on-site bank examination (on-the-spot inspections)—each bank was inspected every five or six years (Welch 1981: 64–65).

* * *

The banking supervision in France was formalized under the Banking Act of 1941 and of 1945. The law adopted in 1941 was endorsed by the same groups who had been against it during 1936–1938. Hence, the Act of 1941 intended to control over the credit in the country as well as to stabilize national economy after abolishing the gold standard. In 1941 the Banking Control Commission as the supervisory agency was created, and rigid financial regulation such as a minimum capital requirement was introduced.

After Liberation, the Banking Act of 1945 can be seen as implementation of the formal banking supervision in France. The essential contents (supervisory organization and bank regulation) of the 1941 Act were upheld. Not only separation of banking business and nationalization of large banks but also introduction of a set of bank regulation resulted in less competition among banks in France. However, less competition was favorable for French government since control of credit toward quick recovery was the top priority in economic policy at that time. The supervisory agency was given a lot of measures to enforce bank regulation.

Authorization of rigid penalties (e.g., a right to replace a misconducting bank manager) enhanced effectiveness of supervisory activities. Therefore, the French banking supervision more or less included prudential function aside from the order of priority over its activities.

The driver of formalization in French case can be summarized as control of credit for the purpose of stabilization of national economy as well as quick reconstruction following Liberation.

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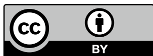

CHAPTER 9

The UK: Financial Globalization and Formalization of Banking Supervision

9.1 A Brief History of Commercial Banking in the UK

The Bank of England was formed as the first joint-stock bank in history in 1694, and came to dominate commercial banking in the British capital for the following one and a half century. Until the mid-nineteenth century, it was the sole bank operating in the London region, while in other parts of the country small private bankers provided banking services to the merchants, the elites, and the businessmen of the industrializing economy. While the Bank of England was a privately owned, for profit commercial bank, its existence was and remained linked to its services as lender to the British government (Tilly 1989).

The private banks, funded by note issuing, mainly offered services of short-term loans to local merchants and businessmen, money exchanges, and settling payments. Very few operated more than one office. From the 1820s and 1830s, merchant bankers developed as financiers and proprietary traders in an international commercial trade system with Great Britain as its center. The funding provided by banks was generally in relation to commercial trade. Several leading bankers, such as the Rothschild, acted as brokers to arrange large loans to governments and participated in market funding on the London Stock Exchange.

After a banking crisis in 1825, the Bank of England's monopoly on joint-stock banking ended partially with the enactment of the Banking Co-partnership Act of 1826. Joint-stock banks could now be

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formed outside the London region. However, few joint-stock banks were founded. The established private bankers actively opposed new competitors outside London, while the Act protected the Bank of England's banking monopoly in the capital. Since the new Act kept the joint-stock bank owners' personal liability, the benefits of the new company form remained limited (Grossman 2010).

In 1833 the Bank Charter Act ended the Bank of England's London monopoly, and the number of commercial banks grew very rapidly, from 48 in total in England in 1834 to 111 just two years later. The Act also allowed national branch networks, although only a few banks would develop until the last decades of the century (Barnes and Newton 2018). The new joint-stock banks, still without limited liability, were not allowed to issue notes for funding, and thus became dependent on the equity capital of the founders and on deposits (Tilly 1989).

The sharp growth in banks was followed by banking crises in the late 1830s and early 1840s. The crises set about a long trend of mergers and acquisitions that would pause first in the early 1920s. The mergers led to a gradual decline in the number of private banks and a growth in joint-stock banks. From nearly 800 private banks operating in England (and Wales) in 1813, the number decreased to just over 400 by 1850 and less than 200 by 1900. In contrast, the number of joint-stock banks increased from zero in 1813 (except for the Bank of England) to 100 by 1900 (Davies et al. 2010). Via the mergers several commercial banks came to operate networks of branches around the country. Scale became an important element for the commercial banks that adopted the strategy of keeping up with the growing companies of industry and trade. By the end of the First World War, British banking was dominated by the "Big Five," namely Barclays, Lloyds, Midland, National Provincial, and Westminster Bank (Capie and Rodrik-Bali 1982).

The market continued to concentrate in the early twentieth century. Out of concern for the banking market being too concentrated, the banks accepted to base all further mergers on the approval of the UK Treasury in 1918. Although this arrangement was not regulated in law, the number of mergers fell significantly after this year (Wadsworth 1954: 780).

In the interwar years, the British banking sector, just as much of the industry, recovered more slowly than in many other countries. The US dollar overtook the UK pound as anchor currency in international trade and in the re-emerged gold standard. The British commercial banks focused on trade finance since investment capital was generated via the

stock exchange. The UK financial system became market oriented, as in the US, while the German financial system, among others such as the Japanese and the Swedish ditto, became more bank oriented (Ross 1996).

In contrast to many other industrial economies, the UK did not experience any severe financial crisis during the first decades of the twentieth century. While the periods 1907–1908, 1920–1922, and 1929–1933 were turbulent for British banks, no banks were closed or offered liquidity. No banks called for other government rescue intervention in any of the crises (Davies et al. 2010). Most banks operated with high levels of liquidity for such periods, over 30% of total assets on average. At the sector level, the British banks managed the periodic slumps and recessions by more mergers and consecutive market concentration. By the middle of the twentieth century, the “Big Five” commercial banks had approximately 75% of total bank assets (Davies et al. 2010).

After the Second World War, the British economy recovered better, as did its banks. The banking sector was marked more by cooperation and coordination among the banks rather than competition. The currency controls and other quantitative controls implemented to uphold the Bretton Woods exchange rate regime contributed to this development, as did the cartel-like cooperation of the Big Five clearing banks. During the 1950s and 1960s, the British governments and the Bank of England accepted the limited competition in favor of market stability (Capie and Billings 2004).

