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THE EVOLUTION OF CAPITAL ADEQUACY RULES - THE CONTRASTING CASES OF SWEDEN AND BRITAIN

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The Evolution of Capital Adequacy Rules – the contrasting cases of Sweden and Britain

Abstract

Banks' capital adequacy became a focal point (again) for regulators after the latest financial crisis that began in 2007. When joint-stock banks began to emerge in Sweden in the 19th century, the size of bank capital became an issue and the authorities began to regulate capital. The banking law was revised and stipulated, among other things, the minimum level of capital needed to establish a joint-stock bank. Over time the rules changed from minimum capital requirements to specifying what constitute adequate capital. This paper examines the path pursued by Sweden since 1911 to regulate capital adequacy and actively supervise banks to ensure compliance. The Swedish pro-active approach is contrasted to the approach adopted in Britain and it is suggested that their respective civil and common law traditions may explain the divergent approaches to defining and regulating capital adequacy.

INTRODUCTION

The question of banks' capital adequacy became a renewed focal point for regulators after the latest financial crisis that began in 2007. How much capital should banks' hold to manage their risks? What is an adequate level to counter perceived moral hazard in situations where banks may well to receive support from government agencies in times of crises? Why is it that the approach to regulating bank capital differs in different jurisdictions? These questions are certainly not new, and much work has been devoted to find answers.

In 1911, Swedish banking law proscribed an early version of capital adequacy rules and gave the new supervisory agency the legal right to examine banks and access all their documents. Sweden continued to develop its statutory rules and keep a close eye on banks until the 1970s when the Bretton Woods system broke down and a process of international convergence of banking regulation began. The Swedish approach characterised by strict rules and a supervisory agency with far-reaching powers contrasts sharply with the well-researched British case of reliance on minimum regulation and rather informal supervision.[1]

This paper will trace the developments of capital adequacy rules for commercial banks in Sweden from 1903 when commercial banks lost the right to issue notes and risk-based capital adequacy was enshrined in the 1968 Banking Law. These developments reflect the civil

[1] It is the English banking laws that are studied but for the long-term perspective I refer to Britain

law tradition in Sweden combined with a pragmatism by authorities aimed at keeping control over the banking sector without nationalising it.

Sweden and Britain might seem to be poles apart when it comes to statutory rules but in the 1950s the authorities pursued similar economic policies aiming to direct bank lending. That raises a question about the effectiveness of formal regulation. To investigate this further, the paper starts with the Swedish case building on a range of sources and then contrasts this with the England as it has been discussed in the literature.

WHY DO BANKS NEED CAPITAL?

Before examining the legislation, it is worthwhile to discuss bank capital, what it is and what the purpose of bank capital is. Simply put, in terms of a balance sheet for joint-stock banks, bank capital is the difference between assets and liabilities. A bank’s assets are the loans it has provided, and the liabilities are the deposits. The difference between these two constitutes bank’s capital. In its simplest form, bank capital consists of equity and retained earnings. Over time, reserves for loan loss provisioning and different types of capital have been added to the capital base, but in the early 20th century the balance sheets remained relatively simple. The exact definition of ‘capital’ varies between jurisdictions. Even in the first Basel Accord of 1988 there is only agreement on what is termed tier one capital whereas the definition of tier two capital is allowed to differ between jurisdictions.[2]

[2] BCBS 1988.

There are four main reasons for banks to maintain capital. First, there is the need to have a capital cushion as revenues may fluctuate; this makes it possible to handle (temporary) losses. Second, deposit-taking institutions need capital as an assurance to depositors that they will be repaid. Third, capital assures the general public that the bank is solvent and will stay in business. Fourth, capital is needed to manage maturity risks. Deposits tend to be short-term, often payable on demand, whereas credits are longer-term creating a maturity mismatch that must be managed. Thus, capital is needed to perform asset-liability management.

When central banks developed lender of last resort facilities and deposit insurance schemes were introduced, moral hazard has increased. This led to demand for raised capital requirements. The argument was that if banks were re forced hold a certain level of capital, banks might - in theory - manage their risks better. If problems were to arise then banks should use their own capital before turning to official sources.[3] Explicit deposit insurance schemes were introduced in Britain in 1982 and in Sweden only in 1995, thus after the time period studied.

EARLY CODIFICATION AND FORMAL INSPECTION IN SWEDEN

Banks have existed since the 17th century in Sweden. The oldest bank was founded by private charter in 1656, and the central bank, *the Riksbank*, was established in 1668. At the time the central bank did not have a monopoly on note issuance, nor was it a lender of last resort. Swedish commercial banks emerged a bit later initially to finance industry through

[3] Angell, 1992; Flammia, 1988; Gardener, 1981; Miles, 1995; Milne, 2006.

intermediating between savers and investors, even though credits were short-term in the early 1800s.[4] As long as banks were allowed to issue notes deposit-taking was of minor importance. Over time, deposits became a larger source of funds. Stockholms Enskilda Bank, founded in 1856, was the first commercially oriented bank that sought to attract deposits. The deposits were then channelled into short-term commercial loans.

