

# The “regime context” of banking supervisors’ competence

## - The Swedish case over the 20<sup>th</sup> century -

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### **Abstract:**

The quality of banking supervision is generally recognized to depend on the quality of the banking supervisors. In this paper the Swedish banking supervisor, the Bank Inspection Board’s, aggregate human capital (education and different types of work experience) is analyzed over a long period, and related to the financial environment and events that shaped Swedish the 20<sup>th</sup> century. The study finds that the human capital mix, (that is, work experience from supervision, private sector *and* the public sector), of the supervisor was relatively well balanced around the banking crises of 1907-8 and in 1932. In the financial crisis of the 1920s, the staff had too little in-house experience, while in the 1990s crisis it seems that the supervisor had too much in-house experience (and too little experience from the banking sector). The paper further discusses how the supervisor’s human capital composition is related to the overall financial regulatory regime, which ultimately defines the role of the banking supervisor. The strict regulatory regime from World War 2 until the mid 1980s was enforced by the Swedish central bank and de facto became supervisor of the banks during this regime. This seems to explain the ‘deterioration’ of the competence of the still de jure supervisor, the Bank Inspection Board, during this period and its ill preparedness when the strict regime was transformed to a market based regime.

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## Introduction

Banking supervision is conducted under clear organizational and regulatory constraints, and under a constant asymmetric information problem relative the supervised companies. The most important resource of the supervisor under these constraints is its staff, and it is reasonable to assume that, the specificities of the formal institutional setting notwithstanding, the human capital of the banking supervisor to a large extent determines the quality of the supervision and in extension the effectiveness of the banking regulation. To learn the profession of banking supervision however takes time, on the job, although academic education in relevant fields can make for good preparation. However, just experience from working in a banking supervisory agency is not enough. Under free market conditions, the banking sector is very dynamic, prone to innovation, changes in organizational structures and of business models. These characteristics pose clear challenges to the supervisors in maintaining awareness and understanding of these market dynamics. If the banking market is not understood, it is difficult to appropriately enforce its regulation.

Simultaneously, the supervisor, as the main implementer and enforcer of banking regulation, must be ready and able to engage in the regulatory process and call for regulatory reforms that it sees as appropriate. But the supervisor is only one stakeholder in the regulatory process, and must obtain and attain the right human and social capital to successfully engage in this process. In other words, the 'right' competence of banking supervisors is actually a mix of different types of human and social capital; (1) appropriate higher education, and (2) experience of banking supervision, of banking, and of the regulatory process.

However, it is important to also note that the context in which the education and work experience has been gained is crucial to assess its worth in terms of the functioning of the banking supervision. In essence, human and social capital is here assumed to be of relative value, depending on the environment. As the

Swedish case will indicate, the human capital may be well suited for one particular context, but then become obsolete if the context of the supervisor changes. The context of relevance here is the overall financial regulatory regime. The reasoning thus goes along the lines; a long work experience gained in one financial regulatory regime becomes less valuable if this regime transforms into another. In the new regime, different skills, education and forms of social capital might be required.

Financial crises are also crucial events that charge supervisors with valuable experiences. In studies of financial crisis the idea has been put forward that learning from a past crisis may lower risk of, or impact of, a future crisis, (see for example Kokko & Suzuki, 2009; and Bayram, 2014). This learning may take the form of institutional and organizational reform, but also adds to the experience of individuals of and within this institutional set-up. There may thus be a significant difference between supervisory staff with experience from working during a financial or banking crisis and those that has not had that experience.

In this article an assessment of the competence of the Swedish Bank Inspection Board between 1910 and 1990 is made based on data on the agency staff's work experience and academic education. Sweden's long history of formal financial supervision makes it a good case for the study of banking supervisors' competence in the long perspective. Unlike in many countries, records of the supervisory staff have been accessible, and nearly complete, for the whole period. Its organization as a single independent agency, and never being part of the Swedish Riksbank, has also enabled a clear focus on the banking supervision staff per se. Lastly, the paper benefits from the body of research on the financial history of Sweden, of which several studies includes accounts of the regulatory regimes that here are believed to be the most important contextual factors to assess the banking supervisor's competence, i.e. the right human capital for the right regime.

## The human and social capital in financial history

The literature on financial history includes many studies of the human and social capital in banking. For example, several contributors in Cassis (ed., 2002) deal with the characteristics of the banking elite and how the human and social capital changed over time. This history provides an interesting contrast to the story of the public sector side of banking (central bankers and supervisors for example). In commercial banking the importance of family ties appears to have remained highly relevant to reach this elite well into the 20<sup>th</sup> century, although the larger scale of joint stock banking permitted, and required, recruitments outside historically established banking families. A higher education, especially in law, combined with apprenticeships and long faithful in-house service, became the norm after the relative demise of private banking in the late 19<sup>th</sup> century, although less so in countries like the UK, and more in countries like Germany. Social pedigree was of some importance in the central banks too, but history does not contain many examples of family central banks of course. Berghoff & Köhler, (2007), study the human and social capital of the German banking elite between 1870-1990, and their study support the long term trend of the studies mentioned above. Interestingly, they conclude that the globalization of banking and finance from the 1970s and 1980s appears to have called for new forms of human and social capital, such as international work experience, language, and academic training in economics, mathematics and IT. This may very well have hit the public sector side of banking as well, although at least in the Swedish case they were far slower to react than many of the commercial banks.

In Green, et al., (2008), bankers are studied as founders, entrepreneurs, managers and owners. In part the volume is motivated to show that banking is far from being “a cold and impersonal discipline”(p.13) as it often portrayed in banking literature, and that the human factor is important to understand in order to understand banking and financial history. Importantly, the contributing authors emphasize the importance of the banking workforce below and/or around the ‘big personalities’. Single leading individuals can indeed have a great impact over specific events or processes of historical significance, but so can

individuals in aggregate of an organization such as a bank, or a banking supervisory agency for that matter. The present study benefits from a near complete staff record for the period 1907-1991 which enables taking this aggregate approach, while at the same time look the 'elite' of the Swedish banking supervision with a bit more detail.