The lack of competition nevertheless became a growing concern, and in 1971 the Competition and Credit Control Act was enacted to allow greater freedom of competition in the banking system. The credit controls, in force since the war, were removed and reserve ratios lowered, and the banks were allowed to compete with interest rates by new types of deposits (Schenk 2014). Average liquidity ratios went from around 25% (cash to total assets) in 1965 to under 5% in 1975 (Davies et al. 2010). The reforms led to a boom in lending and in the house market, in which many fringe banks and other credit institutions participated aggressively. In 1973 a number of these lenders on the fringes of the banking market came close to default in what became known as the “fringe” or “secondary” banking crisis. When the first oil-price shock ended the book abruptly in 1973, the clients and the banks got in deep trouble and were rescued by interventions by the Bank of England with some participation of the tier one, major banks (Schenk 2014). The crisis did not terminate the two-tier system, but weakened the fringe banks to the benefit of the

major clearing banks. As the banking market became increasingly international in nature, the cartel-like arrangements between the "Big Five" gradually disappeared.

Since the late 1950s, more and more international banks and financial companies established offices in the British capital. The trades of the eurodollar markets, although largely existing outside or in between national jurisdictions, were largely carried on out of London. The British authorities, including the Bank of England, were supportive of the City reviving as a leading financial center of the world again, and they maintained very limited regulation and non-existing supervision of banks to attract financial businesses. By the 1980s, London was second only to New York in the US in volume, but leading in several markets (e.g. the Eurodollar market business for example). The City was also the most international center, with more than two thirds of all banks (nearly 600) operating in the UK being foreign owned or controlled (Cooke 1986). The number of foreign banks established in London increased from 53 in 1950 to 351 in 1980 (Baker and Collins 2005).

The reforms from the late 1970s and 1980s enabled the British commercial banks to compete on international markets. In something of a paradox, during the same time-period, bank-specific regulation and supervision were—finally—formalized.

9.2 The Long Road to Formal Banking Regulation

As is well-known, the Banking Act 1979 was a milestone in the formalization process of banking supervision in the UK. The Bank of England first (reluctantly though) accepted the formal responsibilities for prudential supervision—this was a historic moment in the British tradition of informal bank regulation and supervision since the nineteenth century.

The first joint-stock bank in the UK was the Bank of England, established in 1659 mainly for fiscal budget purposes. It was privately owned and was granted a monopoly on joint-stock banking until 1826, when a legal reform allowed new joint-stock banks to form outside the London region. However, the reform—a consequence of the banking crisis in 1825—led to establishment of very few new banks. The private bankers around the country actively opposed new competitors. Since the new act kept the joint-stock bank owners' personal liability, the benefits of the new company form remained limited (Grossman 2010).

A new reform came in 1833 when the Bank Charter Act ended the Bank of England's London monopoly. The number of commercial banks grew instantly, from 48 in England in 1834 to 111 in 1836. Following the crisis of 1836–1837, Sir Robert Peel's deep concern for domestic inflation led to new legal reforms in 1844.

The 1844 "Peel's Act," reformed the Bank of England by organizing it into two departments, separating the note issuing from the commercial banking. The act also gave the bank a monopoly on note issuing that was implemented gradually over the coming decades. The reform affected the private banks the most since many funded themselves with note issuing, and over the nineteenth century the private banks would fight a losing battle for business with the joint-stock banks. The second reform of 1844 brought them temporary respite however (Davies et al. 2010).

The Joint Stock Bank Act of 1844 formulated bank-specific regulations for the first time (Turner 2014). Up until then joint-stock banks had been regulated by general corporate law which favored free enterprise and very limited government intervention. Notably, the 1844 Act introduced a charter requirement for new banks (granted by the Privy Council). The owners and the statutes of the bank needed approval, and the owners also had to put up a minimum of £ 100,000 in equity capital, of which half had to be paid in before opening for business. Once in operation, the joint-stock banks were required to publish monthly balance sheet (Grossman 2010).

The act's requirements reduced the incentives of starting a joint-stock bank. In 1857 it underwent major reforms: in practice all bank-specific requirements were removed. The British commercial banks once again were regulated by the general corporation law, which had been reformed in 1856. The benefits of the joint-stock form were boosted in the following year when limited liability was introduced (Grossman 2010).

Instead of formal regulation, the British banks were subject to informal institutions, such as the principles of business prudence shaped by experiences of crises such as in 1857 and 1878. Unlike banks on the continent, the leading London banks refrained from adopting a universal banking business model, and these banks stuck to short term trade funding, brokering and cooperating in international loan consortia. An important feature of the prudence principles was to maintain high liquidity. By the late nineteenth century, the market concentration had also led to the creation of a socially homogenous elite in banking, which functioned as a social disciplining force against risky business. Also, a form of informal

supervision was exercised by the Bank of England over the main clearing banks—a consequence of its occasional role as the Lender of Last Resort (Capie 2010).

The fact that the UK did not experience severe financial crises in the early twentieth century can possibly explain why the UK commercial banks remained largely exempted from regulation and supervision much longer than most other developed countries.[1] Some regulatory reforms during the Second World War did however affect the banks and the structure of the banking sector.

Just as in many other countries, the British authorities introduced interest rate, credit and currency controls during the Second World War, and most of the regulations remained in force for many years after the war. The Exchange Control Act of 1948 authorized banks of good standing and size to act as clearing banks for the other banks (Reid 1986). This authorization, along with other policies in the 1950s and 1960s, established a two-tier banking system in the UK. The first or inner tier comprised of the large clearing banks, while the second tier comprised of smaller banks and other credit institutions. While the first tier was in regular contact with the authorities, the latter remained outside the view of the Bank of England and others. This made for uneven competition (Gardener 1986). For example, the requests by the Bank of England to reduce lending rates in the 1950s and 1960s were directed to the tier one banks specifically (Wadsworth 1954: 770). The second-tier banks and credit institutions emerged from the early 1960s—a very heterogeneous group in terms of business—operated mainly in wholesale banking with just certain retail services such as large term deposits and loans in foreign currencies (Gardener 1986).

With the consent of the Board of Trade (and its successor), commercial banks could be granted exemptions from complete account disclosures, something which was generally granted for proper "tier one" banks—as the Board determined (Reid 1986). The tier one banks had no tradition of published quarterly reviews that contained information about the bank of interest to its shareholders. Information about reserve funds were made public, although these were known to underestimate asset values

[1] One could draw the conclusion that *the lack* of regulation and supervision in fact was the reason why the UK banks did not experience banking crises. This would of course not explain why other countries without banking regulation and supervision, such as on the continent, *did* experience several crises before the reforms of the mid-1930s.

and underreport inner reserves. Notably, information about both earnings and costs was not shared publicly (Wadsworth 1954).

