Protection against Crises?

A Century of Financial Supervision in Norway

by

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In 1900 the first Savings Banks Inspector was appointed in order to conduct public control of the numerous Norwegian savings banks. During the next century, public supervision developed from primarily being a socially motivated activity covering only specific types of financial institutions into a modern, fully integrated supervisory agency aiming at both the maintenance of sound financial institutions and the stabilization of financial markets. This article analyses the development of financial supervision in Norway from its inception, bringing particular focus to changes in the motives and tasks of the supervisory agencies. As bank failures clearly involve avoidable costs, the detection of threats to financial stability has become an increasingly important task over time. Thus we focus on the anatomy of financial crises.

There is a considerable academic debate whether or not banks should be regulated at all. Some scholars even argue that very often, the origins of banking problems have to be found in regulatory rather than market failure. Today, there is general agreement that it is necessary to regulate and supervise financial institutions – particularly banks – and financial markets. Our historical analysis supports this view, and confirms that supervision matters.

This article is based on our book on Norwegian financial supervision since 1900, entitled *Vern mot kriser? Norsk finanstilsyn gjennom 100 år*. This book was the result of a research project commissioned by The Banking, Insurance and Securities Commission of Norway, The Bank of Norway and Oslo Stock Exchange.

Supervision as social politics

The basis of the earliest financial supervision in Norway was a political urge to protect the interests of common people. In the early 19th century the authorities established limited supervision of two types of financial institutions: life insurance companies and savings banks. A common feature of these institutions was that they had a relatively broad spectrum of customers, who were assumed to have little knowledge of business or economics. In accordance with ideologies of the time, the state should protect the interests of these people and reduce the risk of them losing their savings. Thus, the authorities introduced laws offering public approbation to savings banks and life insurance companies that fulfilled specified requirements regarding organization, management principles, reserve funds etc. Institutions, which were subject to approbation, gained certain privileges and probably also an increased public trust. Most savings banks and life insurance companies thus chose to join these voluntary arrangements.

Whereas paternalistic views of protecting common people gave reason for controlling savings banks and life insurance companies, liberalist ideology encouraged the authorities not to intervene in regular commercial activities. Hence commercial banks, non-life insurance companies and firms of security brokers were not subject to any kind of supervision or regulation. On the contrary, the principle of free banking had a very strong standing in Norway. There was no legislation regulating commercial banks or non-life insurance companies. In 1869 Parliament abolished mercantile regulations of security brokers as part of a general liberalization of the economy, opening the broker business to anyone. The lack of public control was based on widespread opinion that participants in commercial activities were responsible for their own actions, and that the state had little reason to interfere in their business.

To some extent approbation arrangements for savings banks and life insurance companies enabled the authorities to control the establishment and activities of these

institutions. However, there were few possibilities to control the quality of the documentary information provided by the banks. The 19th century legislation gave no authorization to carry out on-site inspections, and the authorities allocated few resources to supervisory activities. Hence, from 1870 onwards several initiatives were taken to improve savings banks and life insurance legislation. However, these initiatives were not coordinated. Unlike today, neither the authorities nor the industries themselves regarded banking and insurance as similar activities or as part of one common financial market. Whereas life insurance continued to be perceived as a social activity, Norwegian savings banks already from the 1840s started abandoning their original philanthropic ideals and pursuing commercial goals. In this aspect they differed substantially from savings banks in most other countries.

The commercial character of the savings banks combined with their broad customer base made the authorities consider extending the public controls. Their worries increased in 1886 when the first severe banking crisis in Norway hit savings banks as well as commercial banks in the coastal town of Arendal. The Arendal crash clearly demonstrated how savings banks could be engaged in high-risk commercial activities and that the authorities had few means to detect problems or prevent crises if a bank wanted to hide its real status. However, due to strong resistance from municipal authorities and local banks as well as regional Members of Parliament all fearing too much interference by central authorities, it took another decade before legislation was tightened and a new Savings Banks Inspector [*Sparebankinspektøren*] was appointed in 1900.

For life insurance companies the process towards more extended supervision was even longer. Initially, both authorities and insurance companies supported the idea of reinforcing public regulation of the insurance industry. However, the legislative process was linked to a more complex process of introducing a new corporate law, which was to form the basis of the insurance legislation. The corporate law was highly disputed by liberalists and regional interest groups, who feared too much centralized control. It took more than three decades to resolve the conflict.

Parliament finally approved the corporate law in 1910. The following year, a new insurance law based on the corporate law was introduced, reinforcing the supervision of life insurance companies and establishing a new supervisory agency, the Insurance Council [*Forsikringsrådet*].

The lengthy processes of reinforcing regulations of savings banks and life insurance companies illustrates a center-periphery conflict which was – and still is – fundamental in Norwegian society and politics. The strong position of regional interests has had profound impact on the development of regulation and the structure of Norwegian financial markets, delaying centralized control and favoring a decentralized unit bank system. Still, based on the socio-political motive of protecting common people, the authorities managed to establish controls for savings banks and life insurance companies. As we will see, this proved useful when manias and crises hit the Norwegian economy after the outbreak of World War I (WWI).

Economic boom and preventive supervisory action

From a long-term perspective, the motivation behind financial supervision has changed gradually from a socio-political focus on individuals towards what we can call a market logic, aiming at facilitating the working of the financial markets and preventing instability. In Norway, the period during and immediately following WWI marks a crucial turning point in the development of financial supervision. Until then, the liberalist principles of free commercial activity in general and free banking in particular had prevented the introduction of public regulations. From 1918 onwards, however, the authorities substantially reinforced their supervision of the financial markets. This was a direct result of a war-related mania and following crises, which seriously threatened to destabilize the Norwegian economy.

From the summer of 1915, after a period of uncertainty during the first months of WWI, Norway experienced a substantial economic boom. Being neutral, Norway benefited from rising prices in the international markets and an increased demand for imported goods from all sides involved in the conflict. The growth was particularly

strong in shipping, whaling and exports of fish, but the manufacturing industry also blossomed. More and more people, with varying personal and professional backgrounds, wanted to benefit from the prospects of quick profits. Soon the boom developed into a bubble fueled by easy money provided by the banking system. Expansionary monetary and fiscal policies following the suspension of the Gold Standard in August 1914 reinforced this development directly by providing more money, and indirectly by leading to inflation, making debt financing cheaper.

Lacking the necessary legislation, the authorities stood without means to control the activities of the stock market, commercial banks and non-life insurance companies. When comparing the development of these sectors with the regulated savings banks and life insurance companies, it becomes clear that the non-regulated sectors grew much faster in terms of numbers as well as assets. Due to the booming stock market, 1304 new brokers' firms were established in the period 1914–1918. Within non-life insurance 103 new companies were founded, a quadrupling of companies. The total assets of the non-life insurance companies increased 500 % and their share of total assets of the domestic financial institutions grew from 3.4 % to 5.9 %. This contrasted with the life insurance sector, where only two new companies were founded in the period 1912–1920. The share of the total assets of life insurance companies in the domestic market dropped from 4 % to 2.2 %, which was an historical low-point, and their share of total loans dropped from 4.3 % to only 1.5 %.[1]

Table 1: Total assets and loans of savings banks (SB) and commercial banks (CB) 1910–1920 in million Norwegian crowns (NOK) and percent share of total

	1910		1915		1920	
	Mill. NOK	%	Mill. NOK	%	Mill. NOK	%
SB total assets	570	32.9	816	28,2	2253	23.4
SB loans	449	34.2	656	31,6	1732	25.7
CB total assets	669	38.6	1334	46,2	5461	56.7
CB loans	524	39.9	985	47,4	4034	59.9

Source: Matre (1992)

Table 1 draws a similar picture for the banking sector; the growth of the non-regulated commercial banks was much stronger than the savings banks. The entry of new commercial banks was also much higher, the number increasing from 119 in 1914 to 192 in 1920, whereas the number of savings banks increased from 525 to 562 in the same period.

