CHAPTER 4

Sweden: Early Adopter of Formal Banking Supervision with Incremental Steps

4.1 Modernization of the Swedish Banking System in the Nineteenth Century

Sweden industrialized over the course of the nineteenth century. In tandem with this development, a "financial revolution" occurred that modernized the ways in which saving, lending, and investments were generated (Ögren 2010). The gradual economic growth itself became an important driver of the banking system's development (Table 4.1), as an ever-larger share of the population became able to set aside some of their earnings for productive investment and/or save for future needs. The population's growing ability to save was promoted by the savings bank movement, established in Sweden in the 1820s. They increased in numbers quickly, especially in the rural parts of the country where the private bankers and the commercial arm of the parliament-owned Riksbank had limited presence. By the 1830s partnership commercial banks were created in the commercial centers to offer short-term funding for trade and investments of the commercial elites, and by the 1850s the first joint-stock banks with limited liability were created (Larsson 1998). The partnership banks were funded by note issuing and guaranteed by the personal liability of the partners who, as in many other countries, were part of the same local elites that the banks serviced. Business prudence was monitored by these social networks.

With the joint-stock banks, the possibilities to fund larger industrial investments and to mitigate risks in the commercialization of innovations

E. Hotori et al., *Formalization of Banking Supervision*,
https://doi.org/10.1007/978-981-16-6783-1_4

Table 4.1 Commercial banks (Joint stock and partnership), 1870–1920 (10-year intervals)

Year	*1870*	*1880*	*1890*	*1900*	*1910*	*1920*
Number of banks	27	43	43	66	80	31
Deposits (million SEK)	74	247	352	772	1,465	4,968
Loans (million SEK)	110	287	457	1,045	2,085	6,210

Source Häggqvist et al. (2019) and Schön and Krantz (2015)

were greatly improved, and by the end of the century the joint-stock banks were beginning to dominate commercial banking. The general success of the joint-stock company was supported by the creation of the Stockholm stock exchange in the 1860s, which eased the funding of new joint-stock companies and the buying and selling of shares in the companies of the industrialized age. Despite periodical economic recessions and a few financial crises (1850s and 1870s), the commercial banking sector grew without pause over the second half of the nineteenth century, from eight banks in 1850 to more than 60 by 1900. In the same period, total bank deposits grew from less than ten percent of GDP to about 50% (Häggqvist et al. 2019).

In addition to the mutually enforcing processes of industrial and financial modernization also came the reforms of the Swedish political system, as well as the development of the public administration and bureaucracy. With the constitution of 1809, the powers of the king's government were reduced in favor of the parliament, and with abolition of the parliament of the estates in 1866 the legislating power received a broader public representation. The parliamentary process gradually increased the demand on the state to guard and promote the rights and wellbeing of the general population (Kahn and Wendschlag 2020). As the banking sector grew and more individuals became bank customers, the soundness of the banks would become a matter of political concern.

4.2 Nineteenth-Century Commercial Banking Regulation

The regulation of Swedish commercial banks originated from the requirement to gain the King's permission to open a bank. This charter requirement first employed in the 1650s in the case of Stockholm Banco—the first bank in Sweden—remained in force even with the general policy shift toward free enterprise that also occurred in the nineteenth century. While most types of commercial enterprises did not require a royal permission by the mid-nineteenth century, the enterprises engaging in banking business did. The poor experience of the first bank—it failed within a decade and was taken over by the parliament and renamed Riksens Ständers Bank (later renamed Sveriges Riksbank)—can explain why the regulation of banks developed separately from the general corporate acts. In this sense, bank specific regulations developed earlier in Sweden compared to many other countries.

In order to obtain a charter, the bank's owners had to be approved as well as its business plan, including the bank's rules for dividend payouts and reserve funds. The charters were for ten years, when a new charter application had to be approved. The administration and scrutinizing of these applications were done by the Ministry of Finance, and these administrative activities associated with bank charters and regulatory reforms were implemented almost annually during the second half of the nineteenth century.