With the reformed company act in 1967 a wider range of business organizations could offer deposit and credit services, as so called second tier banks. The Board of Trade determined which companies were banks, and whether they belonged to the tier one or two category. However, the Board did not conduct any follow-up supervisory activity of licensed companies, and also lacked all enforcement powers to discipline any misuse of the license privilege (Reid 1986).

As mentioned earlier, the 1971 Competition and Credit Control Act opened up for more competition among tier one and tier two banks, the latter operating with much less liquidity than their more prudent peers. Average liquidity ratios among banks rapidly fell from around 25% (cash to total assets) in 1965 to under 5% in 1975, and the reforms led to a boom in lending and in housing market where many fringe banks and other credit institutions participated aggressively (Davies et al. 2010).

In addition, the regulatory reforms reduced the entry barriers for foreign banks, which further intensified the competition (Gardener 1986). When the UK joined the European Economic Community in January 1973, some work had already been initiated regarding harmonization of banking regulation (Cooke 1986). And with the creation of the Basel Committee on Banking Supervision (BCBS) in 1974, more and more discussions on the banking regulation were held at the international level (Schenk 2014).

The secondary banking crisis in 1973–1975 was another triggering event for the formalization of banking regulation and supervision in the UK. The Bank of England was criticized for failing to spot the risks building up in the second-tier banks, although it had no formal mandate or powers to supervise the banks. The Bank of England had long opposed receiving banking supervision responsibilities, arguing that this would end the trust established between the central bank and the banking sector. However, with the enactment of the Banking Act in 1979 the British central bank was given statutory responsibility for supervising the deposit-taking institutions (Arch 2018).

The Banking Act introduced a license requirement for deposit taking institutions,[2] and for the first time defined what a bank is in British law.

[2] The 1979 Banking Act also introduced a deposit insurance scheme for up to three quarters of their sterling deposits (up to £7,500). See Bingham (1992), for further details.

In fact, two types of banks were defined reflecting the established two-tier system. The second-tier banks, now called "licensed institutions," were required to send reports about its business and financial standing to the Bank of England on a quarterly basis. The act did not explicitly require the first tier, or "recognized banks" to do the same, but it was assumed that they would do so voluntarily just as before (Gardener 1986). The Banking Act 1979 gave the Bank of England the power to call licensed institutions to report all information for supervisory purposes. It could also appoint persons in order to conduct examinations of the licensed institution to investigate matters in relation to protection of depositors. Furthermore, the Act set certain conditions when the Bank of England could close the bank. However, the Act gave the Bank of England considerable discretion regarding its supervisory activities, and it used this discretion to maintain the arms-length and customs-based approach (Cooke 1982).

Following the failure of the tier-one bank, Johnson Matthey Bankers, in 1984 the political and public support for this approach came to an end. The failure of the bank—a subsidiary of Johnson Matthey & Co established in 1965 to provide the company group's banking services and trade in bullion—forced the Bank of England to intervene to maintain the confidence in the gold market and the UK banking system (Bingham 1992). Not only had it failed to prevent the tier-one bank's failure, but its failure to convince other tier-one banks to participate in the rescue signaled an end of the "governor's eyebrow" approach over the City bankers and the unfulfilled adoption of a fully formal supervisory arrangement (Busch 2004).

To accommodate the critics, the Bank of England issued a white paper on "Banking Supervision" in December 1985, where it stated its aim to start meeting with the banks on a regular basis, on average twice a year. Such regular supervisory interviews aimed to take place at examined banks' own premises instead of the BoE's office. In the course of these meetings and in other contacts, the central bank would call for more detailed information from the banks than had been done before.[3] The changes were not enough however, and in 1987 the Banking Act was reformed again. Notably, this reform ended the Bank of England's ability to conduct banking supervision informally.

[3] Bank of England, "Report and accounts for the year ended 28 February 1986", pp. 41–43.

The reformed Act required the Bank of England to report its supervisory activities on a regular basis to the Treasury, and the Bank had to publish the principles which would be used for authorizations and license criteria (Bingham 1992). To elevate supervisory issues more than before, a Board of Banking Supervision was created by the Treasury, comprising three representatives from the Bank of England as well as six "independent" expert members. The Bank was to report regularly to the new Board which was to provide expert advice on supervisory matters (Arch 2018).

The Act clarified that only licensed institutions were permitted to accept deposits, and specified the conditions when the Bank of England could revoke a license. The Act also ended some of the banks' granted exemptions from complete account disclosures, and required the bank's external auditors to report observed misgivings to the Bank of England. In addition, the Bank of England could impose restrictions or conditions upon any bank including the removal of a director or a manager, as well as limits on the grant of credit or the making of investments. Especially, large exposures to a single party or "closely related" parties were basically restricted below 10% of the capital base (Collins et al. 2011).

While the rigid formal bank regulation and supervision were introduced with the Banking Act 1987, the trend of market liberalization continued in the 1980s. The securities markets liberalized in 1986 in a rapid series of reforms called the "big bang," which further strengthened the City's central role in international finance. In the same year the revised Building Society Act 1986 opened up for more direct competition for deposits and loans between commercial banks and the building societies. In 1988 the first Basel Accord was issued, with considerable input from the UK and the BCBS chairman Peter Cooke, which introduced internationally harmonized capital adequacy ratios as well as risk-weights for banks' assets (Goodhart 2011). While national exemptions remained concerning the regulation and supervision of commercial banks, it is fair to say that the process for reforms now was held at the international level.

9.3 Supervisory Department of the Bank of England

The Banking Act 1979 for the first time gave the Bank of England statutory responsibilities and powers regarding supervision of deposit taking institutions. In the following year a Banking Supervision Division was

created, headed by Peter Cooke. However, it maintained its arms-length and informal approach, and did not commit much for the purpose of banking supervision.

