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The formalization of banking supervision: A comparison between Japan and Sweden

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Abstract:

This study examines the formalization of banking supervision in Japan and Sweden that occurred in the decades around 1900. Using an incremental change approach, the respective cases are traced and examined from three dimensions: 1) the legal framework, 2) the banking supervisory agency, and 3) bank supervisory activities. As a result of the comparative analysis, we find several similarities and differences. The most important finding is that the two cases are similar, in that financial crises – generally considered to be a primary driver for major regulatory and supervisory reforms – did not play the main role in the formalization of supervision in either Japan or Sweden. Rather, the formalization was an incremental adjustment to the organic development of the banking sector, the general public's increasing exposure to the banks as deposit holders and borrowers, and the increased need for professionalization of the banking sector.

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1. Introduction

Today, banking supervision is a common feature of financial systems in all developed countries. However, the history of formalized banking supervision differs substantially between countries in terms of length and character. Formal banking supervision in the United States (US) has, for example, existed for nearly two hundred years. Mitchener and Jaremski (2014: 7-13) illustrated that the State of New York introduced formal banking supervision in 1826. Robertson (1968: 33-86) detailed the beginning of banking supervision at the federal level with the Office of the Comptroller of the Currency in 1863–64. While in the United Kingdom (UK), previous research (Norton 1991: 7-17; Capie 2010: 587-631) showed that it only started in 1979 with the enactment of the new Banking Act. The US and the UK are polar opposites in terms of institutional history. Previous research (Allen, Cope, Dark and Witheridge 1938; Bähre 1984; Gigliobianco and Toniolo 2009) illustrated that many developed countries introduced, enhanced, or considered formal banking supervision during the Great Depression. A comparative study is one way to better understand conceptually why the (essentially similar) banking supervision in each country was formalized at different points in history. Although several cases (especially the US) have already been subject to academic interest (Mitchener 2005, 2007; White 1992, 2009, 2011), only a handful of comparative studies have focused on countries' differing banking supervision histories. This is the motivation for this study.

Major changes in the institutional set-up of banking systems, including the regulation and supervision of banks, have often been attributed to political reactions to large financial crises. Financial crises discredit the existing order of things, and politicians often respond to changed public sentiments to ensure that financial crises will not occur again. However, direct action in response to financial crises has not led to the best regulations in the long term because overly prudent constraints have been imposed to limit the scope of banking activities.

History also shows that institutional change in this area has not merely been linked to financial crises. Haber (2008: 19-26) illustrated that in some cases in the early 19th century US state officials promoted the establishment of banks for tax revenue reasons. This can be categorized as a sort of early driver of bank regulation. In fact, many cases in the developed countries show a more complex picture of how, when and why banking regulation and supervision emerged and changed.

This study examines two cases where banking supervision was not triggered or primarily driven by financial crises, but rather by more or less incremental institutional change as a result of the changing needs and perceptions of the banking system from the public, political leaders and the banking community itself. The countries that are compared, Japan and Sweden, have a relatively long history of banking supervision, with the formalization process occurring in both countries in the decades around 1900 until being finalized in Japan in 1916 and in Sweden in 1907.

The results of the study show that financial crises were not the main drivers of the formalization of banking supervision in Japan and Sweden. The motives differed somewhat in each case, and yet several commonalities were found. In the late 19th century, the governments of both countries became interested in promoting the growth of the banking sector because of its importance in accommodating the overall economy as well as individual depositors. Public support came in the form of formal recognition of the role banks should play in the economy as stated in new and gradually expanded banking regulations. Thus, banks were subject to increasing supervision.

The rest of this paper is organized as follows. Section 2 explains several key concepts and clarifies the definition of "formalization". Section 3 provides a summary of related comparative studies and outlines the aim of our study, including the reason for selecting the two countries that are examined. Section 4 traces the development of each commercial banking system around 1900. Sections 5 and 6 outline the history of banking supervision in Japan, mainly focusing on the formalization phase, while Sections 7 and 8 outline the Swedish case. The cases are compared in Section 9 and several similarities and differences are identified. Section 10 provides concluding remarks and policy implications.

2. Concepts and definition

In many countries, formalized banking supervision has tended to remain unchanged over the years. It is therefore important to understand how and why banking supervision was formalized in the first place. Given that path dependency appears to be very strong, an institutional approach is appropriate for this study.