During the 19th century, Swedish banking could largely be characterised as free banking in the sense that there were no laws regulating the establishment of banks, nor limiting what a bank was and the business it could undertake.[5] In 1864, the first limited liability joint-stock bank was founded and during the latter half of the 19th century, the majority of commercial banks were limited liability joint-stock banks. These, by and large, became universal banks taking deposits, managing payments, offering credits and providing underwriting services. Banks with unlimited liability for the shareholders existed also until the 1930s.

Savings banks and agricultural banks - established in 1820 and 1915 respectively - were regulated by separate laws until 1968 when the banking law was revised, and a unified legal and regulatory framework was established for all types of banks.

DETERMINING BANK'S CAPITAL AND ITS ADEQUACY

In 1886, the Banking Law specified that joint-stock banks needed a minimum capital of SEK 1 million. However, if the banks were local, that is operating in a more rural than urban location, the capital could be less than one million. Over time, regulations became more detailed and the

[4] Larsson 1998.

[5] ibid

banks' articles of association mattered less. In 1903 the central bank received a monopoly on note issuance. This necessitated a new banking law to ensure that joint-stock banks that had unlimited responsibility for owners had sufficient capital once they lost their note-issuing privilege. A Bank Committee was appointed to review the existing law, recommend necessary changes and draft a new law that applied to all commercial banks. The Committee's review, recommendations and any dissenting views among Committee members were then published. This tradition of appointing expert committees to assess existing legislation and draft new laws has continued in Sweden, providing transparency to the legislative process.

The minimum share capital (*grundfond*) was set at SEK 1 million but could be as low as 0.2 million if the bank only operated in a small town.[6] The law further specified that fifteen per cent of annual profits should be allocated to a reserve fund until the reserve fund was equivalent to fifty per cent of share capital. Retained profits not allocated to the reserve fund could be allocated to another fund which also counted towards capital. This law defined a bank as a business that undertakes borrowing and lending. The approval process for the establishment of new banks was also tightened. The law further stipulated that assets should be valued according to their proper value (or market value). Non-performing loans were to be valued at the amount the bank expected to recover.[7] If bank thought the loans could not be recovered, they were to be written off. One of the Committee members, Mr Robert Benckert, spoke publicly about the proposed law and said that the most efficient control of the banks was

[6] SFS 1903:101 Lag om bankaktiebolag med solidariskt ansvar och Lag om bankaktiebolag.

[7] §37, SFS 1903:101.

undertaken by the public through the publication of financial statements. These must be accurate, and the law therefore specified the above-mentioned rules for valuation.[8] Mr Benckert was a member of the existing bank inspection unit and subsequently became the head of the independent supervisory agency established in 1907.

The joint-stock company law was revised in 1910 and this called for a review and revision of the existing banking law.[9] A five-member Bank Committee was appointed to prepare changes in the law. The absolute minimum capital for small local banks was raised to SEK 0.5 million but the general minimum was kept at SEK 1 million. The Committee felt that there were too many banks and that a consolidation would be beneficial for the financial system. In addition to the raised absolute minimum capital, the King was a granted the power to approve any new bank with unlimited liability. In practice it was the government that would grant approval and there was an understanding that no new banks should have unlimited liability. The revised law applied to joint-stock banks with limited liability and banks without limited liability.

There were 76 commercial banks in Sweden in 1912. The five largest of them accounted for 37 per cent of assets and 30 per cent of deposits.[10] The increased level of capital set in motion a process of consolidation. By 1920, there were 36 commercial banks and by 1940 there were 22. The five largest accounted for 56 and 71 per cent of total assets respectively. The

[8] Robert Benckert, speech 2 April 1903.

[9] Another reason to review the law was the banking crisis in 1907.

[10] Consolidated banking statistics, Statistics Sweden 1912.

consolidation led to a very concentrated banking sector by 1940; this level of concentration remained throughout the period studied. Banks with unlimited liability ceased to exist in the 1930s as a result of the Kreuger crash. They had to change their corporate form to limited liability joint-stock banks.

The 1911 law also introduced limits on deposits in relation to the capital of the bank. The Committee that prepared the law pointed out that a bank must be managed in such a way that it remained solvent and liquid. However, the Committee noted, the law alone could not ensure this but legal rules could "to some extent prevent the fallout of poor management".[11] Since banks had to protect their depositors, the Committee argued that it would only be reasonable to introduce limits on deposits in the law instead.[12] The Committee was thus clear that regulations could only go so far in ensuring that banks were financially sound. They also felt that the rules should be statutory and be the same for all commercial banks.