The internal organization of banking supervision grew out of the Bank of England's Discount Office. At the time of the fringe-bank crisis in the early 1970s, some banking supervisory activities were conducted by civil servants of the Office. A new department, the Banking and Money Market Section, took over these duties in 1974. The department was first headed by Peter Cooke, who also became the British representative to the BCBS (Bingham 1992). The number of staff working with supervision matters increased due to the crisis. The Discount Office had a staff[4] of 15 in 1973, while the Banking and Money Market Supervision section had about 70 staff by 1978. By then the department was headed by George Blunden who would later replace Cooke as chairman of the Basel Committee on Banking Supervision (Reid 1986). However, given the lack of regulatory backing, the call-reports and other activities conducted by the Bank of England heavily relied on the voluntary cooperation of the banks. The newly created supervisory department remained to be limited in scope and purpose (Cooke 1986). The overall stance of the Bank was to maintain the relationship-based, arms-length approach.

In 1987, the Bank's organization for supervision underwent significant changes. As mentioned, the Board of Banking Supervision (BoBS) was created as a permanent, and formal, organization to monitor and council the Bank on supervisory matters.

9.4 The Banking Supervision of the Bank of England

In the UK, the banking supervisory activities evolved in the three steps: (a) prior to 1979 commercial banks followed informal supervisory practice, (b) from 1979 to 1986 formal banking supervisory system was introduced, but informal manner was preferred by the Bank of England, (c) after the Banking Act 1987 the banking supervisory practice was transformed into regular and standardized activity.

The informal banking supervision conducted by the Bank of England from the late nineteenth century until the gradual formalization in the

[4] It should be noted that those staff did not work exclusively with banking supervision.

early 1980s was based on a number of informal institutions. As Cooke put it himself, the Bank of England's supervision "relied heavily on the fact that the City was a compact community exercising its own disciplines…which only required the Bank's intervention in extreme cases" (Cooke 1986). In addition, an important aspect was secrecy. Notably, the reputation of an examined bank was major concern for the supervisor (Capie 2010).

Before 1979, the Bank of England conducted its informal "governor's eyebrow" supervision over the clearing "tier-one" banks. The term "governor's eyebrow" reflected the relationship-based and confidential nature of the supervision. In practice it consisted of person-to-person meetings between the Bank of England Governors and the heads of the leading banks where the latter informed the former on their business operations, matters of concern and the latest market gossip in the City. The Governor could, if deemed necessary, raise an eyebrow of surprise and/or concern, and the bankers should take into consideration. As mentioned, this arrangement was based on the banks' willingness to accommodate the central bank's wishes and the mutual commitment to keep secret of this informal, "club-like" deliberations (Busch 2004).

The primary supervisory concern was bank liquidity, which averaged over 30% (of total assets) from the early twentieth century until the reforms to enhance competition in the 1960s and 1970s. However, given that the Bank of England only maintained regular contacts with the clearing and tier-one banks, the Bank could collect quite limited information about the expanding second tier of banks. The lack of mandatory license requirement for all deposit-taking institutions meant that the Bank did not even have a complete record of all banks operating in the UK.

As aforementioned, even after the fringe bank crisis and the 1979 Act, the Bank of England maintained its traditional informal supervision. In its communication with the banking community the Bank signaled that its supervisory approach would continue to "leave…room for debate, reasoned discussion and persuasion – of bankers by supervisors and vice versa" (Cooke 1986). While the Act empowered the Bank of England to conduct on- and off-site examinations of deposit-taking institutions, it gave the Bank room for discretion to continue to do these activities only sporadically and on informal terms (Norton 1991).

The banking supervisory activities became more systematic, regular, and standardized with the Banking Act 1987. From 1988, the Bank

of England commenced to publish annual reports on banking supervision.[5] Table 9.1 provides the summary of its supervisory activities from 1988 to 1995. The Bank of England administered applications for licenses and authorization for all deposit-taking institutions. Given London's importance in international finance, about half of the authorized financial institutions were incorporated outside the UK including branches of foreign institutions. The Bank of England operated as a host-country supervisor for these branches and had to develop international relationships with other banking supervisors for exchange of information in accordance with the BCBS Concordat of 1983. The prudential interviews were regularly conducted in the frequency of approximately twice a year. The powers of revocations and restrictions were also constantly exercised.

* * *

The UK case provides several interesting facts in comparative perspective. First, of course, it stands out as one of the last modern economies in the world to formalize banking supervision. It occurred about a century later than in the US. Differing experiences in the UK's financial history can explain this to some extent. In contrast to most countries in continental Europe, the UK did not experience a banking crisis in the late 1920s—events that triggered the formalization process in a half of our surveyed countries (i.e., Germany, Belgium, Switzerland, and France). When the UK did experience a banking crisis in the mid-1970s, regulatory reforms were made that started the formalization of banking supervision. The fact that the formalization process began comparatively late may also be related to the lack of strict bank charter requirements.

The reluctance of the Bank of England to adopt formal banking supervision duties slowed the formalization process however. Even after the Banking Act 1979 gave the central bank a formal supervisory objective, the Bank maintained the largely informal approach to monitoring the banks. Only with the banking crisis in 1984 as well as the international push for harmonized banking regulation did the banking supervision become fully formalized. Especially, the international forums for cooperation and sharing of information itself was the crucial factor to undermine the traditional mode of informal supervision in the UK and replace it,

[5] Bank of England, "Annual report under the Banking Act for 1987/88".

Table 9.1 Summary of supervisory activities by the Bank of England, 1988–1995

Year	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
Authorized UK institutions	313	295	289	275	263	253	232	224
Authorized outside-UK institutions	254	256	259	255	255	255	286	301
Total authorized institutions	567	551	548	530	518	508	518	525
Routine prudential interviews	1,000	1,000	1,000	1,089	1,128	1,055	1,041	1,027
Interview frequency per institution (year)	0.57	0.55	0.55	0.49	0.46	0.48	0.50	0.51
Revocations and restrictions	7	2	2	7	5	17	8	1

Notes The UK institutions included subsidiaries of overseas institutions and joint ventures involving overseas institutions. The numbers of routine prudential interviews in 1988–90 were approximate figures

Sources Bank of England (1988–1995)

overlap it, with formal banking supervision. Thus, the UK case suggests that the financial globalization appeared as a final driver to formalize banking supervision.