This study defines informal supervision as having a discretionary, undisclosed, case-by-case, and irregular character with undefined motives, targets, means and responsibilities. In contrast, formal supervision is an arrangement whereby banking supervision is rules-based (Bank Law/Act/Decree), 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 in this study is that of formalization, which is developed from a largely institutional theoretical perspective, in particular inspired by the incremental change approach described and exemplified by Streeck and Thelen (2005). 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 set-up. In addition, in a seminal study of the literature on banking supervision and regulation history, White (1983) emphasized the struggle by various stakeholders to either change or retain the existing banking regulations in the US in the late 19th and early 20th centuries. Furthermore, Streeck and Thelen categorized incremental change into five types, of which one is a layering transformation whereby new elements are attached to existing institutions to gradually change their status and structure.

In this study, the concept of formalization is one of layering, and yet it is used in a somewhat different sense to Streeck and Thelen. In our concept, layering means the gradual introduction of formal institutions (such as laws) on top of informal institutions (e.g. societal norms and business customs). Thus, the formalization referred to in this study is about making a set of existing norms and conventions recognized, accepted, and enforceable by laws and enforcement agencies. 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. Formalization includes the process whereby an informal institution (e.g. a societal or market norm or convention) receives recognition, support and active endorsement from formal institutions (e.g. laws and regulations) and organizations (e.g. government agencies).

Consequently, this study is interested in identifying the point at which informal methods of supervision were complemented by a layering formalization of supervision, and explores why and when this occurred. We examine the supervision of commercial banks in Japan and Sweden from the late 19th century to the early 20th century. Since this study is focused on identifying and accounting for the formalization of banking supervision from an institutional perspective, less emphasis is placed on the effects or quality of the supervision itself.

In addition, this paper is mainly concerned with the shift away from an informal system of banking supervision, and thus does not address informal banking supervision. Of course, we are aware that in every country where a banking sector has developed, some form and level of informal banking supervision developed simultaneously. The creation and operation of a bank automatically brings with it a number of different stakeholders with different incentives to monitor such things as proper conduct, prudence, fair treatment and remuneration. This informal supervision still prevails today, being undertaken by individual depositors, employees, shareholders, customers, analysts and the media, although the development of formal regulation has reduced these stakeholders' incentives. Even formal supervisors make use of informal supervision to complement the laws that regulate financial companies.

In contrast to other studies regarding the history of bank regulation, this study goes 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 study illustrate the merits of looking at three dimensions, rules, enforcers, and enforcement in the study of institutional formalization. In both the Japanese and Swedish cases, banking supervision experienced periods when one or two of these dimensions was/were in place. Hence, the formalization of banking supervision concerned not only the formalization of institutions (putting the norms, rules, conventions of sound banking into legal text), but also the actual implementation and enforcement of bank regulation by regular supervisory activities executed by an organization that was formally empowered. In terms of banking supervision, the state of being "formalized" is realized when 1) a legal framework, 2) a banking supervisor, and 3) banking supervisory activities are in place on a permanent basis.

Specifically, this study operationalizes the idea of institutional formalization in the context of banking supervision history by attempting to empirically capture and analyse 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 regulating the supervision.
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.
3) When the latter has started to enforce/implement the former on a regular basis as evidenced by on- and off-site examinations and enforcement actions.

The banking supervisor is defined as an organizational entity specifically assigned and empowered to enforce bank regulation and to engage in banking supervision as defined above. It 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 checking items will differ. Banking supervision also concerns the enforcement of bank regulations by a range of disciplinary activities such as moral persuasion, fines (imprisonment) or even revoking a bank's licence.

This study considers the following bank regulations: licensing (entry barrier and liability rule), defining the scope of banking business (commercial/investment), limitation (cartel) of interest rates, branching, capital adequacy, disclosure rules, banking business activities (operation/advertisement), restriction of interlocking directorate/insider loans (large loans) and promotion/inhibition of bank mergers. Although some kinds of bank regulation such as a liability rule would be more or less self-enforcing, this study adopts the assumption that regulation requires active implementation and enforcement.

3. Comparative studies of banking supervision history

Despite its academic importance, very few attempts have been made to compare banking supervision history in various countries. Grossman (2010: 131-136) made a novel attempt to search for new criteria to classify financial supervision systems in each country by surveying the temporal sequence of central bank creation and banking supervision. Goodhart (2007) had a similar motivation to the present study, albeit mainly focusing on the role of the central bank. Hall (1993: 175-187) described the differences among Japanese, British and American banking supervision systems in the 1980s. Although theirs was not a comparative study, Allen et al. (1938) investigated bank regulation and supervision in 13 countries, examining the historical background to each country's specific set-up.

Haber (2008) compared the development of bank regulation in the US around 1800 and Mexico in the decades around 1900, linking the chartering of banks (as a way to promote or prevent market entry) to the political institutions in each country at the time from the perspective of promoting or preventing political competition. That study is important 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.

