Bank supervisory arrangements: International evidence and Indian perspective

Narain, Aditya and Ghosh, Saibal

Reserve Bank of India

2001

Bank supervisory arrangements: International evidence and Indian perspective

Aditya NARAIN and Saibal GHOSH[1]

Abstract

Historically, central banks have had the dual objective of safeguarding monetary and financial stability. Increasingly, over the last two decades or so, concerns about financial stability have gained prominence, reflecting the growing number, breadth and severity of bouts of financial distress. At the same time, the role of central banks in safeguarding financial stability has been evolving. In part, this has resulted from developments in the financial system in the wake of liberalisation and innovation. More recently, some central banks have been divested of their supervisory responsibilities through changes in legislation. Structurally, as the blurring of distinction between different types of institutions (banks, securities firms and insurance companies) continues, there remains the issue of whether single or multiple supervisory authorities should be the norm and whether the central bank should be assigned any supervisory role. In this context, the present chapter seeks to understand the cross-country evidence with regard to regulation and supervision. The purpose of the Chapter is to delineate the extant arrangements of regulation and supervision and whether supervisory authority in respective countries is conducted monopolistically by the central bank or shared with other supervisory authorities. Such an analysis seeks to achieve two broad objectives: (a) whether and to what extent do different countries exhibit different supervisory arrangements and (b) on the basis of available evidence, what broad inferences can be gleaned regarding the synergies between supervision and monetary policy?

Introduction

Historically, central banks have had the dual objective of safeguarding monetary and financial stability. Increasingly, over the last two decades or so, concerns about financial stability have gained prominence, reflecting the growing number, breadth and severity of bouts of financial distress (Goldstein *et al*., 2000). At the same time, the role of central banks in safeguarding financial stability has been evolving. In part, this has resulted from developments in the financial system in the wake of liberalisation and innovation. More recently, some central banks have been divested of their supervisory responsibilities through changes in legislation. Structurally, as the blurring of distinction between different types of institutions (banks, securities firms and insurance companies) continues, there remains the issue of whether single or multiple supervisory authorities should be the norm and whether the central bank should be assigned any supervisory role.

In this context, before an examination of the Indian evidence with regard to the present arrangements of regulation and supervision, the present article seeks to understand the cross-country evidence with regard to regulation and supervision. The purpose of the chapter is to delineate the extant arrangements of regulation and supervision and whether supervisory authority in respective countries is conducted monopolistically by the central bank or shared with other supervisory authorities. Such an analysis seeks to achieve two broad objectives: (a) whether and to what extent do different countries exhibit

[1] General Manager, Department of Banking Supervision, Central Office, Reserve Bank of India, Cuffe Parade, Mumbai and Research Officer, Department of Economic Analysis and Policy, Central Office, Reserve Bank of India, Cuffe Parade, Mumbai. The views expressed in the paper are strictly personal.

different supervisory arrangements and (b) on the basis of available evidence, what broad inferences can be gleaned regarding the synergies between supervision and monetary policy?

2. Framework of analysis

Financial stability can be safeguarded by appropriate action at both micro and macro levels. The micro dimension consists of three building blocks: *institutions, markets and infrastructure*, of which *payment and settlement systems* are the element closest to central banks. The macro dimension relates to *interest rates, asset prices and aggregate size of the balance sheet*. The authorities can safeguard each of the three building blocks in three ways: by developing, implementing and sanctioning non-compliance with norms of behaviour (*regulation*), by monitoring the norms (*supervision*) and by providing insurance (*emergency liquidity support, depositor protection*). Regulation yields *direct influence* on behaviour, supervision provides *information* while insurance provides *protection*. For central banks, the macroeconomic lever is the formulation and implementation of monetary policy. At the same time, insurance and though often neglected, prudential controls have macroeconomic implications as well.