The law stated that deposits could not be more than five times the capital. This ratio was based on calculations of the size of deposits in relation to capital. The Committee found that for most banks this was between 0.7 and 6.4 and they settled on a limit of five times capital. Only a few banks would have to make adjustments to meet the new requirement. The law also specified a cash ratio equivalent to 25 per cent of on-demand liabilities. These rules can be interpreted as a type of capital adequacy since the regulation effectively limited the size

[11] Bankkommittén 1907 p 93.

[12] Förslag till lag om bankrörelse, 1908: 93-94.

of banks operations through rules related to capital. The objective was to ensure that banks had an “adequate” level of capital in case of losses.

The limit on deposits was suspended through temporary laws for large banks from 1917 to 1920 since the inflation during the First World War caused deposits to soar. Many banks simply could not keep the deposit limit. Furthermore, in 192,1 a change was made in the banking law stipulating that banks with capital up to 5 million could take deposits up to five times that amount, whereas banks with larger capital could hold deposits to a maximum of eight times their capital. Calculations by the author show that the three largest banks at the time in terms of assets (Svenska Handelsbanken, Stockholms Enskilda Bank and Skandinaviska Kreditaktiebolaget) were well within the limits in the 1920s, even though they had very low reserves during the 1920s. The banking crisis in the 1930s led to further temporary relaxation of the deposit rules but the Banking Committee of 1932 ruled out any permanent change in the law.[13]

During the Second World War deposits at commercial banks grew and the rules were discussed again by a new Bank Committee set up in 1945. The Committee noted that when banks reached their deposit limit their operations were hampered. They discussed options for increasing bank capital to allow banks to also accept more deposits and consequently lend more. The Committee proceeded to examine both sides of the balance sheet and discussed the

[13] SOU 1932:30.

risks associated with lending.[14] They noted that some assets such as cash and assets with very low risk, such as Swedish government bonds, could be considered risk-free. During the Second World War the banks had drastically increased their holdings of government bonds. The Committee compared this to inter-war data and concluded that the overall level of risk in commercial banks was far lower than in the 1920s. Here it is clear that the Committee began to examine banks' assets and thinking in terms of risk in a way that was not discussed by previous Committees. However, this did not lead to a change in the capital rules in the banking law.

BANKING UNDER FINANCIAL REPRESSION

The joint-stock company law was changed again in 1948 and this was one reason to form a new Bank Committee in order to prepare revisions that would align rules regarding joint-stock banks with those in the company law. The new Banking Committee was formed in 1949 and presented their findings and proposed revision in 1952.[15] By 1950 there were 21 commercial banks. The five largest banks now controlled 73 per cent of assets and held 80 per cent of deposits.[16]

The revised Banking Law was enacted in 1955 and the principles relating regarding capital remained in place. The commercial banks could accept deposits in an amount equivalent to their capital if they were small, up to five times their capital if they were of intermediate size and ten times their capital if their capital was SEK 25 million or more. Additional deposits were

[14] Proposition 1946:364.

[15] SOU 1952: 2.

[16] Consolidated Banking Statistics 1950.

accepted according to certain specifications. The Committee noted that countries with well-developed banking systems such as Britain, France, Switzerland, and the United States did not have any provisions regarding deposits but decided to keep the provisions in the Swedish law.

The law did not provide a definition of capital but the Committee that prepared the law determined that what counted as capital was share capital, reserves, profit and loss balance and certain other balances. In the previous law the term *grundfond* had been used but was now changed to share capital to mirror the terms in the Company Law. The detailed rules regarding minimum capital were removed. Instead, it was stated that the articles of association should determine minimum and maximum share capital, though the minimum could not be below the statutory requirement in the Company Law.

In 1968, it was time to harmonise banking legislation through changes in the laws regulating commercial banks, savings banks and agrarian banks to ensure that they would be treated in the same way from a legal and regulatory perspective. The reasons for a unified law for all types of banks was that the different types of banks had come to offer similar banking services, and it was thus no longer meaningful to have different rules for different types of banks regarding capital, deposits and lending.[17] Savings banks continued to have a local focus and agrarian banks continued to serve farmers and agribusiness and in that respect the law did not alter the structure of the banking sector.

This law was also a break with the previous tradition of limiting deposits in relation to bank capital. Instead, this law stipulated a capital adequacy requirement related to assets and

[17] SOU 1967:64.

categorised these according to perceived risk. The Committee argued that this shift was motivated partly because of the unified banking law, partly because a shift in the thinking about risks that had started in the 1940s.[18] The Committee argued that it made more sense from a solvency point of view to relate capital to assets as the level of risk on bank's balance sheet was found on the asset side.