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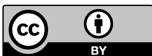

CHAPTER 10

Drivers of the Formalization of Banking Supervision

10.1 Introduction

Chapters 2–9 examined the early history and formalization of banking supervision in eight countries (the United States (US), Japan, Sweden, Germany, Switzerland, Belgium, France, and the United Kingdom (UK)). The purpose of this chapter is to compare these cases in an effort to identify common/unique drivers of the formalization process.

A key finding of this book is that the process of formalization of banking supervision differed among various countries. This observation contradicts the popular view that financial crises have always been the main drivers of major financial regulatory reforms. While this was true in countries such as Switzerland and Belgium, it was not the case in Japan, Sweden, or France.

We identified supporting evidence for our finding, including the fact that the institutions of banking supervision were often formalized incrementally. In complex policymaking contexts, the economic, political, and social interests of various stakeholders shaped the institutional setup. This incremental formalization process was affected by the evolution of the banking sector, the growing responsibilities of the government, the advent of the general public as users of financial services, and the resulting development of the finance industry.

These findings are partly the result of our understanding of the formalization process, whereby institutional change requires more than legislation (e.g., the introduction of a banking act). Notably, we found

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that the formalization process was longer than anticipated and far from straightforward. Indeed, our selection of the beginning and end points of several countries' formalization processes might be considered controversial, and we are aware that the accounts presented in this book omit some aspects of the history of banking supervision in several countries. However, the time points we selected are based on the definition of institutional "formalization" presented in Chapter 1, and we believe that this is the best way to represent the process of formalization of banking supervision.

In this chapter, the process of formalization of banking supervision in the eight countries examined, with particular emphasis on the early stages of development, is compared from the following seven perspectives: (a) charter requirements, (b) banknote issuance, (c) liability rules, (d) ensuring the public's trust, (e) financial crises, (f) economic control, and (g) financial globalization.

10.2 Overview

Table 10.1 summarizes the important elements of the formalization of banking supervision including the drivers of the process of formalization of banking supervision in the eight countries examined.

Although each country looks quite different in important ways, commonalities and/or similarities are also observable. Formal banking supervision emerged much earlier in the US, Japan, and Sweden than in Germany, Switzerland, Belgium, France, and the UK. However, in every case examined, the progression to complete formalization took several years or decades as a consequence of a combination of incremental organizational learning and a gradual shift in the position of the relevant stakeholders. The process of institutional development extended far beyond the time at which the first steps toward a formal banking supervisory system were taken. In almost every case, one or more of the three components, namely, regulation (laws), organization, and enforcement, lagged behind the other components.

Generally, the financial system in developed countries was characterized and defined by indicators such as legal regimes, regional characteristics, and nationality (Allen et al. 1938; Allen and Gale 2000; Hall and Soskice 2001; La Porta et al. 1998). In contrast to the conventional view, the aforementioned seven dimensions place more emphasis on the time frame and evolution of the process of formalization of banking supervision.

Table 10.1 Formalization of banking supervision in the eight countries examined

Country	*Period of formalization*	*Laws underpinning formalization*	*Purpose of launching formal supervision*	*Driver of the formalization process*	*Original supervisory authority*	*Key stakeholders at the commencement of the formalization process*
US	1863–1938	National Bank Act 1864, Federal Reserve Act 1913, Banking Act 1933	Maintaining the value of national paper money (Civil War financing)	Financial crisis of 1907 and the Great Depression	OCC under the Treasury, the Fed, the FDIC, and state governments	Federal government
Japan	1872–1927	National Bank Decree 1872, Bank Decree 1916, Banking Act 1927	Maintaining the value of national paper money and education of "bankers" (merchants)	Bankers maturing and the advent of the middle class	*Ginkō Kensa-ka* (the Bank Inspection Section in the Ministry of Finance)	Government and merchants
Sweden	1868–1907	Banking acts in the 1840s, Banking Act 1889, Bank Supervision Act 1906	Licensing requirements for private note issuing	Advent of the middle class and the need to ensure the public's trust	*Kungliga Bankinspektionen* (the Royal Bank Inspection Board)	Civil society (ordinary bank customers) and politicians
Germany	1931–1961	Moratorium Act 1931, Credit Act 1934, Bundesbank Act 1957, Banking Act 1961	Prevention of financial crises	The need to ensure the public's trust and to ensure the viability of commercial banks	The *Reichskommissar* (the Federal Commissioner of the Credit System) and Reichsbank	Federal government (and bank depositors)

(continued)

Table 10.1 (continued)

Country	*Period of formalization*	*Laws underpinning formalization*	*Purpose of launching formal supervision*	*Driver of the formalization process*	*Original supervisory authority*	*Key stakeholders at the commencement of the formalization process*
Switzerland	1934–1976	Banking Act 1934, strengthening of the Commission's secretariat in 1976	Restoring confidence in banks and developing bailout plans	Banking crises and legitimacy crisis	*Eidgenössische Bankenkommission / Commission fédérale des banques* (the Federal Banking Commission)	Bankers, senior government officials, and the parliament
Belgium	1935–1975	Royal Decree No. 185 of 9 July 1935, revision of law in 1975	Restoring public confidence in banks and control of banks	Despecialization and Europeanization of banking	*Commission bancaire / Bankcommissie* (the Banking Commission)	Bankers and senior government officials
France	1941–1945	Banking Act 1941, Banking Act 1945	Control of credit (for quick recovery)	Rapid reconstruction of the national economy	*Commission de Contrôle des Banques* (the Banking Control Commission) and Banque de France	Bankers and the government
UK	1979–1987	Banking Act 1979, Banking Act 1987	Access to the EEC, creation of the BCBS, and addressing the secondary banking crisis	Financial scandal (the Johnson Matthey Bankers affair) and response to financial globalization	The Board of Banking Supervision within the Bank of England	Foreign banks and politicians

For example, the protection of small depositors was closely related to the advent of the middle class and the spread of universal suffrage in several developed countries. Hence, this chapter also explores the extent to which the time/era can explain the process of formalization of banking supervision in the eight countries examined.