In recent years, much attention has been devoted to understanding what should be the appropriate norms for the micro blocks; examples include the debate on capital standards or the balance between constraints on balance sheet and disclosure. Yet equally significant question relates to the extent to which different competencies for stability should be combined or kept separate across institutions (central banks, supervisory agencies, Governments, etc). The import of the issue stems from two important reasons. First, instability in one component of the financial system almost invariably spills onto the others. The failure of institutions typically causes problems for both markets and infrastructure. Conversely, markets and infrastructure are the key channels of transmission of strains across institutions. An over-extension in aggregate balance sheets and asset prices often lie at the root of generalised financial disturbances, as illustrated by the experiences of East Asian economies. Second, and for much the same reasons, there is a degree of complementarity between the competencies for stability of the various segments. For example, views differ on whether it is possible to reconcile responsibility for the safety of the settlement systems without information about, and some control over, the soundness of participants. Ultimately, this is what lies beyond the problem of defining concretely an overall responsibility for financial stability that excludes a responsibility for individual institutions.

A schematic overview of the objectives of supervision and their degree of importance is given in Table 1.

Table 1: Objectives of Supervision

Type of Business/ Objectives of Supervision	Banking	Securities	Insurance
1. Systemic Risk	**	**	*
2. Prudential (Solvency Control)	**	*	**
3. Consumer Protection/ Conduct of Business	Retail ** Wholesale *	Retail ** Wholesale $	**

Note: ** Very Important; * Important; $ Not clear

It is possible to distinguish three broad categories of financial regulation and supervision: systemic, prudential and conduct of business.

Systemic supervision takes a broader view of the economy than merely the undertakings of individual institutions. Such supervision is focused on the health and ability of financial systems to withstand shocks, with special regard to the likely impact of financial disturbances on the economy as a whole. In practice, this area of supervision is essentially the domain of central banks, given their knowledge of the macro-economy, financial markets and payment systems and their ability to assist in managing threats to systemic stability.

Prudential supervision, on the other hand, examines the health of individual financial institutions. In other words, such supervision places explicit emphasis on analysing the balance sheet of individual institutions, especially with regard to their compliance of certain broad parameters (e.g., capital adequacy, asset classification and provisioning norms, credit concentration norms, etc) as laid down by the regulatory authorities. The aims of prudential supervision can be seen as both consumer protection and reducing the threat of spill-over effects on the larger economy. The latter concern is especially relevant for the larger financial institutions.

The final type relates to the *conduct of business regulation*. In other words, it seeks to examine how financial firms carry out business with their customers. It is focused more on aspects of consumer protection, such as information disclosure, honesty, integrity and fair business practices. Conduct of business regulation sets rules and guidelines as to appropriate behaviour and business practices when dealing with customers.

3. Cross-Country Evidence

It is instructive to examine, in this context, the cross-country evidence of regulation and supervision of banks in different economies. Recently, several studies have documented the role and degree of involvement of the central bank in regulation and supervision (Tuya and Zamolla, 1994; Goodhart, 1995a 1995b; Goodhart, 1998a, 1998b; Goodhart and Schoenmaker, 1998, Goodhart *et al*., 1998). It is instructive to look into these experiences. Without being unduly exhaustive, a set of countries sufficiently representative across continents in terms of supervisory responsibility has been considered, taking into account the information availability and the data set for the empirical exercise that is to follow.

In developed economies, there is a general tendency among central banks to retreat from supervisory function (Briault, 1999). This was exemplified recently in the UK by the breakaway of the supervisory functions from the Bank of England in May 1997 and the establishment of the Financial Services Authority (FSA), a mega financial supervisory authority. Several reasons have been advanced for this trend. First, banking is becoming increasingly complex business and less clearly defined. Leading banks are active in several jurisdictions as providers of a gamut of financial services. Linked to this are new developments in financial supervision, which increasingly stresses the role of self-regulation and internal risk management in financial institutions. Finally, there is growing acceptance that bank failures are increasingly becoming expensive, going beyond the sums that banks can provide from its own resources. This was demonstrated earlier in the decade by Nordic countries (Sweden and Norway), in certain European countries (Denmark and France) and in some Asian economies (Japan and Korea).