During economic booms financial fragility is likely to increase substantially, due to increased credit risk, market risk and operational risk.[2] By exposing and preventing such risks, public supervision may limit subsequent losses and larger financial crises. During WWI, the Savings Banks Inspector in particular took active steps in order to prevent the savings banks from undergoing the same risk exposure as the unregulated commercial banks. The Insurance Council, on the other hand, contributed more indirectly to moderate growth within the life insurance sector. As a newly founded organization the Council was mainly preoccupied with establishing long-term routines and working principles during WWI. It did not take direct actions in order to expose whether life insurance companies were involved in high-risk activities. By promoting co-operation and limiting competition, however, the Council contributed indirectly to restricting a strong expansion within life insurance.[3]

The economic boom during WWI coincided with the investiture of a new head Savings Banks Inspector, Bjarne Haugaard. Haugaard suspected that savings banks might participate in stock market speculation, high-risk shipping engagements and related activities. During 1916 and 1917, he therefore carried out 264 on-site inspections of 263 savings banks, which comprised almost half of all the savings banks. This implied a distinct increase of supervisory activity. Previously on-site inspections rarely had exceeded 50–60 per year. In order to make the amount of work manageable Haugaard chose to concentrate his inspections to the coastal areas, where the banks were more likely to be involved in the booming shipping industry. This meant that inland savings banks, which were heavily engaged in financing local councils and the development of hydroelectric power, hardly had any supervision at all. The inspections revealed that a considerable number of savings banks were

engaged in what was defined as speculative activities. They financed the trading and building of ships and accepted shipping stocks at "unreasonably high prices" as security. In addition, the accounting and management practices of many of the banks turned out to be insufficient.[4]

Based on these revelations the Ministry of Finance and the Savings Banks Inspector took a series of initiatives in order to make the savings banks terminate their high-risk engagements. Firstly, the Ministry appealed directly to the savings banks that had violated the law and threatened to withdraw their licenses unless they changed their practices. Secondly, the Ministry issued circular letters to all savings banks warning them against high-risk exposure particularly in shipping and the stock market. Here the Ministry also tried to prevent the spread of a possible future crisis in the non-regulated commercial banks by demanding that the savings banks distribute their excess liquidity across several commercial banks rather than one, and to avoid the commercial banks that were most heavily engaged in speculative activities. Thirdly, inspector Haugaard used the press to warn against the problems in the savings banks sector. He gave interviews where he dramatically described the high-risk investments that some savings banks were making. He also compared the situation to a previous boom and crash in the Christiania real estate market in 1899 and warned of the impending danger of a new banking crisis.[5]

Even if it is methodically difficult to measure the exact effect of the steps taken by the supervisory agencies, there can be little doubt that they contributed to limiting growth and preventing high-risk engagements among savings banks. Through the system of licenses the Insurance Council and Savings Banks Inspector controlled all new entries and could thereby limit the number of new banks and reject less serious actors. The activities of the Savings Banks Inspector and Ministry of Finance towards savings banks in the coastal areas were generally successful. Some banks tried to protest and argued that they were fully entitled to finance shipping and investments in stocks, but ultimately they all gave in and phased out these activities. Hence, when the post-war international slump hit the Norwegian economy from

August 1920, the savings banks had relatively small losses in these sectors compared to the commercial banks. Another point indicating that public supervision mattered is the fact that the majority of savings banks that were hit by crisis were situated in inland areas, and had financed local authorities and the development of power plants, to which the Savings Banks Inspector had paid little attention.

Crises and reinforced public supervision

The unregulated financial sectors, which had experienced almost unlimited growth during the war, were hit hard by the post-war recession. The recession triggered a dramatic drop in domestic prices as well as exports. In one year, exports dropped by 49 % and unemployment rose substantially. In 1922, export started to recover, but prices fell continuously from the fall of 1920 until December 1922. Price levels stabilized during 1923, rose again through 1924, but started to fall incessantly in 1925 until May 1928, when the currency was legally restored to its pre-war gold parity. The post-war slump and deflation had a very negative impact on investments and set off an investment pause. Seen in relation to GDP, gross investments in fixed capital dropped from 36 % in 1919 to 16 % in 1927. Together with the drop in exports, this brought about reduced economic activity and growing business problems. From 1920 to 1921, the number of bankruptcies increased steeply, while the number of registered foreclosures doubled. Consequently, an increasing number of business enterprises defaulted on their loans.

These general economic problems triggered fundamental difficulties in the financial markets, hitting the unregulated sectors particularly hard. Already in the autumn of 1918, the stock market was hit by depression. From 1919 until 1921, the total sales value of stocks at the Christiania stock exchange dropped from 201 to 17 million Norwegian kroner (NOK). This of course had huge consequences for brokers. In 1920 only 250 of the 1304 new brokers' firms established in the period 1914–1918 remained.[6] Conditions in the non-life insurance sector were not much better. Many companies had speculated in war-related rocketing prices and faced huge problems

when prices plunged in the post-war recession. In the period 1918–1936, 117 companies were liquidated of which 87 had been established from 1914–1920. 1924 was probably the worst year, when 49 companies faced liquidation or bankruptcy proceedings.[7]

For the commercial bank sector, the 1920s was the most severe period of crisis ever. From 1920–23, 25 commercial banks and one savings bank had to suspend their payments and either went bankrupt, were liquidated or saved through acquisitions. The Norwegian Central Bank launched a support program but failed to save most of the banks or prevent the crisis from spreading. From 1923–28, 47 commercial banks and 19 savings banks were taken under public administration and an additional 18 banks were liquidated.[8] Among the failed banks were three of the six largest commercial banks, which controlled more than half of total bank assets. In total, 129 commercial banks collapsed. Hence, the crisis represented a devastating blow to the Norwegian financial system. Along with the gold-parity depression in Norway 1925–28, the banking crisis had a considerable negative impact on the economy during the twenties.

Norwegian historians have heatedly debated the causes of the 1920s banking crises. The prevalent view has been that tight monetary policy contributed heavily to the crisis.[9] Some scholars have even suggested that the so-called par policy, aiming at restoring the pre-war gold parity of the Norwegian currency, was the main cause of the crisis.[10] The crucial empirical basis of these views are the official statistics published by the Central Bureau of Statistics (CBS), which dates the most severe bank losses to the years 1923–27. According to these figures, the banking crisis coincided chronologically with the par policy, which was pursued consistently from 1924. However, our new in-depth examinations of the foundation of the CBS statistics suggest that the loan losses for the period 1920–22 are underestimated, while losses reported in the years 1923–27 are highly overestimated. It turns out that banks under public administration neglected to write off loan losses when they actually occurred, which to a large extent was in the period 1921–24. In retrospect, the CBS rather

arbitrary spread these losses over the years 1925–27. In other words, the most severe phase of banking crisis was 1921–24, that is before the par policy was systematically effectuated. Thus, even if the monetary policy undoubtedly had damaging effects on Norwegian economy in the inter-war years, it can hardly have triggered or caused the banking crisis in the 1920s.[11]

According to our analysis, the boom during WWI formed the foundation of the banking crisis of the 1920s. Reckless bank lending increased the credit risks considerably, and when the international slump and drop in prices reached Norway, the commercial banks encountered a huge non-performing loans problem. Excessive bank lending, lax economic policy and a large-scale capital inflow that was ultimately intermediated by the banking system, stimulated the boom. This led to asset price inflation, which created a bubble built on over-optimism about future profits, especially in the equity market. When the bubble burst, the share prices fell considerably. This worsened the situation for the banks because they, to a large extent, had lent against stocks as collateral. Hence, rather than faulty post-war monetary policy, it was dispositions of private actors as well as the authorities during the war that created the financial crises in the 1920s.

