

Policy Paper

Financial Regulation and Supervision in India and Japan: Case of Banking Sector*

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I Background and Motivation

Banks matter for economic growth, for poverty alleviation, for income distribution and for human welfare as a whole. And banks matter when they fail. According to Levine [2005], the fiscal costs of banking crises in developing countries since 1980 have exceeded \$1 trillion, and some estimates put the cost of Japanese banking problems alone over this threshold. Therefore, researchers and financial agencies across the globe have realized the importance of bank regulation and supervision. The International Monetary Fund and the World Bank developed and revised international standards and codes that serve as a benchmark for sound prudential regulation and

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supervision. Furthermore, the recent global downturn has thrown a number of important perspectives that range from questioning the role of regulatory and supervisory regimes in handling the risks posed by financial innovations to a discussion on the efficacy of several policy initiatives and measures adopted by governments and central banks across the globe. Amidst these global perspectives and initiatives, there are lessons to be learned and practices worth emulating.

Finance experts, economist and international consultants while suggesting an appropriate model for bank regulation and supervision for developing countries often base their advice on how their home country does things, for lack of availability of information on cross-country practices. As a result, their recommendations reflect home bias rather than facts. So, the main aim of the policy paper is to contribute to a better understanding of bank regulatory and supervisory regimes of India and Japan such that it provides a fertile ground for any future research or policy formation to achieve effective banking regulation and supervision.

II Overview of the Banking Sector

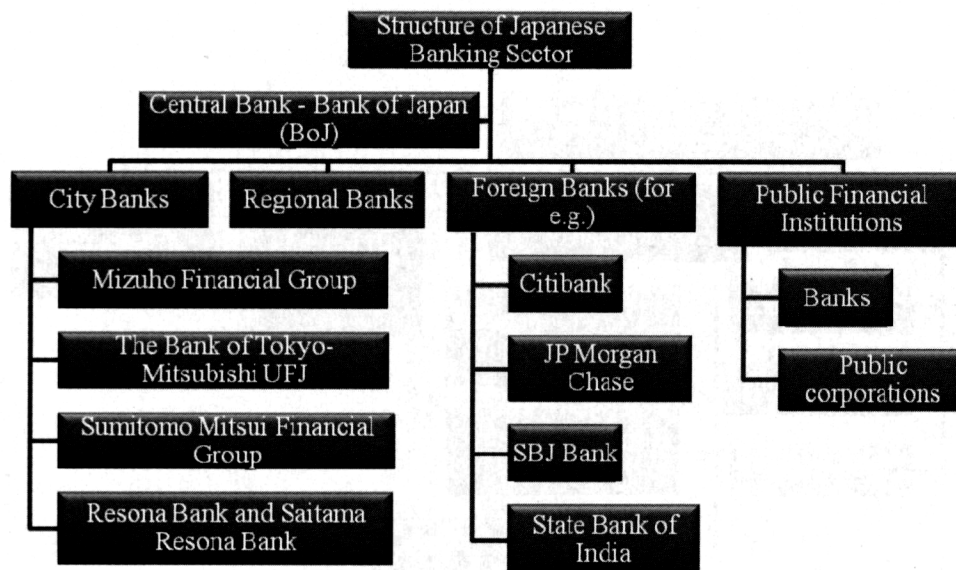
1. Banking Structure

(1) Japan

Figure1 shows the structure of banking system in Japan. The Bank of Japan (BoJ) was established as Japan's central bank in 1882 under the Bank of Japan Act. The Bank was reorganized on May 1, 1942 in conformity with the Bank of Japan Act (hereafter the Act of 1942). The Act of 1942 was extensively revised in June 1997 and it came into effect on April 1, 1998. The Act defines purposes and organization of the BoJ. It is not a government institution and has a legal status that of a "special corporation." The government owns 55 per cent of the capital, with the remaining invested by the private sector.