## **The human and social capital of banking supervisors**

The human and social capital in financial history has been the subject of quite a large number of studies, although very few have concerned banking supervisors. In their respective accounts of the history of the Office of the Comptroller of the Currency, Robertson (1963), and White (1992), provides some interesting descriptions of the staffing, organization and leadership of the agency. We learn that the problems of recruiting and attaining skilled staff while not being permitted or able to match the wages of the bankers supervised was evident from the very start of the OCC in 1863. The Swedish Bank Inspection Board, (from now on, the Inspection) too raised its concern about recruiting and keeping skilled staff more than a hundred years ago. When the Inspection was created in 1906, the agency requested that the salaries of the staff were set high enough to: (1) be at least equal to the salary of the highest ranking bank staff that the bank supervisor might encounter; and (2), ensure that the bank supervisor would not be too tempted to take a job in one of the banks. Experience was also identified as key. The head of the agency estimated that it took at least a few years for an employee to become a good supervisor. For the agency to meet its objective, he argued for high wages for his staff so that they would stay at least a few years in order to reap the benefits of the first years' of training and accumulation of practical experience, (Betänkande bankkontrollen, 1905; SFS 1906:104).

Outside the financial history literature, the human capital of financial supervisors has been studied in several studies and identified as an important factor for the quality of banking supervision. In discussing important factors on supervisory quality Goodhart, (2000), stress the importance of the quality of

supervisory staff (other being institutional independence, placement of supervision inside or outside the central bank, and other legal system characteristics). The quality of supervisors is generally believed to be largely a product of experience from working as a banking supervisor, other work experiences, and of relevant higher education. According to Folkerts-Lindau & Lindgren (1998, p. 42) bank supervision competence “can only be earned over time” by working as a supervisor. The professional work experience and education figure in most, or all, studies concerned with the competence of banking supervisors, (such as Goodhart et al., 2001; Barth et al., 2006; Jackson, 2010).

The importance of work experience from the financial sector that is supervised has been emphasized in some studies with the argument that such experience provides deeper knowledge of the business of banking itself, (for example Goodhart et al., 2001). Another argument could be the social capital gained from such experience that may benefit the banking supervision. A former banker becoming a supervisor may have what Putnam (1995) calls “bridging social capital” which enables connections between different groups. A banking supervisor who knows people in the industry may receive valuable informal information about the banking community that formal channels would not allow, say on tips of troubled banks. In the other direction, the bankers’ social bond to a supervisor may in some form influence the former’s prudence in business. Social ties between supervisors and bankers is of course more often identified as a potential danger of ‘regulatory capture’ or ‘forbearance’, i.e. the risk that bankers are better at influencing supervisors than vice versa, which could lead to a weaker banking supervision.

However, there are important aspects of work experience that are not covered in the survey above. The supervisors’ experience from working in the private financial sector is one example, but experience from working in the public sector, and closer to the regulatory process, may be another type of competence that at least at times is of great importance to banking supervisors. This is because a banking supervisory agency, being mainly the enforcer of regulation rather than

the maker of regulation, is just one of several stakeholders in the regulatory process. The supervisor clearly has an interest in affecting this process, but its success in doing so, say in competition with political and banking industry groups, is far from certain. Some institutional features ensure the supervisor a formal say in regulatory reforms, but like in all policy making, social and human capital is of great importance, even for the main implementer and enforcer of the regulation in question. It is therefore believed that financial supervisors may benefit from staff experienced from working in the public sector, and especially in partaking in some part of explicit regulatory process. In the case of Sweden, the banking supervisor's main 'in' to the banking regulatory process has been the human and social capital of the head of the supervisory agency. Over time, this capital has changed which also affected the input the agency has had in the process.

The three types of experiences here believed to be especially relevant to the banking supervision are thus; (1) in-house experience of working as a banking supervisor; (2) experience from other parts of the public sector, (especially the Ministry of Finance); and (3), work experience from the financial sector, (especially banking).

**Figure 1: Professional background as human capital for banking supervision**

<b>Professional background</b>	<b>Human capital (skills developed)</b>	<b>Social capital (network/contacts developed)</b>
Bank supervision	Practice of banking supervision/ implementation of banking regulation/ organizing supervision	Expert/public sector/Formal 'ins' to the regulatory process
Other public sector	Implementation of policy/regulation; organizing policy implementation	Expert/public sector/formal 'ins' to the regulatory process
Financial sector	Practice of banking/of complying with regulation/organizing banking	Banking/clients/market/network 'ins' to the regulatory process*

In addition to these types of experiences, it is also believed that bank supervisors' competence is steeped in the context of their time and of critical events of special importance. The regulatory regimes are believed to be the most important context of the banking supervision, while the crises are the most 'critical events'. Both the regimes and the crises are believed to be of relevance in our study's main focus, the competence of the banking supervisor. The financial and banking crises are the major ones in Sweden's 20<sup>th</sup> century financial history: 1907-8; 1920-22; 1932; and 1990-93. For the concept of regulatory regime, the paper relies on a number of previous studies. Larsson & Jungerhem (2013) identify the main components of the regulatory regime as the banking regulation, the exchange rate regime and the currency regulation, and the overall objective and intent of the economic policy. These components are central also in Llewellyn's (2001) more elaborate, but at the same time more technical, understanding of the regulatory regime. It could be added that the argument made here about the importance of the context to assess human and social capital is similar to the context considerate approach of Battilossi (2008:77) who stress "the nature of banks as socially-constructed and historically specific institutions whose functions and performance are dramatically shaped by the social structure, the cultural environment, and the legal and political set-up".

## **The Swedish bank supervisors, the regulatory regimes and crises in the 20<sup>th</sup> century**

Banking supervision has a comparatively long history in Sweden. While a weak form of supervision of savings banks emerged in the first half of the 19<sup>th</sup> century, commercial bank supervision emerged during the second half of the 19<sup>th</sup> century. Unlike the savings bank supervision, which was assigned the local county administrations, the supervision of the commercial banks was centralized from the start. The supervision of commercial banks had been conducted within the Ministry of Finance since the 1860s due to its responsibility for handling bank license applications (Hotori & Wendschlag, 2014). Thus, the profession of banking supervisor was being established already in the 1870s, which made Sweden one of the first countries after the USA to develop such competences. In the USA, the profession had developed in some states as early as the 1820s, and on a federal level with the creation of the Office of the Comptroller of the Currency in 1863 (Mitchener & Jaremski, 2014, Robertson, 1963).

The Bank Inspection Board's objective was to ensure the public's trust in the banking system and that the banks complied with the going banking regulation. The Inspection handled applications for bank licenses that included scrutinizing the applicant's funding, ownership, statutes, business model, dividend scheme and geographical location. In addition the Inspection conducted on-site examinations of the licensed banks and had the authority to issue different forms of sanctions and ultimately recommend the king (the ministry of finance) to revoke the bank license (SFS 1906:104).