A comparison of the early Japanese and Swedish histories of banking supervision is not only motivated by the authors' special interests. An additional contribution of our study is the presentation of accounts of these cases, for few previous studies have been published, especially in the English language.

The comparison is also motivated by several other factors. The formalization of banking supervision occurred comparatively early in both countries, which had few other countries to learn from. Thus, the institutional change was not a product of international pressure, as in the UK,[1] and the processes were driven by domestic factors and conditions. International influences mattered, especially in the design of formal institutions such as banking acts, while other factors, such as the characteristics of the supervisor and the actual supervision, did not matter at that time. Although only the US case existed as an example, neither Sweden nor Japan drew very much from the institutional and organizational arrangements that were in place in the US.

With regard to the banking sector, Japan and Sweden have multiple obvious differences, such as the size of the economy, banking and industrial characteristics, political and cultural traditions, and geographical location. While the source of the Swedish institutional build-up of big government in the late 19th century can be traced to a gradual strengthening of centralized parliamentarism and the accompanying weakening of the king's power from the late 18th century, Japan's financial authorities emerged from an ingenious mixture of institutional imports of "the best practices" of the developed countries from 1868 (Meiji Restoration).

At the same time, Japan and Sweden share some similarities that have already been pointed out in the literature. Both countries experienced rapid industrialization during the second half of the 19th century (especially at the turn of the century), and their respective governments played an active role in promoting economic transformation via regulatory and policy reforms. These conditions are the most important denominator to our account of why and how banking supervision became formalized.

Furthermore, both countries are categorized as having a bank-oriented system, with close and enduring relationships between big industry and the banks with the implicit or explicit consent

[1] An important driver of institutional change in the banking regulation context was the establishment of the Basel Committee on Banking Supervision in 1974 as well as the Wimbledon effect in the City of London in the 1980s.

of the government. Hall and Soskice (2001: 17-21) categorized both Japan and Sweden as "coordinated market economies". From the legal origin perspective, Sweden is in the "Scandinavian origin" category while Japan is in the "German origin" category. However, La Porta et al. (1998) pointed out several similarities between these two traditions such as market concentration. They also have similarities in terms of the development of a centralized bureaucracy from the late 19th century that was empowered and willing to promote industrialization, not least via legal reforms (but often via guidelines). Essentially, as previous research (Mosk 2001; Schön 1997) showed, bureaucrats pursued the funding of major infrastructure projects as well as the monetization of an increasingly urban and less agriculturally oriented economy.

4. Development of commercial banking in Japan and Sweden around 1900

Following the Meiji Restoration from 1868 in Japan, as Tamaki (1995: 21-45) elaborated, the modern banking system was introduced and quickly developed via multiple paths. Commercial banking was divided into two streams – *Kokuritsu Ginko* and *Shiritsu Ginko*.[2] The former model was basically that of the US national banking system, whereby each bank takes deposits and provides loans, as well as issuing its own banknotes. The number of banks increased to 150 during the boom of 1877–79. To maintain the value of their banknotes, the establishment of new banks was no longer permitted from 1880 onwards. Furthermore, the creation of the Bank of Japan in 1882 meant the centralization of note issuing. Each *Kokuristu Ginko* transformed into a commercial bank by 1899 and constituted a significant part of the commercial banking sector. The *Shiritsu Ginko*, which was mostly the successor to financial merchants in the Edo period (1603–1867), provided deposit and loan services. The number of banks increased from 1880,

[2] The main founder of *Kokuritsu Ginko* was feudal lords and *samurai*s, while the main founder of *Shiritsu Ginko* was wealthy merchants and farmers.

especially during the first industrial boom (1886–89) and the Sino–Japanese War boom (1894–96). Under the Bank Decree of 1890, each *Shiritsu Ginko* was formally categorized as a commercial bank.

According to Goto (1970: 56-57), the number of commercial banks peaked at 1,890 in 1901. This meant that even the general public were able to access commercial banking services (deposits and loans) within their community (town or city) from around 1900. Overall, the business of Japanese commercial banks was converging into that of deposit-taking banks in the 1900s. Due to the defectiveness of the formal stock exchange and related institutions, companies (e.g. textile, mining and trading companies) preferred to avail themselves of commercial banking services (in particular for loans). Even railway or electricity companies partially depended on the commercial banks to avoid the high cash dividend payments that accompanied increases in capital. In the early 20th century, the interests of the commercial banks were increasingly intertwined with the development of modern industries, as well as the daily business of the general public.