In developing countries, the central bank is primarily responsible for the regulation and supervision of deposit-taking institutions, and in several cases, several other financial intermediaries as well (India, Malaysia, Malawi, Sri Lanka and Uganda). Only three central banks (Peru, Mexico and Chile) do not perform the primary prudential regulator and supervisor role. Peru, for instance, assign the narrowest financial stability role to its central bank: it has no direct responsibilities for the development or implementation of the regulatory or supervisory environment (Sinclair, 2000). The Chilean banking system has certain powers specified in the law and retains responsibility for the regulation and supervision of the foreign exchange market under the *Central Bank Organic Law*. The central bank might give its views to the supervisor on new entrants and closures, with respect to the stability of the financial system. In other countries, the central bank has expanded its supervisory role as new financial intermediaries have developed. Broadening the central bank's supervisory role beyond banks has enabled countries to respond to gradual changes in the financial sector without incurring the costs of a review and the implementation of a change in institutional responsibilities (Table 2).

Table 2: Studies on Central Bank Involvement in Supervision

Author/Year	Country/ Period	Issue
Hawkesby (2000)	--	Combining bank supervision and monetary policy
Courtis (1999)	Developed and developing	How countries supervise their banks, insurance and securities markets
Di Noia and Di Giorgio (1999)	Developed and developing	Should banking supervision and monetary policy be vested to different agencies
Peek, Rosengren and Tootell (1999)	US banks	Synergies involved in retaining bank supervision with central bank
Barth, Nolle, Phumiwasana and Yago (2002)	Cross-country	Analysis of bank supervisory framework and performance

4. Mega-financial Supervisor *versus* Specialist Supervisor

Another issue of attention is whether financial supervision should be assigned to one entity or should be determined by the type of business of the institution under supervision. The case for the former, at first sight, seems attractive, more so if the successful functioning of the FSA is taken into account. It presupposes that there are economies of scale (and probably economies of scope)[2] in supervision, as well as certain practical advantages. There is 'one-stop shopping' for authorizations for conglomerate financial groups. Expertise is pooled and cooperation between different functional supervisors guaranteed. A single authority could also lead to lower supervisory fees, at least in economies where the financial sector

[2] Economies of scale imply that higher output levels can be sustained at lower average costs. Economies of scope extend the notion of the relationship between size and costs to multi-product firms (a larger size and range of operations permits finer specialization of labour and a more intensive utilization of inputs).

contributes directly to the cost of supervision. Among the 40 countries surveyed, 6 have a 'mega regulator'[3] (combined regulator for banking, insurance and securities), whereas several countries have a supervisory structure where banking, insurance and securities (2 out of the three) are under a single umbrella, while the remaining is under a specialist supervisor (see, Briault, 1999 for a discussion of the UK experience).

The differences in risk profiles and in the nature of businesses remain an important argument against a mega-supervisor, most importantly for banking as compared to insurance business. In fact, the case for efficiency of mega-regulator is not well-established (Goodhart *et al.*, 1998). A mega-authority could quickly become a collection of separate divisions. Moreover, it could be a very powerful entity and increase moral hazard (reduce the incentive for institutions to prudently manage their business). The public perception might be that the while financial sector is under control, and the loss of confidence arising from the failure of one institution could be even larger (Table 3).

Table 3: The Case for Specialist versus Multiple Supervisors

A Mega-Supervisor	Specialist Supervisor
One stop shopping for authorizations	More effective and easier to manage
Pooling of expertise and economies of scale	Clearly defined mandates
Lower supervisory fees	More adapted to the differences in risk profiles and nature of the respective financial business
Adapted to evolution in financial sector towards financial conglomerates	Better knowledge of the business
Cooperation between type of financial business guaranteed	Stimulates inter-agency competition
Limited regulatory arbitrage	
Greater transparency	

What does evidence point out in this regard? In order to understand the institutional separation of two of the major functions of central banks (monetary policy and supervision), we conduct a simple test towards understanding whether independent central banks are better in attaining the goal of price stability *vis-à-vis* ones which are not. Towards this end, we classify central banks into four classes: monopolist in supervision and independent, monopolist in supervision and non-independent, non-monopolist in supervision and independent and non-monopolist in supervision and non-independent). In matrix format, this can be represented as in Table 4.