From the chart we can see that the Japanese financial system is broadly characterized by the presence of central bank, private financial institutions and public financial institutions. Private financial institutions can be further divided into depository and non-depository institutions. City banks, regional banks and foreign banks fall under the category of depository institutions. According to the Japanese Bankers Association (Zenginkyo), as on March 31, 2009, there were six city banks organized into four banking groups namely Mizuho Financial Group, The Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Financial Group and Resona Bank and Saitama Resona Bank. They are large in size with branches in major cities. As on March 31, 2009, they accounted for 47 per cent of deposits placed with Japanese banks and owned 48 per cent share of the entire

Figure1. Structure of Japanese Banking Sector



loan market. (Zenginkyo)

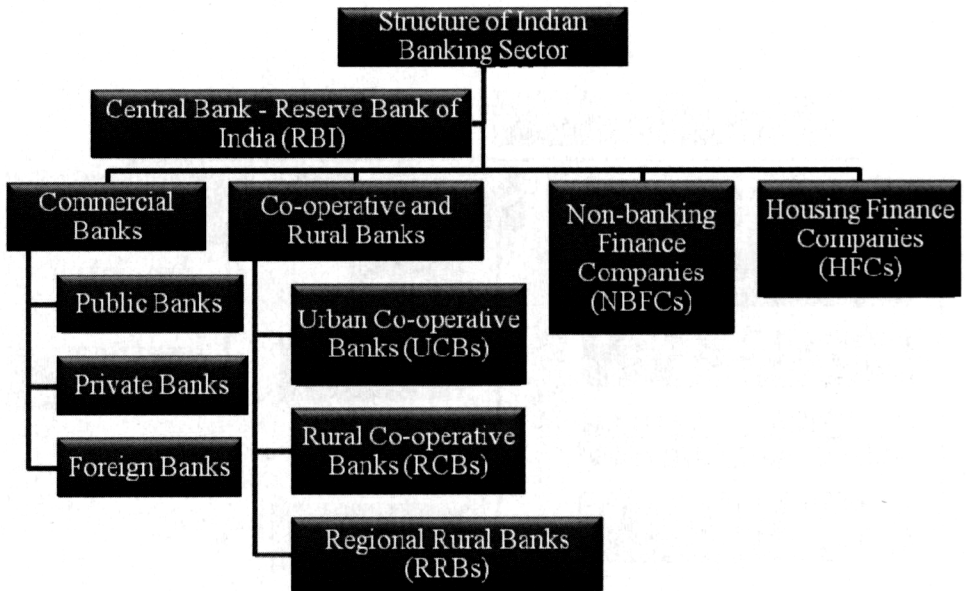
Regional banks are based in a particular prefecture and conduct their operations mainly within that prefecture. They are small to medium in scale and mostly cater to small and medium enterprises. The 2008 study by Loukoianova [2008] (published by the IMF) reports that more than 80 percent of the regional banks' customers are local small and medium size enterprises (SMEs), with individual deposits accounting for approximately 70 percent of total deposits.

Foreign banks operate through Japanese branches or through their Japan offices. They have to obtain license for each branch from the Prime Minister and are subject to the Banking Law. As in September 2009, there were 59 foreign banks in Japan. (Zenginkyo)

Other financial institutions include trust banks, cooperatives, credit federations and various other specialized financial institutions.

Initially, Japanese banking sector was largely owned by the government. Funds were raised by huge amount of postal savings deposits at the Japan Post which were entrusted to the government. Until 2001, government operated the postal savings business, but it was later transferred into the hands of new state-run government corporation. Furthermore, privatization of Japan Post started in 2007 and the saving business was succeeded by Japan Post Bank which is fully funded by the government and thus, comes under the umbrella of public financial institutions.

Figure2. Structure of Indian Banking System



(2) India

Figure2 displays the broad structure of the Indian banking system. The Reserve Bank of India (RBI) was established as India's central bank on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

Commercial banking sector in India is dominated by state-owned commercial banks. As on March 31, 2009, commercial banks comprised of 27 public sector banks (State Bank of India and its six associates, 19 nationalized banks and the IDBI Bank Ltd.), 7 new private sector banks, 15 old private sector banks and 31 foreign banks. According to the RBI data, as at end-March 2009, public sector banks accounted for 71.9 per cent of the total assets in the commercial banking sector, with private banks accounting for 19.6 per cent and foreign banks accounting for the remaining 8.5 per cent of the assets.