In Sweden, as Ögren (2010: 5-11) stressed, the rapid industrialization during the second half of the 19th century occurred in conjunction with the "financial revolution", whereby more and more banks found new projects and provided services to facilitate industrial growth. Although the number of commercial banks increased from the 1860s, the commercial banks' exposure to the broader population was quite limited. For a long time, the savings banks that emerged in Sweden in the 1820s remained the main provider of savings and loan services for the largely rural population. The Swedish government played an active part in the industrial revolution, not only as investors in grand projects such as a nationwide railway network, but also as "enablers" of the financial revolution. The regulation that was formulated in the second half of the 19th century was marked by the government's intention to promote commercial banking services and their investment in new industries. With the increasing monetization of the economy, as Larsson (2010: 170-179) found, the growing wealth of individual citizens provided the opportunity for banks to offer deposit and investment services.

The Swedish Riksbank also operated deposit-taking and lending facilities on a large scale and in direct competition with the private banking sector until the 1897 reform that gave it a note-issuing monopoly in exchange for dismantling its commercial banking arm. Joint-stock limited liability banks now dominated the older unlimited liability note-issuing banks. The joint-stock limited liability banks were able to scale up their operations, and were then able to take more risks in supporting the rapid industrial development that was taking place. Since equity capital was basically limited to the original funding, the new commercial banks increased their efforts to attract depositors away from the traditional savings banks. Hampered by tradition and legal requirements to operate as small-scale local non-profit entities in the spirit of the savings bank movement, as Lindgren (2002: 825-829) showed, the savings banks offered hardly any competition to the commercial banks. Thus, the commercial banks succeeded in attracting a larger share of depositors by offering better interest rates, more forms of loans and opportunities to invest in the rapidly developing stock market. The growth of the securities market, including bonds, was enabled by the introduction of the joint-stock company system, and was enhanced by the rapid industrial progress, commercialization of major innovations and investments in large-scale infrastructure projects.

According to Lilja (2010: 46), by the beginning of the 20th century, approximately 80 commercial banks were operating around the country, almost twice as many as in 1860, while the number of branch offices increased even more rapidly, from 50 in 1860 to 270 in 1900. Although still primarily serving the commercial and industrial sector, more and more deposits were being received by the commercial banks as the general public gained increasing access to commercial banking services.

In both Japan and Sweden, the significant rise in the number of depositors as well as a policy of rapid industrialization were important in providing the background for the formalization of banking supervision.

5. Institutional development of formal banking supervision in Japan

The process of formalization of banking supervision in Japan took place in the second half of the 19th century. The Ministry of Finance was responsible for licensing banks under the national or ordinary banking system from 1872. Similar to the US, as Hotori (2011: 31-33) illustrated, the formal motive for banking supervision was the monitoring of each national bank with the aim of maintaining the value of its banknotes, as well as ensuring proper accounting practices. With the National Bank Decree of 1872, the organization of the Japanese banking system (*Kokuritsu Ginko*) was modelled on the US national banking system that had been implemented earlier. The Decree outlined the terms for the issuance of national banknotes, and included specific provisions for bank examination (Articles 73 and 74). The national banks were also required to obtain a bank licence.

Following the establishment of the Bank of Japan in 1882,[3] the issuance of banknotes was finally centralized in a national currency, although regulatory power was not granted to the Bank of Japan. With the creation of a central bank, the national banking system was abolished, and thus existing national banks were incentivized to convert to ordinary banks. Ordinary banks in Japan basically engaged in commercial banking business. The most critical incentive that was offered was the deregulation of large loans to certain borrowers, as well as much looser banking supervision, which meant a virtual suspension of on-site examinations. Kasuya (2000: 8-28)

[3] The Belgian central bank inspired the institutional set-up of the Bank of Japan.

detailed the transition of the Bank Decree over the Meiji period, and pointed out that Japanese bankers were slow to recognize the importance of systemic risk even after the failure of the large *Hyaku-Sanju* Bank in 1904. Over the period of lax bank regulation and supervision (1893–1914), the number of Japanese banks increased threefold, which was accompanied by a significant increase in problems related to insider lending (the "*Kikan Ginko*" problem). The historical experience provides an interesting case of the reversal of the institutionalization process. Similarities are apparent between this period in Japan and the US free-banking experience in the antebellum period.

