Rigid Regulation, Dynamic Markets, Adaptive Enforcement, the case of Swedish banks' right to own and trade in stocks[1]

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Abstract:
The article develops a theoretical framework based on institutional economic theory to analyze the function of the Swedish Bank Inspection Board in handling the commercial banks' innovative business of trade and acquisition of stocks during the first decades of the 20th century under incomplete regulation. The slow regulatory process required the Inspection to stretch its room for discretion to oversee the banks' stock trade which increased rapidly in the 1910s and especially during World War 1. The Inspection's room for discretion was wide in terms of operational interpretations of often imprecise formal legal text, but narrow in terms of its jurisdiction. Only in 1919 the stock brokers and the stock exchange came under its supervision. Although the risks of the banks' stock trade business were evident by the mid-1910s, no regulatory change was made. However, the 1920-21 economic crisis brought down all the investment companies. In 1932, regulators acted to revise the regulation to again prohibit the banks from owning or trading in stocks. The Bank Inspection Board can be seen as an example of an 'institutional organization', an enforcer of regulation and implementer of policy, and a additional unit of analysis to institutions and organizations in the institutional economic theory Whereas institutions, such as laws, are hard and time-consuming to change in order to adapt to the dynamics of the innovative organizations, the institutional organization may provide the institutional framework with flexibility, and combined the stabile institutions and the adaptive enforcers may form the adaptive efficiency to facilitate the innovative process for economic development.

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[1] Early draft – Do not quote

Introduction

Institutional economic theory is based on two units of analysis, the institutions and the organizations. According to the famous sports analogy of Douglass C. North, the former are the ‘rules of the game’ and the latter the ‘players’ of it. The focus of the research field in part is given by this theoretical construct, with much attention given to the matters of how institutions are created and how they are changed. In both cases it is believed that the existing institutional framework itself and the competition of the organizations within it that is the key to these questions, and this may very well be the case. Actors of interest in orthodox institutional economic research are thus regulators, courts and market interest groups. However, in a theoretical framework based only on institutions and organizations, important elements of social, economical and political order and change are reduced or neglected. The matter of enforcement of regulation and implementation of policy are among them. It would be too much to say that the enforcement of regulation and the implementation of policy has been assumed to be unproblematic, but not that it has not been subject to much research or theory by institutional economists. A solution is the assumption of ‘enforcement characteristics’ embedded within institutions, but in the case of regulations, this seems implausible, and has the danger of being used as an escape-clause for researchers to do away with the complexes of regulation and implementation. History abounds with examples were a formal regulation has been followed by an unexpected market or actor response and this article stresses a raised awareness of the enforcement and implementation aspects of regulation and political policy. The concrete focus of the theoretical discussion of the article is on the relationship between rigid regulation, adaptive enforcement and market dynamics. The theoretical framework is then used to analyse a historical case of the Swedish banks’ right to own and trade stocks in the first decades of the 20th century and how the Bank Inspection Board attempted to overcome the incomplete regulation by adapting its enforcement to the organizational innovativeness of the banks at the time.

The stability and flexibility of the institutional framework

The ability of an institutional framework to adapt to organizational dynamics facilitate innovation has been recognized as a crucial element for economic development. The institutional framework should at the same time be stabile to provide solid grounding upon which economic decisions can be made. From an institutional design perspective, the two objectives are difficult to combine. To North (1990) the answer in theory is clear: “The

society that permits the maximum generation of trials will be most likely to solve problems over time"[2]. This is a key aspect of the innovative process that must be underlined. The key to progress is learning the right lessons from a trial-and-error process, and the success in structurally accommodating this process, and handling failures, is what North means by adaptable efficiency. The characteristic feature of an economy with adaptable efficiency should thus be that it is permissive of alternative problem solving solutions, i.e. innovations. At the same time, and this is of course were North has put most of his emphasis, institutions are stabile over time, and that this has important benefits as well. The positive aspect of stabile institutions is that they set limits to the world's true complexity, limits the number of choices and alternatives that the individual or organization has to process at any one time etc.[3] And since they are hard to change, they lower the uncertainty about what rules will apply tomorrow, in a month, a year. Only if structural elements are believed to be stabile, will companies, or organizations, dare to invest in innovative enterprises. But as the companies innovate, the stability of the institutional framework is weakened. Or, the rigidness of the institutional framework is so great that no innovation will be conducted. Economic development may thus be constrained by the existing institutional framework. Ideally, the institutional framework should provide stability to lower uncertainty while at the same time be adaptive to handle the innovative process. But how is it accomplished? In an orthodox theoretical framework based on institutions and organizations this is difficult, as institutions are slow to change and only organizations are reactive actors. Institutions have to rely on "enforcement characteristics" to affect the actions of them. But given that innovations are to some degree novel[4], one cannot expect institutions designed ex ante to handle these sufficiently. If an innovation is novel, how could an institution contain enforcement characteristics to constrain it before it exists? This is a major limitation to the orthodox institutional theoretical framework.

It is here argued that to achieve the adaptive yet stabile institutional framework that is calls for, another theoretical entity must be considered, which could be called an 'institutional organization' if you will. This type of entity exists abound in the state apparatus and has done so for a very long time. It is an actor on behalf of the institutions, much like a referee in a game of sport. Like the referee, the institutional organization is the enforcer and implementer of regulation and policy, and a look at contemporary and historical cases supports the

[2] North (1990), pp. 81-85?
[3] North (1990), pp. 40??
[4] North (1999)

hypothesis that the institutional organization is a necessary feature of the state apparatus. There are several reasons why an enforcer/implementer is needed, two being the incompleteness of regulation and the slowness of the regulatory process.

Incomplete regulation and the slowness of the regulatory process

There is a general recognition of the inevitable incompleteness of laws. A major reason for this is the incomplete information available to the regulators at the point in time when the regulation is made. The regulators lack information both about all the relevant conditions at the time of legislating, but also of the conditions in the future when the regulation is to apply. Given that regulations (and all formal institutions) are fixated at some point in time, as conditions for which the regulation is to apply change, it becomes obsolete to some (probably) increasing degree. Regulation is incomplete for many other reasons[5], but for this article the inability to encompass novel conditions of the future is the most important one. Another important feature of regulation is that it is slow to change. Procedural elements of the institutional framework are explanations to this, as are other democratically motivated 'checks-and-balances'. The competition between political interests also renders a slow regulatory process. Given that the legislative system is slow, laws could be seen as fix in the short term. The good thing about this is that it provides stability for economic actors to make up plans for the future, including investing in innovative new businesses. The bad thing is that the fix laws are incomplete, among other things related to innovative enterprise. However, the fact that regulation is incomplete may raise some uncertainty costs too. In a 'non-ergodic world'[6] as Douglass C. North has put it, regulation cannot be created ex ante to properly and sufficiently to regulate whatever situation, conduct or process which may emerge in the future. The innovative process of the market in turn ads to the uncertainty by actively attempting to do or make something novel, in a sense undermining the stability of the institutional framework intentionally.