Co-operative and rural banks have been an important channel of financial inclusion in India. They form a heterogeneous group in terms of geographical spread, area of operation, size and individual bank performance. Urban co-operative banks (UCBs) provide banking services to the middle and low income sections in the semi-urban and urban areas. Rural co-operative banks (RCBs) and regional rural banks (RRBs) supply the credit requirements of rural population and marginalized sections of the society. According to the RBI data (2007), assets of UCBs constitute more than 2.7 per cent of the total assets of the financial system; assets of RCBs constitute more than 4 per cent

of the total financial sector assets, while the RRBs constitute more than 1.8 per cent of the total financial sector assets. As at end-March 2009, there were 1,721 UCBs, 96,061 RCBs and 86 RRBs operating in the country.

Non-banking finance companies (NBFCs), which were initially intended to cater to the needs of small savers and investors, have now developed into institutions that can provide services similar to those of banks and hence, are enhancing competition and diversification of the financial sector. The Reserve Bank of India Act, 1934 was amended in January 1997 to provide a comprehensive legislative framework for regulation of NBFCs. NBFCs have been broadly classified into non-deposit taking NBFCs (NBFC-ND), deposit taking NBFCs (NBFC-D) and residuary non-banking finance companies (RNBCs). As on March 31, 2009, the number of NBFCs registered with the RBI stood at 12,740 including 336 NBFCs-D and 2 RNBCs, and together they accounted for around 9.1 per cent of the total assets of the financial system. NBFCs are different from banks in the sense that they are not permitted to accept demand deposits, are not required to maintain a cash reserve ratio with the central bank and are not part of the payment and settlement system.

Before the setting of the National Housing Bank in 1988, 80 per cent of the housing stock in the country was financed from informal sources. Since then, the housing finance companies (HFCs) have been a dominant contributor to the growth of housing industry. As at end-March 2007, the assets of the HFCs constituted 2 per cent of total assets of the financial system. Currently, the scheduled commercial banks and co-operative banks are also playing significant role in the housing loan market.

In comparison to the Indian banking sector, Japanese banking sector is much older in existence and is characterized by specialization and huge compartmentalization which lends it a complex structure. Furthermore, there is difference in ownership pattern of the central banks. In case of India, the RBI is fully owned by the government, while in case of Japan, the government owns only 55 per cent of the capital of the BoJ, and the remaining is invested by the private sector. Lastly, the Indian financial system is a bank centered financial system with commercial banks dominating the financial landscape by accounting for 60 per cent of its total assets, whereas the Japanese financial system is a market-based and competitive system. Though the post war financial system of Japan was bank dominated and heavily regulated, the deregulation that started in the mid 1980s caused this movement from indirect bank based financing to market based financing.

III Regulatory and Supervisory Framework

1. Japan

Until 1998, regulation and supervision of the financial institutions came under the purview of the Ministry of Finance (MoF). Banking and insurance firms were supervised by the Banking Bureau of the MoF, while securities business was supervised by the Securities Bureau. But demand for greater transparency and fairness of regulation in light of the non-performing loans problems faced by Japanese financial institutions in the latter half of 1990s called for separation of fiscal policy from financial administration. The functions of the Banking Bureau and the Securities Bureau were transferred from the MoF to the Financial Supervisory Agency in June 1998, which was subsequently renamed as the Financial Services Agency (FSA) in July 2000. The FSA is an extra-ministerial agency affiliated with the Cabinet. It acts as an integrated regulator exercising regulatory power over banking, insurance and securities business. It holds regulatory as well as supervisory authority. Three major policy objectives of the FSA are as below:

- ① Ensuring stability of the entire financial system.
- ② Protection of users and improvement of Convenience.
- ③ Establishing fair and transparent market.

Since 2007, the FSA is placing "Better Regulation" as the basis and sees it as an overarching theme for its work in the coming years. It has identified following four pillars of "Better Regulation":

- ① Optimal combination of Rules-based and Principles-based supervisory approach.
- ② Timely recognition of priority issues and effective response.
- ③ Encouraging voluntary efforts by financial institutions and placing greater emphasis on providing incentives
- ④ Improving the transparency and predictability of regulatory actions.

On the other hand, the Bank of Japan (BoJ) is not the regulator but carries out inspection of the financial institutions that maintain current accounts with the BoJ. Article 44 of the BoJ Act stipulates that the BoJ can enter into contracts with financial institutions to carry out on-site examinations in fulfillment of its financial stability system objective. Regular on-site inspections have given huge power to the BoJ to collect wide range of information on financial institutions through off-site monitoring. The BoJ also conducts inspection of overseas branches of the banks. The legal framework for banking supervision in Japan is contained in the Act for the Establishment of the FSA (Act No. 130 of 1998), the Banking Act (Act No. 59 of 1981), Cabinet

Ordinances, Cabinet Office/Ministerial Ordinances, and Administrative Guidelines issued pursuant to the Banking Act.