In 1901, the Ministry of Finance issued a guidance under which the government no longer granted banking licences to newcomers. In addition to the administrative entry barrier, banking regulation and supervision were reintroduced in the second decade of the 20th century. In 1915, the Banking Bureau was created within the Ministry of Finance, and in 1916 a specialized post for bank inspection was established in the newly created Banking Bureau. According to Hotori (2011: 34), the numbers of examiners and assistants were just two and four, respectively, at its launch, and gradually increased to eight and 22, respectively, by 1922. Following discussions among the Financial System Research Committee in 1926,[4] the Bank Inspection Division was created as part of the Banking Bureau in 1927. After that, the numbers of examiners and assistants were increased to 18 and 54, respectively, which allowed the frequency of on-site examinations to increase to at least once every two years (Table 1). In 1928, the Bank Examination Division was created within the Bank of Japan, mainly with the aim of supporting the on-site examination activity by 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. As Hotori (2006: 76-77) pointed out, *Zaibatsu* bankers did not

[4] The committee, which was created by the government, discussed a fundamental revision of the Bank Decree of 1916 and a significant enhancement of the banking supervisory system.

oppose the implementation of the new Banking Act of 1927, which contained much stricter regulations such as an increase in the minimum capital required to one million yen. The examiners, as well as the head of the division, were appointed from among the high-ranking officers in the Ministry of Finance until 1942, when on-site examinations were suspended because of the War.

6. Change in the purpose of banking supervision in Japan and the completion of formalization

The Meiji Restoration in 1868 led to the Japanese people's first experience with modern banking. Therefore, the main role of bank examination was the education of bankers, that is, training the new bankers in practices such as double-entry bookkeeping, methods of risk management and distinguishing between deposits and capital. Even the banking supervisor himself was initially engaged in the commercial banks' organizational learning rather than in banking supervision proper. Dai-Ichi Ginko (1957: 214-235) documented the earliest bank examiner report of the First National Bank of Tokyo in 1875. The on-site bank examination was directed by Alexander Allan Shand (1844–1930), who was the Secretary for the Ministry of Finance at the time.[5] Many points he made in his examination report concerned the proper and prudent management of a bank's affairs. As could be expected, Japanese banks experienced a lot of fundamental problems with their banking business and operations in the early stages. Bank examiners primarily endeavoured to detail the problems of each bank as clearly as possible, as well as providing instructions on how to cope with 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

[5] Although the model for the national banking system was the United States, Shand was a Scottish banker who never worked for a US bank. Later, he became a director of the Parr's Bank in the UK.

Shand and his staff. If necessary, the Ministry of Finance appointed an officer to the board of a problem bank.

Following the period of lax or no on- and off-site examinations in the late 19th century and the early 20th century, the financial crises of 1900 and of 1907 made more bankers realize the importance of systemic risk. Shibuya (1975) documented a series of special bank investigation reports by the Ministry of Finance that covered failed or bad banks. Those reports illustrated the seriousness of the financial crises during 1907–1914. In December 1914, Anonymous (1914: 6-8) reported that a number of bankers requested the resumption of the on-site examination system. The period of lax supervision led to some hard-earned lessons for Japanese bankers, and the gradual maturing process 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, as Hotori (2006: 48) found, the outbreak of the First World War prompted a return to the banking supervisory system by the Ministry of Finance.

The nature of the supervision now changed from education of bankers to proper prudential supervision. In addition to the creation of the Banking Bureau in 1915, the Ministry of Finance recommenced on-site examinations. To force bankers to comply with the examiners' orders, strict sanctions were also introduced in 1916. 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 imprisonment for a period of up to one year. The main objective of bank examinations during 1915–34 was to ensure soundness through the reduction of bad loans and insider lending.

The Japanese case illustrated that not only the supervisors' but also the bankers' understanding of systemic risk was necessary for the implementation of supervision because it included a reversal of the formalization process that was in place in the decades before the First

World War.

7. Early development of banking supervision in Sweden

The regulation of commercial banking in Sweden developed from the requirement to obtain royal permission to start and operate a bank. This requirement separated banks from other commercial businesses from the beginning. According to Wetterberg (2009), the first bank in Sweden, Stockholm Banco, obtained royal permission in 1656, but failed after less than a decade, and then after a few years of reconstruction re-emerged as Sveriges Riksbank, the world's oldest central bank, in 1668.

To obtain a bank charter, applicants were required to submit detailed information about the prospective bank including its statutes, its location, its business scheme, its funding, and its owners. The early banking acts of the 19th century gave the County Administration the power to examine a bank on behalf of the king. However, on- and off-site examinations were seldom conducted. Consequently, the main way to monitor a bank and its owners was when a licence application was submitted to the Ministry of Finance, which was responsible for handling these matters. Licences or charters had to be renewed every ten years, which provided an opportunity to evaluate the bank's business and prospects. According to Wendschlag (2012: 23-24), it was rare for a bank not to have its charter renewed.