During WWI, the authorities had no means to prevent speculation or high-risk engagements by commercial banks, non-life insurance companies or security brokers. The lack of proper regulations gradually became obvious. The Government and Parliament, however, were unable to establish the necessary legislation until after the crises had started, too late to implement preventive measures. In August 1918, Parliament passed a new law regulating brokers. It introduced a new supervisory agency, the Brokers' Control Agency [*Meglerkontrollen*], which had the authority to control the establishment, organization and management principles of security brokers. Before the Brokers' Control Agency was operational, however, the stock market crash was already a fact. In a similar way, the first permanent legislation on commercial banking was enacted in April 1924, after the peak of the crisis. Following the new banking laws, public supervision was reorganized in a new Banking

Inspectorate as a joint commercial- and savings banks agency. For non-life insurance companies the legislative process was even lengthier. The first initiatives to introduce controls of non-life insurance companies came in the early 1920s, but due to political as well as practical complications, Parliament introduced legislation in this sector as late as 1938. Thereafter, the non-life insurance companies were subject to prudential supervision by the Insurance Council.

From a long-term perspective, the protracted legislative processes can be explained by so-called institutional inertia, implying a strengthening of the public supervision in the aftermath of a crisis and not in the phase leading up to it. This inertia weakened the authorities' ability to prevent or counter-act crises in the financial sector, and illustrates a general trend in the development of financial supervision based on market logic.

Even if the legislative processes were characterized by inertia, the authorities were able to learn from previous experiences. This was illustrated clearly in 1931, when an international recession again hit Norway and two of the country's major commercial banks faltered. In contrast to its actions in the early 1920s, the Central Bank now acted without hesitation as a lender of last resort, and kept the banks from going bankrupt. The main basis for this firm action from the Central Bank was information provided by the new Banking Inspectorate. In the period 1925–1930, the Inspectorate developed considerable competence on how to carry out on-site inspections, and had in-depth knowledge of the banks' financial position. The Inspectorate also worked out a plan which made it possible to recapitalize the banks in the ordinary capital market. The activities of the supervisory authorities thus seem to have contributed substantially to limiting the development of financial instability during the early 1930s.

Decline in business and growth in bureaucracy

The experiences of the inter-war years taught the authorities that financial instability could have serious consequences for the economy as a whole. By introducing

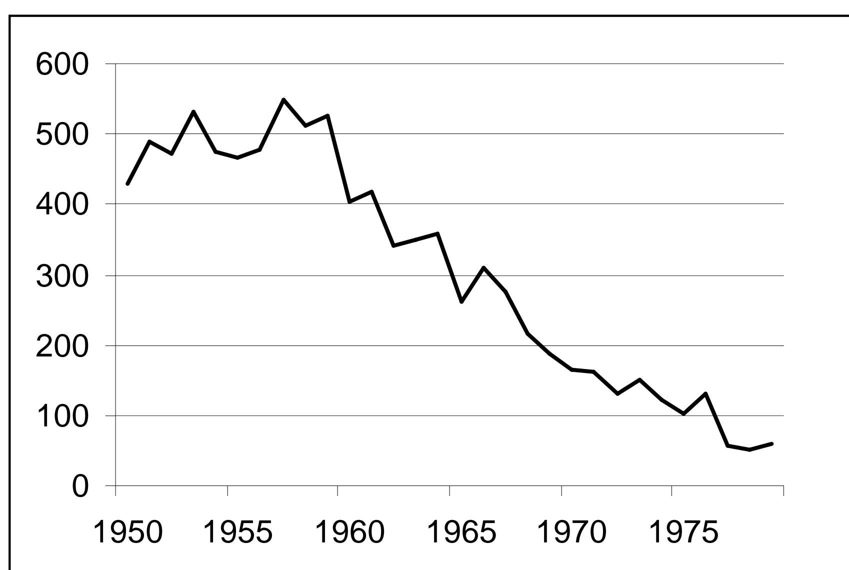
legislation in all main financial sectors, the aim was to prevent similar crises from occurring by uncovering the real status of the financial institutions and by counter-acting any jeopardizing activities. As we have seen, however, neither the legislative processes nor the supervisory agencies were coordinated. The three different agencies, which supervised banks, insurance companies and security brokers, were under the authority of three different ministries. The Banking Inspectorate reported to the Ministry of Finance, the Insurance Council worked under the Ministry of Social Affairs, while the Ministry of Trade controlled the Brokers' Control Agency. This reflected the fact that they were still viewed as distinct, activities, rather than similar sectors of one financial market. Even though some argued that a larger degree of coordination could lead to more efficient supervision, it took several decades before a process of integration began. During these decades, there were fundamental changes in the political and economic environment of the supervisory agencies, which changed their tasks and status substantially.

While the inter-war years were characterized by economic instability and market fluctuations, the decades following WWII represented a period of stable growth and prosperity. This was partly a result of institutional changes enabling a combination of international trade and national stabilizing regulations. The inter-war experiences had triggered growing support of the state playing a more active role in governing the economy. Political movements on the left as well as on the right believed that by introducing planning and regulations the state could contribute a more efficient allocation and utilization of resources than in a free-market situation. Experiences during WWII, when the allied nations successfully used direct regulations to control production, reinforced these believes. In Norway, the Labour Party became a driving-force for increased state planning and regulation. Labour won the first free post-WWII election in 1946 and stayed in government for the next two decades. Backed by a parliamentary majority until 1961, the Labor Governments were able to develop an economic policy where the state played a vigorous role and where a selective credit policy with extensive capital market regulations was a key element.

The new economic policy had profound consequences for the three supervisory agencies. During the post-war period, the Brokers' Control Agency was reduced to being an agency in the Ministry of Trade, administrating brokers' exams and licenses and performing a minimum of supervisory activities. The main reason for this was the low activity level in the stock market. The security trade had recovered slowly from the post-WWI crash. After WWII control of capital allocation was a vital part of Labour's economic policy and by introducing higher taxes and dividend regulations the authorities contributed to keeping a low turnover in the stock market. Measured in fixed prices, securities sales did not reach WWII levels until the mid-1960s, and until the 1980s the stock market hardly developed at all. All in all, the post-WWII policy regime left little room for a growing stock market and assigned the Brokers' Control Agency a very modest role.[12]

The development of the Banking Inspectorate and Insurance Council during the post-war period was characterized by a distinct decline in traditional supervisory tasks and a corresponding growth in bureaucracy. Initially, the most important tasks of the two agencies had been to scrutinize documentary data provided by the banks and insurance companies, and carry out on-site inspections in order to provide more in-depth information. In addition, the agencies had an advisory function towards the financial institutions as well as the political authorities. From the 1950s, however, the number of on-site inspections of both banks and insurance companies was reduced. This development was particularly dramatic in the banking sector, as illustrated in figure 1. While in the 1950s the Banking Inspectorate carried out on average 492 on-site inspections, the average dropped to 312 in the 1960s and 113 in the 1970s.

Figure 1: Number of on-site banking inspections 1950-79



Source: Banking Inspectorate

According to the Banking Inspectorate, the main reason for the decline in on-site inspections was an increasing amount of bureaucratic work, which was not compensated by an equivalent growth in resources. The political authorities assigned the supervisory agencies an increasing amount of preparatory work for new banking and insurance laws. In the 1960s, the Banking Inspectorate also used an increasing part of its resources on two major studies of structural reorganizations in the banking sector. As mentioned earlier, the Norwegian banking sector had an extremely decentralized structure, characterized by numerous unit banks with strong local roots. Many saw the relatively small banks as a bottleneck in the industrial development. Thus, the political authorities on the one hand wished to incite mergers and acquisitions. On the other hand strong regional interest groups feared too high concentration around the largest cities, and tried to counteract an on-going process of concentration where the three largest commercial banks acquired local banks in the regions. The political solution, drawn up and concretized by the Banking Inspectorate in co-operation with several Ministries, was so-called ‘decentralized centralization’. This implied that the authorities urged regional banks to merge with each other

locally, rather than with one of the large city-based banks. To a large extent, however, the strategy of decentralized centralization failed. Few of the local mergers suggested by the authorities were carried out and the acquisitions by three largest banks continued. Still, the concentration process went much slower than in the other Scandinavian countries and the Norwegian banking system continued to be characterized by many, relatively small regional banks.[13]

The new bureaucratic tasks of the supervisory agents were obviously demanding of resources. An additional burden was that during the post-war period the Banking Inspectorate became responsible for supervising new types of financial institutions, such as credit associations, mortgage companies etc. So a key question is why the political authorities did not compensate for this by supplying more resources in order to maintain the traditional supervisory work? The answer lies in the political and economic changes throughout the post-war period. While the crises of the inter-war years had brought attention to the importance of financial supervision, the stable economic growth of the 1950s and 1960s had the opposite effect. Economic development as well as prevailing economic theory suggested that crises were a phenomenon of the past. New instruments for planning and governing the economy seemed to have enabled the industrialized economies to overcome cyclical fluctuations, and economic policy basically became a question of administering the growth. In this political climate, financial supervision was regarded as less important.