The Banking Law regulates city banks, regional banks and foreign banks, but it is not the only form of regulation. It delegates detailed provisions necessary to enforce itself to orders and ordinances, which unlike laws, do not need to be passed by the Diet and are used for minor adjustments. The Banking law also empowers the FSA to undertake inspection and supervision of banks. In addition to the Banking Law, there are other principal laws concerning banks and banking such as the Antimonopoly Law, Anti-Money Laundering and Counter Terrorist Financing Act, Law concerning Mergers and Conversion of Financial Institutions, Law concerning the Reserve Deposit Requirement System, Depositor Protection Law etc.

2. India

Unlike Japan, complete regulation and supervision of banks in India rests with the central bank, the Reserve Bank of India (RBI). The RBI protects the interests of the depositors, ensures orderly development and conduct of operations in line with customer interests, and has a critical role to play in ensuring overall safety and soundness of the banking system. Different departments of the RBI oversee different banks. Commercial banks are regulated by the Department of Banking Operations and Development, supervised by the Department of Banking Supervision. Urban co-operative banks are regulated and supervised by the Urban Banks Department. Regional Rural Banks (RRB) and Cooperative Banks are regulated by the Rural Planning and Credit Department and supervised by the National Bank for Agriculture and Rural Development (NABARD). Lastly, the Non-Banking Financial Companies (NBFCs) are regulated and supervised by the Department of Non-Banking Supervision. The Board for Financial Supervision (BFS) oversees RBI's regulatory and supervisory activities.

As the regulator of the banking sector, the RBI's role entails the following:

- ❖ Licensing
- ❖ Prescribing minimum capital requirements
- ❖ Monitoring governance
- ❖ Setting prudential regulations to ensure solvency and liquidity of the banks
- ❖ Prescribing priority sector lending
- ❖ Regulating interest rates in specific areas
- ❖ Setting regulatory norms related to income recognition, asset classification, provisioning, investment valuation, exposure limits etc.
- ❖ Initiating new regulation

As the supervisor of the banking sector, the RBI makes use of the following supervisory tools:

- ❖ On-site inspections
- ❖ Off-site inspections
- ❖ Thematic inspections, scrutiny and periodic meetings

As regards the legal framework for banking supervision in India, it is based on the Banking Regulation Act (BR Act), 1949. Furthermore, there are specific acts governing the banking operations in India such as the Companies Act, 1956 (governs banks as companies), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980: (relates to nationalization of banks), Bankers' Books Evidence Act, Banking Secrecy Act and the Negotiable Instruments Act, 1881. In addition to these, there are acts governing individual institutions such as the State Bank of India Act, 1954, NABARD Act, National Housing Bank Act, Deposit Insurance and Credit Guarantee Corporation Act etc.

India follows rules-based regulatory system but there is a continuous debate on whether or not India's regulatory regime should move from rigid and prescriptive rules-based regulation to a non-interventionist principles-based regulation. Like Japan, optimal combination of both, rules-based and principles-based regulation, is being favored whereby a set of principles is identified and the existing rules are clubbed and validated under these broad principles.

IV Status of compliance with the Basel Core Principles (BCPs) – Comparative study

The Basel Committee, established by the central-bank Governors of the Group of Ten countries in 1974, developed a comprehensive blue print for effective supervision in shape of "Basel Core Principles for Effective Banking Supervision (BCPs)" issued in September 1997 and revised in October 2006. The BCPs comprise 25 principles that need to be in place for a regulatory and supervisory system to be effective. Hence, they serve as a benchmark for sound prudential regulation and supervision of banks and assessment of a country's compliance with BCPs is seen as a useful tool in the implementation of an effective system of banking supervision.

1. Financial System Stability Assessment of India and Japan

Financial Sector Assessment Program (FSAP): A joint initiative of the International Monetary Fund (IMF) and the World Bank (WB) that began in 1999 is a voluntary and comprehensive analysis of a country's financial sector. The program includes assessment of status and implementation of international standards and codes in the regulation and supervision of institutions and markets.