The enforcement of regulation and implementation of policy

The solution found in practically all state apparatuses is the delegation of authority and discretion to an agency to enforce the regulations and implement the policies that has been generated by the regulators/policymakers. From the policy makers, the politicians, this matter

[5] Williamson (1985), Pistor & Xu (2002), Becker (1968), Stigler (1970), etc.
[6] North (1999)

of necessity, has its up- and down-sides. The delegation of authority is necessary to overcome the incompleteness of the regulations and policies by permitting the agency some discretion to adjust the 'guiding document' to real conditions. At the same time, it implies a reduction of the policy maker's power and control[7].

Delegation of authority

The policies and regulation are thus implemented and enforced by bureaucratic agencies and "bureaucrats", who could be defined as the non-politically elected/responsible staff and structure of the state apparatus. The enforcement of law and policy is often also delegated to courts, but "[i]n the area of economic regulation the legislative choice has generally been the administrative agency rather than the court."[8] It is also important to note that courts act reactivly, and when called upon, whereas the bureaucratic agency is in constant motion.[9]

The bureaucratic agency is authorized to make responsive re-interpretations of the formal rules to a changing, and to some degree novel, world. It is this feature that makes it able (although not necessarily successful) to react with flexibility to innovative enterprises of the market. It is through its credible discretion it can provide the institutional framework with adaptive efficiency. The flexibility of the enforcement allows market participants to enter the trial-and-error process of innovation without the risk of too frequent law changes. The authority of the enforcer in turn provides order even as conditions change, say due to the marketing of an innovation. The "buffer" provided by the bureaucratic enforcer between the fixed regulation and the flexible market enables the economic system to combine the benefits of stability and flexibility for innovativeness. The institutional framework's adaptive efficiency should thus contain the "institutional organization" having the discretion to react by reassessing the going interpretation of the institutions.

The difference between regulatory discretion and enforcement discretion

Richard B. McKenzie and Hugh H Macaulay (1980) believe that the bureaucratic agency, and especially its director, will attempt to expand the agency's sphere of operations to make it more powerful and harder to dismantle. They believe that the agency's means for this is to create more regulation, which it then becomes responsible to enforce and implement. The bureaucratic agency will increase the regulatory burden on the private sector until it becomes

[7] Control of budget ex post is inefficient. Refernece.
[8] Posner, (1974), pp. 350
[9] Pistor & Xu (2002)

so inefficient that the bureaucracy credibly can take over the sector. This is an extreme perspective on the bureaucratic agencies. It also assumes that the agency has regulatory powers, which not all agencies have. In fact, McKenzie and Macaulay is far from alone in failing to account for the difference between regulatory discretion and enforcement discretion. Kydland and Prescott's (1977) classic article "Rules rather than discretion" in fact concerns regulatory discretion, and have less to say about enforcement discretion. While the former indeed would infringe on the positive stability and predictability effects of the institutional framework, it is not true to the same extent in the latter's case. True, the enforcer could also have regulatory powers, which would imply dangers of regulatory discretion. It is also fair to assume that the enforcer of regulation, even if it is lacking formal regulatory powers, by its authority to make the "going" interpretation of a regulation, and of how to enforce it, in effect is creating regulation[10]. The differences between regulatory and enforcement discretion are however large. Having the discretion to change the rules is different than having the discretion to make the interpretation of them. The checks-and-balances of the regulatory process evidently is in place in part to prevent a too hasty changes in regulation, whereas the interpretation of a regulation can be changed with very short notice if some major event occurs, or by a change of the agency's management. Generally the decisions of a bureaucratic agency are also more easy to contest than the decision of regulators, including courts.

Regulatory capture and enforcement capture

Although the article will not focus on attempts of the regulators or the banks to influence the Bank Inspection Board's work and objectives, it could be of interest to say something about matter of 'capture' theoretically, as it has been argued that regulating and enforcing are two different things. In the regulatory capture theory, Richard A. Posner explains, "regulation is supplied in response to the demands of interest groups struggling among themselves to maximize the incomes of their members"[11]. The interest groups are usually those affected by the current or planned regulation, who will find it sensible to spend resources on attempting to influence the regulators and policymakers. Posner gives an account of the regulatory capture theory, but clearly a similar rational exists to influence the enforcers of regulation or "enforcement capture", as for example Spiller (1990) has investigated. In the article, Spiller

[10] Pistor & Xu (2002), argue that it is good if the enforcement agency also has regulatory powers in highly innovative markets such as the financial market, and state the central banks' right to set interest rates as an example

[11] Posner (1974)

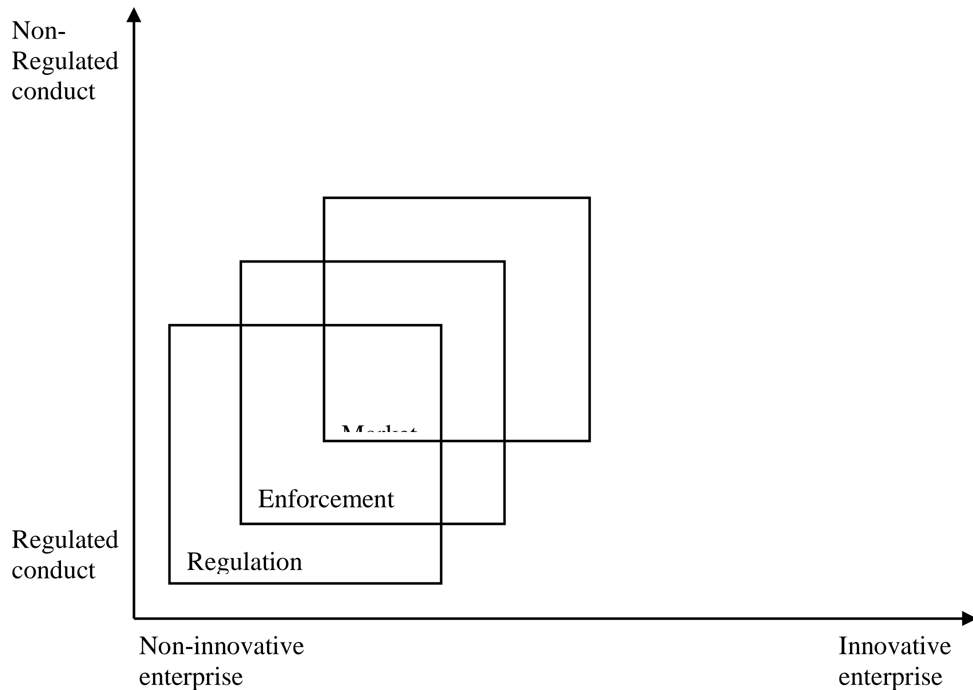
sees the policymakers to be in competition with the regulated interest groups in affecting the work of the bureaucratic enforcement agency.[12] It would be an interesting field to explore theoretically and empirically how interest groups pool their resources to influence regulators and enforcers respectively.