The Committee decided to classify assets into four groups and the level of capital required varied from zero percent of the assets in group A to eight per cent in group D.[19] Group A included assets like cash and government bonds. Group B included corporate bonds and lending with collateral in property. Group C included assets were where collateral was made up of stocks and certain types of property (such as detached houses and farms). Group D included guarantees and other assets.

The Committee had estimated losses during a ten-year period for each of the categories in major banks and suggested risk-weights in line with their findings. The Committee also presented calculations for each bank according to the proposed capital adequacy rules. For most banks the level of capital would be lower with the new rules. Three of the eleven Committee members disagreed with the proposed capital adequacy rules, precisely because these meant that banks could hold less capital and take on more risk through expanded

[18] SOU 1967:64.

[19] §56, SFS 1968:60.1

lending.[20] Their objection had no impact on the final law though. From 1968 risk based capital adequacy requirements were stipulated in law in Sweden.

INSPECTING THE BANKS

Codification of banking rules thus has a comparatively long history in Sweden and so has mandatory supervision. In 1846 a royal proclamation set up conditions for banks that issued notes and among these was a requirement to submit quarterly financial statements to the Ministry of Finance. This was the first formal reporting requirement for banks. Supervision until then had been irregular and when it took place, the purpose was primarily to check if the banks adhered to their charter (Wendschlag, 2012). Inspections mainly took place in Stockholm unless a bank had financial difficulties. A specialised unit was set up within the Ministry of Finance in 1889 with a mandate to oversee the banks and ensure that their activities were carried out properly and in accordance with each bank's articles of association. In 1907, the inspection unit in the Ministry of Finance was replaced by an independent supervisory agency, *Bankinspektionen*. This remained in operation until the Financial Services Authority was established in 1994 with a mandate to regulate and supervise all financial firms.

The reasons for establishing a separate agency were said to be a need for more resources to oversee a rapidly expanding banking sector. A separate inspectorate would be able to act more swiftly than officials at the Ministry of Finance, and since the bank inspector was more knowledgeable than the minister of finance it was better with a separate specialised agency rather than to refer decisions through the ministry to the minister (Wendschlag, 2012).

[20] SOU 1967:64.

The 1911 banking law contained a section for supervision of banks (Section IV §28-228, Bankrörelselagen 1911). Banks were obliged, among other things, to make their accounts and other documents available to the supervisors in addition to submitting monthly financial statements. The inspectorate was funded by fees from banks based on the size of banks' own capital. The fact that the inspectorate had the right to examine all documents gave the inspectorate a very powerful position.

The Swedish approach to regulation and supervision thus has old roots, evolving from simply checking that bank charters were adhered to, to examining deposit ratios and later credit restrictions. This early codification of rules for banks and for supervisors is very much a civil law approach. This contrasts sharply to developments in common-law Britain where legal changes were infrequnet and supervision informal.

REGULATING BY SUASION IN BRITAIN

The oldest joint-stock bank in Britain is the Bank of England founded in 1694. It was not then a central bank in the modern sense.[21] The Bank of England issued notes and it was not until about 1900 that it had a de facto monopoly on note issuance. From 1709 until 1826, the Bank of England was the only joint-stock bank in England and Wales. Most banks at the time were privately owned partnerships with no more than six partners. The oldest banks in England acted as financial intermediaries and safe-keepers of funds.[22] (Channon, 1977; Pringle, 1973). Merchant banking arose as a side business for merchants who had surplus funds to invest in

[21] Fforde, 1992; Sayers, 1951.

[22] Channon, 1977: Pringle, 1973.

various ventures. These merchant banks were often partnerships and did not take deposits. Their role was primarily to finance trade. If these banks failed the owner/founders or those who invested money via the banks lost their money. There was no regulation of capital until joint-stock banks were allowed. These by definition needed to have a capital base.

The Banking Co-Partnership Act of 1826 made it possible to start joint-stock banks with more than six partners in England and Wales outside a 65-mile radius from London.[23] In 1833, this restriction was removed, and new joint-stock banks could be founded in London as well. In 1844, the Bank Charter Act regulated the entry requirements for banks, and joint-stock company legislation set minimum capital at 100,000 pounds.[24] At the time most banks were small and had no branches, but this would change with joint-stock banks. In 1857, the Joint-Stock Companies Banking Act allowed unlimited liability and in 1858 limited liability was introduced. Limited liability, of course, made each shareholder liable only for his or her share. New banks emerged as joint-stock banks and they emphasised to prospective customers that they had a broader capital base than the partnership banks, thus signalling that they had capital and could therefore be trusted to be safe and sound.[25] Research shows that the limited liability banks indeed did have more capital than unlimited liability banks.[26] Size became more important over time and mergers began to take place bringing about banks with branches. In

[23] Banking Co-Partnership Act 1826.