India first participated in FSAP in 2001, since then it has been associated with independent

assessments of standards and codes by the IMF or the WB. It conducted first independent self-assessment in 2002 which was followed by another review in 2004. In September 2006, the Government of India, along with the RBI, constituted Committee on Financial Sector Assessment (CFSA) which undertook a comprehensive self-assessment of India's financial sector. Their final report (referred to as 2009 CFSA report) was released on March 30, 2009 which includes assessment of India's observance of the BCPs and forms the basis of our study of banking regulation and supervision in India.

Japan participated in FSAP in 2003 under which the IMF published its Financial System Stability Assessment (FSSA) report. This report included assessment of status and implementation of BCPs in supervision of Japanese banking sector. Unlike India, there has been no self-assessment of Japan's financial sector. Hence, the IMF's FSSA report is the main source of information on status of compliance with BCPs.

2. Compliance status: cross-country comparison

Clear responsibilities and objectives: In India, the RBI is the sole body entrusted with regulation and supervision of banking sector, while in Japan, in addition to the regulatory and supervisory authority of the FSA, some supervisory authority also rests with the BoJ with respect to institutions that maintain current accounts with the BoJ. This however suggests a supervisory overlap and can lead to conflict of interest between supervisors.

Operational independence: Although the RBI is operationally independent and accountable de facto, the central government has the power to remove the head of the supervisory authority without specifying any reasons. Hence, the accountability framework needs to be better delineated and more transparent. Similarly in case of Japan, it is believed that the constitutional framework of the FSA might cause lack of operational independence due to political pressures.

Budgetary independence and resources: The RBI is financed by its own budget and does not receive any financial support from the central government. Whereas, the FSA lacks budgetary independence since it is funded from the central government budget. This could be dealt with by charging the supervised institutions for the cost of supervision. Furthermore, the FSA operates with minimal supervisory staff levels, so it is advised to provide additional resources to the FSA, in form of human capital.

Legal framework: According to the 2009 CFSA report, India has a suitable legal framework for banking supervision in the form of the Banking Regulation (BR) Act, 1949. In case of Japan, their

legal framework is based on the Act for the Establishment of the FSA, the Banking Act, Cabinet Ordinances, Cabinet Office/Ministerial Ordinances, and Administrative Guidelines issued pursuant to the Banking Act. Hence, the legal framework for banking supervision in Japan is more mature and complex in comparison to the same in India.

Exchange of information between supervisors: The law in India does not permit the RBI to enter into formal Memoranda of Understanding (MoUs) with overseas supervisors but it shares information based on reciprocity and understanding of confidentiality. Similarly in case of Japan, there are no formal procedures for a regular exchange of information between the BoJ, which also supervises some banks, and the FSA, and such exchanges take place on an ad hoc basis. However, these organizations maintain close contact at operational and senior official levels. The exchange of information with foreign supervisors is also based on informal arrangements.

Licensing: As for India, the BR Act, 1949 clearly defines the term banking and prescribes the permissible activities that can be undertaken by entities licensed and supervised by the RBI. In case of Japan, the IMF's 2003 FSSA report states that while the Banking Act clearly defines the term "bank" and the permissible activities of banks, it does not deal with the public financial institutions. For starting a banking business, institutions have to obtain a license from the Prime Minister, who normally delegates his functions to the Commissioner of the FSA, and is the sole authority for granting banking licenses.

Transfer of ownership: The 2009 CFSA report indicates that the BR Act, 1949 requires banking companies to acquire acknowledgement/approval of the RBI for any transfer of shares which exceeds 5 per cent of the paid-up capital of the bank. The RBI has requisite powers to reject/prevent any proposal for a change in significant ownership. Similarly in Japan, the Banking Law empowers the FSA to grant authorization for acquisitions or increase in qualifying holdings.

Investment by banks: Laws or regulations in India and Japan define the types of permissible investments in very general terms. Hence, supervisory approval is not required for investments within the limit in both cases.