Another reason for downgrading supervisory tasks was the extensive Norwegian credit and foreign exchange regulations, which gave the authorities considerable control of the dispositions of banks and insurance companies. The credit policy regime was introduced around 1950. A cornerstone in this regime was the policy of low interest rates, which resembled the cheap money policy introduced after WWII in countries like the UK and Sweden. It aimed at keeping interest rates at a stable level well below what would have been market rates. In the early 1950s, when other countries abolished or relaxed the cheap money policy, the Norwegian authorities reinforced market controls and continued to pursue a policy of low interest

rates.[14] To avoid over-heating the economy by a too rapid credit growth, the authorities introduced rationing mechanisms. These controls also served as instruments to allocate credit to sectors with high political priority, such as energy-intensive industries, development of hydroelectric power, shipbuilding and housing. Initially, the main instruments were moral persuasion and agreements with banks and life insurance companies. After 1965, a new law of credit and monetary policy replaced these voluntary arrangements with a system of liquidity reserve and bond investment requirements, controls of bond issues and interest rates and other measures. The authorities also promoted a system of price cartels and agreements within the banking and insurance sectors, which benefited the established financial institutions by drastically reducing competition. In addition to the regulations of the national credit market, the authorities maintained strict currency regulations, where all foreign exchange transactions except current trade credits required a public license.

In this post-war regulatory regime the supervisory agencies played no prominent part, and this was probably a third reason for the insufficient supply of resources. In the early 1950s, the Ministry of Finance intended to use the Banking Inspectorate and Insurance Council to implement and control the credit regulations. Through their inspections the two agencies had unique knowledge of the dispositions of individual banks and insurance companies. The Ministry of Finance considered utilizing this knowledge to control whether the financial institutions fulfilled agreements and legislative requirements. However, the Ministry met forceful resistance from the Insurance Council and the Ministry of Social Affairs, which refused to recognize insurance companies as financial institutions, and argued that they should not be part of the credit policy regime. This view was rooted in the traditional view of insurance being a socio-political rather than commercial activity, which still dominated in the supervisory agency. The Banking Inspectorate was less skeptical of the credit policy regime. During the 1950s, however, a number of coinciding incidents regarding the use of credit policy instruments gave the Norwegian Central Bank rather than the Banking Inspectorate the key role as the

executing agency of Ministry of Finance. Hence, the supervisory agencies ended up on the sideline in the credit policy regime and were thereby regarded as somewhat less important institutions.[15]

All in all, a lack of resources and increased bureaucracy resulted in the supervisory agencies losing competence in their core activities. The thoroughly regulated credit market, inactive stock market and stable economic environment reinforced this by giving the supervisory agents little experience in handling economic fluctuations and free-market situations. Thus, when the 1970s appeared with economic stagnation, inflation and increasing volatility in the international capital markets, the supervisory agents along with the political authorities in general were not well equipped to handle the new challenges.

The seedbed of instability: deregulation and credit expansion

The international slump following the OPEC II oil crisis also affected the Norwegian economy, and unemployment increased with decreasing GDP growth. During 1983, however, a new upswing started. At the outset, the propelling force of this upswing was an upsurge in investments, especially in the offshore sector. From about 1980, increasing flows of revenues from oil production were channeled into the Norwegian mainland economy. Both the trade balance as well as the central government's income were increasingly dependent upon oil revenues and the prices on crude oil and natural gas. Consequently, both exchange rate development and the interest rate level were to an increasing extent determined by the oil price. After a while, however, rapidly rising domestic consumer spending became the driving force in the upswing. Norway experienced a very steep rise in household spending during 1984–85. From 1984, even private investments outside the offshore sector increased substantially, strongly stimulated by the growth in consumption.

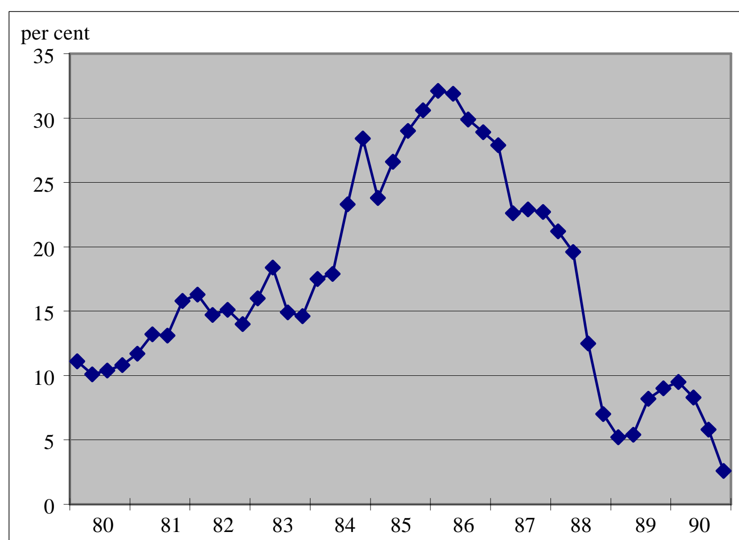
This exploding growth in consumption and investments was financed by a considerable increase in borrowing, both by households as well as firms. The bulk of the loans were provided by commercial- and savings banks. Even finance companies,

either owned by banks or insurance companies expanded their lending substantially. Hence a credit fueled boom developed. Figure 2 illustrates the growth in bank lending during the 1980s. The boom was stimulated by the Government's expansive fiscal policy over the period 1983–85.

The heavily regulated financial sector was liberalized during the first half of the 1980s. The highly interventionist old model of selective credit regulation was not scrapped in one formal decision, but rather through a process of several decisions stretching over a period of ten years. However, some decisions ought to be characterized as more seminal than others. Actually, the first steps towards deregulation of the financial markets and institutions started during the late 1970s. The first deregulatory step was a change in the interest rate policy in the autumn of 1977, when the pegging of interest rates on bank loans was abolished. In order to curb accelerating inflation, however, a price and income freeze was launched in September 1978. This regulation affected interest rates on lending, but did not comprise the interest rates on deposits. Thus, the banks competed severely on the price on deposits, while the maximum rate of interest on loans was regulated by the authorities.

The price and income freeze was lifted in 1980, but a policy that aimed at imposing a politically determined *interest rate level* was introduced. The Government did not try to peg the interest rates on various types of loans any longer, but attempted instead to govern the interest rate levels through so-called 'interest rate declarations' issued by the Minister of Finance. The declaration set an average maximum rate on interest and commissions on both long-term and short-term loans. This system was abandoned in 1985. Even so, the Government attempted to keep interest rates lower than the market price through political measures until ambitions to control interest rate levels were finally abandoned during the autumn of 1986.