[24] Bank Charter Act 1844, Joint stock Company Act 1844.

[25] Newton, 2015.

[26] Turner, 2014.

addition, new joint-stock banks began to pay interest on deposits, thereby attracting more depositors and more capital.[27]

In the second half of the nineteenth century, change and consolidation took place with the number of partnership banks diminishing while the number of joint-stock banks increased. However, the joint-stock banks sought scale and a number of mergers took place which led to fewer banks.[28] The next dramatic consolidation took place in 1916-18 with a series of mergers that resulted in ten clearing banks that were later reduced to five. By the end of the 1920s, five clearing banks accounted for about 80 per cent of assets in the banking system. [29]

Over time, the statutory requirements for joint-stock banks were merged with the company law. There was no regulation regarding capital levels apart from the minimum share capital required. Examining internal records of banks, Goodhart (1972) estimated that in the late nineteenth century, bankers thought that 15 per cent cash to assets and 40 percent available assets to public liabilities signalled that the bank was safe and sound. During this time, English banks were not the main suppliers of long-term capital to industry and indeed had not been the principal financiers to industrial development in England. Their credits were mainly short-term which could contribute to comfortable and stable capital positions with comparatively less of a maturity mismatch.[30] In addition, London city banks were more engaged in multilateral trade finance than domestic long-term loans. This may well explain the

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[27] Pringle, 1973.

[28] Newton, 2015.

[29] Cottrell 1994.

[30] Collins, 1995.

comparatively high ratios of cash to assets and available assets to public liabilities. Banks that provided long-term funds for industrial development were less likely to have readily available cash.

In the late nineteenth century and until the Bank of England was nationalised in 1946, it did not have a formal, or statutory, role in regulating or supervising banks. Instead, a de facto supervisory function evolved during the 1920s when the Governor began to hold regular meetings with bank general managers, while the bank was privately owned at the time.[31] A number of financial services associations, not least the Banker's Association, had developed rules and procedures that their respective members followed. The Bank of England could engage in this type of informal supervision of the banks and the banking system because there were few dominant banks, and the managers all knew each other.[32] In addition, the banking market was almost an oligopoly and the Bank seem to have discouraged new entrants. There was also a latent threat of nationalisation that aided the Bank when suggestions were made to bankers regarding the development in their respective banks. While the Bank of England had no formal supervisory role, bank general managers and chairmen met annually with the Bank of England Governor, Executive Directors and the Principal of the Discount Office and discussed developments. In lieu of formal sanctions the Bank could: "persuade or cajole, but had to be very careful about giving orders" to bankers.[33] The Bank of England relied on monthly balance

[31] Fforde, 1992.

[32] Turner, 2014.

[33] Fforde, 1992, p.696.

sheet statements, annual reports and the information provided during meetings with the Governor and senior staff as a base for their assessment of the banks' soundness. This informal approach to supervising the banks continued until statutory powers were given.

The Bank of England Act of 1946 state that the Bank "may request information from and make recommendations to bankers".[34] That remained the extent of the legal basis for supervision and regulation that was in place until 1979. Banking supervision was very informal involving meetings between senior Bank of England representatives and senior bank management to discuss the bank's business.[35] Rather than sanctions, the raised eyebrow of the Bank of England Governor signalled displeasure. A very small group including, the Bank of England Governor and the Principal of the Discount Office were privy to the financial details of the banks.

REGULATING CAPITAL

Capital consisted of share capital and reserves in published accounts plus hidden reserves, which were not published but merely revealed in discussions with the Governor and/or Principal. Statistics were gathered but the published statistics are rather rudimentary, and the concept of hidden reserves makes it difficult to gauge the true capital position of the banks. The Company Act from 1947 raised reporting requirements for firms but banks were exempt from some of the provisions. This meant that banks could maintain hidden reserves until 1969. These could be used to smooth reported profits over time and signal that their banks safe and

[34] Bank of England Act, section 1:3.

[35] Fforde, 1992.

sound.[36] Midland Bank, for example, established a hidden reserve as early as 1866.[37] Until 1969 banks were not even required to publish their true profits and true capital. [38]

The Bank of England did use ratios relating cash to deposits and liquidity after 1946. The minimum cash ratio was fixed at 8 per cent of deposits and the liquidity ratio at 30 per cent until 1963 and 28 per cent thereafter. Liquid assets included cash, discount bills, Treasury bills and commercial bills.[39] Examining the ratio of capital as percentage of total assets Billings and Capie found that the ratio declined from 16.4 in the period 1880-1889 to 8 per cent 1910-1919.[40] The clearing banks continued with a larger share of short-term credits to industry and continued to be well-capitalised in the 1930s. After the Second World War, however, the ratio dropped significantly and was as low as 2.8 per cent in the 1950s before returning to an average of 4.6 per cent during the 1960s.[41] The Bank of England did not perceive the comparatively low level of capital in the 1950s to be a problem.