The creation of the Bank Inspection Board, in operation on the 1<sup>st</sup> of January 1907, was part of the enlargement of the state and of the institutional modernization of Swedish banking that took place around the turn of the century. Just two years before the Inspection was created, a similar agency had been created for the supervision of the insurance industry, and indeed one of the arguments put forward in favor of creating the Bank Inspection was that banking had become at least as important to the Swedish public as a well functioning and

reliable insurance industry (Wendschlag, 2012). The 1897 Riksbank act granted the Swedish central bank a note-issuing monopoly while requiring it to dismantle most of its commercial banking activities. This reform, together with the joint stock bank acts of the 1840s-60s drove the commercial banks towards adopting a deposit taking business model, with more competition for these resources. The massive success of the joint stock company act in general sparked an unprecedented interest in the stock market, and the Stockholm Stock Exchange too underwent considerable modernization in the first years of the new century (Broberg, 2006).

The expansion of the public sector was accompanied by reforms of the banking regulation, except for the mentioned end to note issuing. With the 1903 banking act, different categories of commercial banks, (especially private banks with unlimited liability, joint stock banks with limited liability) for the first time came to be regulated by the same act. This harmonization intensified competitive pressures. However, since the new act in general confirmed the going business practices of the banks with few direct constraints, the regulatory reforms was mostly a formal institutional setting of the prevailing a market based regulatory regime, (Larsson & Jungerhem, 2013). The license requirement remained, as did the traditional separation between deposit and investment banking although this latter restriction was removed almost as soon as the ink of the 1903 act was dry.

Although the regulation of banks underwent significant reform in the late 19<sup>th</sup> century, overall regime has by all accounts been identified as a market oriented regime that more or less ended first with the Second World War, (Larsson & Ögren, (2011). It can noted that the Swedish case by and large follow the international regime trends as identified by Forsyth & Notermans (1992), with a liberal market regime from the late 19<sup>th</sup> century until the 1930s, followed by a strict regulatory regime from the Second World War until the late 1970s after which a new market oriented regime was adopted. In relation to this international regime shifts, these may have come with some lag in Sweden, both in the end of the free market regime at the beginning of the century, and with the end of the strict regime in the last decades of the century.

The first Bank Inspector, Robert Benckert, from the start was aware that it took time to train new staff to become good banking supervisors, (Söderlund, ed., 1976). This training can take some years. In some sense, a banking supervisor needs to have seen the whole spectrum of bank soundness in order to gain the judgment necessary to overcome the many challenges of her or his work, (Khademian, 1996).

The in-house experience of the Inspection's staff naturally was low at its creation in 1907, although it was able to attain almost all of the staff of the agency's predecessor, the Bank Bureau within the ministry of finance. The small crew of the new agency however depended heavily on the long experience of the named Benckert, who had led the banking supervision of the Bank Bureau since 1888. During the following two decades, he had been able to get funding for more staff, which was necessary due to the continually increasing workload. The training of this new staff was to accompany a more experienced supervisor on on-site examinations. All decisions related to sanctions and of the formal communications with the banks were made by the Inspection's board, chaired by the director of the Inspection. The board initially comprised of three Inspection representatives and three external members from the public and private sector, but over time the board would comprise mostly of senior staff from within the Inspection.

Just half a year into existence, in the fall of 1907, the Bank Inspection Board got heavily involved in managing a number of small- and medium banks' crises that were a consequence of excessive lending abroad to the export sensitive industry as well as some speculation in the share market and in real estate (Larsson & Lönnborg, 2014; Wettergren, 2009). The handling of the banking crises of 1907-8 was very much in the hands of Benckert, who used his influence and esteem in banking circles to have incompetent bank managers replaced, and for fragile banks to be taken over by more healthy banks, (Söderlund, 1976). In total four banks were liquidated, five reconstructed and some 10-15 taken over by other banks (Larsson & Lönnborg, 2014).

Although it led to a sharp drop in economic growth in the short term, the economy recovered within the next few years. The negative effects on the economy was also due to a series of major strikes in 1907-9 which led to weaker economic output (Larsson & Lönnborg, 2014). For the banking system, the 1907-8 crisis never evolved into one of systemic proportions. The government did not take any significant steps to intervene in the crisis management, while the Riksbank ensured the banking system overall access to liquidity by taking loans abroad, (Wettergren, 2009). The Inspection on the contrary was very involved in the bank crisis management. The agency acted as mediator to facilitate mergers between weak and strong banks, and the head of the Inspection himself used his influence to have 'incompetent' bank managers fired and replaced by people of his approval, (Söderlund, ed. 1976).

In the following years the Inspection was unfortunately unsuccessful in keeping its staff for very long, especially from 1916 and onwards. The close interaction with the banks during the 1907-8 crisis may have made Benckert's staff come into the eye of the larger commercial banks, because this is where they all ended up in the 1910s. This loss of in-house experience became highly problematic since the 1910s banking sector was more dynamic than possibly ever before (or since) in Swedish history. The largest commercial banks competed for national branch networks by aggressive takeovers of smaller banks (not always conducting due diligence). Bank act reforms in 1909 and 1911 also permitted these banks to engage in share trade, leading to record high trading and prices on the stock market. The Inspection was still able to recruit staff with banking experience, but with the high turnover they did not necessarily develop into good supervisors.

When Benckert was replaced by Folke von Krusenstjerna in January 1914, Benckert stayed on as a board member. Krusenstjerna had a similar background as Benckert in having an education in law, and having worked for the Stockholms Enskilda Bank for several years. In addition, Krusenstjerna had led the modernized Stock Exchange from 1905-11, and had in 1912 married the daughter of one of Benckert's brothers. Krusenstjernas background with the

stock exchange may have influenced his judgment of the banks' share speculation during the first years of World War 1, although this of course is difficult to verify. The banking acts had been changed before his term, and the overall mood of the Swedish economy was that the end of the war would lead to a great demand for the Swedish exports. These expectations were not realized and by 1919 the stock market was in free fall. As a consequence, most of the large commercial banks quickly got into financial trouble. The government's deliberate deflation policy to return to the pre-war gold standard of course made the situation much worse.