Figure 2: Growth in banks' lending 1980–1990. (Per cent each quarter)



Source: Norwegian Financial Services Association

In November 1978 a first step was taken towards the relaxing of capital controls. From this juncture the banks had free access to borrow or place in foreign currencies as long as they held a balanced daily position between NOK and their portfolio of foreign currencies (the so-called *zero-position rule*). This opened up for an extensive use of deals in currency futures and currency swaps. Moreover it made it possible for the banks, unrestricted, both to borrow abroad in order to provide domestic loans and to provide loans for their customers in foreign currency. In 1984, key credit controls were lifted for both banks and insurance companies, whilst the bond market was gradually liberalized during 1984–85. At the same time the interest rate level was still regulated downwards, below the market price. These measures boosted the supply side of the credit market, while concurrently a lax fiscal stance increased the demand for credit. Simultaneously, the asset markets were liberalized and stimulated. Price restrictions in the real estate market were abolished. Several deregulatory initiatives towards the stock market were also taken. Consequently, the asset markets took off, further stimulating the credit boom. Asset price inflation thus became an important

feature of the evolving boom. For example, real prices for business property rose by 100 per cent over the period 1983 to a peak in 1987. The stock market quadrupled its turnover from 1983 to 1984 and continued to grow until the crash of October 1987.

Another, very important incentive to excessive borrowing was the Norwegian tax system, characterized by unlimited deductions for interest rate charges. During the accelerating inflation of 1970s and early 1980s, this made the real interest rate after tax negative. There were some initiatives to gradually reduce the effect of this mechanism through tax reform. This was met, however, by fierce resistance from the Conservative Party.

After 1980, most of the commercial banks pursued aggressive growth strategies. Strong expectations about a quick transformation to a business environment characterized by liberalized financial markets and deregulated financial institutions underpinned the expansionist strategies. It became a major goal for the banks to capture the largest possible share of the credit market as fast as possible. This race increased financial fragility substantially, whilst at the same time internal governance- and control systems were put under substantial stress. This development led to a loss of control in a large number of Norwegian banks. The management of the banks also turned a blind eye to frictions in the deregulatory process. Consequently, they developed illusions about how quick markets would adapt to a deregulated environment. These attitudes also contributed to a loss of control.

The steep credit expansion over the period 1980–1986 increased systemic risk substantially. Systemic risk can be defined as negative externalities occurring when somebody takes a risk that causes a further risk for others in the financial system.[16] Thus, systemic risk refers to a situation where shocks to one part of the financial system lead to shocks elsewhere, in turn impinging on the stability of the real economy. This exacerbated the possibility that a failure of an individual bank could spread across the banking system.

The Banking Inspectorate faces new challenges

The Banking Inspectorate, responsible for supervising the banks until 1986, was not very well fitted to cope with the new situation characterized by liberalization of financial markets and a strong credit-fueled boom. As we have seen, the Banking Inspectorate as well as the Insurance Council experienced that the Government did not prioritize their resource supply while their amount of administrative work increased. This increasing mismatch between tasks and resources continued during the first half of the 1980s. Consequently, the Banking Inspectorate went on with keeping the frequency of on-site inspections very low. Thus, both the capacity of verification of the financial institutions' accounting practices as well as competence to carry out inspections was lost. When the economic conditions became more turbulent and less predictable during the late 1970s and early 1980s, the supervisors were not very well prepared. In spite of this development, the Government and the Ministry of Finance (MoF) were primarily concerned with saving resources. When, for example, the Banking Inspectorate in 1985 asked for funding to fill vacancies for which qualified applicants had been found, this was refused by the MoF.

However, the consequences of the banks' reckless lending expansion was not very well understood by the leadership of the Banking Inspectorate either. An example illustrating this point is the agency's policies concerning capital adequacy requirements.[17] While share capital and retained profit constitute genuine equity, subordinate loan capital represents a type of quasi-equity. Defined as a ratio of equity to total assets, capital adequacy requirements represented a bottleneck or a limit for the banks' growth in assets and hence lending. Over the period from the early 1960s towards the late 1980s, Norwegian capital adequacy regulations were increasingly diluted. There were good reasons for some of these changes in the regulations, for instance, the introduction of a type of risk weighting in 1972. Even the first legislation on commercial banking in 1924 permitted the banks to use subordinated loan capital to fill up parts of the capital requirement.

During the late 1970s and early 1980s, the political authorities as well as the Bank Inspectorate developed a more liberal attitude towards the banks' wish to finance their expansion by using subordinated loan capital. Consequently, share capital reduced its fraction of total bank capital from 54 to 39 per cent over the period 1978-81, whilst the share of subordinated loan capital increased from 2 to 23 per cent. There were three major motives for the banks to apply for increased use of subordinate loan capital. Firstly, such capital was less expensive for the bank than share capital. Secondly, the use of loan capital allowed the banks to expand their activity in a situation when share capital was very difficult to obtain. The political authorities launched a debate on 'bank democratization' during the 1970s. This debate signaled the threat of some kind of public take-over of the banking system. Consequently, the market for issues of bank equity was ruined for several years. Thirdly, the banks' ability to build up sufficient capital to finance rapid expansion by retaining profits was limited. During the period 1974–83, only one third of the average growth in bank capital was generated internally.

During the early 1980s the Banking Inspectorate supported a proposal, which would allow the banks to use subordinated loan capital corresponding to 50 per cent of total capital. During 1986 the major banks started to use so called *perpetual subordinated loan capital* and applied to the authorities for permission to use this instrument in addition to 'ordinary' loan capital with a fixed date of maturity in order to meet their adequacy requirements. The banks suggested a 50 + 50 formula meaning that they now wanted authorization to let the sum of perpetual and 'ordinary' subordinated loan capital correspond to 100 per cent of genuine equity (share capital and internal funds). The supervisory body recommended that the MoF accept the 50 + 50 formula, and in November 1987 it was approved.

The result of this process was that the Norwegian capital adequacy regime became rather lax, even in comparison with most other European countries. This liberal stance on capital requirement standards led to serious consequences in relation to both the boom and bust sequences. First it stimulated the hyper-growth of the boom

period. Secondly, it weakened the banks' solvency and hence their defense when major losses occurred during the bust period.

The Brokers' Control Agency was responsible for the supervision of securities brokers. In addition, the Agency supervised the real estate market and brokers. In 1982, the Government decided to merge the Brokers' Control Agency with the Banking Inspectorate from January 1983. This agency's experiences were gained during a period characterized by a politically administered bond market, and a sluggish stock market due to regulations and taxes. When the securities markets exploded in 1983, the Brokers' Control Agency had neither the resources nor the competence to provide efficient supervision. At the same time it became an absolute necessity to speed up the work on new legislation on the securities trade, which had been ongoing for years. In 1985, new legislation was passed by the Parliament.

The liberalization process also affected the insurance business considerably. In 1982–83 the price cartel (SKAFOR) in non-life insurance collapsed when horizontal price co-operation was banned in the financial sector. The gradual deregulation of credit market controls also had a significant impact on insurance, considering the fact that more than 50 per cent of the life-insurance companies' income came from investments in financial markets. The Insurance Council, which was in charge of supervising the insurance companies, was, however, stuck in the old regulatory regime. As previously mentioned, the logic of social politics characterized the practice of the 70-year-old Council. In 1983, a commission appointed by the Government to evaluate the need for change in legislation in the insurance sector, published its report. The report proposed completely new and modernized legislation. Among other things, the report proposed an integration of the supervisory bodies in banking and insurance. A new and comprehensive law comprising the whole insurance business was enacted in 1988 based on the insurance commission's proposal.

The creation of Kredittilsynet

The Banking, Insurance and Securities Commission of Norway – *Kredittilsynet* – was established by the Parliament in the spring of 1985 (henceforth referred to as *The Commission*). The new organization was responsible for a wide range of tasks, including the supervision of banks, finance companies, mortgage companies, insurance companies, pension funds, securities trading and real estate brokers. It took some time, however, to organize the new integrated supervisory authority. In December 1985, the Ministry of Finance appointed the Board with Professor of Law, Erling Selvig, as its Chairman. In March 1986, *The Commission* was put into operation, when the personnel from the former Brokers' Control Agency, Banking Inspectorate and Insurance Council moved together. Thus, integrated financial supervision was shaped through a merger of all three of its existing financial sector regulatory bodies.

The process of finding an executive leader for the new agency took considerable time. It was not until June 1987 that the Ministry of Finance appointed Svein Aasmundstad to the job as the new Director General of *The Commission*. Meanwhile, Chairman Selvig had to take responsibility for the agency's executive and administrative tasks, more or less acting as managing director over the interim period.