Table 4: Matrix of Supervisory and Monetary Control of Central Banks
(selected countries)

Supervision-> / Monetary Policy↓	Monopolist	Non Monopolist
Independent	Poland, Israel	Austria, Mexico
Non Independent	Iceland, Egypt	Thailand, UK

In general, financial supervision could be carried out by one agency for systemic stability, a second for prudential supervision and a third for consumer protection and conduct-of-business considerations. Conduct-of-business supervision looks after transparency, disclosure, fair and honest practices and equality of market participants. The 'stability' agency concentrates on systemic issues, the

[3] These include, Austria, Denmark, Iceland, Japan, South Korea, Norway, Sweden and UK.

prudential agency controls the solvency and soundness of institutions and enforces depositor protection. Such a structure obtains in Australia, wherein Australian Prudential Regulatory Authority (APRA) supervises financial institutions on prudential grounds, the Reserve Bank of Australia looks after systemic stability and provides liquidity assistance and the Australian Securities and Investment Commission (ASIC) controls market integrity and conduct-of-business rules. Some EU countries have elements of objective driven supervision. In Italy, for example, the *Banca d'Italia* is in charge of controlling financial institutions on financial stability and prudential ground, the CONSOB enforces conduct of business rules for the banking and securities industry.

5. Indian Perspective

There are several agencies entrusted with the task of regulation and supervision of the different institutions and market participants in the financial sector. The three main regulators are the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA), which are the supervisory agencies for the banking, securities market and the insurance sector, respectively. While their specific objective may vary from depositor/investor/consumer protection to market regulation, their broad concern remains that of maintaining the soundness of the financial system. This structure is not unique to India, and most other countries have different agencies for supervising the securities, insurance and banking sectors (Table 5). As Abrams and Taylor (2000) observe, 'the combination of banking and securities regulation is most clearly appropriate where the system comprises universal banks. In countries where banks are not significant players in the securities markets, the case for a combination of function is much less strong. Similarly, the combination of banking and insurance regulation is most appropriate where linkages between banks and insurance companies are particularly significant. Combining the regulation of all three sectors within a single agency will, therefore, be most appropriate when the financial services industry of the country comprises of a number of diversified, multi-activity groups or where the distinctions between different types of financial intermediaries have become blurred'.

Table 5: Regulatory Structure in Selected Countries

Separate agencies for each main sector	35
Combined securities and insurance regulators	3
Combined banking and securities regulators	9
Combined banking and insurance regulators	13
Unified supervision (in central bank)	3
Unified supervision (outside central bank)	10

Source: Abrams and Taylor (2000). Sample 73 countries.

Historically, the Reserve Bank has been the major oversight agency in the financial system and it regulates and supervises the major institutions and markets through its various departments and affiliated/owned institutions. The supervised institutions include commercial banks, non-banking finance companies, all-India financial institutions, urban co-operative banks and local area banks. The Government debt markets and the Primary Dealers in the securities and the foreign exchange markets and the Authorised Dealers in foreign exchange are also covered by the supervisory oversight of the RBI. In addition, the regional rural banks (RRBs) are regulated by RBI, though their supervision has been relegated to NABARD, an institution owned jointly by RBI and Government. In turn, NABARD supervises the other co-operative banks (central and state) in the rural sector. In all cases where co-operatives are involved, the oversight responsibilities are shared between the RBI / NABARD and the Registrar of Co-operative Societies (RCS). The National Housing Bank (NHB), a subsidiary of the RBI, regulates and supervises the functioning of Housing Finance Companies. RBI also has nominees on the Boards of State Financial Corporations, which are supervised by IDBI (a function being transferred to SIDBI). Interestingly, as part of its supervision over the financial institutions, RBI is the supervising agency for NABARD, NHB and IDBI/SIDBI. DICGC, an associate institution of RBI, also exercises limited oversight responsibility over the insured institutions.