The crisis in the early 1920s is one of the largest in Swedish history. Its resolution has been identified as an example of the 'Swedish model' of crisis management. Through the establishment of a 'bad bank' jointly by the banks and the state, but with state guarantees, the most fragile banks were offered favourable loans with 'illiquid' assets as collateral. Despite the arrangement, the crisis led to the liquidation of fourteen banks and state support to an additional handful of the largest banks in Sweden (Hagberg 2007). One of the main explanations to this major financial crisis was the major commercial banks' extensive speculation in shares and real estate during the First World War (See for example Lindgren & Sjögren 2003). From 1915, the prices on these assets increased dramatically as the investors and the industry started to bet on a post-war boom in demand for Swedish exports. However, when the war ended the boom did not come, and the shares and real estate held as collateral to the banks (or owned by them) fell in prices leading to massive credit losses. In addition to the excesses of the banks, the Swedish government's policy to relentlessly pursue a depreciation of the krona back to the pre-war gold exchange rate was a major factor contributing to the crisis, (Östlind 1945).

The Inspection had intensified its onsite supervision up to this point, but now backed down somewhat so not to push the banks over the edge, (Wendschlag, 2012). To help the banks improve their financial condition the Riksbank together with the banks organized a bad bank/clearing house in 1922 where the banks could get credit while offloading some of the distressed assets. In this acute

process, the Inspection was not directly involved. However, in the remainder of the 1920s the supervisor was very active in bank-by-bank negotiations concerning their longer-term recovery, (Broberg, ed. 2007; Sjögren, ed, 1994). The weakening of the banking sector may explain why the Inspection now was able to retain its staff to a much higher degree in the 1920s than in the previous decade. The agency remained very small in terms of manpower, but the low turnover of the now crisis-experienced staff suggests an improvement of the Inspections' competence. Kindleberger's (19??), notion that highly skilled individuals can be attracted to banking supervision when the job is especially demanding and exciting, such as in the event of a banking crisis, is not unreasonable at this point either.

Regardless of the underlying reasons, the fact was that the Inspection's staff stayed much longer, and definitely got to see the whole scale of bank soundness during the 1920s. In combination with the more prudent bankers, this led to the banking system to regain its profitability in the second half of the decade. In international comparison the Swedish economy remained relatively stable, as did the political system. The Great Depression that drove most of the developed world into a deep recession from the end the 1920s, initially did not affect the Swedish banks too severely. The industry of course found it near impossible to export its goods abroad, but could meet some of this slack by a larger domestic demand (Larsson & Lönnborg, 2014). Sweden's decision to follow the UK's abandonment of the gold standard system too was an important factor to why the economy fared comparatively well. However, in 1932 the international recession found a channel into the Swedish banking system when the internationally renown 'Match king', Ivar Kreuger, shot himself in a hotel room in Paris.

Most probably, he committed suicide to escape the revealing of his multinational corporate conglomerate's true financial standing, (Partnoy, 2009). In any event, it was soon revealed that he owed most of the larger Swedish banks huge amounts of money, which could affect or even disrupt the whole banking system. Almost one of every five Krona lent out by the commercial banks in 1932 was

owed by Kreuger, and in the case of his main 'housebank', Skandinaviska kreditaktiebolaget, it was one in every third Krona, (Larsson & Lönnborg, 2014). The Riksbank had got involved already in 1931 by extending a large loan to Kreuger, and lost some of its credibility when the Kreuger affair unraveled. The Swedish parliament in any case granted the Skandinaviska bank a large loan to prevent it from failing. The Inspection had successfully persuaded another commercial bank, Svenska Handelsbanken, to reduce its large exposure to Kreuger's empire in the second half of the 1920s, but had not been as successful with Skandinaviska. The fact that the latter bank's manager had once been recommended by the former Bank Inspector Benckert, (Söderlund, 1976), may have put him in a higher esteem than should have been the case.

By and large however, the Kreuger-crash did not have long term effects on the Swedish banking sector, other than leading to banking act reforms and the improvement of accounting standards and the introduction of consolidated financial statements. The 1911 banking act's allowance for banks to own and trade shares was now formally completely reversed, although the banks, with the permission of the Inspection, got until the 1950s before all the shares were off the books (Broberg, ed., 2007), The largest banks placed their shares in holding companies and so maintained very large ownership stakes in the Swedish industry.

A generational shift took place in the Inspection during the second half of the 1930s that significantly altered the human and social capital of the Inspection. Most importantly, the now very experienced Krusenstjerna left the agency in 1936 after 23 of the most turbulent years in Sweden's financial history. He took the position of director in the insurance company Skandia, and later also served on the board of the commercial bank Inteckningsbanken until 1949. His replacement was the lawyer Sven Lindeberg who had acted as the trustee of the Kreuger & Toll bankruptcy estate since 1932. His background was different from his two predecessors since he had no working experience from the banking sector, (something which no future head of the agency would have either). In addition to Krusenstjernas departure, several senior and experienced

supervisors left at this time. Three of the most experienced banking supervisors, with a combined work experience of over 60 years, left with Krusenstjerna, and the new Bank Inspector Lindeberg first had to deal with filling this gap in his organization. He succeeded in recruiting staff with a background in banking, but few of the incoming staff had much experience from the public sector, and neither had Lindeberg. Unlike in the last change of leadership, Lindeberg did not have the benefit of having a former Bank Inspector in his board of directors, and with no personal experience of working with banking supervision, it is not surprising that the Inspection changed its operations at this time.

The emphasis now became to improve the supervised companies book keeping and reporting standards, and this led the Inspection to focus less on the largest banks who by now had matured in terms of internal book keeping etc. More attention was paid to the agricultural credit associations that came under the Inspection's jurisdiction in 1937. They had started as small-scale cooperatives run by and for farmers in the 1910s but had developed rapidly in the next decades to become the main bank to the still significant agricultural population. Their rapid growth had come at the price of organizational weaknesses, and the Inspection found much room for improvement in this new segment of the Swedish banking system.

After the Second World War, the Swedish Social Democratic Party began a very long term in power, empowering a belief system of government intervention in the economy, which led to significant changes in the regulation of the financial market. Larsson (1998, p. 139) characterizes the relationship between the state and the financial market between the 1940s and late 1970s as the period of "strong state control". For the financial market, the new regime consisted of controls over credit expansion, interest rates and bond issuing among other things, all enforced by the Riksbank who became the instrument of the political leadership during this regime. Although the Bank Inspection Board remained the agency that was formally assigned the objectives of supervising the financial institutes, the Riksbank acted as a 'de facto' supervisor of the banks during this 'state control' regime (Wendschlag 2012).