Modelling rigid regulation, market innovation and adaptive enforcement

Based on the assumption that regulation is rigid in a short term perspective, the financial market is fast to innovate, and the bureaucratic agency is assigned with the enforcement of the regulation and granted some discretion to do so to bridge the gap between the incomplete regulation and the dynamic market, it is possible to model their relationship and to illustrate, in a theoretical "ideal" form, how the addition of the institutional organization, the enforcer, enables us to develop an important aspect of what North calls an institutional framework's "adaptive efficiency".

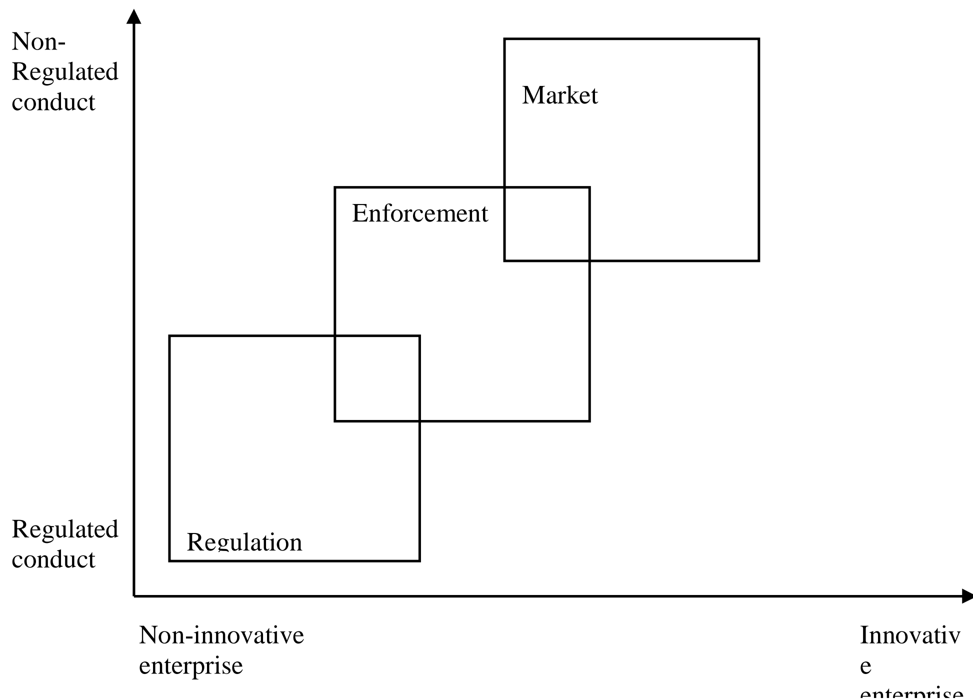
Figure 1: Theoretical model of relationship between regulation-enforcement-market

[12] Spiller (1990)



In the model above, the function of the enforcer as a “bridge” between market innovativeness and “regulatory lag” is illustrated. Non-innovative, or “known”, business practices is assumed to be covered by formal regulation, whereas new, innovative enterprises is not covered by formal regulation. If the market becomes increasingly innovative, the regulatory lag increases. The innovative enterprise thus is un-regulated in this sense, as the regulation in place is not designed to deal with the novelties of the innovation. The role or function of the enforcer in this process is to link innovation to the regulatory framework through a reassessment of its objectives and of the regulation at hand. Figure 2 below illustrates a situation when the market has innovated beyond the frames of current regulation.

Figure 2. A stretched relation between regulation, enforcement and market caused by market innovation



In the figure above, the market has moved in a direction unanticipated by the regulators. Existing regulations, being back-ward looking, has not accounted for the new instrument in any specific way. In this situation, the enforcer may act to bridge the discrepancy between the market conduct and the regulatory framework by reinterpret these regulations, as to get at least a temporary, or partial, control over the new situation. Through its credible discretion, it can provide a working order to a novel situation. The flexibility of the relationship allow market participants to innovate, while at the same time allow some level of control of the "unperceived" through the allocation of discretionary powers to the enforcer. The flexibility also allow for the trial-and-error aspect of innovations, without imposing great costs of regulating each time some new product is tried on the market, since not all products, or innovations, survive for a sustainable period of time. A short fad or trend could thus be handled in a fixed regulatory framework, given that the enforcer has the flexibility and authority to account for this change until it disappears. In the event that the innovation in fact is durable, then the regulation needs to be changed. In the longer run a regulatory "catching-up" is necessary to reinforce the credibility of both the regulatory framework, and the authority of the enforcer, inevitably will start to deteriorate.

The theoretical framework developed above stress the importance of studying acts of enforcement and the functions of the enforcers. Studying the way regulation come about, what

they say and how the regulatees react is also important, but it is believed that the enforcement and implementation phase is equally important, and that this aspect has been neglected. The cases study below provides some support for the theoretical framework and shows the importance of enforcement as an explanatory variable.

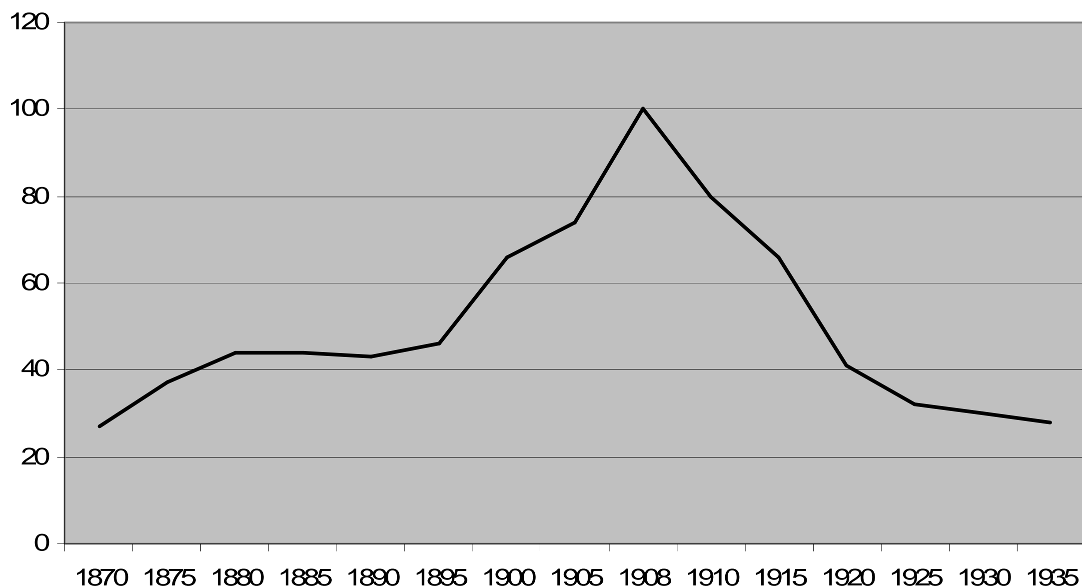
The case of Swedish banks' right to own stocks in the early 20th century