However, once a charter had been obtained, the commercial banks were not subject to day-to-day supervision. Nor did the banking regulations of the early and mid-nineteenth century imposed much constraint on the business practices of banks. Notably, the partnership banks' note issuing began in the 1830s—the royal decree of 1824 had not accounted for note-issuing business nor explicitly prohibited such business.[1] The issuing of private notes became the most important measure for funding for the partnership banks, and with the 1846 Partnership Banking Act, this note-issuing business came under formal regulation.

The 1846 Partnership Banking Act tasked the local County Administration to appoint civil servants to monitor locally established banks. The representative's powers was limited however, concerned mainly to ensure that the bank did not violate its note-issuing privileges. The representatives did not perform supervisory activities in any standardized or regular fashion during the first half of the nineteenth century (Wendschlag 2012). The personal liability of the partners and the monitoring within the local social networks remained the main form of supervision.

[1] Kungliga kungörelsen den 14 januari 1824 angående inrättande av enskilda banker (The Royal Decree on 14 January 1824 regarding establishment of individual banks).

The first Joint-Stock Bank Act was adopted in 1848. Similar to the Partnership Bank Act, the County Administrations were to appoint a "King's representative" to oversee the joint stock banks. The Act gave the County Administration the right to participate in the bank's board meetings, the obligation to appoint an external auditor of the annual report, and, on behalf of the government in Stockholm, the power to request the information about the bank it deemed necessary to verify compliance. As for the partnership banks however, the supervisory activities of the County Administrations was very limited, irregular, and without common standards of practice between counties. Conversely, social forms of discipline were important for the early joint-stock banks, since those banks operated locally and were dependent on the good faith of local commercial interests both for funding and business.

None of the banking acts implemented in the 1840s provided much provisions in the form of supervisory power for the County Administration. According to the acts, the only enforcement action available for the County Administration was to recommend the Ministry of Finance to revoke or not renew the bank's charter. This option was too drastic for most discrepancies observed in the banks, and the lack of range in disciplining tools prevented proper supervision to develop at the time. Moreover, local politicians or civil servants were mostly the board members of banks and/or significant customers of banks, which further undermined the counties' credibility as supervisors.

By the late nineteenth century, the joint-stock commercial banks came to dominate over the partnership banks in financing the new industry.

The joint-stock banks were more adapted to the times with the new industries of electricity, telephone, hydropower, and chemicals. Due to unlimited liability, partnership banks could not enlarge their business scale sufficiently to satisfy the financial needs of these new industries. Most important to the demise of partnership banks was however, the 1897 Riksbank Act that granted the central bank a monopoly on note issuing (Larsson 1998). This ended the partnership bank's funding model, and more or less forced them to incorporate as joint-stock banks and to base their funding on deposits (and bond issues to some extent). Both types of commercial banks remained in operation however, but practically all differences in legal treatment were erased with the 1903 Banking Reform Act.

While the market and the regulators favored the joint-stock bank, it was regarded as a less reliable form of incorporation. Most important was the fact that the owners' liability was limited, which could lead to too risky or disengaged operations. Another problem came with the overall trend of commercial banks branching out of their home regions. In 1885, 44 commercial banks operated 156 offices, and fifteen years later 66 banks were running 270 offices.[2] With this development the disciplining power of local social networks declined. For external stakeholders, it was becoming difficult to oversee the bank's full operations. The County Administrations shared the problem caused by the branching out, not the least due to the lack of coordination between counties for the supervision of banks operating in multiple counties. As with the state apparatus in general, the banking supervision developed toward further formalization and centralization (Wendschlag 2018).

4.3 The Bank Inspector Profession

Although the banking acts implemented in the 1840s did not introduce day-to-day standardized supervision, the acts required the commercial banks to submit several financial reports per year (frequency depending on size) to the Ministry of Finance. By 1868 the workload in relation to these reports, the administration of charter applications, and dealing with bank regulation reforms were quite demanding. The Minister appointed a civil servant to work exclusively with these matters. The civil servant commenced to develop specialized understanding both of the regulatory requirements and of all the commercial banks in the country. By 1876 this civil servant was given the title of Bank Inspector, and an assistant was hired by the Bank Inspector.[3]

Thus, the formalization and centralization of banking supervision had begun incrementally in Sweden. Indeed, the banking acts identified the County Administrations' responsibility for performing monitoring activities. Yet, those activities were practiced irregularly with weak mandates. The Bank Inspector performed on-site examinations, but quite infrequently. From 1870 to 1889 just 4–6 examinations were conducted per

[2] These figures are drawn from *Statistik om bankerna* (Statistics on the banks).