The other major regulator in the financial system is the Securities and Exchange Board of India (SEBI) and it supervises the capital market institutions – the stock exchanges, mutual funds and other asset management companies, securities dealers and brokers, merchant bankers, rating agencies and collective investment schemes. The involvement of the RBI capital market segment is limited to a position on the Board of SEBI.

With the opening of the insurance sector and the expectation of an increasing number of private players entering this sector, the role of the Insurance Regulatory and Development Authority (IRDA) as a insurance sector regulator is expected to gain prominence in coming years

In addition to the above, various agencies /departments of the Government play a role in the regulation of the financial sector. Illustratively, the Registrars of Co-operatives of different states jointly regulate the banks in the co-operative sector, both urban and rural. For multi-state institutions, the Central ROC under the Ministry of Agriculture is the main regulator. While RBI/NABARD are concerned with the banking function performed by them, the management control rests with the State / Central Governments. This dual control over institutions in this sector impacts the supervision process by both RBI and NABARD. Given the sheer number of institutions in this sector, co-ordination with RCS continues to be important to resolve operational issues. The Department of Company Affairs (DCA) of the Central Government regulates the deposit-taking activities of non-banking non-financial companies and also certain aspects of activities of some non-bank financial companies.

As early as 1991, the Committee on the Financial System (Chairman: Shri M.Narasimham) had recommended that *'the duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for the regulation of the banking system'* (pp.130). In line with the recommendations of the Committee, the supervisory function of banks (and other financial institutions) was hived off to a separate authority as an autonomous body under the aegis of the Reserve Bank. In pursuance of the same, the Board for Financial Supervision (BFS) was constituted in 1994 as a Committee of the Central Board of Directors of the Reserve Bank to pay 'undivided attention to supervision', with the Governor of the Reserve Bank as the Chairman and four non-official Directors of the Reserve Bank and the Deputy Governors of the Reserve Bank as members[4]. Operational support was provided by the erstwhile Department of Supervision which was subsequently bifurcated into Department of Banking Supervision and Department of Non-Banking Supervision to cater to the supervision of banks (and financial institutions) and non-banking financial institutions, respectively. The BFS, in effect, integrates within the Reserve Bank the supervision of banks, non-banks and financial institutions, which comprise the bulk of financial sector assets. Apart from enabling the provision of a uniform policy perspective to the regulation of these institutions, this arrangement also exploits the synergies arising out of the supervision of these institutions. This has resulted in similar prudential supervision being applied to non-banking sector, particularly those accepting/holding public deposits. This was also deemed as relevant in the long-run for the AIFIs, which, as envisaged in the *Discussion Paper*, would eventually convert themselves either into banks or NBFCs.

Subsequently, in 1998, Report of the Working Group for Harmonising the Role and Operations of DFIs and Banks (Chairman: Shri S.H.Khan) proposed the concept of a 'super-regulator'. The Group advocated two alternative approaches towards regulation. First, in view of the increasing overlap in functions being performed by various participants in the financial system, the Group felt that it would be desirable to have a measure of co-ordination among regulators, in order to equalize the 'net regulatory burden' (the difference between the benefits and costs of regulation). This would seek to ensure that no intermediary is relatively disadvantaged in performing an identical function *vis-à-vis* other intermediaries, because of the high level of net regulatory burden on it. Alternately, *the Group recommended the establishment of a 'Super Regulator' to supervise and co-ordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment* (pp.65).