The regulation of commercial banks was harmonized in incremental steps throughout the 19th century. This harmonization took place on two levels, one being between note-issuing partnership banks with unlimited liability and (from the second half of the century) deposit-based joint-stock banks with limited liability, while the other was between individual banks, whose statutes under the new legal requirements were becoming increasingly alike. As Fritz, Kastner and Larsson (1989) found, the business of banking as it would be conducted for the next century (deposit based) became legally defined with the joint-stock bank act of 1846 and its revisions in 1855, 1864 and 1889.

The banking acts also stated that the king's local representative (the County Administration) was required to ensure that the bank's owners consisted of at least 30 shareholders, all Swedish citizens, and to ensure that the basic fund was fully paid up. In the event of large losses, the County Administration was to order the bank to replenish its capital. The supervision of commercial banks through regular and fairly standardized on- and off-site examinations on a regular basis started in the 1870s, although these activities were reduced during and for some years after the financial crisis of 1878–79. As Boksjö and Lönnborg-Andersson (1994) showed, the financial crisis was caused when many banks were on the brink of failure after funding and/or speculating on the railway boom. Bank acts and chartering requirements formulated the rules of commercial banking, as well as the purposes and duties of supervision. However, on- and off-site examinations remained infrequent, particularly during the financial crises of the 1870s and 1880s (see Table 2).

The supervisory activities were conducted by civil servants from the Ministry of Finance. The Minister of Finance was formally and ultimately responsible to the king for the collection of bank information, the handling of charter applications and the preparation of material for regulatory changes, and the compiling and publishing of monthly bank data, as well as for conducting on-site examinations of the commercial bank offices around the country. The king still granted the bank charters, but generally followed the recommendations provided in the minister's reports.

With the introduction of the 1903 Banking Act, all commercial banks were regulated by the same act for the first time. Most partnership banks with unlimited liability had willingly ended their note issuing and transformed into joint-stock banks with limited liability in the preceding decades. Instead of a business based on note issuing, the new breed of banks used equity capital and deposits as the basis of their operations. This led to increased competition to acquire deposits. Larrson (1993) detailed this deposit-taking competition. Initially, wealthy urban depositors were targeted, but after the biggest commercial banks started to form nationwide branch networks, a broader segment of the public was targeted.

As mentioned earlier, the commercial bank acts from 1846 onward identified the local County Administration as the king's representative responsible for several supervisory activities, mainly to ensure that the chartered banks' basic funds were fully paid up. The Banking Act of 1864 further stated that the County Administration had the right to empower a civil servant to take part in the bank's auditing and correction of any wrongdoing. However, this right was not often exercised, except in connection with the initial chartering of the bank, and the County Administration did not constitute a bank supervisor in the full sense of the term. According to the materials in Söderlund (1976), the civil servants who were sent to visit the banks at the time of audit were rarely experts in banking, bank regulation, bookkeeping or bank examination. In addition, the County Administration lacked all the necessary powers to enforce bank regulation. At best, the County Administration could only send a letter to the Minister of Finance requesting that it undertake its own inspection.

As the number of commercial banks increased, the bank-related work of the Ministry of Finance also increased. In 1868, a civil servant from the Ministry (a Bank Inspector) was assigned to handle bank matters exclusively. The Minister was still responsible for executive decisions, but all the day-to-day work related to the commercial banks was now handled by the Bank Inspector. Although the Bank Inspector at the time did not have the authority to directly sanction any wrongdoing on the part of the banks, he was able to inform the Minister of Finance, who could issue formal correction/compliance demands to the bank's board or management. As the king's representative, the Minister of Finance was also empowered to revoke charters based on the advice of the Bank Inspector.

8. Creation of the Bank Inspection Board and the completion of formalization in Sweden

Overall, the 1890s was a decade of relatively high growth for the Swedish economy, and the number of commercial banks started to increase again, peaking at approximately 80 in the 1900s, while the number of bank offices continued to increase rapidly until the financial crisis of 1920–22 (see Table 2). An important factor in the development of the banking sector was the government's desire for the general population to gain better access to banking services. In addition, 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 improve the production of their own farms or small businesses. Thus, the increase in the numbers of banks and branch offices demanded more resources for the supervision of the commercial banks. In 1889, a small Bank Bureau was created within the Ministry of Finance to concentrate on all matters associated with the commercial banks. According to Wendschlag (2012: 32-33), the Bank Bureau consisted of the Bank Inspector and two assistants, and represented the formal organizational recognition and separation of banking supervision, albeit within the Ministry of Finance.