Capital adequacy: In India, the RBI requires all commercial banks to maintain a Capital Adequacy Ratio (CAR) of at least 9 per cent of the risk weighted assets (above the stipulated Basel II norm of 8 per cent). The capital requirements are uniformly applied to all banks, including foreign banks operating in India, by way of prudential guidelines on capital adequacy. Capital adequacy ratios

across bank groups are significantly above the regulatory minimum. As per the RBI data, the capital adequacy ratio of commercial banks improved to 13.2 per cent as at end-March 2009 from 13 per cent as at end-March 2008. However, to deal with non-compliance, the scheme of Prompt Corrective Action (PCA) has been put in place by the RBI. In Japan, banks employing domestic standards (domestic banks) are required to keep capital adequacy ratios of 4 per cent or higher, while banks employing international standards (foreign banks) must have capital adequacy ratio of 8 per cent or higher. Taking into account the impact of recent financial crisis, Japanese government introduced some flexibility to capital adequacy regulations in order to prevent reduced financial intermediation as part of its efforts to stabilize financial and capital markets. Like the RBI, the FSA has in place the concept of PCA to deal with non-compliance.

Loan evaluation and provisioning for bad loans: The RBI requires the Board of Directors of each bank to institute an appropriate credit risk management framework. It verifies the quality of credit portfolio through Annual Financial Inspections (AFIs), off-site inspections and informal discussions with top management. The RBI also issues guidelines on early identification of problem assets and give directions on higher provisioning and higher capital level. Further, the RBI comments on asset quality and value during the on-site inspection process. In Japan, the FSA has improved recognition and provisioning of bad loans. Provisioning requirements in Japan are based on accounting standards and guidelines issued by the Japanese Institute of Certified Public Accountants (JICPA). Banks have to conduct frequent assessments of their portfolio to ensure that provisioning requirements are in line with the FSA guidelines.

Exposure limit: The RBI prescribes limit on banks' exposure to borrowers to avoid concentration on credit and on exposure to sectors to ensure better risk management. In addition, the RBI also prescribes prudential limits for capital market exposures. In case of Japan, the IMF's 2003 FSSA report indicates that regulations and on-site inspections provide adequate guidance on large loan exposure.

Country risk and transfer risk: In India, the RBI mandates the banks having overseas operations to report details of their country-wise exposures as part of their off-site returns. The 2009 CFSA report indicates that banks have in place appropriate information systems to track their exposures to all those countries where the exposures to each are in excess of 1 per cent of its total assets. However, in case of Japan, the IMF's 2003 FSSA report states that country and transfer risks are not regularly reported and not properly supervised.

Internal controls: In both the countries, adequacy and efficacy of internal controls in individual banks is checked routinely during the on-site inspection process. In case of Japan, the Financial Instruments and Exchange Act (enacted in 2007) specifically provides for internal controls in public companies. In case of India, the RBI introduced the concept of Risk Based Supervision and Risk Based Internal Audit in 2003. The RBI also issued guidelines to banks asking them to streamline their inspection and audit machinery, and to introduce concurrent audit and internal control system for prevention of frauds etc. Further, the 2009 CFSA report states that Section 36-AA and 36-AB of the BR Act, 1949 empower the RBI to remove managerial and other persons from the office of banking company and appoint additional directors on the Board to secure proper management in the interest of public.

KYC/AML: Under Section 35A of the BR Act, 1949, the RBI has issued Know Your Customer (KYC) /Anti Money Laundering (AML) guidelines, and non-compliance of these attracts penalties. The RBI further maintains a database of frauds and the information is shared with the banks. As per the 2009 CFSA report, guidelines issued by the RBI require all banks to develop a proper policy framework on KYC. As for Japan, the IMF's 2003 FSSA documents that on-site inspections review banks' policies, practices, and procedures regarding AML initiatives. In November 2004, the Diet approved legislation banning sale of bank accounts to prevent misuse of purchased accounts for fraud or money laundering. The 2007 Global Survey by the Institute of International Bankers (IIB) states that on January 4, 2007, Japanese government partially revised the Enforcement Ordinance and Enforcement of Regulation of the Law on Customer Identification and Retention of Records by Financial Institutions, and Prevention of Fraudulent Use of Deposit Accounts (so-called Customer Identification Law), while on March 13, 2007, the FSA partially revised the comprehensive supervisory guidelines for major banks and regional banks in the area of AML and combating the financing of terrorism.