Norway's decision to combine its banking, securities and insurance regulation by setting up *The Commission* took place in the midst of a credit fueled boom, but actually it was a result of a lengthy process. Since the late 1960s, Norwegian authorities had been looking for organizational solutions which would make it possible to achieve economies of scale and scope. In addition, the shaping of *The Commission* should also be understood as the Government's answer to perceived challenges that the supervisory agencies were encountering during the late 1970s and early 1980s. Rapid structural change, spurred by financial innovation and liberalization of financial markets, had blurred the boundaries between the banking, insurance and securities sectors. Legislation permitting 'bank assurance' business was

not enacted until 1990. In spite of this, however, a process of de-specialization unfolded and gave impetus to the emergence of financial conglomerate groups.

As early as 1970, the managing director of the Banking Inspectorate had sent a letter to the MoF, proposing that the Inspectorate be transferred to the Bank of Norway, where it would be organized as a department of the central bank. One of the arguments for this was the Banking Inspectorate's great difficulties recruiting adequately competent personnel during the 1960s. Another argument was the shrinking resources allocated to the Banking Inspectorate. It was argued that by handing over responsibility for supervising the financial institutions, economies of scale would be created. Moreover, it was pointed out that "increasing economic stability has generally reduced the risks associated with the banks' lending business". The proposal was considered by a commission working on the revision of central bank legislation. In 1976, the MoF proposed legislation that would give the go-ahead to a merger between Parliament the Banking Inspectorate and the Bank of Norway. However, the legislation was not passed by the Parliament. A major reason for this was resistance from the Bankers' Association and lack of support for the bill among the Opposition parties. Thus, the new integrated financial sector supervisory agency was organized separate from the central bank when it came into being.

The priority of tasks

The Commission was established when the credit-fueled boom peaked. During the winter of 1985–86 oil prices collapsed. However, the boom continued for a while. Credit growth did not reach a turning point until the second quarter of 1986. Pressured by the steep fall in oil prices, the incoming Labour Party administration launched an austerity package to curb the boom. It took some time before the tightening of fiscal and monetary policies affected the economy. But during 1987, a distinct downswing occurred. Bank lending decreased and the real estate market experienced a sharp drop in prices. Consumer spending dropped and the number of bankruptcies increased. Consequently, loan losses surged during 1987.

This was the situation facing *The Commission* when it commenced its operation at the end of March 1986. However, it is obvious now that *The Commission* at the outset did not prioritize its resources in a way that reflected the problems building up in the banking sector. First of all, main concern had to be devoted to the organizational structure of the agency. Associated with this, several problems and frictions stemming from differing organizational cultures and experiences developed and took much time. Moreover, top priority was given to supervising the securities brokers, market behavior and the actors' compliance with the market rules and regulations stipulated by the new legislation on securities trading. Furthermore, work to prepare new legislation covering the financial sector was also given considerable priority. When the new integrated supervisory body was established, the MoF gave very definite signals that the supervision of securities trading was to be prioritized. Thus, both the resource situation and the priorities on the political level confined the agency's efforts to supervising the banking sector.

Table 2: Kredittilsynet – size of permanent staff

	1986	1988	1990	1992	1994	1996	1998	1999
Permanent staff	71	81	95	97	124	129	139	149

When *the Commission* was established, the permanent staff consisted of 71 employees. At this juncture, only 2–3 staff members were responsible for doing on-site inspections in banks, mortgage banks and insurance companies. In addition to the core tasks associated with banking, insurance and securities trading, the Government assigned both the supervision of debt collecting agencies as well as auditors to the new supervisory agency in 1988.

The banking crisis 1987–92

Ex post we can conclude that the sharp downswing in 1987 triggered a huge banking crisis in Norway. This crisis stretched over a six-year period from 1987–92, with a peak in 1991. Over these years, the banks lost an incredible 76 billion NOK, and a majority of the major banks had to be bailed out by the state. At the outset of the crisis, a number of banks experienced increasing problems with defaulting loans. Thus, the first phase of the crisis was characterized by troubled individual banks. During 1990–91, however, the problems spread across the banking sector and turned into a systemic crisis.

Because of the priority of tasks, *The Commission* did not have its main focus on the emerging problems in the banking sector during 1987. In fact, the MoF's yearly guidelines to the agency signaled that supervision of the securities trading should be the agency's main assignment both in 1987 and 1988. However, the unfolding banking crisis and a growing number of troubled banks occupied gradually more and more of the agency's work. During 1988, handling the crisis became the main task of the financial supervisory authorities, and continued to be over the next five years.

Apparently a change in emphasis came about in winter 1988, when the board decided to escalate *The Commission's* efforts on supervising banks and finance companies. But as a consequence of limited resources and priority of tasks, the agency's modus operandi followed, to a large extent, the principles of a fire brigade – it only acted in response to arising problems. During the autumn of 1988, it became clear to *The Commission* that Sunnmørsbanken – Norway's 5th largest commercial bank in terms of assets – had lost all its capital. Thus, Sunnmørsbanken was the first defaulting bank during the banking crisis. The supervision of this bank demanded substantial attention until its merger with Christiania Bank in winter 1990.

Sunnmørsbanken had expanded its operation and lending immensely over the period 1982–86, when its yearly average growth in lending exceeded 30 per cent. This expansion led to significantly increased credit risks in Sunnmørsbanken's loan

portfolio. This bank had also failed to meet the capital requirement standard during most of the years of the expansion period. Thus it had very weak buffers to meet the loan losses generated during the downswing.

Norway's largest commercial bank, DnC, also experienced substantial trouble in 1987–88. The problems were partly due to losses on securities trading associated with the stock market crash in October 1987. However, the problems mainly stemmed from huge losses on loans provided by local branches in DnC's regional network.

A major shift in supervision practice occurred during 1988–89. At that time it became clear to the *Commission* that previous levels of on-site inspections and document control were insufficient tools to reveal a realistic picture of the situation in troubled banks. In 1987, only two on-site inspections were carried out in the banking sector. In 1988, the number rose to 26 inspections in 22 banks, and then doubled to 44 inspections in 1989. In addition, consultations were held by a large number of banks at the Head Office of the *Commission.* The agency had to intervene in 25 banks where loan losses had wiped out capital. These defaulting banks taxed a substantial part of the supervisory body's strength over several years.

During 1990–91 it was generally accepted that the ongoing banking turmoil had developed into a systemic crisis when it became obvious that the three largest commercial banks were in serious trouble. The *Commission* informed the MoF about the serious situation in the banking sector at a meeting in October 1990. The crisis had now become so widespread that it could be characterized a systemic crisis, the Ministry was told. From 1988–90, the commercial banks' number of non-performing loans rose 50 per cent, whilst they increased 160 per cent in the savings banks. The loan losses increased considerably during 1990. However, 1991 turned out to be the year of catastrophe. Loan losses wiped out capital in two of the major banks, which had to be bailed out by the state.

Theory and research on banking crises

Research on the Norwegian banking crisis has been published in a wide range of works. We have chosen to use a theoretical framework where financial crises are analyzed within a financial fragility approach. This approach has provided a rewarding ground for analyzing past crises and thereby the context supervisors acted within when they had to deal with financial instability. Great importance is attached to the role of debt in causing financial difficulties. This argument rests on presumptions that discriminating between good and bad credit risks are more difficult when the economy is expanding rapidly. One of the reasons is the deterioration of governance – and credit control systems, mainly because of organizational stress. Another factor contributing to bad credit control is that many borrowers are at least temporarily very profitable and liquid. Increased financial fragility is also a result of "debt contracted to leverage the acquisition of speculative assets for subsequent resale."[18] Sharp swings in assets markets like real estate, equity prices and even in commodity markets, intensifies the crisis because of high loan concentrations in these areas. Moreover, asset price declines depress the market value of collateral. We will also emphasize that this framework is consistent with theories built on information problems – for example asymmetric information in credit contracts.