This development most certainly affected the human capital composition of the Inspection. Again, Kindleberger’s (2005) assumption that skilled staff leave banking supervision if it becomes ‘too boring’ seems relevant, since the banking supervision did become fairly uneventful in the next few decades. The staff that Lindeberg had recruited stayed until retirement in the late 1950s and 1960s, and thus spent their whole careers as supervisors without ever experiencing a bank crisis. The number of onsite examinations declined, and the work that the Inspection did seem to excel at during these post-war decades was in off-site examinations of bank statements etc., (Wendschlag, 2012). It may well be the case that the close attention to the agricultural credit associations prevented a crisis of some magnitude, although it of course is difficult to assess, (this is part of the inevitably ungrateful task of banking supervision, as pointed out by Goodhart, (2000).

The Inspection however remained being a small agency, and cannot be deemed to have gained much bureaucratic fat even in the uneventful 1950s. The staff more than doubled however when the Inspection (responsible for the supervision of commercial banks, the stock exchange, the brokers and the agricultural credit cooperatives), was merged with the Savings bank Inspection in 1962. See the table below for some basic information about the Inspection’s resource endowment.

**Table 1. Staff of the Swedish Bank Inspection Board 1910-1990**

	1910	1920	1930	1940	1950	1960	1970	1980	1990
<b>Budget SEK, Index 1950 = 100</b>	95 169	199 895	218 705	230 908	261 384	415 111	1 590 732	2 084 135	4 018 935
<b>Total staff</b>	8	14	13	16	20	21	40	66	80
<b>Onsite examinations</b>	79	146	158	94	94	82	132	140	120
<b>Companies under supervision</b>	80	91	89	837	690	624	808	744	701
	1910	1920	1930	1940	1950	1960	1970	1980	1990
<b>Budget per staff</b>	11 896	14 278	16 823	14 432	13 069	19 767	39 768	31 578	50 237
<b>Companies per staff</b>	10,0	6,5	6,8	52,3	34,5	29,7	20,2	11,3	8,8
<b>Onsite examinations per staff</b>	9,9	10,4	12,2	5,9	4,7	3,9	3,3	2,1	1,5
<b>Onsite examinations per company</b>	1,0	1,6	1,8	0,1	0,1	0,1	0,2	0,2	0,2

The Savings bank inspection had been created in 1929 after a scandalous bankruptcy in a group of claimed savings banks, and become responsible for the supervision of the very large number of very small 'real' savings banks thereafter. The large number of savings banks had required a relatively large supervisory agency, and these now joined the Inspection's staff in a single supervisory agency (the Insurance Inspectorate, founded in 1905, remained independent for a few decades more.). Around the time of the agency merger many of the Inspection's senior staff that had been hired in the mid 1930s, retired. In aggregate, this led to a new change in the human capital composition of the Inspection.

First, around the merger year 1962, the Inspection lost staff with many years of in-house experience, but then an opposite trend started that would continue for the rest of the century. Lindeberg had died unexpectedly on New Years Eve in 1944, and after two years his permanent replacement was found in the career civil servant Kurt Wulff. Since no records exist that explain the process of recruiting persons for the Inspection leadership, we cannot be sure why it took so long to find a new agency head.<sup>1</sup> The interim solution was apparently not acceptable. He was Albert Tondén, who had a long career in the Inspection behind him (beginning in 1919) and surely was one of the most obvious candidates for leading the Inspection. However, for some reason he was not appointed and instead quit when Wulff came on board to become manager of the Skandinaviska bank's holding company Custos AB in 1947. Although the circumstances of his recruitment are difficult to decipher, we can see that little changed in the Inspection under Wulff's long leadership, (1947-71), and that the Lindeberg-Tondén-Wulff period, 1936-1971, marks a quite unremarkable period in the history of Swedish banking supervision. This of course could be said of Swedish banking in general, due to their strict regulation during this period and beyond.

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<sup>1</sup> According to former finance minister Kjell-Olof Feldt, (2010), the recruitment process was very much informal at least until the end of the period studied here. Basically the minister of finance found someone deemed suitable and then asked if they would be interested in the job.

Many of the staff of the Savings bank Inspection had had a background in the savings bank movement before becoming supervisors. The business of savings banks, and their supervision however still differed from that of commercial banking. Legal reforms in the 1950s and 1960s reduced the differences between the bank types, but still differences remained in practical business for some time. For the next few decades, the Inspection to some extent could continue on the route it had been on since the late 1930s. Just like in the agricultural credit associations, many of the savings banks were still run locally by individuals with little or no academic or practical experience of banking. The standards of bookkeeping and statements as well as business practices therefore differed considerably among the savings banks. The Inspection therefore was very actively promoting the market trend of mergers in the savings bank sector, and an increased professionalism in their running.

The Inspection's attention to the savings banks and the agricultural credit associations, who in the 1970s were transformed into cooperative commercial banks, was however not entirely of the supervisor's own choice, but also due to the fact that the Riksbank was monitoring the most important aspects and actors of the Swedish banking system. The grip of the Riksbank however started to slip by the late 1970s, and so did the support for, and faith in the strict regulation of the banks. Within the Riksbank the belief in the central bank's ability to control the financial system started to wane, and in the 1980s it started to dismantle many of the restricting regulations, pretty much on its own initiative, (Werin, ed. 1993; Feldt, 1991). Unfortunately, this process was not coordinated with the Inspection, who with hindsight at least should have been informed about the Riksbank's actions (Wendschlag, 2012).

When the credit expansion regulation was removed in the fall of 1985, the banking system in effect was operating in a free market regime that had not been in place since before the Second World War. In the new environment, the Riksbank no longer monitored the banks, while the Inspection had gotten an expanded jurisdiction with the deregulation of the 1980s. Wulff's successor, Sten

Wahlberg, had taken over in 1972 and was more or less in favor of the new dynamics of the financial system starting in the late 1970s. Onsite examinations had increased under Wulff's leadership, and remained stable under Wahlberg, although the examinations of commercial banks fell to an all-time low (Wendschlag, 2012). Wahlberg had made a career in civil service and was, like Wulff before him and Hans Löwbeer after him, appointed to lead the Inspection as the last office before retirement. Within the Inspection, the staff turnover had stalled to near nothing, which meant that the organization did not receive much inflow of human or social capital from either the transforming banking sector nor from the new generation of regulators (in the Riksbank and the ministry of finance) that were changing the 'rules of the game' in its core.