On-site and off-site supervision: In India, the RBI adopts the CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and Controls) approach for supervisory risk assessment and rating of domestic banks, and adopts the CALCS (Capital adequacy, Asset quality, Liquidity, Compliance and Systems and Controls) approach in case of foreign banks. As per the 2009 CFSA report, the RBI has laid out a list of objectives to be followed in its on-site inspections process. An off-site monitoring and surveillance (OSMOS) system set up in 1995 has the primary objective of analyzing the financial position of the banks in between on-site inspections. In addition to these, there are mechanisms in place for periodical monitoring of banks like meetings for various purposes like discussions on Resource Management, consultation with

banks before introduction of major reporting changes, etc. As for Japan, the FSA conducts on-site and off-site supervision and reviews and monitors banks' financial conditions with the information and data required of banks.

Contact with the bank management: The RBI in India and the FSA in Japan maintain regular and on-going contact with banks' management in the course of monitoring and inspection. Moreover, each supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

Consolidated supervision: Although both, the RBI in India and the FSA in Japan, supervise banks on consolidated basis, the FSA has the authority to conduct on-site inspection of a bank subsidiary while the RBI does not have the power to cause inspection of any entity of the banking group. However, the same is being sought through the introduction of a new Section 29A in the BR Act, 1949.

Accounting standards: In India, Section 29 of the BR Act, 1949, prescribes the formats for preparation of financial statements. All banks get their annual accounts audited every year by external auditors who are appointed with the prior approval of the RBI under Section 30 (1-A) of the BR Act. The disclosure standards are reviewed by the RBI. To ensure disclosure on par with international standards, banks are mandated to disclose certain additional information as part of their annual financial statements. In case of Japan, the FSA released a roadmap for IFRS application in June 2009. According to the 2010 update available on the Deloitte & Touche IAS Plus website, voluntary application of IFRS by certain Japanese listed companies (Specified Companies) has already started from April 1, 2010, and the country plans to move towards full adoption of IFRS by 2015 or 2016.

Timely corrective action: Both the RBI and the FSA have the power to issue directions to banks in the interest of public and in the interest of banking policy, and to prevent affairs of banks being conducted in a manner detrimental to the interests of depositors. Furthermore, a prompt corrective action scheme is in place and observed by the supervisory authorities.

Cross-border banking: In case of India and Japan, the current regulatory and supervisory framework does not contain specific provisions relating to global consolidated supervision.

Home-host relationships: Foreign banks operating in India and Japan are subject to same

legislation and regulatory requirements as applicable to domestic banks in respective countries. In both cases, there is lack of formal arrangement with the home/host supervisors for exchange of information at periodical intervals.

V Conclusion and Policy Suggestions

1. Conclusion

Banking sector plays a vital role in channelizing savings towards most productive investments and fosters the process of capital formation in an economy. It occupies a crucial place in development efforts and acts as a vehicle for socioeconomic transformation as well as a catalyst to economic growth of a country. But the recent financial turmoil and the following recession blemish this record. The global financial crisis has exposed weaknesses in the bank regulatory and supervisory frameworks of many countries. The policymakers and the central bankers are hence facing the challenge of designing appropriate strategies for recapitalization and restructuring of viable banks and for careful resolution of non-viable banks.

In response to the crisis, the Bank of Japan (BoJ) took steps to address the domestic impact of the financial crisis from a financial policy perspective as well as measures to stabilize the financial system. In an effort to manage crisis at financial institutions and to stabilize financial and capital markets, Japanese government stepped in to buy loss making stock held by banks and introduced some flexibility to capital adequacy regulations so as to prevent reduction in financial intermediation. However, the financial sustainability of Japanese banks in the time of intense competition, high credit cost and historical low profits remains weak vis-a-vis other developed countries.

On the other hand, the effect of financial crisis on Indian banking sector has been rather muted. Study undertaken by the Reserve Bank of India (RBI) in September 2007 revealed no direct and limited indirect exposure of Indian banks to the sub-prime markets in the US or elsewhere. Though the indirect exposure of banks through their overseas branches and subsidiaries was negligible, few such banks with exposures to credit derivatives suffered on account of mark-to-market losses caused by widening of the credit spreads. Impact of crisis in context of banks' exposure to equity investments was minimal due to the prudential limits on banks' exposure to capital markets. The regulatory limit on individual banks' total exposure to capital market is now capped at 40 per cent of banks' net worth as at end-March of the previous year.