Some background - the formalization of bank supervision in Sweden

The Swedish financial sector developed considerably in the first decades of the 20th century. The stock market underwent a considerable modernization in the first years of the new century. An increased number of banks were formed all over the country, especially of the joint-stock type with limited liability. The Riksbank's note-issuing monopoly was fully implemented by 1903. More and more banks, private and joint-stock, started to expand their deposit services to the public. The larger banks looked to support the successful industrial companies in their expansion both domestically and internationally. While the financial market was in a truly dynamic state, the formal regulation of the sector, and especially of the banks, also developed. The political leadership became increasingly aware of the importance and impact of the emerging financial sector in servicing the general public's needs for loans, savings, mortgages and payment system services, as well as in providing credit to the industry's growth. Originating in the evaluation process by which licences for operating note issuing banks were granted, the state control of the financial sector expanded throughout the 19th century. As the number of applications to start a bank or a new bank office increased in the second half of the 19th century, the bank related work of the Ministry of Finance (MoF), responsible for handling charter applications, increased. In 1868 the MoF was granted means to employ a staff member to work exclusively with the bank matters. The note-issuing banks were monitored by the MoF. The Minister of Finance was still responsible for making the decisions, but the preparation of the cases and the day-to-day work related to banks, was trusted with this administer. In the following years, the number of banks, bank offices and their variety continued to increase, which increased the need for additional resources. In 1876 a Bank Bureau was established within the ministry, and an administer assistant was employed. The Bank Bureau collected and compiled monthly data on the banks for the government, but also for publishing in daily newspapers and distribution to the banks themselves. The title of the administer was changed to Bank Inspector, and it was his job to conduct the on-site

inspections of the banks, go over the reports and have the contact with the banks and with the Minister of Finance who still was formally responsible for the bank supervision. He had the executive power to decide which on-site inspections to be carried out, and of actions to be taken if a bank was found to be operating in ways in conflict with the letter and spirit of the law, and/or its own bank statutes. In 1905 the king, most probably on the Inspector's recommendation, was given the parliament's approval to conduct an inquiry/investigation on the future monitoring of banks[13]. The investigation was conducted by the Inspector and his two assistants. In 1906 the group presented a report with strong arguments for the establishing of a separate state agency, but responsible to the MoF, to which all the bank supervision matters should be transferred from the Bank Bureau.[14] The report gave three main reasons why the supervision should be reformed and expanded. Firstly, the number of banks and bank offices had continued to increase and would require more resources to monitor. From some 30 private and commercial banks in 1871, the number had increased to close to a hundred by 1908.

Figure XX. No. of commercial (joint stock banks with limited liability and private banks with unlimited liability) banks in Sweden 1870-1935[15]



[13] Betänkande bankkontrollen (1905)
[14] Betänkande bankkontrollen (1905)
[15] Sammansatta Banko- och Lagutskottets Utlåtande N:o 2 1906, SOS Uppgifter om Bankerna, fondkommissionärerna, Postbanken VPC och fondbörsen 1968-74

The investigation concluded that the growth of the bank sector had not been met by an equivalent increase of the bank supervision's resources. Secondly, with a separate agency, the Minister of Finance would no longer be required to make the executive decisions for the bank inspector to act. This was believed to speed up the handling of often urgent matters. The bank sector specific knowledge of the Minister was naturally less, and less updated, than that of the Inspector and his staff and in reality the decisions in banking matters where already made by the Bank Inspector for the reason above. A formal shift in authority would do little but confirm an already established working order and hopefully speed up the administrative process. Thirdly, the Insurance Inspection Board (Försäkringsinspektionen) had been founded in 1905 and served as an example of an independent agency with similar objectives, but for the supervision of the insurance sector. It was now argued that the banking sector had grown just as important to the general public that a similar supervisory arrangement was required.[16] The parliament in large parts accepted the outline of the new agency, except that there would be no formal requirement for the Bank inspector to be legally trained[17]. On the 16th December, 1906, the Bank Inspection Board's first instruction was issued.[18] It was responsible for the supervision of the private (Enskilda) banks and the joint-stock banks with limited liability. When the agency started operating on the 1st of January 1907, Sweden became the second country in the world to have a central independent agency for bank supervision, (The Office of the Comptroller of the Currency in USA was founded already in 1864[19]). The Bank Inspection shared office space with the Bank Bureau which still existed, and the Bank Inspector was the director of both organizations[20]. The new agency took over the Bank Bureau's responsibilities regarding the supervision of private banks and limited liability banks. The County Administrations still appointed the king's local representative in the bank boards and where responsible for all the supervision of the savings banks. Most banks where still local or regional in scope at the founding of the Inspection, and it thus made sense that some supervision was conducted by the regional County administration rather than from Stockholm. The Inspection's formal instruction stated that it was authorized to require the banks to supply information about its book keeping as often, and to such an extent as the Inspection saw necessary. The Inspection was also authorized to conduct on-site inspections

[16] Betänkande 1905
[17] Although this was not made a formal requirement, historical records show that all its directors had a legal education until 1990 when a general director trained in economics was elected.
[18] SFS 1906:104
[19] See White (2009) for example
[20] The bank bureau remained in existence until 1910, when its duties of preparing law proposals was transferred to the ministry of finance and the duties of collecting, compiling and publishing bank report data was transferred to the Bank Inspection Board.

of any bank office under its supervision and scrutinize the bank's statutes (and see to that the statutes were followed). The Inspection could call upon the Bank's board of directors to make corrections in the event that regulation and/or the bank's statutes were not followed. If corrections were not made the Inspection could "issue remarks (erinringar) or take the measures, which were deemed required"[21]. Some of these measures included publicising its remarks in the press and to call an extra board meeting. If the Inspection had the belief that the bank had made losses equal to the reserve fund plus ten percent of the basic fund, it had the right, and duty, to call upon the bank's board of directors to call in accountants to make a financial statement. The head of the Inspection, the Bank Inspector, was appointed by the King's office, and the Inspector selected his staff by making recommendations to the MoF[22]. The Inspection was from the start entirely funded by fees charged on the banks under its supervision. According to its 1906 instruction, the Inspection were to inform the Ministry of Finance (MoF) of how high the fee for each bank would be in the coming years, (not exceeding one thousand of a percent of the bank's own funds as they were in the end of the year two fiscal years back. The MoF collected the fees and directly deposits them on a special account by the Statskontoret (Agency for Public Management).