[3] Kungligt beslut den 15 december 1876 (The Royal Decree of 15 December 1876).

year with little systematization, while the frequency was higher around the 1878–1879 railway bond market crash.[4]

With the 1889 appointment of former banker and head of the Stockholm Stock Exchange, Robert Benckert, as the Bank Inspector, the number of on-site and off-site examinations increased drastically. By then a Bank Bureau had been formed within the Ministry of Finance, which was headed by the Bank Inspector.[5] However, the arrangement required that all executive decisions had to be made by the Minister of Finance. This was an inefficient process, especially since the Minister had to rely on the Bank Inspector's expert advice in most cases (Wendschlag 2012). The special skills developed by the Bank Inspector were also in high demand in the political sphere as the banking acts frequently came up for reform. The political leadership in parliament was in favor of promoting the banking sector's expansion. At the same time the industry's and the general population's growing dependence on banking services (for saving, borrowing, payments, and investing) called for the state to ensure that banks were reliable and prudent in their businesses.

The continued growth of the banking sector called for new reforms. In 1905, the parliament appointed a committee, headed by Bank Inspector Benckert, to investigate a suitable new organization for the banking supervision. The report, published in 1906, argued for the establishment of an independent banking supervisory agency. The agency was still to be organized under the Ministry of Finance but with a board given executive powers, more resources and a clearer mandate to supervise and discipline the commercial banks. Although the growth of the banking sector was an important motive for the reform, the inefficient decision-making process of going via the Minister of Finance was a strong argument for creating an independent agency. The fact that the Insurance Inspectorate had been established in 1904 for the supervision of commercial banks was another argument—the soundness of commercial banks being at least as important as that of insurance companies. The proposed agency would be fully funded by fees paid by the supervised banks, and its board was to be appointed by the Minister of Finance. The board would take over all

[4] Unfortunately, the archives are limited in detail of the work of the banking supervisor during the crisis.

[5] K Maj:t:s beslut den 31 maj 1889 angående inrättandet av en bankbyrå (May's decision on 31 May 1889 regarding establishment of a bank branch).

the supervisory duties of the County Administrations.[6] The board would have the power to grant and revoke bank charters, and could also require the banks to submit all data and information on request.

The supervisory agency was also authorized to conduct on-site inspections of any bank office under its supervision. It could call upon the bank's board of directors not to execute board decisions or to reverse decisions already put in force. If corrections were not made, the Inspection Board could "issue written reprimands or take the measures, which were deemed required."[7] These measures included publishing reprimands in the press and calling an extra meeting of the bank's board. If a bank had made losses equal to the reserve fund plus ten percent of the basic fund, the Inspection had the duty to require the bank's board of directors to bring in external accountants to make a financial statement without delay. New owner capital would then be necessary to rescue the banks from liquidation. The County Administrations still held the power to appoint the King's local representative who took part in preparation of the commercial banks' accounting reports, but these appointments now required the Bank Inspection Board's approval which in effect led to raised competence requirements for these representatives.

The 1906 investigation did not propose substantial alternatives to its main proposal.[8] Allocating the banking supervisory power to the central bank—a solution that was later favored in many other countries (Grossman 2010)—was never discussed. While the 1897 Riksbank act had initiated the dismantling of the central bank's commercial banking arm, the Riksbank was still a competitor to the commercial banks in many respects (Barvell et al. 2019).

In the fall of 1906, the parliament voted in favor of the proposal, and on the first of January 1907 the new agency, the Royal Bank Inspection

[6]The County Administrations still were supposed to monitor savings banks.