In 1905, a thorough investigation was conducted to obtain a more general view on the future control of banks. Instead of hiring another Bank Inspector, the investigation report suggested that a new agency should be created with more resources and an executive board. It was suggested that the new agency should be named the Royal Bank Inspection Board (Kungliga Bankinspektionen). This supervisory agency, albeit under the Ministry of Finance, was authorized to conduct on-site examinations of any bank office.

A major banking crisis occurred during the Bank Inspection Board's first year of operation in 1907 as the bank panic in the US spread to Europe and Sweden via falling stock market and real estate prices. However, the crisis did not precede the creation of the Bank Inspection Board, and therefore could not have been a driving force behind this major institutional change. The investigation's proposal was written during 1905 and presented in early 1906, and did not make any reference at all to vulnerabilities or risks in the banking industry and the stock market. The arguments raised by the investigation report for creating a single supervisory agency were mainly concerned with the growth and expansion of the banking sector and the need for the government to ensure that the public trusted the banking system.

According to Wendschlag (2012: 37-39), the new agency consisted of the Bank Inspector, two assistants, one secretary, and two external members of the executive board. The Bank Inspector and the secretary were trained in law, while the assistants who were appointed over the next few decades were people with at least ten years' experience working in banks and other private financial institutions.

The Inspection Board had formal powers to enforce regulatory compliance. It could call upon a bank's board of directors not to execute board decisions or to reverse decisions that were already in force. If corrections were not made, the Inspection Board could issue written reprimands or take other measures including publishing reprimands in the press and calling an extra meeting of the bank's board. If a bank had incurred losses equal to the reserve fund plus ten percent of the basic fund, the Inspection Board had the power to order the bank's board of directors to bring in external accountants to prepare a financial statement without delay. The bank was also required to raise additional capital to avoid liquidation. These powers, together with moral persuasion, were exercised during the banking crisis that occurred in the first year of the agency's existence. As Wendschlag (2012: 41-42) found, the Inspection Board's willingness to apply its enforcement powers established it as a credible supervisor from the beginning.

The creation of the Inspection Board marked the final step in the formalization of banking supervision in Sweden with the introduction of continuous, standardized and legally guided supervisory activities such as examinations. The annual number of on-site examinations of commercial bank offices conducted by the Inspection Board increased dramatically during the first decades of the 20th century (see Table 2) and then stabilized after the financial crisis in the early 1920s. In organizational terms, Swedish banking supervision was formalized stepwise, with the formal title of Bank Inspector as a profession introduced in 1868, the Bank Bureau in 1889 and the creation of the Bank Inspection Board in 1907. Banking regulation was also formalized in steps, starting with the bank-specific charter applications and their gradual replacement with generally recognized and applicable rules for banking formulated in increasingly elaborate banking acts. The process was driven in no small part by the government's positive stance towards the development of banks and the spread of banking services.

9. Comparative analysis

At least three points of similarity can be identified regarding the formalization of banking supervision in Japan and Sweden. First, the main driver of formalization in both countries was not a financial crisis. In Japan, the gradual development of the banking sector and better-educated bankers in the early 20th century provided the background for the positive transformation of the supervisor's role. The major trigger for the introduction of formal banking supervision in Japan was the outbreak of the First World War, which made it necessary to prevent confusion among depositors. In Sweden, the increase in the number of commercial banks and the growing exposure of regular depositors to commercial banks around the turn of the century called for the formalization of banking supervision with sufficient resources in a single agency. Neither the financial crisis in 1878–79 nor the banking crisis in 1907–08 drove the formalization process in Sweden.

Second, neither Japan nor Sweden formalized banking supervision via their central bank. From the time of its establishment in 1882, the Bank of Japan was under the control of the Ministry of Finance (until 1997). Even when the Bank Examination Division was created within the Bank of Japan in 1928, the Bank was not vested with the authority to enforce bank regulation nor to remedy the deficiencies of a problem bank. The only tool the Bank was given was the power to report the results of an on-site examination to the Minister of Finance. In Sweden, the long history of the Riksbank as a commercial bank, as well as being the central bank, appeared to present an obstacle to being empowered for banking supervision. If the Riksbank had conducted on-site examinations of commercial banks, there would definitely have been conflicts of interest between the Riksbank and the examined banks. In the late 19th century, few examples existed whereby the central bank was responsible for bank supervision, nevertheless in Sweden this was not debated at all.

Third, the purpose of formalizing banking supervision was to protect depositors. This similarity relates to the timing of the formalization of banking supervision, namely, the early 20th century. In Japan, the costs of banking supervision such as travel expenses for on-site examinations were basically covered by national 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.[6] In Sweden, the supervision was funded by the banks themselves, who paid annual fees as well as a one-off fee for their charter application. Eventually, the costs of supervision were transferred to

[6] Universal suffrage was introduced in Japan in 1925.

the customers of the commercial banks. Depositors felt that such a scheme was acceptable because banking supervision served to minimize the risk of loss of their deposits as a result of mismanagement.