The regulation and realities of Swedish banks' right to own and trade stocks between 1903 and 1933

An early feature of Swedish banking legislation, as in many other countries, was an explicit prohibition for banks to own or trade in stocks. The Banking Act of 1903, as the previous acts had done, underlined the principal importance of separating credit from ownership.[23] The reason was that banks could become prone to grant credits etc. on merits of "kinship" rather than strict business rationale, and thus endanger the bank's direct and indirect stakeholders. In the first years after the turn of the century however, several of the major banks increased their engagement in the stock market, and by 1905 many of them had created regular stock brokering departments within their organization[24]. There are several reasons for this, a major one being the general boom in the number of joint stock limited liability companies in Sweden, and the unprecedented growth in size in some of them following the successful industrialization of Sweden in the last decades of the 19th century. There was also a strong

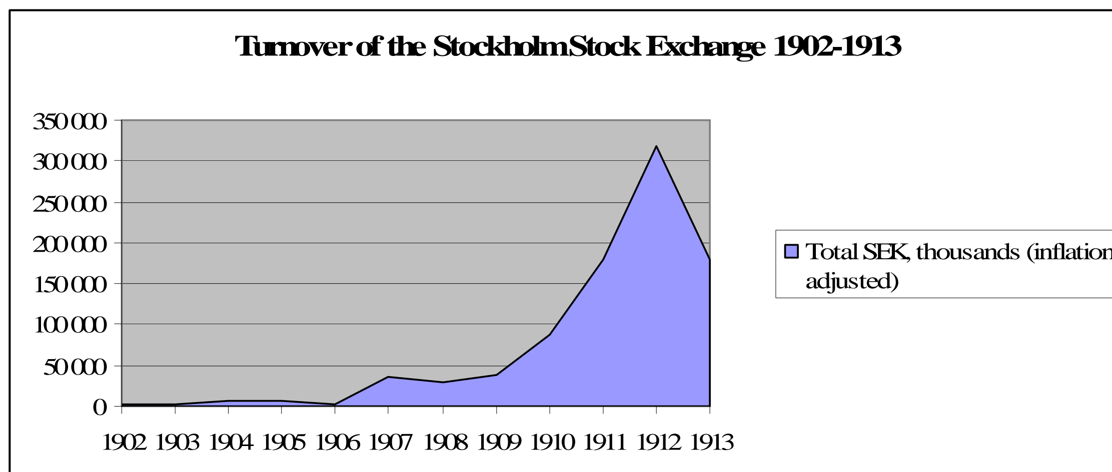
[21] SFS 1906:104 § 2.2
[22] Instruktion 1906 bankinspektionen…, Sammansatta Banko –och Lagutskottets Utlåtande N:o 2 1906
[23] SFS 1903: 101, Lindgren & Sjögren (2003), pp. 139
[24] Östlind (1945), Bilaga till Betänkande om fondhandelns reglerande, 1914, pp. 143

influence from the success of the German universal banks in participating in the growth of the industry as creditors and owners[25]. Due to these developments, the banks were interested in, and needed to be, changing with the times to accommodate the changing needs of their clients. The increase in the number of stock companies also brought a need for a modernized stock market. For the modernizing of the Stockholm stock exchange the banks' large trading volume was needed to strengthen the exchange.[26] In the same year as the Bank Inspection Board started operating, 1907, the largest commercial banks where permitted to become members of the Stockholm Stock Exchange, increasing the total number of members from five to 21.[27]. In spite of a major formalization of the stock market, it only housed a fraction of the real stock transactions.[28] The banks stood for a large part of this 'grey' trading. At the 1906 parliament a motion called for an investigation to the legality of the stock related business of the banks. An investigation concluded that the banks were within the realms of the law when servicing its clients as middleman in stock trade.[29] The acquisition of stocks for own account was however still prohibited. The only exception was in event of a failure of a client, when the bank had the right to acquire stocks and real estate to protect their claims. The bank could acquire the stocks and hold on to these until they could be sold without loss. The crisis of 1878-79 had been such a situation, leaving several major banks with large stock portfolios to unload in the coming years. As the figure below shows, the turnover of the stock exchange increased drastically when the banks became members, from less than 3.000 SEK in 1906 to over 36.000 the following year[30]. Between 1904-and 1906 the stock market was booming, and the speculative trade with it. Only the major banks where permitted as members of the exchange[31], and the medium sized banks around the country (who also speculated in stocks) where not. In the fall of 1907, the stock market dropped drastically, and the economy was hit by a recession that lasted throughout 1908.[32] In 1908 a tax on stock transactions is also introduced to curb speculation, and the Inspection is made responsible for the new tax and for keeping a register of stock market transactions. [33] As the graph illustrates, the tax does

[25] Lindgren & Sjögren (2003)
[26] Algott (1963)
[27] Algott (1963), Lindgren (2009)
[28] Lindgren (2009)
[29] Bilaga till Betänkande om fondhandelns reglerande (1914), pp. 143
[30] In spite of the inclusion of much bank trade, according to Östlind (1945) the real stock trade turnover was much greater than the official figures in the graph illustrates as a large number of trades where made elsewhere than on the stock exchange.
[31]
[32]
[33] Förordningen den 6 november 1908 angående en särskild stämpelavgift vid köp och byte av fondpapper. See also Waldenström (2001)

not seem to have had the desired effect. In the first years of the 1910s the stock market again booms.