10.3 Charter Requirements

One interesting observation is that the early adopters of banking supervision systems, that is, the US, Sweden, and Japan, implemented bank licensing requirements involving strict evaluation procedures. Conversely, the UK, Germany, Switzerland, and Belgium did not exercise such strict charter constraints. Notably, in Germany, the Company Act of 1870 removed the licensing requirement for banks (Berghoff and Köhler 2007). Despite the financial crisis and scandal in the early 1930s in France, licensing requirements remained lax until the introduction of the Banking Act of 1941.

In the nineteenth century, the UK and Germany enjoyed a "free enterprise" period following the abolition of medieval guild membership, which probably delayed the introduction of the charter system in relation to the commercial banks. The US experienced a "free banking" era from the late 1830s to 1864, during which time charter requirements were unnecessary. However, even during this period, chartered banks accounted for the majority of banks in the US. Additionally, state ownership of banks served as a substitute for the charter requirement system. This was also the case in France, where important banks (e.g., Crédit Lyonnais, Société Générale, and BNP) were half state-owned and were therefore practically controlled by the government.

More generally, entry requirements were affected by the preferences of the incumbent actors as a means of ensuring that they maintained their dominant position in the market. Thus, the adoption of either open or restricted entry requirements also depended on the ability of the dominant bankers to influence decision-making during the formalization process.

10.4 Banknote Issuance

In the second half of the nineteenth century, commercial banks in several countries were allowed to issue banknotes to provide a source of funding.[1] Private banknotes were generally required to be fully backed by legal tender in the form of gold or other specie, and in some cases, such as the creation of the US Office of the Comptroller of the Currency, banking supervision developed partly to ensure that these note-issuing privileges were not abused.[2]

This was the case in the US.[3] During the Civil War, the government faced a significant fiscal deficit, and one means of providing war financing involved the issuance of national banknotes. Under the National Currency Act of 1863 and the National Bank Act of 1864, each national bank could issue its own banknotes up to the total amount of its paid-up capital (Section 16). To secure its banknotes, the bank was required to deposit a national bond equal to one-third of the amount of the issuance with the federal government (Section 15). The primary aim of these bond-secured notes was to maintain the value of both the national bonds and the legal tender (greenbacks). Initially, the main aim of bank examinations was to check the health of a national bank to ensure that the value of its banknotes was maintained. The supervision of national banks was stricter than that of state banks, which ceased to issue their own banknotes.[4] As the merit of issuing banknotes decreased in the late nineteenth century, the focus of bank examinations shifted to "a close scrutiny of the 'business' of the bank" to ensure prudent management (Robertson 1968: 71–73).

[1] In Germany, the currency was unified from 1871 to 1875, and the Reichsbank was created in 1875. Although several note-issuing banks (private banks and savings banks) still existed, they no longer comprised the majority of the banking sector (Krieghoff 2013: 57–62).

[2] In the UK, following the Bank Charter Act 1844, the issuance of bank notes was restricted to the Bank of England in England and Wales. In Scotland and Northern Ireland, every new issuance of banknotes by a commercial bank was required to be 100% backed by gold in an effort to prevent abuse.

[3] Friedman and Schwartz (1963) describe the transition of the "currency" in the US.

[4] In 1865, Congress imposed a tax of 10% on state banknotes, whereupon the remaining state banks ceased to issue their own banknotes. Instead, they relied on deposits, which became the mainstream of the banking business in the twentieth century (Robertson 1968: 53–54).

This was also the case in Japan. Under the National Bank Decree of 1872, each national bank could issue its own banknotes up to 60% of the total amount of its paid-up capital.[5] This was a more conservative provision than that in the US. The main aim of the national banking system was to reduce inflation by replacing various forms of legal tender that were declining in value with a more stable (redeemable in specie) national currency.[6] Following the amendment of the Decree in 1876, national banks were no longer required to reserve specie when issuing banknotes. However, as an issuer of a national currency, every national bank was required to maintain sound management practices and operations. Because the government recognized the possibility of systemic risk and the immaturity of the "bankers" (financial merchants) (Hotori and Wendschlag 2019), on-site bank examinations were conducted almost every year to check the health of each national bank and to educate the inexperienced "bankers" until the creation of the Bank of Japan in 1882, which enabled the government to unify the issuance of the national currency. From that point, the frequency of on-site bank examinations declined significantly. There were 177, 191, 54, and 34 on-site examinations conducted in 1880, 1881, 1882, and 1883, respectively (Hotori 2011: 31).

The importance of note issuing as an element of banking supervision declined during the early twentieth century, as the right to issue banknotes became monopolized by the central bank in most developed countries (Capie et al. 1995: 6). This explains why this element is less important in countries that formalized banking supervision relatively recently.

10.5 Liability Rules

In general, a shift from unlimited liability to limited liability of shareholders took place in the second half of the nineteenth century. The

[5] Originally, national banknotes were redeemable in specie: each bank was required to hold as much as 40% of the value of its capital stock in specie as a reserve for redemption. Following the amendment of 1876, the bond deposit amount increased to 80% of the value of its paid-up capital. The specie reserve provision was abolished, and banks were only required to hold reserves of legal tender equivalent to 20% of their paid-up capital. Thus, national banknotes were no longer redeemable in specie.

[6] The government aimed to restrain inflation by replacing the various forms of legal tender that were in circulation with a national currency (Kato 1957: 25).

limited liability rule enabled financiers to invest in large projects such as railways, which resulted in further economic development in conjunction with the Industrial Revolution. However, the shift from unlimited to limited liability also enabled ambitious bankers to take excessive risks. One example resulted in the failure of the Western Bank of Scotland in 1857, and the Limited Liability Act of 1855 was severely criticized by a prudent banker (Anonymous 1859). In some but not all countries, banking supervision was formalized in an effort to counter the anticipated increase in such excessive risk-taking.[7]

This was the case in Japan. When the National Bank Decree was enacted, no accompanying corporate/commercial law was implemented. In 1887, the Court first ruled that a shareholder's liability was limited in all cases. Prior to then, the shareholder's liability was basically unlimited even if there was a clause in the articles of association stating that liability was limited (Takamura 1996: 70–73, 128–130). However, under the National Bank Decree (Article 18, Section 12), the liability of a shareholder in a national bank was limited to the amount of his/her paid-up capital.[8] Hence, it is reasonable to assume that banking supervision was at least partially introduced with the purpose of protecting the creditors/depositors of national banks.[9]

The US case was affected by the unique liability rule, that is, double liability. Under the National Currency Act of 1863 (Section 12), a national bank shareholder was liable for twice the value of his/her shares. Although the OCC directed on- and off-site examinations of national banks, the regulatory and supervisory system prior to 1913 was considered to be relatively "light-touch." The double liability rule imposed a degree of pressure on bank owners to minimize the risk of having

[7] For example, this was not the case in the UK. Instead, British bankers learned the importance of sound banking from historical lessons, and thus became prudent bankers (Ross 1998: 2, 166). In the case of Germany, this was more complicated because many joint-stock banks were founded around the time of the war-related boom of 1871. Although the Banking Act of 1875 did not contain any regulatory provisions, the Corporate Act of 1896 included several rules aimed at protecting the public from potentially fraudulent acts by corporations (Krieghoff 2013: 58–60).