DIFFERENT PATHS BASED ON TRADITION

The laws are the main difference between Britain and Sweden. Where both countries enacted laws providing for joint-stock banks with limited liability in the mid-nineteenth century, Sweden went into much more detail with each law that was enacted. Britain did the opposite, once

[36] Billings & Capie, 2007.

[37] Collins, 1995.

[38] Roberts & Kynaston, 1995.

[39] Bank of England Quarterly, 1969:2.

[40] Billings & Capie, 2007.

[41] BoE Quarterly 1971:3.

limited liability joint-stock banks were provided for in the legislation, no further banking law was enacted to set out details of banking business or capital rules. The company law regulated the establishment and governance aspects of joint-stock banks rather than a banking law. The Bank of England chose to pursue its supervisory role in a flexible manner issuing no written regulations until the 1970s. These two countries are in this sense at opposite poles of the legislative spectrum, ranging from a more hands-off common law approach in Britain to strict advance codification in civil law in Sweden.

The two legal systems both derived from Roman law and the main dividing line in the present systems is the codification of law in civil law systems. The thinking in civil law is that the whole law could be codified into a coherent system with no gaps to fill by judges. Judges are thus expected to apply the law as written. The codification dates from the late eighteenth century.[42] The role of jurisprudence would be limited in the legal process in civil law countries, whereas in common law systems it is central.

Common law systems, by contrast, rely more on jurisprudence and evolve over time. In the area of financial regulation, the dividing line between the two legal traditions has been mainly explored in capital market laws with an emphasis on investor protection. La Porta et al argued that investor protection is stronger in the common law tradition because there is stronger protection of property rights in common law than in civil law.[43]

[42] Gomard, 1961; Stein, 1992.

[43] La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998.

Several scholars have pointed out that the common law and civil law dichotomy is not as clear cut as the original Law & Finance article suggested. Furthermore, common law has not been a coherent concept historically.[44] Moreover, the laws governing the financial sector in the United States and Britain differ widely and reflect different approaches within common law systems.

The English approach, as discussed above, depends on lawmakers standing back and letting the bankers develop business, trusting that it is in their interest to pursue sound business practices. The absence of statutory capital requirements and the supervisory approach after 1946 shows that the central bank trusted the banks to act properly within the bounds set by the company law and the credit restrictions in place. In addition, the Bankers Association may have exerted some peer pressure over and above the meetings with the Bank of England Governor. The Swedish approach was the opposite with its reliance on statutory requirements and inspectors who assess compliance regularly both on and off site in a more rigid manner. These different approaches seemingly follow the dichotomy of common and civil law, but they may also be products of general traditions in the two countries.

CAPITAL ADEQUACY AND FINANCIAL REPRESSION IN THE 1950S

The Swedish and English cases are opposites when it comes to codification of capital adequacy rules. While the objective of this paper is to examine the development of capital adequacy rules one needs to take the overall financial policies in Sweden and Britain after the Second World

[44] Acheson, Campbell, Turner, & Vanteeva, 2015; Gower, 1956; Guinnane, Harris, Lamoreaux, & Rosenthal, 2007; Lamoreaux, 2016.

War into consideration as well. Both countries pursued repressive financial policies and this financial repression served to direct bank lending towards what the respective governments regarded as priority sectors which severely limited banks operations.

In Sweden, specific regulations were introduced during the Second World War in order to direct lending to productive resources.[45] The banks purchased government bonds in large measures and after the War these were sold. The rapid sale of these sparked fears of inflation. The government was already concerned that inflation could rise after the War and insisted on keeping certain price regulations in place, remaining adamant that interest rates should be kept low to stimulate investments. In 1947, the Riksbank thus requested the commercial banks to restrict lending to productive and export-oriented sectors. They reiterated this request in 1950 when the war in Korea sparked renewed fears of inflation.[46] The Banker's Association duly complied.