The *Discussion Paper* released by the Reserve Bank in January 1999 observed that the question of whether the supervisory responsibility should lie solely with the Board for Financial Supervision or with separate supervisory system to be devised for the purpose, would need to be considered in due course. The view was also reinforced in a Discussion Paper on Corporate Governance, which emphasized that financial institutions should be brought fully under the regulatory and supervisory ambit of the Reserve Bank and suitable norms/tools needs to be devised for regulation/supervision of these institutions, consistent with the nature of their operations. However, the efficacy of the common supervisory mechanism would not only require strengthening the internal controls and ease of monitoring based on a few identifiable parameters, but also necessitate stricter auditing and disclosure standards.

Several issues need to be considered in this regard. First, the structure of the banking industry in India comprises of commercial banks and co-operative banks. The distribution of financial assets among different intermediaries reveal that banks remain by far the most dominant in terms of their financial assets. As at end-March 2000, banks remain the most dominant with nearly 62 per cent of financial assets, followed by investment institutions (18.6 per cent), term-lending institutions (15.1 per cent) and co-

[4] The BFS exercises integrated supervision of banks and co-ordinated supervision with other regulators.

operative banks (2.6 per cent)[5]. In view of the overwhelming dominance of banks in the financial system, supervision of banks needs to be attached utmost importance.

Second, there are some other supervisory agencies in the financial sector which are closely linked to the Reserve Bank *viz*., NABARD has been relegated the function of supervising RRBs and the co-operative institutions in the rural sector. This overlap of supervisory authority creates problems of regulatory gaps and overlaps, which often lead to differential net regulatory burden for financial institutions offering similar services and/or products.

Third, the asset structure of co-operative banks is distinctly different from that of commercial banks. Apart from the different regulatory authorities involved in their supervision/inspection, the sheer numbers[6] and their dispersed and local character (with a different niche clientele) can affect the regular programming of inspections by supervisors, given that the supervisory resources are limited. In view of the above, supervision of UCBs often proves to be a challenging proposition for the Reserve Bank, so that it might prove worthwhile integrating the supervision of co-operative banks under one umbrella. In this context, the Monetary and Credit Policy of April 2001 has emphasized the creation of a separate apex supervisory authority which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs, with manpower and other assistance to the new supervisory body, when created.

Fourth, another major issue involved in the setting up of a separate body is that of culture and funding. Supervision is a costly exercise and with growing sophistication and inter-linkages across markets and institutions, requires increasingly sophisticated skills and tools. In India at present, supervision has access to deep pockets of the Reserve Bank. In the event that the budgetary support is provided by the Government, then it might be akin to a department of the Government and subject to political economy considerations, possibly with independence being compromised. The independence of supervision function is often a *sine qua non* and has been reiterated by the Basel Committee for Banking Supervision (BCBS).

Fifth, the re-ordering of relationship between Government as principal/owner and banks as agents, through legislative changes or otherwise, would influence the future direction of reforms. In view of the conflicting objectives involved in the central bank being both the owner as well as the regulator of several institutions, the Monetary and Credit Policy of April 2001 emphasized that the ownership of financing institutions could ideally be de-linked from the Reserve Bank through transfer of ownership to the Government. It also stated that the Reserve Bank has accepted the recommendation from transfer of ownership of its shares in State Bank of India, National Housing Bank and the NABARD to the Central Government and was in touch with the Government in this regard.

It seems that the Board for Financial Supervision (BFS) model is best suited and its role could be expanded in future to include oversight of other markets /institutions being supervised by the Reserve Bank

[5]Investment institutions comprise of UTI, LIC and GIC and its subsidiaries. Term-lending institutions comprise of IDBI, NABARD, ICICI, IFCI, EXIM Bank, IIBI, NHB and IDFC. The aggregate assets of NBFCs and RNBCs as at end-March 1999 comprised roughly 5 per cent of the assets of SCBs.