[8] Additionally, the nationality of shareholders was limited to Japanese citizens to avoid takeovers by foreigners under the National Bank Decree of 1876 (Ishii 2012: 55–60).

[9] In 1884, the Ministry of Finance ruled that liability of the shareholders of a non-national (private) bank should be unlimited. The Mitsui Bank (a *zaibatsu* bank that adopted the unlimited liability rule) was a renowned example (Takamura 1996: 69–70).

to pay dearly in the case of bankruptcy. Despite the high frequency of bank failures during the period 1865–1913, losses incurred by depositors were relatively small. White (2011: 23–33) pointed out that the owners' personal liability probably worked as an effective incentive for bankers to monitor the bank's status more closely, and to voluntarily liquidate the bank long before it was declared insolvent to avoid excessive losses. Because of this double liability rule, examinations of national banks were seen as complementing the banks' self-disciplinary activities (White 2015: 22–23). The US case illustrates a barter-type relationship between the liability rules and banking supervision.

10.6 Ensuring the Public's Trust

The development of deposit-taking banks and the advent of the middle class resulted in a significant increase in the number of individual depositors in all developed countries during the late nineteenth century and early twentieth century. Additionally, by 1925, universal suffrage had spread throughout most developed countries. This meant that politicians, especially during election campaigns, paid more attention to issues relating to average citizens. Thus, the term "protection of depositors" was adopted to ensure that securing the public's trust became an important political aim,[10] and in several countries, the formalization of banking supervision was partially motivated by the desire to protect individual depositors, even though the deposit insurance system had not yet been widely introduced.[11]

This clearly applied in the case of Sweden. From the 1890s onward, the overall increase in wealth led to a growing proportion of the population being able to save some of their earnings and take out loans to

[10] We are aware that this did not apply in all cases. In the UK, universal suffrage for all men was achieved in 1918, but formal banking supervision was not introduced then. Under the rigid class system that existed, working people's deposits in penny banks were protected by the charity of the rich and the large banks that were the lender of last resort (and/or the Bank of England). The bailout of the Yorkshire Penny Bank in 1911 is a good example (Larson et al. 2010: 127–129). In Germany, universal suffrage was achieved in 1919 under the Weimar Constitution. However, "deposit protection was not on the agenda throughout this period." Instead, banks preferred to become larger as a means of maintaining their liquidity (Krieghoff 2013: 104–105).

[11] The Federal Deposit Insurance Corporation was created by the Banking Act of 1933.

improve the productivity of their farms or small businesses. The government wanted the general population to be able to safely access banking services. Thus, the increase in the number of banks and branches required more resources for the supervision of the commercial banks. In 1905, a thorough investigation was conducted with the aim of obtaining information regarding the future regulation of banks. The investigation report resulted in the creation of a new agency for banking supervision, namely, the Royal Bank Inspection Board (*Kungliga Bankinspektionen*).

In Japan, the need to provide protection for depositors also prompted the government to complete the process of formalization of banking supervision. Given the increase in the number of commercial bank branches during the interwar period, it seems that the number of ordinary depositors increased dramatically during this period.[12] Following the implementation of the General Election Law of 1925, universal suffrage for all men was finally realized in the subsequent national and local elections. The next national general election was scheduled for 1927, and the politicians were keen to campaign in advance. The minutes of the Financial System Research Committee meeting held on 13 October 1926 documented the official opinion that from then on, banking supervision should be enhanced for the "protection of depositors."[13] Thus, all banks were forced to disclose their payment reserve report following a bank examiner's inspection under the Banking Act of 1927. Notably, the financial crisis of 1927 took place one month after the implementation of the Banking Act of 1927. Therefore, the financial crisis did not prompt the introduction of the Act.

The salience of deposit insurance as a driver of the formalization of banking supervision also depended on the general population's ability to access banking services. The higher the proportion of households with a bank account at a commercial bank, the more concerned citizens and policymakers were regarding the need for deposit insurance. Conversely, while large sections of the population were effectively excluded from retail banking services, deposit insurance remained less relevant in policy debates on banking supervision.

[12] No official records remain in this regard (Goto 1970: 146–149). However, Osaka Asahi Shimbun (1928) provided a clear illustration of this trend.

[13] "Minutes of the Financial System Research Committee in 1926–27," Bank of Japan (1956: 42).

10.7 Financial Crises

Although the difference between banking supervision and bank regulation is not always clear, numerous studies have found that a financial crisis was a critical driver of the formalization of banking supervision in many developed countries (Gigliobianco and Toniolo 2009). A financial crisis provides the initial stimulus, inducing a regulatory reaction, which in turn leads banks to circumvent the regulations by moving into unregulated areas, thereby commencing a new cycle.

The most well-known case is probably that of the US. The financial crisis of 1907 led to the creation of the central banking system and the Federal Reserve (colloquially known as the Fed), which blurred the lines of responsibility for banking supervision between the OCC and the Fed (and the state governments). The supervisory system was already formalized for national banks, while supervision of state banks was relatively lax. The Great Depression in the early 1930s was the catalyst for the creation of a comprehensive banking supervisory system. Following the Banking Act of 1933 and the creation of the Federal Deposit Insurance Corporation (FDIC), all commercial (national and state) banks were subject to supervision by the OCC, the Fed, the FDIC, and/or state governments.[14] Moreover, the Banking Act of 1935 granted federal supervisors permanent discretionary authority in relation to bank charters.