The Inspection's room for own initiative was limited, it was not permitted to hire more staff without the parliament's consent, and the booming financial sector would have made it near impossible to compete for skilled new staff anyway. When the largest financial crisis in Sweden since the 1920s began in the fall of 1990, the human and social capital of the banking supervisor probably was of the least appropriate mix possible. The staff more or less had remained unchanged since the peak of the strict regulatory regime in the early 1970s, having been led by a string of civil servants at the end of their careers and with no previous experience in banking supervision, nor of banking. The poor readiness of the Inspection to take over the supervisory gap left by the Riksbank, and its inability to adapt its human capital mix to the changed market conditions, was only one minor contributing factor that contributed to the crisis of 1990-3, but it definitely was one of them (Wendschlag, 2012).

The work to revitalize the Inspection had to some extent started already before the financial crisis started, with the appointment of the vice director of the Riksbank, Anders Sahlén, in the spring of 1990. He was the first head of the agency with a degree in economics rather than in law like all the predecessors. His work to reorganize the Inspection may have been ill-timed given the start of the crisis, but so was the government's hastily processed merger between the Inspection and the Insurance Inspectorate, in effect on the 1<sup>st</sup> of July, 1991. The

staff of the new agency was the sum of the two merging organizations, but it took several years before they truly evolved into one and the same organization (Östman & Åsbrink, 2001). We can end this account of the human capital history of the Swedish banking supervision by noting Anders Sahlén's shortened term in office. After challenging the government's pick to run Securum, the 'bad bank' created to handle the bad assets of Nordbanken, taken over by the state in 1992, Sahlén was pushed into resigning in 1993, despite the government having no formal power to make such demands (Dagens Nyheter, 1992; Expressen, 1992). In the years after the 1990s, another generation shift occurred which led to a somewhat more balanced mix of human capital. However, when the Inspection, now called the Swedish Financial Supervisory Agency, succeeded in hiring highly educated staff with experience from the banking and or relevant public sector, it found it very difficult to keep them for long.

## Assessing the Inspection's human capital 'mix' in the financial regime context

In support of the historical account above the study make use of available data for all the Inspection's supervisors, to enable a deeper analysis of the human and social capital 'mix' of the Inspection in each year between the creation of the agency in 1907 and its merger with the Insurance Inspectorate in 1991. Data on the agency staff's work experience has been collected to create a simple measure of the Inspection's 'competence' for each year in the survey. The competence is measured as the average number of years work performed by the average staff in three categories respectively: (1) the private financial sector, (2) the public sector, and (3), the Inspection itself.

Information about the Bank Inspection Board's staff (number of staff, employment duration, work experience etc.) has been collected from the agency's staff archive which is complete for most years covered in the study. In addition, information about the staff's previous work experience has been extracted from the annual publication *Svensk statskalender* ("the Swedish state calendar") which lists all permanent non-junior staff within the Swedish state (departments, agencies, public owned companies etc.). The annual publication *Vem är Vem* ("Who's who") has also been used. It documents the persons holding leading positions in politics, business and academia as well as their past occupations and has been used in other studies for similar purposes (for example by Engwall 1995).

All prior occupations in various types of banks, investment banks, brokerage companies, investment companies, credit companies, finance companies and insurance companies have been categorized as work experience from the private financial sector. The supervisors' prior employments at other state agencies and departments, courts, regulatory committees, embassies, and in publicly owned companies have been categorized as public sector work experience. Since the Inspection's personnel were occasionally called to take part in the highly influential regulatory committees, the staff could gain public sector work

experience while employed by the Inspection. To avoid double counting, the equivalent reduction has been made in the accumulated years worked in the Inspection. The three types of work experience become a straight forward measure of the 'skill' of the average non-administrative staff of the Inspection from 1910 to 1990.

A clear limit to the study is the small absolute number of staff of the Inspection during the first half of the twentieth century. Until the 1950s, less than ten permanent non-administrative staff was employed by the Inspection. The 'skill' of each of these individuals clearly had a great impact on the overall 'quality' of the supervision. With such limited observations, one should be careful to draw too strong conclusions. Nevertheless, since practically no data is missing until 1970, the data obtained even for the first half of the century should be indicative of the overall competence of the supervisor. Until 1974, information has been obtained for 98-100 percent of the staff. Between the years 1975 to 1982, the data covers between 70-80 percent, and data for 60-70 percent of the staff has been obtained for the years 1983-1990. For the first half of 1991, data on 48 percent of the staff has been collected. The data is based on information about the individual staff's employment duration at the Inspection and their previous work experience in the private financial sector and in the public sector.

The non-administrative staff has been the main focus of the study, but in some counts the total staff has been calculated as well<sup>2</sup>. The administrative staff is without doubt important, especially by enabling an internal division of labor and specialization. However, the inclusion of the administrative staff in the calculation of the average work experience would have been somewhat misleading since the competence gained from working in the administrative department of a bank not necessarily is that different from a similar job in a non-bank work place.

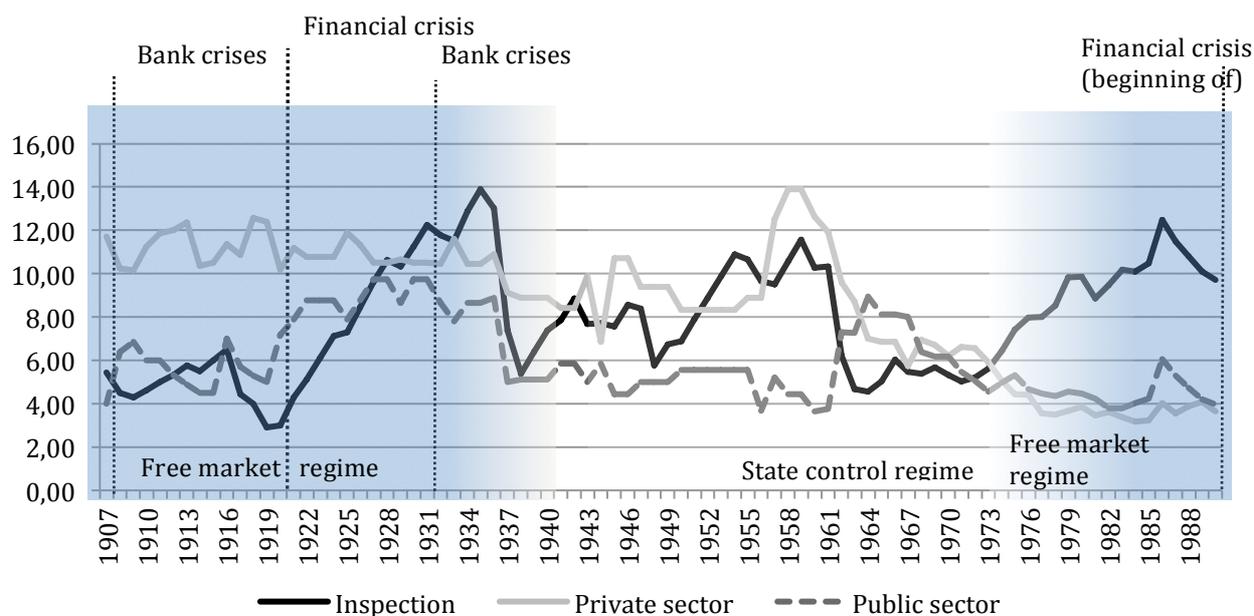
As mentioned, the context of most relevance to supervisors is believed to be the overall financial regulatory regime, and in the figure below the three significant