Table 1 gives a cross-country comparison of CAR and NPL for 2007 and 2008. It indicates that in case of India, the CAR (or the Regulatory Capital to Risk-Weighted Assets ratio) increased from 12.3 per cent in 2007 to 13 per cent in 2008, whereas in case of Japan, it dropped to 12.3 per cent

Table1. Comparison of select banking indicators (per cent)

Banking Indicators Country	Capital Adequacy Ratio (CAR)		Non-performing Loans to Total Loans (NPL)	
	2007	2008	2007	2008
India	12.3	13.0	2.5	2.3
Japan	12.9	12.3	1.5	1.5

Source: Global Financial Stability Report, April 2009, IMF

in 2008. But in both cases, the CAR is significantly above the regulatory minimum. As regards the NPL ratio, even after registering a decline of 0.2 per cent in 2008, the NPL ratio in India is higher than that of Japan.

As per the RBI, banks' direct investment in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and all exposures to venture capital funds should not exceed 20 per cent of its net worth.

According to the 2009 RBI "Report on Trend and Progress of Banking in India," the Indian banking sector is relatively robust and balance sheets of the banks are little affected by the unsettled conditions in financial markets. The asset quality and soundness parameters of the Indian banking system have improved significantly in the recent period. This is primarily because of the untapped potential in the sector that provides a favorable outlook way ahead.

2. Policy Suggestions

Against the backdrop of the recent financial crisis, regulatory and supervisory structures need to be revamped to prevent another build-up of systemic risks. Based on our comparative study of the regulatory and supervisory regimes of India and Japan, and on the basis of lessons learnt from the crisis, we make the following policy recommendations for an effective banking regulation and supervision:

- ① There is a need to harmonize national regulatory policies and legal frameworks to enhance international co-ordination of banking supervision. This rests on two foundations; national systems' capability in supervising their banks' overseas operations, and a willingness on the part of supervisors to co-operate in monitoring of activities of overseas branches of their own banks and those of the foreign banks operating in their territory. Constraints on coordinated supervision arise out of banking secrecy laws and regulations that cannot be amended easily. These secrecy laws or regulations were established when international banking wasn't developed fully and when international coordination of supervision was still in a nascent stage. However, these constraints can be removed over time if supervisors mutually agree that the

information transmitted will be limited to what is required for supervisory activities, that the arrangements for transmittal will be reciprocal, and that the confidentiality of information will be protected by law in the recipient country.

We have seen that in case of India and Japan, there is no formal arrangement for exchange of information with domestic and foreign regulators. So, the policy makers in both countries need to realize the importance of information flow and cooperation among regulators and take necessary steps for formalization of this relationship.

② The perimeter of regulation should be expanded encompassing institutions which are presently outside the scope of regulation and beyond the detection of regulators and supervisors. This is especially true in case of Indian NBFCs which are less closely regulated and supervised than the banks.

③ In case of Indian co-operative banks, the problem of dual control by the RBI and the Regional Co-operative Societies needs to be addressed. While in case of Japan, the supervisory overlap between FSA and BoJ needs to be dealt with in order to avoid any conflict of interest. A clear division of role and responsibilities between the two supervisors can reduce double checking and save time and resources.

④ The issue of inadequacy of resources and budgetary dependence of the supervisor on the government can be resolved by charging the supervised institutions for the cost of supervision.

⑤ Another policy suggestion relates to revision of capital rules enabling banks to increase their regulatory capital when profits allow them to do so, in order to provide a capital buffer to support continued lending to the economy in times of crisis.

⑥ Lastly, in many countries, regulation and supervision have remained geared toward individual financial institutions. Hence, the regulatory mechanisms should also take into account the systemic and international implications of domestic institutions' actions.

Heterogeneity in the economic background, level of development and financial conditions of various countries place a constraint on universal adoption of international standards and practices. The constraint can however be relaxed by granting flexibility in adoption of these standards and by encouraging their implementation in a phased manner (nevertheless setting a deadline for complete adoption).

The oversight body of the Basel Committee on Banking Supervision, met on September 6, 2009 to review a set of measures to strengthen the regulation, supervision and risk management of the banking sector. These measures, only if complemented by efforts to strengthen the ability and willingness of supervisors to enforce them in a timely and credible manner, can be effective in reducing the probability and severity of economic and financial crisis.

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