Switzerland provides another example of this situation. As a result of the 1931 banking crisis in Europe, two large banks, the *Banque d'Escompte Suisse* and the *Schweizerische Volksbank*, called for bailout assistance in an effort to avoid bankruptcy. Thus, the 1934 Banking Act was introduced and an independent supervisory agency, the *eidgenössische Bankenkommission* or Federal Banking Commission (FBC), was created. Although the supervisory activities of the FBC heavily depended on private auditing firms, one of the important roles of the FBC was to verify banks' compliance with liquidity and equity ratios and to confirm the annual audit of every bank.

Additionally, the severe economic and banking crisis of the early 1930s led to an important reform of the banking system in Belgium. Following

[14] The Federal Reserve Act of 1913 included specific provisions for the supervision of member banks. However, it was not until 1938 that the OCC, the FRB, and the FDIC agreed to a formal division of responsibilities in relation to the examination function (Robertson 1968: 105–112, 125–128).

complex political debate, Royal Decree no. 185 of 9 July 1935 established a new institution to undertake the supervision of commercial deposit banks: the *Commission Bancaire* (Banking Commission). Notably, the supervisory measures of the Banking Commission were inspired by the Swiss banking supervisory system (especially the reliance on private auditing firms), which provided considerable leeway for the continuation of self-regulatory arrangements without state intervention.

In Germany, the banking crisis of 1931 was an initial driver of the formalization of banking supervision, while the push toward the centralization of supervisory powers that enabled the government to counter the re-emergence of the largest banks completed the process of formalization after the Second World War (Krieghoff 2013: 124, 141).

The secondary banking crisis in the 1970s and several failures of international banks such as Germany's Herstatt Bank are generally viewed as the drivers of the formalization of banking supervision in the UK (Capie 2010: 611–616, 625–628). However, in our view, the main driver was financial globalization, as described later.[15]

10.8 Economic Control

Following the Second World War, rapid reconstruction was the top priority in relation to economic policy because of the emerging Cold War between the US and the Soviet Union. This influenced the development of banking supervision in the post-war period.

The case of France provides a perfect example. The Banking Act of 1945 in France contained two essential elements: the nationalization of large banks and the separation of banking business into short-term and long-term activities, and into deposit-taking and investment-banking activities. Under the Banking Act of 1945, competition among banks declined significantly, and the banks were rarely allowed to open new branches. Until the mid-1960s, to provide sufficient finance for reconstruction, the French government preferred control of credit and systemic stability rather than competition (or efficiency).

Similarly, in Belgium, the supervisory agency (the Banking Commission), together with the central bank and the Treasury, made use of banking control regulations in the post-war period. In an effort to reduce

[15] In this regard, our view is basically in line with that of Lee (1979).

the huge public debt that had been amassed during the war, a large share of bank credits was channeled toward the public sector. The ratio regulation introduced by the Banking Commission was one of the measures taken to reduce the massive public debt, as banks were obliged to hold considerable amounts of state bonds.

In Japan, the aim of banking supervision shifted toward systemic stability from 1949 in an attempt to promote the rapid recovery of the national economy. Under the US occupation (1945–1952), the authorities separated the banking business from the securities business and created a new category of special long-term lending banks. Although the aim of banking supervision did not formally alter, in practice the aim of banking supervision shifted from prudential supervision to the prevention of bank failures (Hotori et al. 2018: 115–116). With no commercial bank failures, Japan achieved high levels of economic growth during the period 1955–1973.[16]

10.9 Financial Globalization

Financial globalization and liberalization occurred from the 1970s onward. This ongoing trend appears to have been a driver of the formalization of banking supervision in several late-moving countries such as the UK.

In the case of the UK, pressure for reform emerged in the 1970s mainly from international forums such as the European Commission and the Basel Committee for Banking Supervision that led politicians to introduce institutional changes despite protests from both the commercial banks and the Bank of England. Following the introduction of the Banking Act of 1979, the role played by the Bank of England was gradually transformed into that of a semi-formal banking supervisor, although the level of enforcement remained "light-touch." Eventually, the financiers' desire to lift the UK's status to that of a global financial center prompted more formal banking supervision, as the previous informal supervision (colloquially known as "the governor's eyebrow") had proven ineffective in relation to foreign banks that were playing an increasing role in the UK under the Thatcher government. Margaret Thatcher's "Big Bang" regulatory reforms of 1987 completed the formalization of banking supervision

[16] Sweden is also an example of this type of transformation.

in the UK. Under the Banking Act of 1987, the independent Board of Banking Supervision was formally created in November 1987.

Another example of an acceleration of the formalization process is the case of Belgium. In the post-war period, the role of the supervisory agency (the Banking Commission) was incrementally extended in response to the growing internationalization and despecialization of the financial system. In 1957, the Banking Commission assumed responsibility for the supervision of investment trusts, and in 1964, it was further empowered with the supervision of all of the institutions that received deposits from the public, such as consumer credit and mortgage companies.

* * *

In this chapter, the drivers of the process of formalization of banking supervision were examined from seven perspectives. We found that formalization took place in response to the shifting needs of the time/era, and that the formalization process was basically incremental. In the US, formalization began in response to the need for Civil War financing, while in Japan and Sweden it was closely linked to the organic development of the banking sector and the general public's increasing exposure to the banks as both depositors and borrowers. In Germany, Switzerland, and Belgium, the formalization process was triggered by the Great Depression in the early 1930s, although the specific forms of the crisis (e.g., bank runs, financial crises, economic crises, and political crises) varied considerably among the three countries. In France, the formalization process was linked to the Second World War and the subsequent control of the economy, while in the UK, progress toward financial globalization prompted a shift from informal to formal banking supervision. Notably, although financial crises are generally considered to have been the primary drivers of major regulatory and supervisory reforms, they did not always play a key role in the process of formalization of banking supervision. Additionally, it should be noted that from a historical perspective, regulation and supervision have not been "natural" responses to dysfunction in the banking system. Rather, the formalization of banking supervision was the product of complex political actions negotiated by relevant stakeholders with divergent interests in a specific social, political, and economic environment.

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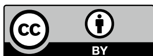

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