Focus on increased financial fragility and systemic risk caused by the accumulation of debt during a boom throw light on the very important tasks of the supervisors during the upswing. Thus it is clear that prudential supervision and solidity control is particularly important during a period of steep expansion. Historical experiences also underline the importance of adequate supervision during periods of credit expansion as a main source of information to the central bank and thus its ability to act as a lender of last resort in a best possible way. Furthermore, focus on increased financial fragility caused by credit expansion emphasize the importance of more modern tools like early warning systems, macroeconomic surveillance, risk evaluation models etc.

Historical analysis demonstrates that financial crises usually involve corporate debt problems in the non-financial sector. Banks do not get into trouble if borrowers can easily service their debt. Thus we want to define a financial crisis as an occurrence of instability linked with sharp declines in the prices of financial assets, defaults by debtors, sharply increased non-performing loans and loan losses, and difficulties in the banking system in meeting the demand of its debtors. These problems are closely related to the banks' expansion in lending and the building up of debt in the non-financial sector. The key problems for the banks during the crisis of 1987–92 as well as earlier crises were a substantial and increasing amount of non-performing loans, which in turn instigated huge loan losses. Consequently, it is important to avoid a too narrow definition of financial crises. For example, confining crises to bank runs that either produce or aggravate the effects of monetary contractions does not give a satisfactory framework for summing up experiences with past crises. Even though bank runs occurred both in the 1920s and during the crisis of 1987–92, they only constitute a fraction of the whole picture. Moreover, deposit insurance schemes have reduced the possibility of depositor runs.

The financial fragility approach thus includes both emphases on economic policy and macroeconomic performance as well as the behavior of particular banks facing changes in the business environment and incentive systems. Economic policy is, of course, related to macroeconomic stability. The history of financial supervision in Norway clearly reveals that lax monetary policy during a boom creates fertile soil for instability later on, whilst tight monetary policy during the downswing of a business cycle also contributes to financial instability.

While banking crises may be triggered by developments in the macro economy, historical analysis of past Norwegian experiences show that an unstable macroeconomic environment is not a sufficient condition for banking crises to emerge. The source of problems also lies internally within banks, and may even be associated with failures of supervision and regulation. A bank's willingness to accept the risk of suffering credit losses is dependent on both the macroeconomic

environment and the bank's internal governance- and control systems. Losses may thus be caused by managerial decisions, by a general market movement, or by a combination of the two. Thus, individual banks can fail within a reasonably stable macro economic environment because of a weak management system. Moreover, banks can avoid insolvency even within a volatile economic environment, if strong internal risk analysis and well functioning management systems are in place. Above all, bad banking can contribute to the development of a systemic banking crisis.

The Norwegian banking crisis of 1987–92 has generated a great deal of literature on what caused the crisis. It is not possible within the confines of this paper, to give a presentation of this research. We will point out, however, that reports on the banking crisis have been published by two public commissions. The first commission was appointed by the Government and led by professor of economics, P. Munthe. It submitted its report in October 1992 (NOU 1992: 30 *Bankkrisen*). The second commission was appointed by the Parliament. It handed in its report in June 1998 (Stortinget: Dokument nr. 17 (1997–98)). This commission was led by professor of law, E. Smith. In addition, a classified report summarizing 11 sub-reports was written by the so-called Wiker-utvalget. This committee was commissioned by and reported to *Kredittilsynet*, and was mandated to investigate for legal offences in financial institutions that had suffered significant losses.[19]

The strengthening of Kredittilsynet

As already mentioned, a cornerstone in the public governance of the financial system, until the liberalization of financial markets during the 1980s, was administratively fixed interest rates. Interest rate pegging aimed at the maintenance of a policy of low interest rates. This created a credit rationing system and opened for a discretionary based system for the allocation of credit.

The Munthe-commission pointed out the 'low level interest rates' policy as a major cause of the banking crisis. The commission's report also emphasized weak capital bases, feeble credit evaluation and inadequate supervision. In 1987–88, a

directive was issued by *The Commission*, which gave rules and procedures for how the banks should handle non-performing loans. According to the commission, this directive seriously exacerbated the Norwegian banking crisis.

In 1996, this discussion flared up again, when some scholars and politicians alleged that the financial supervisory authorities had forced the banks into insolvency by forcing an over-provisioning against bad debts. They asserted that the directives issued on the handling of non-performing loans and the provisioning against defaulting loans was actually a major cause of the crisis. This discussion caused the setting up of the Smith-commission. This commission's report rejected the assertion that regulations on the handling of non-performing loans forced banks into insolvency. Recent research has supported this view. Major banks like Christiania Bank and Fokus Bank had, by considerable margins, no equity capital left in 1991, whilst DnB's capital was almost wiped out.

As already pointed out, there is little doubt that the Banking Inspectorate acted inadequately, and did not have adequate resources to provide efficient supervision during the crucial period of credit expansion and boom. The *Commission* was yet not established during these critical years of credit-fueled boom. When it was established, the agency's priorities were misdirected for a long period. However, the assertion that ineffective supervision was a major cause of banking instability was based on weak arguments. In the Norwegian system, the MoF and the Bank of Norway are in charge of maintaining macro economic stability, with the MoF having a responsible position. It is quite clear that the destabilizing effects of the steep credit expansion during 1983–85 were misjudged by the authorities. So both feeble macroeconomic surveillance and inadequate supervision contributed to aggravating instability.

Even so, the conclusion of the Munthe-commission led to heavy criticism against the *Commission* in various political circles. As a result of this discussion the MoF then proposed to put the supervisory agency under the responsibility of the central bank. This proposal was, however, turned down by the Parliament in autumn

1992. Instead, the Parliament expressed a strong will to strengthen the *Commission* as an integrated financial sector supervisory agency, outside the central bank. Hence, the agency was supplied with increased resources. The staff was expanded, and new leaders were appointed to the Finance and Insurance Department, the Capital Markets Department and the Accounting and Auditing Department. During 1993, competence in insurance supervision and regulation was strengthened as well.

In March 1993, Bjørn Skogstad Aamo was appointed the agency’s General Director. Being an economist, with extensive administrative and political experience, and broad knowledge about the financial sector, this meant a strengthening of the agency’s professional competence. The work to increase the *Commission’s* competence, professionalism and supervisory capabilities was reinforced during the 1990s.

The *Commission* has been able to sum up important experiences on bank supervision stemming from the supervisory work during banking crisis. Supervision on the basis of capital requirements is important but not sufficient, since it gives a static picture of the situation of the bank under scrutiny. A more dynamic framework is needed, as the data acquired will be obsolete at the juncture when the supervisory work is performed. Moreover, both current and historical experiences demonstrate that accounting rules and practices leave a large measure of discretion, both for those preparing the accounts as well as the auditors. Thus, verification work, to ensure that the figures presented are reliable and realistically reflect the actual situation of the bank under consideration, is very important.

Furthermore, it is impossible to judge whether the bank under consideration is likely to retain its solidity, unless the macro economic environment is taken into consideration. Hence, a supervisory agency needs its own macro economic expertise and capability to do macro economic surveillance. In association with this, early warning systems, CAMEL-ratings, credit risk models etc. have become important tools in judging the solidity of banks from a dynamic perspective. All these tools were adopted by Norwegian supervisory authorities during the 1990s.

It should be emphasized, however, that financial crises are caused by a very complex set of factors. Thus, it is almost impossible to predict precisely the outburst of a crisis. However, tools making it possible to detect an emerging crisis as early as possible, are very useful. Historical experiences demonstrate the considerable costs of bank failures, ranging from 5 to incredible 80 per cent of GDP (the recent crisis in Indonesia). As banking crises involve avoidable costs that may be significant, there is a welfare benefit to be derived from reducing the costs of bank failures that do occur.