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<sup>2</sup> Such as secretaries, janitors etc.

regimes of the 20<sup>th</sup> century have been highlighted together with three separate lines that indicate the average years of experience the average bank supervisor had from each one of the three types of work experience believed to be of high relevance to the Inspection and the quality of the supervision.

**Figure 2: Average work experience of the average Inspection staff in years<sup>3</sup>**



The Inspection’s endowment of banking sector experience changed significantly over the 20<sup>th</sup> century. By its creation in 1907, the Inspection set out to hire individuals (men) with high education and work experience from the banking sector. The Bank Inspector himself at the time, Robert Beckert, had worked some 15 years for the Wallenberg family’s commercial bank Stockholms Enskilda Bank. As we can see in the graph above, (the light grey line), the average staff had many years of experience from the banking sector at least until the 1930s.

<sup>33</sup> Averages based on the following sources: The Bank Inspection Board archive (1907-1920 and 1962-1991) and Bank and Securities Inspection Board archive (1920-1961): “Tjänstematriklar” and “Tjänstgöringsjournaler” (Staff and employment records); “Sveriges statskalender” (the Swedish State calendar) annual publications, issues 1907-1991; and “Vem är vem?” (Who is who) annual publications, issues 1907-1991

The quality of the banking supervision depends on being able to recruit and keep its staff for a longer period of time. When experienced staff leaves, the organization loses in competence. The loss comes both from losing the staff itself, but also due to the costs incurred in recruiting and training new staff, (search costs, training, mentoring etc.). Consequently a high turnover of staff may affect the organization's ability to meet its objectives. In the specific case of banking supervisors, the risk of losing your best staff to the banks that are supervised is a particular dilemma, since it could be seen as a zero-sum game where the gain of the banks (in recruiting the supervisor's best staff), is a loss for the supervisor.

Throughout the 1910s the Inspection succeeded in hiring staff with long experience from the private financial sector as well as from the public sector. However, the continuously high turnover rate prevented the agency from accumulating in-house experience of working as a supervisor. Almost all but the Bank Inspector himself moved on to jobs in the banking sector, as bank directors (Wendschlag 2012c). The experience gained from managing the 1907-8 banking crises was thus quickly lost to the Inspection.

When the speculative bubble burst in 1920 the Inspection stood with staff that had little experience from working in the Inspection, which may have had an impact on the length and/or depth of the crisis. The Inspection did not play a central role in the systemic phase of the crisis, around 1921, but nevertheless was very active in the year before and the years after bringing fragile banks to merge into large units, in working out and enforce institute specific programs for writing off bad debt and selling shares at a point when this could be done without incurring a loss, (Broberg, ed. 2007; Sjögren, ed. 1994).

Contrary to the situation after the banking crises in 1907-8, a large part of the Inspection's staff recruited at the time of the crisis in 1920-22 stayed with the agency. This is seen by the annual increase in the average years worked in the Inspection from 1919 to 1936. After the systemic phase of the 1920s crisis, the

Inspection again got deeply involved in the fragile banks' programs for writing down bad debt and the selling of shares as their prices gradually rose (Ibid.)

The long experience of the staff, including working during the financial crisis in the early 1920s, may have contributed to the fact that Sweden did not experience a financial crisis in the early 1930s as many other countries did. It is difficult to separate the impact of a skilled supervisor from numerous other factors to Sweden's relatively mild treatment during the Great Depression years.

The Inspection however without doubt contributed positively by its work with the banks to recover from the 1920s crisis and maintain prudence in their banking operations (Kreuger's house bank excluded of course!).

Figure 2 shows a marked drop in the average non-administrative staff's average work experience around 1936-37 and this coincides with a change of head of the agency. The Inspection comprised some 10-15 non-administrative staff of which many had worked closely for more than fifteen very turbulent years. A change of leadership in such a small organization may have large effects on how it is run, which in turn may trigger additional staff changes. In the case of the Inspection, the leaving (Krusenstjerna) and coming Bank Inspector's (Lindeberg) differed substantially.

The leaving Inspector, Folke von Krusenstjerna, had had a long career in both the private and public sector before replacing his even more esteemed predecessor in 1914. During his term in office, Krusenstjerna contributed markedly to the design of financial regulation, and also managed the Inspection through a major financial crisis and the mentioned banking crises in the early 1930s. In the banking community his will to refrain from too strict a reading of the formal regulation in order to help banks write down their losses during the 1920s was recognized and appreciated (Broberg ed. 2000). The coming Inspector, Sven Lindeberg, had a different background. He had admittedly worked as the manager of the Kreuger & Toll bankruptcy estate prior to becoming Bank Inspector in 1937 (Vem är det: Svensk biografisk handbok 1943; Bank- och Fondinspektionens arkiv, tjänstematriklar), but other than that had no own work

experience from the private financial sector. In fact, after 1936 no head of the financial supervisory agency in Sweden has had any significant working experience from the private financial sector. Nor were any successor to the first Inspectors Benckert and Krusenstjerna as centrally involved in the regulatory process.