Figure: 1 Turnover of the Stockholm Stock Exchange between 1902-1913[34]



Despite the sharp drop in stock prices from the fall of 1907 which continued in 1908, the bank industry worked hard for a reform which would permit them to own and trade in securities directly[35]. In 1909 a regulatory change came, although not entirely to their wishes. The regulators solution to keeping credit and ownership apart, while permitting banks to some stock market operations was to create a new form of bank, the issue bank (emissionsbank). It was to have its main business in issuing, trading and owning stocks, would be owned by a group of banks and have a very limited loan and deposit service to the public. The new form of bank would require a license to operate and where to comply with the same regulation and supervision as the commercial banks.[36] The policymakers' intention was to enable the major banks to participate in the expansion of the Swedish industry, through organizing and backing stock issues. Probably to the surprise of the regulators, who for years had been hassled by the bank industry on the matter, no emission bank was founded in 1909, or in 1910. Instead the banking industry organization started to lobby for a change in the law to permit banks to own and trade in stocks directly. As the bank law underwent a major revision in 1911, the largest banks where permitted to own a limited amount of non-emission bank stocks directly[37]. THe Inspection approved of the change. At the time of the regulatory change, nineteen banks met

[34] Betänkande ang. fondhandeln (1914)
[35] Söderlund (1978)
[36] 1909 års lag om emissionsbanker m. m
[37] 1911 års banklag

the stipulated requirements, which allowed them to acquire a stock portfolio equivalent to about 1.5 percent of all commercial banks' total assets.[38]

The bank's organizational innovativeness

The innovative solution of the banks to the limitation in permitted trade and ownership of stocks has by Lindgren and Sjögren (2003)) been phrased as "*organizational innovativeness*"[39]. In the first years of the 1910s, the stock portfolios of the largest banks increased substantially. The banks also increased their share of credit granted with stocks as collateral. Once the banks were permitted to own stocks, they established side-owned companies and subsidiaries which borrowed money from the mother bank to by stocks or real estate, using the stocks or real estate as collateral for the loans.[40] There was no prohibition on the individuals of the banks' board members to create stock companies, and this is what was done on a large scale. Individual owners or closely affiliated persons founded a joint stock company with limited liability with a very small stock capital. The purpose of these companies was to participate in stock issues, acquire, sell and broker stock trade. Through their close affiliation with a 'mother bank' these companies could purchase large volumes of stocks, using money borrowed from the mother banks with the purchased stocks backing the loan. The banks were permitted to accept stocks as collateral, and the law did not state how the banks were to assess the value of the collateral or set a maximum of stock a bank could hold in total.[41] In 1913 and 1915 the Inspection issued concerned reports which concluded[42] that the banks had used their new right to found or gain control of "regular" emission companies like the Stockholms Handelsbank sidobolag Emissionsbolaget, the first such 'side-owned company' founded already in 1907[43]. In fact, several more were founded in the following years, when the prohibition of the banks engaging in stock trade was in force.[44] The Inspection reported that many banks on many occasions granted credit for 80 percent of "well known" stocks' traded value, or more, and the total outstanding credit with stocks as collateral increased threefold between 1904 and 1914.[45] With the encouragement of the Inspection, the

[38] Söderlund, (1978), pp. 19
[39] Lindgren & Sjögren (2003)
[40] Söderlund (1978), pp. 19
[41] First with the banking act of 1932 a general guidence was included in the legal text stating that the bank was to assure that the collateral used as security for loans was of comforting value.
[42] Skrivelse den 31 Oktober 1913 till finansministern, som Bilaga till Betänkande om fondhandelns reglerande (1914), pp. 139 – 147, Bankinspektionens skrivelse den 31 mars 1915, refererad till i 1917 års Bankkommitté, Betänkande nr 5, Förslag till ändringar i Lagen om Bankrörelse
[43] Söderlund, (1978),, pp. 8
[44] Betänkande om fondhandeln 1914, pp. 54, 140
[45] Letter from the Inspection to the Ministry of Finance of 31 October 1913, cited in Östlind (1945), p. 253

bank industry organization Svenska Bankföreningen started to issue recommendations of stock price valuations in 1912 which where intended as guidelines for bank's lending on stocks.[46] These recommendations where in general followed by the organization's members, but not by all banks. A limit of the recommendations which the Inspection noted as problematic was that many new stock companies where created during the 1910s, for which no historical values where available. The Inspection was sceptical to the banks' ability to price these new stocks.[47] The matter of determining "fair" values of the stocks used as collateral also became a matter for the Inspection, and it too was probably lacking competence in thus area. The evaluation was also very difficult to do in a volatile stock market, and with a boom in new company issues for which no previous records existed also put a new strain on the banks who facilitated issues and lent on stock collateral. The new business segment was thus novel to all parts concerned, although the profit rational to pursuit into a new territory was clear to many banks.

Needless to say, the bank inspection and the regulators where not pleased with this development, which was not in conflict with the letter of the new law, but in direct conflict with its intention. The Inspection was left to indirectly approaching these holding and investment companies by requiring the "mother banks" to provide more information about its assets, its terms for credits, etc. and persuade the bank industry organization, Bankföreningen, to act. The limit of the Inspection's discretionary reach was that it had no formal authority or tools of sanctions to interfere with the banks' stock operations. As the stock rates started to drop in 1918, the Inspection acted to assure that bank loans with stocks as collateral was given additional backing[48]. Some banks started requiring their customers to amortize on their loans and stated that the Inspection forced them to do so, something that the Inspector at the time said was not true.[49] It used its mandate to assure that the banks had sufficient capital to retain the publics' trust.

In 1917, an expert group was assigned by the MoF to investigate whether a regulatory change was needed, and shared the Inspection's concern about the dangers if the banks' innovative interpretation of the law at the time would continue and expand. However, the recommendation did not lead to any immediate actions. On the contrary, the Banking Act Committee in January 1919 stated that the innovative investment companies performed an important function in the economy. It suggested however that they would come under state

[46] Sjögren och Krusenstjerna (1994), p. 27-28
[47] Benckert (1976)
[48] Sjögren och Krusenstjärna (19??) p.34
[49] Sjögren och Krusenstjerna (19??), p. 34

regulation and supervision similar to the banks.[50] Although the Inspection was voicing its concerns about the speculative turn the banks' right to trade in stocks had taken, as late as in 1919 it was of the opinion that the right should remain, although not include the right to own stocks in brokerage or investment firms.[51] It took until late 1920 until the matter was handled by the MoF, and by the turn of the year the Swedish economy, and the banks, experienced a severe crisis. In 1921 the parliament voted in favour of prohibiting banks from acquiring stocks in companies engaged in stock brokering business or dealing in real estate, with some exceptions. The new regulation also stated that the book value of the stock portfolio could not amount to more than 10 percent of the total value of the basic and the reserve fund. The ten-percent limit however caused no big problem for the banks,[52] most probably because their subsidiaries, through which they controlled huge amounts of stocks and therefore companies, had been founded with very small stock capital.