This policy continued and by early 1952, commercial and savings banks were asked to restrict credit and the insurance companies were directed to invest primarily in government bonds.[47] In the 1950s the direction was to guide all banks (and insurance companies) towards buying government bonds and buying housing bonds to ensure that the government's plans for construction of housing could be realised. Voluntary agreements were reached with industry representatives (the Bankers Association, the Savings Banks Association and so forth) to limit credits overall and direct lending to preferred sectors. The banks were required to meet specific asset-liability ratios set according to the size of the bank. The Riksbank specified which assets

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[45] Jonung, 1993; Larsson, 1998; Larsson & Söderberg, 2017.
[46] Letter to the Bankers Association 11 August 1950 from the Riksbank Governor, A 1B:1950, Riksbank Archive.
[47] Internal Riksbank memo 2 January 1952, A 1B:1952.

and which liabilities that counted and in order to meet the quotas the banks essentially had to buy more government bills and bonds.[48] The Bankers Association duly issued a circular recommending the commercial banks to comply and urged them to inform their corporate clients that less credit would be provided henceforth.[49]

Since the agreements meant that credits to private industry would have to be curtailed, the Riksbank assumed that this would lead to more bonds being issued. The Riksbank thus reserved the right to have final approval over bond issuance, the amounts, terms and conditions (ibid). In this capacity the Riksbank implemented the Government's policy of directing financial resources towards construction of apartment buildings. Power firms were also granted permission to issue bonds but very few industrial firms were allowed to do so.

The Riksbank Governor held regular meetings with managers from the largest commercial banks to discuss the implementation of these restrictions. In the meeting notes there is no hint of nationalising the banks, but it was suggested that legally binding rules could be introduced similar to legal restrictions during the Second World War. At a meeting in 1954 for instance one of the leading bankers expressed concern about the effect on business with corporations, whereby the Governor pointed out that if the banks did not comply and the overall goals for monetary policy would not reached with their voluntary cooperation, then binding legislation could be introduced.[50]

In 1955, the Governor was concerned that clients who were denied credit in one bank could take their business to another bank that would approve the loan. This could undermine

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[48] Governing Board Minutes 31 January and annex with agreements, A 1B:1952.
[49] Circular 4 February 1952.
[50] Minutes meeting 10 June 1954, F1C:8 1954.

the restrictions if major clients bargained with different banks. This prompted the Banking Association to demand that banks collaborate on credit applications. Banks should consult one another if they received an application from a client in a rival bank.[51] This exemplifies the active role the banks took in compliance although they did complain that they had to turn down business opportunities in order to comply.

In early 1958 the Riksbank's Governing Board ceased to discuss banks' financial position and lending to housing at monthly intervals. However, regular meetings with commercial bank managers continued and the Governor conveyed time and again that he expected the banks to lend responsibly.[52] Since Sweden had extensive foreign exchange regulations the development of the euro market in London did not really have an impact on bank lending in Sweden.

Consequently, during the 1950s Swedish banks were subject not only to the capital adequacy rules that limited the size of their operations through the limits on deposits to capital but they also agreed to direct lending to preferred sectors and restrict their lending. In the 1950s credit restrictions rather than capital adequacy rules limited banks operations. While the banking law aimed at protecting depositors the Riksbank regulation aimed at achieving policy goals.

In Britain, government debt had increased rapidly during the Second World War reaching an estimated 237.7 per cent of GDP.[53] The government aimed to reduce this and this was achieved through financial repression via low nominal interest rates.[54] With an interest

[51] Cirkulär från Svenska Bankföreningen 18 January 1955.
[52] Governing Board Minutes 8 July, A1B:1959.

[53] Turner, 2014.
[54] Radcliffe Committee 1957; Nobay 1973 and Allen 2014.

rate cartel in place from the late 1930s the clearing banks were already aligned in their interest rate setting.[55] Their dominance probably made it easier to pursue low interest rates. After 1946 the Bank of England used a mix of cash ratios and liquidity ratios to compel banks to increase reserves with the Bank as well as buying government bonds to meet these liquidity ratios. These policies were pursued until the 1970s.

In addition, bank lending was directed towards priority sectors which included defence, exporters and agriculture and this was achieved through a mix of qualitative and quantitative directives that the Bank had to implement. These were not statutory and Turner suggests four reasons why the banks complied.[56] First, the Bank of England Act contained a provision allowing the Bank to direct banks. Second, sanctions could be imposed, such as closing the discount window and closing accounts with the Bank. Third, the banks were profitable and their interest rate cartel could continue. Finally, there was a latent threat that banks could be nationalised.

The financial repression effectively limited the banks operations, preventing excessive lending and thereby reducing the need for regulating capital adequacy. This de facto limitation coupled with a tradition of flexibility in England seem to have reduced any need for outright capital adequacy rules to further limit banks' extension of credit. Perhaps it was less the common law approach to legislation and regulation than the direct outcome of financial repression that led to the more relaxed approach to regulating banks' capital even when statutory powers had increased.

[55] Nobay, 1973.
[56] Turner, 2014, p 181.