[7]SFS 1906:104 § 2.2 Kungl. Maj:ts nådiga instruktion för dess bankinspektion och för dess finansdepartements bankbyrå (May's gracious instruction for the bank inspection and for the finance department in the bank bureau).

[8]Betänkande med förslag till förändrade bestämmelser angående bankkontrollen, afgifvet den 15 november 1905 (Report of proposed changes to the banking control, issued on 15 November 1905).

Board commenced its operations.[9] At the beginning, the new agency coexisted with the Bank Bureau (still headed by the Bank Inspector) which maintained several functions—collecting reports from the banks, producing bank sector statistics, and work related to regulatory affairs. By 1910, these duties were fully transferred to the Bank Inspection Board.

Initially, the number of staffs of the supervisory agency was quite small. It consisted of the Bank Inspector, his two assistants, one secretary, and two external members of the executive board. The Inspector and the secretary were trained in law, while most of the staff hired in the next few decades would be persons with some ten years of work experience at banks and/or other private financial institutes.[10] The agency expanded in the coming years with 15 examiners (and a handful of administrative staff) in total in 1920, and the budget for the Bank Inspection Board increased tenfold between 1907 and 1920 (Fig. 4.1).

4.4 Supervisory Activities of the Bank Inspection Board

With the new agency, the supervisory activities, i.e., on- and off-site examinations, increased drastically compared to earlier. An important reason for this was the banking crisis that began in the summer of 1907 which keep the supervisors busy until the end of the following year. While triggered by the international stock market and credit crisis, excessive domestic lending as well as rapid branch-network expansion were observed among most of Swedish banks that got into trouble (Grodecka et al. 2018).

The Bank Inspection Board was greatly involved in the crisis management. About 20 on-site examinations were conducted in 1906. In 1907 and 1908, the number rose to over 80 per year, and such high level of supervisory activity was maintained for the rest of the decade more or less (Ottosson and Wendschlag 2019). Although the Bank Inspection Board Act of 1906 had no specific guidance on the agency's mandate or role in a banking crisis, Bank Inspector Benckert personally made interventions

[9] SFS 1906:104 § 2.2 Kungl. Maj:ts nådiga instruktion för dess bankinspektion och för dess finansdepartements bankbyrå (May's gracious instruction for the bank inspection and for the finance department in the bank bureau).

[10] SFS 1906:104; Bankinspektionens arkiv, tjänstematriklar (The Archives of the Bank Inspection Board, materials).

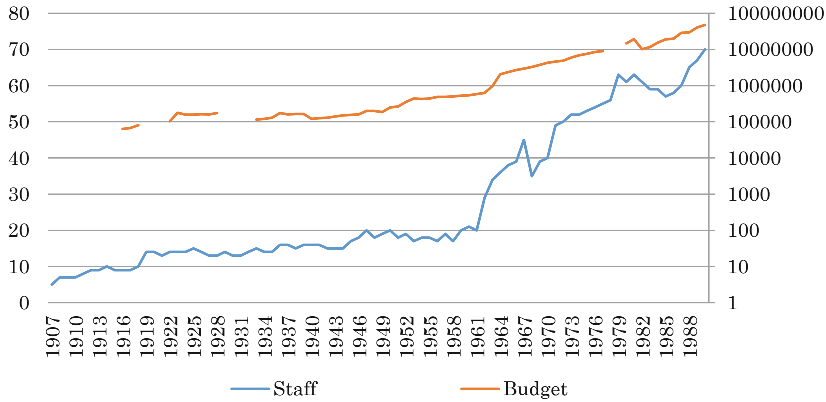

Fig. 4.1 The Royal Bank Inspection Board: Staff and Budget, 1907–1990. *Note* Number of staff: left line. Budget (SEK, not adjusted for inflation): right line. The Bank Inspection Board merged with the Savings bank Inspectorate in 1962. In 1991 it merged with the Insurance Inspectorate to form the Swedish Financial Supervisory Agency (*Sources* Bankinspektionen, *Tjänstematriklar,* and Svensk Bankmatrikel, 1906–1944)

in problem banks. Many bank boards were persuaded to replace incompetent managers, in many cases with persons proposed by Benckert himself. The agency also acted as a broker in cases when weak banks were taken over by or merged with larger banks (Söderlund 1976).