The Inspection's jurisdiction is extended

To come to grips with the increased stock activity of the large commercial banks, it was in 1919 decided that the bank inspection would take over the supervision of the stock brokers (thus including the banks) and the stock exchange as a whole and that its name would be changed on the 1st of January 1920 to Bank- och Fondinspektionen[53]. Since 1866, the Stockholm trade and shipping board (Stockholmstads handels- och sjöfartsnämnd) had monitored (and regulated) the stock market[54]. A law on stock brokering and broker firms was created in 1919 as well which required brokers to be granted the Inspection's permission to act as a stock broker.[55] The permission could be revoked. The king's permission was needed to operate a stock exchange, and the exchange was to be supervised by the Inspection although the operational supervision was delegated to the board of the exchange immediately. The number of stock broker firms had increased very rapidly in the second half of the 1910s, from about 30 in 1914 to over one hundred five years later.[56] For the increased jurisdiction the reformed Inspection received close to the double amount in its budget compared to the previous year. However, the inflation during these years made the real amount equal what the

[50] Söderlund (1978), pp. 20
[51] SOU 1932:30, 1932 års banksakkunniga, Betänkande med förslag till alg om ändring i vissa delar av lagen den 22 juni 1911 om bankrörelse m.m.
[52] Söderlund (1978), pp. 20-21
[53] 1919 lag om fondkommissionsrörelse och fondbörsverksamhet, SFS 1919:811
[54] Lindgren (2009)
[55] The broker needed to fill certain qualitative criteria, such as being over 21 years of age, having acquired knowledge of the stock market and the brokerage profession etc.
[56] Östlind (1945), p. 267

Inspection had received in 1914, when it still only supervised the private and limited liability banks.[57] According to the new law and instruction, the Inspection now also was responsible for ensuring that the stock brokers and the stock exchange was operating in accordance to current and coming regulation and ordinances. The Inspection was to inspect the stock brokers and the exchange, and use remarks (erinrans) to call upon the owners of the company to make the corrections that the Inspection saw necessary. The Inspection could require the companies to provide it with all the information it needed. The extended jurisdiction came in force by January 1920, but already by the end of the 1921-22 crisis, all the investment companies had gone bankrupt[58]. The need to supervise such companies thus no longer was a pressing regulatory issue, and the Inspection turned to assist, and sometimes push, the many minor banks in distress to make the proper write-offs, prevent inappropriate dividends and "soaping the board" of incompetent management.[59]

The Bank Act Committee of 1924 was among other things assigned to investigate the relationship between the banks and the industry, as it was believed that the latter in many cases had become controlled by the former. The industrial companies had also suffered greatly in the 1921-22 crisis and as a consequence become highly dependent on extended credits from the banks. The committee recommended that the banks' right to own stocks should be withdrawn, and that it would be best to go back to how things were before 1911.[60] Again it took time for a regulatory response, and first in 1932, after the outbreak of the Great Depression and the implosion of the Ivar Krueger-conglomerate, the recommended revision was processed. In 1933 it was finally decided that the banks' right to own and trade in stocks was prohibited except for protecting its claims.[61] The banking act also for the first time stated the requirement that a bank loan could not be granted without tangible or intangible property as collateral, which by the bank's estimate was of comforting value. The emission/issuing bank company form was abolished, without one ever being founded. The act came in force in 1934 and permitted an adjustment period until 1938 for the banks to dispose of their stock assets. For some banks, such as Svenska Handelsbanken, the adjustment period was too short, and according to Ernfrid Browaldh, heading the reconstruction of the Svenska Handelsbanken's asset portfolio after the Krueger-crash, the Inspector's willingness to accept a slower write-off of the bank's large losses probably not only saved the bank (the second

[57] See appendix 1 for an inflation adjusted table of the Inspection's budget.
[58] Söderlund (1978)
[59] Krusenstjerna (1994?)
[60] Söderlund (1978), pp. 23
[61] SFS 1933:277 (dubbelkolla!!)

largest bank in Sweden at the time) but also probably saved the entire Swedish banking system from a severe and long-lived credibility crisis.[62]

Analyzing the discretionary acts of the Bank Inspection

The Bank Inspection board acted to handle financial innovativeness to adjust for lack of formal regulation in several ways and on several occasions. In the first years of the 20th century, the Inspection seems to have looked between its fingers with the stock market "jobbing" of the major banks. This strategy seems to have conformed with the political climate of the times, as banks were permitted to become members of the Stock Exchange in 1907. The year before an expert group had determined the meddling of stock transactions was in accordance with the law as well. The formal banking acts prohibited credit givers from acquiring ownership in companies until 1909, so the Inspection's discretion must have been aware of and accepting the development of the banks new business segment and the consequential speculative nature of this business. The exception permitting banks to accept stocks as collateral contributed to a sliding scale of legality requiring the discretion of the Inspection to assess on a case-by-case level, but trying to be consequent, the correctness of the banks operations. It is clear that the exceptions to the prohibition put pressures and demands on the Inspection which it was not formally assigned, or resource-wise equipped to handle. For some years however, they seemed to have managed. By the mid-1910s, it became clear that the banks engaging in stock market transactions did so using non-bank investment companies, which due to their legal status did not fall under the Bank Inspection's supervision or jurisdiction. The Inspection was thus circumvent from using its formal authority directly on these companies' activities, and instead had to re-interpret its objectives and raise new demands on the banks behind the investment companies. The investment companies, and stock brokers and the stock exchange itself were by this time still not subject to specific regulations, and the monitoring of the stock exchange was still in the hands of the Stockholms stads Handels och sjöfartsnämnd. This was a clear case of the regulator's failure to anticipate the path chosen by a dynamic market, and were the enforcer, the Inspection, used its room for discretion to act on this development until the regulatory process would catch up. The Inspection put pressure on the banks to disclose credit terms given to its clients, to reveal unsound lending to bank-near companies and brokers. In dialogue with the Bankföreningen, the bank industry organization by 1912 started to issue stock price recommendations to be

[62] Browaldh (2007)

used when lending with stocks as collateral. To the Inspection, a big problem was that the stock exchange and the activities on it was outside its reach, while much of the activities on the stock exchange originated in the banks which it was to supervise. In 1919 the supervision of the stock exchange and the stock brokers was assigned to the Inspection, which increased its supervisory burden, but did not resolve the matter of the banks' innovative investment companies. It was proposed in the same year that the investment companies should come under the Inspections supervision, but the matter's urgency dropped drastically with the crisis of 1921-22. It was a general agreement that the banking crisis of 1920-22, when several of the major banks had to be rescued by state intervention, underlined the importance of resolving the matter of speculation and bank ownership of, and exposure to non-bank companies. However, the lack of political resolve, and the predicaments of the banks following the crisis, made the matter harder to come to ends with. The health of the banks was so bad that they could not be forced to sell their low-valued stocks without risking bankruptcy. Legal changes were made in 1920 and 1921 in direction to press the banks to decrease their stock portfolios but for the remaining part of the 1920s no dramatic regulatory change came about. The Inspection during this time was busy assisting and sometimes forcing distressed banks to make the proper write-offs, inject new capital from its owners, merge weak banks with strong ones and replace incompetent management. It took another crisis however, the death of Ivar Krueger and his Krueger-conglomerate to give sufficient political resolute to reform the banking laws and re-introduce the strict prohibition of credit institutions from owning stocks which had existed prior to 1909.