Thus, contrasting Sweden and Britain, Swedish banks acted on a small heavily regulated and supervised market whereas the English ones acted in an international financial centre with far fewer formal rules. The Bank of England also had much less room for manoeuvre with the development of the euro market which diminished the impact of the financial repression policies. The Swedish case illustrates a different story than the English one with statutory rules regarding capital and formal supervision on the one hand and financial repression on the other. The result was that banks were bound by capital rules and in addition had limited options to lend based on a purely commercial basis. The financial repression policies limited banks business options to such a degree that capital adequacy rules appear superfluous from a financial stability perspective.

The different legal traditions and approaches in Sweden and Britain are clear when it comes to statutory rules but the economic realities after the Second World War prompted both governments to pursue financial repression and that meant directing bank lending through a combination of central bank regulations and moral suasion. These developments took place in the Bretton Woods era when international capital flows were limited through outright capital controls or by other regulations. International thinking and practice concerning capital adequacy evolved slowly at this time.

The international convergence of banking regulation and supervision that started in the 1970s shows that harmonisation across jurisdictions and legal traditions can be achieved. A 1974 survey undertaken at the Bank for International Settlements for the Meeting of Experts to examine supervisory practices and central banks' approaches to ensuring capital adequacy illustrate the differences between jurisdictions.[57] Britain stood out with its reference to "yardsticks of normal banking prudence" rather than exact statutory rules.[58] However, it should be noted that at the time the rules summarised in the survey report related mainly to capital controls, to the extent that banks and countries were subject to limits on capital transfers.[59] There was some discussion regarding liquidity and solvency but much more focus on the supervision of banks' foreign branches since the main concern was the growth of the euro-currency market.

The subsequent formation of the Basel Committee on Banking Supervision and the process of international convergence of rules relating to capital adequacy shows that while the legal traditions in common and civil law countries differ substantially on what and how to regulate common principles could be agreed.[60]

CONCLUDING REMARKS

This review of regulations regarding capital and capital adequacy from 1900 to 1970 has shown that statutory rules regarding capital other than minimum capital required for joint-stock banks, has been in place in Sweden for more than a century. Moreover, the Swedish authorities instituted a separate regulator with extensive powers enshrined in law. The rules evolved in line with the civil law tradition to use regulation to achieve control. This system remained in place throughout the period studied. This formality contrasts sharply with the English case with its reliance on moral suasion and peer pressure until 1946. Even after the Bank of England gained

[57] BISA, 1974 a.
[58] BISA 1974 b.
[59] BISA 1975.
[60] BCBS 1988.

a statutory right to regulate and supervise, it continued with what has been called “light touch regulation”. The common and civil law approaches are obvious in Britain and Sweden, with the former light on prudential regulation and statutory rules, while the latter promulgated detailed rules for banks, their capital, balance sheet limits as well as corporate governance matters.

Financial repression in both countries during the 1950s shows that both central banks in implementing these policies could strongly influenced banks’ activities regardless of any rules regarding capital. During the Bretton Woods era banks’ operations were constrained through foreign exchange and other capital controls which meant that rules relating to capital only were part of an overall regulatory framework, and possibly had a more limited effect on banks than current rules in place today.

Subsequent international convergence has illustrated that common rules can be developed regardless of legal tradition. However, the question of adequate capital remains far from settled. Sweden has tried different options to calculate capital adequacy for more than a century. Risk-based capital adequacy has been in place since 1968 but an optimal formula seems to be elusive, as is a view on what is indeed adequate capital.

ARCHIVES

Riksbank Archive

A 1B:1950-1959 Bankofullmäktiges Särskilda Protokoll (monthly minutes from the meetings from the Governing Board)

A 1B:1952, internal Riksbank memo 2 January

A 1B:1952, Governing Board Minutes 31 January and annex with agreements

A 1B:1959, Governing Board Minutes 8 July

F1C:1952-59 Carl-Göran Lemne's files (monthly meetings with commercial bank managers).

F1C:8 1954, Minutes meeting 10 June 1954

Bank for International Settlements Archive (BISA)

BISA (1974a) File ref 1.3 (a) 'Letter 2 May 1974 requesting information on supervision practices'

BISA (1974b), File ref 1.3 (a), Bank of England response to the May 2, 1974 survey

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<u>Sweden</u>

Lag om bankrörelse 1886

SFS 1903:101 Lag om solidariska bankaktiebolag och lag om bankaktiebolag

SFS 1911: Lag om bankrörelse

SFS1955:183 Lag om bankrörelse

SFS1968:601 Lag om ändring i SFS 1955:183

SFS 1971:612 Lag om ändring i SFS 1955:183

<u>Britain</u>

Banking Act 1929

Banking Co-partnership Act 1826

Banking Charter Act 1844

Bank of England Act 1946

Company Act 1929

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