* * *

The process of banking supervision formalization in Sweden was finalized with the creation of the Bank Inspection Board in December 1906. The commercial banking regulation development from the 1840s but did not enhance supervisory duties/activities of the County Administrations. The supervisory powers of the County Administrations were not exercised in a day-to-day, uniform or transparent way. With the creation of the Bank Bureau and the development of the Bank Inspector profession in the 1860s and 1870s, banking supervisory activities such as on- and off-site examinations became marginally more frequent, but began the process of centralization of the banking supervison. Still the lack of independence (dependent on political decision makers) was still problem for effectiveness of the supervisory system. The creation of the Bank Inspection Board in 1906 and the transfer of supervisory executive powers from the Ministry of Finance to this new supervisory agency were the final step of the formalization process. Already in its first year of existence, the agency was forced to test the limits of its mandate with its involvement in the banking crisis of 1907–1908.

The main driver in the formalization process was the development of the banking sector itself and the initial and kept treatment of banks as the "special" type of businesses—manifested by the charter requirement. The centralization of the banking monitoring from the local County Administrations to the government in Stockholm was in part driven by the success of the joint-stock bank incorporation that reduced the disciplining powers of local social networks of elites.

References

Barvéll, K., M. Nessén, and M. Wendschlag. 2019. The Riksbank's organisation and operations: A look back through history. *Sveriges Riksbank Economic Review* 2019 (1): 67–113.

Grodecka, A., Kenny, S., and Ögren, A. 2018. Predictors of bank distress: The 1907 crisis in Sweden. Sveriges Riksbank Working Paper Series 358.

Grossman, R.S. 2010. The emergence of central banks and banking supervision in comparative perspective. In *State and financial systems in Europe and the USA: Historical perspectives on regulation and supervision in the nineteenth and twentieth centuries*, S. Battilossi and J. Reis, 123–137. Burlington: Ashgate.

Häggqvist, H., P. Hedberg, L. Karlsson, and M. Larsson. 2019. The development of Swedish commercial banking, from establishment to consolidation: A presentation of a new database, 1866–1938. Uppsala Papers in Financial and Business History 24.

Kahn, C., and M. Wendschlag. 2020. Den svenska finanstillsynens organisering och uppdrag i historiskt perspektiv (The Swedish financial supervisory authority's organization and assignments in historical perspective). In Finanstillsyn 2020 (*Financial supervision* 2020), ed. A. K. Stockenstrand, R. Söderström, and P. Öhman. Liber (in press)

Larsson, M. 1998. Staten och kapitalet (*The state and capital*). Stockholm: SNS Förlag.

Ögren, A., ed. 2010. *The Swedish financial revolution*. Basingstoke: Palgrave Macmillan.

Ottosson, J., and M. Wendschlag. 2019. The management of the Swedish 1907–8 banking crisis. Paper presented at the conference on uses of the past in International Economic Relations, May 9–10, in Oxford University, Oxford

Schön, L., and O. Krantz. 2015. New Swedish historical national accounts since the 16th century in constant and current prices. Lund Papers in Economic History 140.

Söderlund, E., ed. 1976. *Benckerts testamente – konfidentiella anteckningar angående bankinspektionens verksamhet (Benckert's will—Confidential notes on the bank inspector's activities)*. Stockholm: Kungliga samfundet för utgivande av handskrifter rörande Skandinaviens historia.

Wendschlag, M. 2012. *Theoretical and empirical accounts of Swedish financial supervision in the twentieth century*. Dissertation, Linköping University

———. 2018. Finanstillsynens utveckling i Sverige från mitten av 1800-talet fram till 1990-talskrisen (The financial supervisory authority's development in Sweden from the mid-1800s until the 1990s crisis). In Ett liv som handledare: Mats Larsson 65 år (A life as a professor: Mats Larsson 65 years). ed. M. Lönnborg and P. Hedberg.Uppsala Papers in Financial and Business History 23.