[6] There are as many as 2,084 UCBs, of which 51 are scheduled UCBs and the rest are non-scheduled.

and its allied bodies. With the major disturbances in the financial markets in the past decade having been linked to the penetration of firewalls between banks and the capital markets, and given the entry of banks and the emergence of NBFCs as major players in the insurance business, the co-ordination mechanism among various supervisory institutions like the SEBI and IRDA would need to be strengthened. Mention may be made in this context that the Narasimham Committee-II had also recommended that the since the functions of regulation and supervision are organically linked, BFS should be renamed as Board for Financial Regulation and Supervision (BFRS), in order to institutionalise both the regulation and supervision function it should perform. The moot issue then remains is whether the supervisory framework should evolve towards integrated supervision with a segregation of supervision from central banking, or towards coordinated supervision with a structured forum for sharing of information and joint action, wherever required. The concept of super-regulator (integrated supervision) is viewed as more relevant where markets are fully integrated. For all practical purposes, in emerging market economies, where markets tend to be segmented and the transmission of monetary policy is not uniform across markets, co-ordinated supervision is viewed as a more workable alternative.

6. Tenets of supervisory co-ordination

This brings us to the final issue: what can be the basic tenets of supervisory co-ordination? As discussed earlier, given the liberalisation of national financial markets, technological innovation and the removal of legal and trade barriers, institutions have become more complex. With the opening up of the insurance sector and the entry of banks and NBFCs into the insurance business, financial structures are expected to become increasingly diversified with complex management and corporate setup. The rapid evolution of such diversified financial conglomerates which offer a comprehensive range of financial services, including banking, securities and insurance services on a global basis as well, presents significant challenges to supervisors, with their field responsibility being determined solely by national legislation. Given the growing inter-linkages between the institutions in the financial sector, either through common markets or products, an appropriate framework for coordination between domestic and international supervisors would need to address both information sharing and joint action, in both normal and emergency situations. These arrangements can be built around formal MoUs or informal exchanges of letters in case of bilateral coordination, such as with overseas supervisors. In a scenario where several regulators are involved, a forum which provides for regular interaction built around structured agenda might prove to be a more efficient solution. Communication and trust among supervisors therefore becomes the *sine qua non* of co-operation.

Recognising the relevance of supervisory coordination in a world where multiple agency regulation is the norm, the Joint Forum on Financial Conglomerate, which has been set up by the BCBS, International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO), has examined ways to enhance supervisory coordination and suggested several principles on which information sharing and coordination can be based. Although intended for the different supervisors of the regulated firms in the financial conglomerate, these can be equally applied to coordination amongst all the regulators in the financial sector.

This would call for one of the supervisors to be designated as 'the coordinator' to facilitate information sharing efforts in a timely and efficient manner. In the case of financial conglomerates, it is normally the supervisor of the parent entity or dominant entity in terms of either balance sheet size or criticality, which is designated as primary supervisor. In the case of a college of domestic regulators, it could similarly be the supervisor who takes primary responsibility for supervising the segment of the financial system or the supervisor that carries out consolidated supervision who takes on the responsibility of maintaining the arrangements for coordination.

The arrangements for information sharing between the coordinator and other supervisors and for any other form of coordination in emergency and non-emergency situations would need to be decided in advance, in order to avoid any delay or information asymmetries that might arise during the period. Such arrangements should specify the tasks to be performed by the coordinator in terms of information gathering from regulated entities, unregulated entities (where permitted by law) and from the various supervisors involved or a combination of those sources. Arrangements made in advance may require certain modifications to take into account the unique properties of the emergency.

7. Concluding observations

The present chapter has attempted to assess the validity of having a unified regulator for the banking sector, keeping the Indian realities in mind. The balance of evidence is a pointer to the fact that the benefits of internalizing the externalities by retaining supervision with the central bank tend to outweigh that, if otherwise. If the evidence of the most respected central banks in the world, the Federal Reserve, is anything to go by, then this should perforce be the case. It is instructive in this context to reminisce the observations by Goodhart (2000):

> I doubt .whether the pressures to establish a unified, supervisory agency are quite strong in most developing countries. The financial system is less complex, and dividing lines less blurred. Commercial banks remain the key players. Moreover, the central bank in most developing countries is relatively well-placed for funding, is a center of technical excellence, and can maintain greater independence from the lobbying of commercial and political interests on behalf of certain favoured institutions. If the supervisory agency is placed under the aegis of the central bank, it should share in these benefits of better funding, technical skills and independence. There are too many cases of supervisory bodies, outside central banks, failing in such respects. For such reasons, I do not believe that the case for separation, which has become stronger in developed countries, should be transposed also to developing countries.