The short story of regulatory changes here above make evident that the generally held notion that the regulatory process moves slow is true. Although it was evident to all concerned that the banking sector had become highly integrated with the securities market already by 1905, it took until late 1919 for the regulatory response of adding the securities market to the supervisory authority of the Inspection. Between those years then, the Inspection had to reinterpret existing regulation and its own mandate to capture the innovative enterprise and organization of the banks. Not only was there a wide gap between the regulation and the market development, but the attempts to fill the gap by the regulators in hindsight seem quite inappropriate. In 1906 it was concluded that banks could act as middlemen in stock trades of their clients. The permission to let banks become members of the modern stock exchange of course gave an impression that the policymakers were ready to permit banks to enter the securities sector. In 1909 the banking act was changed to permit emission/issue banks, owned by banks, to own and trade in stocks. This regulatory change is an interesting example of the

difficulty in steering the market through regulatory innovation, as no such bank was created. Instead the increased acceptance of the banks' participation in the issuing of new company stocks, and the accompanying right to own and trade stocks on own account, gave the banks sufficient wind fall to successfully lobby for a right to own and trade stocks directly in the 1911 revision of the banking acts. The banks soon used their right, which was limited, to start and take control over regular investment companies through organizational innovativeness. In terms of our theoretical model, this market innovation had stretched the distance between it and existing regulation, with the Inspection in the middle attempting to cover the novel enterprises through a reinterpretation of its objectives and of the available regulation. Since the investment companies were not under its supervision, it attempted to require more information from the mother banks about its credit portfolio, its lending requirements and what collateral was behind granted loans. The increased informational pressure was intended to assure that the investment companies were not getting favoured treatment and that the bank also lent to other companies than in its own sphere of influence. After the crises of 1907-08, 1920-22 and the early 1930s, several banks were also forced to accept a lot of collateralized stocks from failing clients. By the time the regulatory wind had changed back to separate credit from company ownership in the 1920s, the Inspection used its discretion to permit banks to sell-off stocks and write-off bad debt at a slower pace than what the formal regulation now started to require. The final ban on the banks direct stock market business came first in the mid-1930s, although some banks were still making write-offs well into the 1950s.

Re-linking to theory

In reality, formal regulation is rarely or never left to the hopes of having "enforcement characteristics" embedded within them which assure a certain level of compliance. Instead, formal regulation is enforced by a bureaucractic agency assigned with the implementation and enforcement of a specific set of regulations and policies, and the state sanctioned authority to do this. The regulations are inevitably incomplete and the regulatory process is slower that the pace of innovation that characterize the financial markets as our case study has shown. The Bank Inspection Board was acting to bridge the incomplete regulations to the innovativeness of the market, acting as a referee in a soccer game making calls as the game is played, or as an institutional organization if you will. As our case also shows, there is no certainty that the existence of an enforcer within an institutional framework makes the institutional framework

efficient or successful, but that the institutional organization is the feature that enables the possibility of the institutional framework to provide both stability and flexibility.

Summary

The article develops a theoretical framework based on institutional economic theory to analyze the function of the Swedish Bank Inspection Board in handling the commercial banks' innovative business of trade and acquisition of stocks during the first decades of the 20th century under incomplete regulation. Although the Banking Act of 1903 strictly forbade it, several banks were engaging in stock trade at the time. An expert group in 1906 concluded that the banks had the right to act as middlemen in stock transactions of its clients. By 1907, the same year as the Bank Inspection Board was founded, the largest banks were permitted to become members of the Stockholm Stock Exchange. In 1909, the banking regulation was changed to permit the banks to found special issue banks (emissionsbanker) through which they could engage in some stock issuing operations. These new types of banks would be under the supervision of the Inspection. In 1911 the banking act was changed once again to permit the banks to acquire a limited sized stock portfolio. The Bank Inspector, a key figure in the regulatory committees behind these regulatory changes, was in favour of these changes. The competitiveness of the banking sector, the booming stock market, and the ability to work around the regulator's coverage led to an 'organizational innovativeness' were the banks found ways to form regular investment companies, outside the jurisdiction of the Inspection. The slow regulatory process required the Inspection to stretch its room for discretion to oversee the banks' stock trade and the 'regular' investment companies. It did so by requiring the banks to give more information about their assets and clients and conditions for loans, by reporting to the Ministry of Finance of the development with suggestions of regulatory changes and by dialogue with the banking industry organization. The Inspection's room for discretion was wide in terms of operational interpretations of often imprecise formal legal text, but narrow in terms of its jurisdiction which from 1907 until 1919 only covered the commercial banks, and after 1919 also put the stock brokers and the stock exchange under its supervision. The banks' stock trade, which during WW1 had become highly speculative and elaborate, did not lead to a regulatory response in spite of several alarming reports from the Inspection. After the war, Sweden experienced a severe economic crisis in 1920-21 which among other things led to many banks coming very close to default due to speculative businesses channelled through the investment companies. Minor regulatory changes were

made in the early 1920s regarding the banks right to own and trade in stocks, but the severity of the crisis had made the banks unable to unload the low-valued stock portfolios they already held, and ineligible to acquire new stock by the conditions set in the banking act. The Inspection following the crisis used its room for discretion to permit individual solutions to the minor banks in distress. The largest banks were rescued by a state intervention operation in which the Inspection played no apparent leading role. As the crisis of 1920-21 brought down all the investment companies, and was close to take the mother banks with them, the pressure for regulatory reform was decreased, although several expert committees throughout the decade recommended a reintroduced constraint on the banks' stock trade. It took an international economic depression starting in 1929 and the implosion of the match king' Ivar Krueger's empire in 1932 for the regulators to process the matter. In 1934 a revised banking act came in force which prohibited the banks from acquiring stocks other than to protect its claim, basically the strict separation between creditor and owner which had been the leading norm before the changes in 1909 and 1911. The issue bank company form was abolished without one ever being created.

It is argued that empirical evidence such as this case abound to support an added unit of analysis to institutional theory, the institutional organization, the implementer of policy and enforcer of regulations. The Bank Inspection Board is an example of such an institutional organization, a 'referee' to the sports analogy used by new institutional economists to describe the theoretical units of analysis of concern, the institutions being the rules of the game and the organizations being the players. Whereas institutions, such as laws, are hard and time-consuming to change in order to adapt to the dynamics of the innovative organizations, the institutional organization may provide the institutional framework with flexibility, and combined the stabile institutions and the adaptive enforcers may form the adaptive efficiency to facilitate the innovative process for economic development.

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