In Sweden, banking regulation has historically been highly influenced by the investigations of 'regulatory committees', consisting of experienced and influential individuals both from the private and public sector and from the academia. Being part of these committees was in other words both an indication and a confirmation of a high level of human and social capital. The interest group participation in the regulatory process appears to have functioned as a guarantee of a broad consensus, or at least understanding, on the reforms that the committees proposed. The proposals, often the result of several years of deliberation, generally came to serve as blueprints of the new acts more or less fully accepted by the formal legislators of the Swedish parliament. The commissions were assigned by the government to investigate a set of issues of concern in current regulation, but were also able to suggest additional issues of importance. Although the role of regulatory committees in the Swedish regulatory process has diminished in the last few decades, they were important during most of the twentieth century. Thus, it was important for the Swedish Bank Inspection Board to be part of these committees to partake in the shaping of the regulation that it was to enforce.

The trend over the 20<sup>th</sup> century was that the Inspection moved from being a key contributor to the banking regulation committees at the start of the century, to being excluded from the late 1930s, which can be explained in terms of lost human and social capital. The head of the Inspection sat or chaired in practically all regulatory committees related to the financial system from the late 19<sup>th</sup> century until the 1930s, but in none after that. In addition, the long tradition of close contacts between the Inspection and the Riksbank ended around the time the strict regulatory regime was introduced at the end of the 1930s.

With the start of the Second World War, a number of regulations were imposed that restricted the activities of the financial institutes that after the war were made permanent. The Inspection was to play a relatively subdued role under this regulatory regime. The control over the credit expansion, the interest rates, the currency exchange operations and the liquidity ratios of the banks were assigned to the Riksbank, who de facto became the supervisor of the commercial banks.

The marginalized role of the Inspection in the new regime is illustrated in Figure 1 from the late 1930s until the early 1960s. During this period, the staff's average work experience from the public sector was reduced drastically. More important was that, although the staff may have had some public sector experience prior to joining the Inspection, once recruited the staff gained additional public sector experience by participating in the regulatory committees who in Sweden were highly influential in the regulatory process as previously mentioned. In fact, contrary to the previous two Bank Inspectors, the new Inspector Lindeberg did not have a seat in any regulatory committee during his term in office (1937-1944), nor did his successor (1947-1971). The 'sidelining' of the agency still formally responsible for the financial supervision does not appear deliberate, but was a consequence of the large role played by the central bank in this 'market control' regime, (Wendschlag, 2012).

Some changes in the work experience 'mix' can be observed after 1962 when the Bank Inspection Board was merged with the Savings Bank Inspection Board (created in 1929 due to the 'Allmänna Sparbankerna' scheme already mentioned) (SOU 1961:65). After the merger, the agency consisted of some forty employees (Bank- och Fondinspektionens arkiv, tjänstematriklar). The merger led to few new hires in the coming years, and a new period of growth in the in-house work experience begun by 1970. However, contrary to the similar trend in the 1920s, the staff that stayed with the agency had no experience of working with supervision in times of serious market unrest. Contributing to the trend was that administrative staff in the 1970s started to take non-administrative positions within the agency. Once a former administrative staff has taken a non-

administrative position, his or her in-house work experience has been added to the calculation of the average.

If too high turnover of staff is problematic from a human capital perspective, so is too little if one takes the contextual factors into account. Some minimum, steady turnover is positive to the organization, to feed the internal job market, balance retirements etc. A steady inflow of new staff is also an important way for the organization to gradually adapt to a gradually changing environment. In our case, the flow of new staff, with new combinations of competences, into the banking supervisory agency enables it to adapt internally to the changes in the environment, i.e. in the banking market and in the regulatory regime.

A larger share of the staff stayed longer with the Inspection, increasing the average employment duration. In addition, new staff was recruited shorter after graduating from university or college. These employees had less work experience in general. This appears to have been a general trend in the financial sector as well. Some banks started to recruit directly from the universities by the late 1960s (Wallander 1997). The traditional way of recruiting staff to low-level positions and then facilitating opportunities for in-house advancements was abandoned. According to Engwall (1995) too, the commercial banks started to hire more staff directly after graduation, especially in the 1980s. During the 1980s, the banks started to recruit staff from each other to a larger degree than they traditionally had done.

The Inspection also recruited more staff directly from the universities and colleges. The constraints put on the Inspection however made it incapable of competing with the banks for the best university talents. As a bureaucratic agency, it was not permitted to match the wages of the private financial sector, nor could it replace 'less competent' staff with new as easily as the financial institutes. The Inspection Board could ask for permission to increase the number of staff in connection with the annual budget application, but there was no guarantee that the request would be granted.

The gradual devaluing of work experience in the banks coincided with the start of the transformation from the 'state control' regime to the 'free market' regime in the early 1980s. In the increased competition for new staff with some experience or education in the new 'free market' regime, the Inspection was at a disadvantage to the banks. For the Inspection, having staff with limited experience of work in the 'free market' financial sector became problematic. At the same time, it had long lost staff with experience from the regulatory process, which during the strict regime in essence had been directed by the ministry of finance and the Riksbank. The Inspection had no seat in the regulatory committees of the late 1970s and 1980s, and it so lacked clear influence over the regulatory changes. When the crisis started in the fall of 1990, the Inspection had a staff with very little practical experience from the private financial sector. Although the competence of the financial supervisors may just be a minor factor affecting the occurrence and severity of financial market crises, the Swedish case suggests that it may be of relevance.

## Concluding remarks

This paper has accounted for the Swedish banking supervisor's human capital during the 20<sup>th</sup> century in the context of the financial regulatory regimes, regime changes and of banking and financial crises. The study adds to the growing literature concerned with assessing the quality of financial supervisors. The empirical data used has permitted a more thorough attempt to use the supervisors' work experience as a measure of competence than done in previous studies. The historical perspective has also permitted a more contextual assessment of the work experience that is lacking in studies without a long-term perspective. The study finds that the human capital mix, (that is, work experience from supervision, private sector *and* the public sector), of the supervisor was relatively well balanced around the banking crises of 1907-8 and in 1932. In the financial crisis of the 1920s, the staff had too little in-house experience, while in the 1990s crisis it seems that the supervisor had too much in-house experience (and too little experience from the banking sector). The paper further discusses how the supervisor's human capital composition is related to the overall financial regulatory regime, which ultimately defines the role of the banking supervisor. The strict regulatory regime from World War 2 until the mid 1980s was enforced by the Swedish central bank and de facto became supervisor of the banks during this regime. This seems to explain the 'deterioration' of the competence of the still de jure supervisor, the Bank Inspection Board, during this period and its ill preparedness when the strict regime was transformed to a marked based regime.

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