References

Abrams, R.K., and M.W.Taylor (2000), 'Issues in the Unification of Financial Sector Supervision', *IMF Working Paper* No. 213. IMF: Washington DC.

Barth, J., D.Noelle, T.Phumiwasana and G.Yago (2002), 'A Cross-Country Analysis of Bank Supervisory Framework and Bank Performance', Working Paper No.2, Office of the Comptroller of Currency, USA.

Briault, C (1999), ‘The Case for a Single National Financial Services Regulator’, *FSA Occasional Paper* No.2, FSA, London.

Courtis, N (1999), *How Countries Supervise Their Banks, Insurance and Securities Markets*, Central Banking Publications: London.

Di Noia, C and G.Di Giorgio (2000), ‘Should Banking Supervsion and Monetary Policy Tasks be Given to Different Agencies?’, Working Paper No.11, Financial Institutions Centre, The Wharton School.

Goldstein, M., G.Kaminsky and C.M.Reinhart (2000), *Assessing Financial Vulnerability: An Early Warning System for Emerging Markets*, Institute for International Economics: Washington.

Goodhart (1995a), ‘Why Do Banks Need a Central Bank? Should Regulation and Supervision be Separated?’ *Oxford Economic Papers*, 22, 33-48.

Goodhart, C. (1995b), ‘Should the Functions of Monetary Policy and Banking Supervision Be Separated?’ *Oxford Economic Papers*, 539-560.

Goodhart, C (1998a), ‘Financial Globalisation, Derivatives, Volatility and the Challenge for the Policies of Central Banks’, in C.Goodhart (ed.) *The Emerging Framework of Financial Regulation*, Central Banking Publications Ltd., U.K.

Goodhart, C (1998b), ‘Some Regulatory Concerns’, in C.Goodhart (ed.) *The Emerging Framework of Financial Regulation*, Central Banking Publications Ltd., U.K.

Goodhart, C. (2000), 'Whither Central Banking', *11 th C.D.Deshmukh Memorial Lecture*, Reserve Bank of India: Mumbai.

Goodhart, C., and D.Schoenmaker (1998), ‘Institutional Separation Between Supervisory and Monetary Agencies’, in C.Goodhart (*ed.) The Emerging Framework for Financial Regulation*, Central Banking Publications: London.

Goodhart, C., P.Hartmann, D.Llewellyn, L.Rjoas-Suarez and S.Weisbrod (1998), '*Financial Regulation: Why, How and Where Now?*' Routledge, London.

Government of India (1991). *Report of the Committee on Financial Systems* (Chairman: Shri M.Narasimham), Government of India: New Delhi.

Hawkesby, C. (2000), ‘Central Banks and Supervisors: The Question of Institutional Structure and Responsibility’, *Paper presented at the Workshop on Central Bank Responsibility for Financial Stability*, Centre for Central Banking Studies, Bank of England, London.

Peek, J., E.Rosengren and G.M.B.Tootell (1999), 'Is Bank Supervision Central to Central Banking?' *Quarterly Journal of Economics*, 74, 629-653.

Reserve Bank of India (1998), *Report of the Working Group on Harmonisation of the Role of DFIs and Banks* (Chairman: Shri S.H.Khan), RBI: Mumbai.

Tuya, I and L.Zamolla (1994), 'Issues in Placing Banking Supervision in the Central Bank', in T.J.Balino and C.Cottarelli (*eds.*) *Frameworks for Monetary Stability*, IMF : Washington.