Conversely, there are two points of difference between Japan and Sweden. The first relates to the independence of the supervisor. In Japan, the bank examination section was created within the Ministry of Finance. Although each bank examiner was expected to have high moral standards, structural vulnerability existed because banking supervision was influenced by fiscal policy. Saito (1996: 122-125) pointed out that this problem occurred in the late 1980s. Even under the bubble economy, the Ministry of Finance did not correct the risk-taking behaviour of commercial banks to maintain economic growth and tax revenues, although the problem was pointed out through on-site bank examinations. In Sweden, on-site examinations were conducted by civil servants from the Ministry of Finance. The low frequency of examinations in the late 19th century was the result of political pressure to promote the widespread development of commercial banking. From 1907 onwards, the expertise of supervisors of regulatory and banking matters appeared to have been insulated from political interference because the Bank Inspection Board did not consist of political appointees.

Second, the path towards formalization was different in the two countries. In Japan, the three dimensions of the formalization process, the legal framework (bank act), the banking supervisor and banking supervisory activities, developed around the same period. In addition to creating the Banking Bureau in 1915, the government recommenced bank examinations on a regular basis. The revised Bank Decree including provisions for bank regulation and supervision was enacted in 1916. At the same time, a specialized bank inspection post was established in the newly created Banking Bureau. In Sweden, banking acts and charter requirements gradually formalized the rules of commercial banking in the second half of the 19th century. Compliance with these rules had long been limited to the application process for a charter, and on- and off-site examinations developed from 1870 onwards, albeit with low frequency. The formalization process was finalized with the creation of an independent inspection agency in 1907 that was empowered to enforce banking regulation.

10. Concluding remarks

The process of formalization of banking supervision, as defined for the purposes of this study, when considering not only the enactment of bank acts but also their enforcement by an empowered enforcer, appears to have evolved in response to the shifting needs of the institutional set-up of the country in question. The growth, modernization and spread of the banking sector required the traditional process of informal supervision of banks to be replaced or complemented by formal institutions and organizations ensuring dedicated bank regulation and supervision. As this study shows, the formalization process basically followed an incremental change approach. In Japan, formalization was largely a form of maturation, including the reversal phenomenon, which fitted with the incremental change approach. In Sweden, formalization occurred more gradually in a stepwise manner, which mostly followed the layering transformation process.

Furthermore, this study found that financial crises were not the main drivers of the formalization of banking supervision. Rather, formalization was a reaction to the development of the banking sector, the maturity of the commercial bankers and the emergence of the general public as customers/depositors. Therefore, the findings of this study suggest that the emergence of large numbers of depositors (customers) as well as the maturity of the commercial bankers, who recognized the cost of bank failure, were the conditions leading to the formalization of banking supervision. Financial crises should be categorized as one of the triggers that introduced/enhanced formalized banking supervision.

These findings are applicable in the field of development economics. Even if a developing country experiences a financial crisis, the timing of the formalization/enhancement of banking supervision should be determined by the aforementioned conditions, namely, whether there is an increasing trend in the number of depositors (customers) and whether the commercial bankers are sufficiently mature to accept (understand) the need for formalized banking supervision. At the same time, the country's history should be carefully considered using the incremental change approach.

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Tables

Table 1. Frequency of on-site bank examinations by the Ministry of Finance in Japan (1915–34)

	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924
Number of exam.	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)	55.6	26.3	30.3	45.5	55.6	333.3	28.6	16.4	28.6	16.9
	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934
Number of exam.	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)	17.9	29.4	71.4	2.7	2.1	9.1	3.8	4.1	2.9	4.2

Source: Hotori (2011: 34).
Note: Frequency means the expected interval between on-site supervisory visits to a bank.

Table 2. Frequency of on-site bank examinations by the Ministry of Finance in Sweden (1870–1910, five-year intervals)

	1870	1875	1880	1885	1890	1895	1900	1905	1910
Number of exam.	8	4	11	3	17	2	n.a.	5	79
Number of banks	27	37	44	44	43	46	66	74	80
Frequency (years)	3.4	9.3	4.0	14.7	2.5	23.0	-	14.8	1.0
Number of branches	100	n.a.	161	156	145	166	269	400	579

Source: Wendschlag (2012: 31, 49, 53).
Note: Frequency means the expected interval between on-site supervisory visits to a bank.

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