Norwegian financial supervision over 100 years

The first more modern kind of financial supervision, combining document-based controls with on-site investigations of the institutions, was established in 1900 with the employment of a special inspector for savings banks [*Sparebankinspektøren*]. In 1912, the supervision of life insurance companies was extended and modernized with the establishment of The Insurance Council [*Forsikringsrådet*]. The motivation behind these improvements was still mainly a socio-political one, however towards the savings banks there was also an element of more modern market logic. Unlike in most other countries, the Norwegian savings banks were from an early stage heavily engaged in commercial activities, and an important task for the new savings banks inspector was to detect and prevent problems in the savings banks sector, which could have consequences for the economy as a whole. Thus, stabilizing the financial market was another important motive behind the increased supervision.

The market logic behind the public supervision became more dominant throughout the 20th century, even if the supervision of the life insurance companies still had an important socio-political element. The wish to stabilize the financial markets was important when the broker firms, commercial banks, non-life insurance companies finally became subject to public regulations. However, unlike the savings banks and life insurance companies, these regulations were only introduced after the crisis following WWI was a fact.

Our historical research has found that the establishment of supervision based on market logic generally has been marked by institutional inertia. The political authorities have had little ability to establish or strengthen the supervisory agencies until a crisis has already taken place or it is too late to implement preventive measures. The supervision and control of security brokers and commercial banks came as a direct result of the crises, which emerged in these sectors after WWI. During the war, there were a few initiatives to establish controls in order to stop the rapid expansion of the broker's firms and commercial banks, but the authorities were not able to agree on this until the problems were so large and visible that it was too late to prevent a crises. This was the case in 1918, when The Brokers' Control Agency [*Meglerkontrollen*] was established, in 1919 when supervision of savings banks was extended, and in 1925 when the first permanent law for commercial banks, which included public supervision, was carried into effect and the new joint Banking Inspectorate [*Bankinspeksjonen*] was established.

The second major financial crisis in Norway hit the banking sector in the late 1980s. During the decades leading up to this crisis, we find other examples of institutional inertia. In this period, the three institutions responsible for financial supervision experienced a clear decrease in their allocated resources while their amount of administrative work simultaneously increased. An important reason for this was that both the dominant economic theory and economic development of the Western countries suggested that economic crises were a thing of the past, and thus thorough supervision of the financial markets seemed less important. Besides this, the financial markets were subject to extensive controls of other kinds, and supervisory institutions never played an important role in carrying out these controls. Therefore, they gradually lost their status as important institutions. The result of this long-term decrease in their supply of resources was that the institutions for financial supervision lost important competence in core areas like on-site investigations, which decreased distinctly during the 1960s. When the economic conditions became more turbulent and less predictable in the 1970s, the supervisors were not very well prepared.

Combined with the implementation of a major organizational reform of public supervision in the mid-1980s, this made the financial supervisory authorities incapable of preventing or counteracting the crisis, which was to come. In particular, more adequate supervision and actions towards banks during the period of steep credit expansion, could have reduced the huge increase in credit risks, and hence financial fragility and systemic risk.

It is methodically difficult to determine the impact of public supervision. However, both the theoretical and empirical findings of our historical analysis suggest that supervision of financial markets matters. During WWI, lack of supervision of commercial banks, non-life insurance companies and broker's firms was a main reason for massive expansion and speculation in these sectors, leading to the crises of the 1920s. Savings banks and life insurance companies did not experience a similar war-related boom or such substantial crises. A main reason for this was that the public inspectors worked actively and successfully, especially towards the savings banks, to prevent them from participating in speculations on the stock market, particularly in shipping shares, during the war. When the two major banks faltered in 1931, the Banking Inspectorate supplied the Bank of Norway with in-depth information based on on-site inspections and documentary examinations, enabling the central bank to act without hesitation as a lender of last resort. The Banking Inspectorate also worked out the plan that made it possible to re-capitalize the banks in the ordinary capital market. The activities of the supervisory authorities thus seem to have contributed substantially to limit the development of financial instability during the early 1930s.

Even during the banking crisis 1987–92, it is clear that supervision mattered. After a poor performance during the boom period and the first phase of the subsequent banking crisis, the supervisory authorities strengthened the quality of its work substantially during the remaining part of the crisis. This work undoubtedly contributed to reducing the negative impact on the economy.

Notes

[1] H.I. Matre, *Norske kredittinstitusjoner 1850–1990. En statistisk oversikt*, report no. 42 in Research on Banking, Capital and Society, Oslo: NORAS 1992, table 1a and 2a.
[2] For a theoretical exposition of this so-called financial fragility approach to analysing economic crises, see C. P. Kindleberger, *Manias, Panics and Crashes. A History of Financial Crises*, London 1989 (1978) (second edition); I. Fisher, "The Debt Deflation Theory of Great Depressions", *Econometrica,* Vol.1, No.4, 1933, pp. 337–57; Dow, J., "What is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation", in *Monetary and Economic Studies*, December 2000.
[3] The activity of the Insurance Council in this period is elaborated in G.J. Ecklund and S. Knutsen, *Vern mot kriser? Norsk finanstilsyn gjennom 100 år*, Bergen: Fagbokforlaget 2000, chapter 2.
[4] Archives of the Banking Inspectorate at the National Archives [hereafter: RA–BI], annual report of the Savings Banks Inspector for 1916 and 1917 including unpublished appendices, parcel B 187.
[5] Annual report of the Savings banks inspector for 1916 and 1917; circular letter of November 15, 1916 from the Ministry of Finance, RA–BI file 18. Article in *Morgenbladet* April 28, 1918.
[6] T. Kili, *Aksjemarkedet i Norge 1880–1990*, Research on Banking, Capital and Society, report no. 88, Oslo: Norges Forskningsråd (1996), pp. 115–16; H. Ramm (ed.), *I næringslivets tjeneste. Christiania Børs 1819–1924. Oslo Børs 1925–1969*, Drammen: Børskomiteen (1969), p. 143.
[7] Statistics from the Insurance Council published in *Forsikringstidende* no. 12/1938. See Ecklund and Knutsen, *Vern mot kriser?…*, chapter 5, for more information on the Norwegian insurance crisis in the inter-war years.
[8] Annual report of the Banking Inspectorate 1928, RA–BI.
[9] E.g. Hodne, F., *The Norwegian Economy 1920–1980*, Beckenham: Croom Helm Ltd. (1983); Nordvik, H.W., "Bankkrise, bankstruktur og bankpolitikk i Norge i etterkrigstiden", *Historisk Tidsskrift*, No. 2 (1992): pp. 170–192.
[10] Hanisch, T.J., *Om valget av det gode samfunn*, Arendal: Høyskoleforlaget (1996).
[11] For more elaborated argumentation and empirical data, see Ecklund and Knutsen, *Vern mot kriser?…*, chapter 4.
[12] See Kili, *Aksjemarkedet i Norge…*, pp. 169–78; Ecklund and Knutsen, *Vern mot kriser?…*, pp. 219–220.
[13] Ecklund and Knutsen, *Vern mot kriser?…*, p. 212–15.
[14] For an overview of the British and Swedish cheap money policy, see S. Howson, *British Monetary Policy, 1945–51*, Oxford: Claredon Press (1993); M. Chick, *Industrial Policy in Britain: Economic Planning, Nationalisation, and the Labour Governments*, Cambridge: Cambridge University Press (1997), pp. 4–5; L. Jonung, Riksbankens politik 1945–1990, in L. Werin (ed.), *Från ränteреglering til inflationsnorm*, Stockholm: SNS Förlag (1993).
[15] For a more elaborate analysis of this process, see Ecklund and Knutsen (2000), chapter 7.
[16] Dow, J., "What is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation", in *Monetary and Economic Studies*, December 2000.
[17] For a detailed analysis on capital adequacy standards, see Ecklund and Knutsen (2000): pp. 244–64
[18] Kindleberger *Manias, Panics and Crashes*, p.17, cfr. H. Minsky, H.P. Minsky, "The financial instability hypothesis", Working paper # 66, The Jerome Levy Economics Institute of Bard College, May 1992.
[19] This commission's work is described and analysed in Ecklund and Knutsen (2000), chapter 10.