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"BRIDGE, POKER AND BANKING: Deregulation and Recession in the Swedish Banking Sector"

with

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Would there be any point in throwing a bunch of serious, honest bridge players into the throes of professional poker without first preparing them for it? This is what seemed to happen in the eighties when the Swedish banks failed to take the time needed to adapt their internal structures to deregulation in the financial services sector. Swept along by the general euphoria of the boom years, the banks headed straight for disaster. There are several lessons to be learnt from their experience.

PRESENTATION

Some of you may find the title of this presentation a little strange. Let me tell you a story which might make things clearer.

My story's heroes are the long-standing members of a famous bridge club. They had been meeting up for years at sedate bridge parties and the club's cosy life was going very smoothly. There was just one hitch: the members had heard about another game, called 'poker'. Poker was supposed to be thrilling, and the bridge players all dreamt of trying it. The problem was, the club's managers had banned the game. Then overnight, the rules changed radically and poker became the only game that was authorised. All the other clubs had taken up poker, and it was now a question of reputation. The club members were delighted and threw themselves wholeheartedly into the game. It seemed all the more fun with all the new members who'd joined. However, there was one small problem: while everyone had been familiar with the rules of bridge, the poker rules were beyond many of the club's veterans. This meant that the old players were reduced to mimicking the newcomers. And the new members certainly knew the rules! They had a great fun playing the game, especially since the chips were piling up in front of them. But the time came when they started to notice some of the new players leaving. Then they wanted to cash in their winnings. Alas, by this stage, their chips were no longer worth anything! It reached the point where some of the club's members were in dire straits and had to bow out.

It goes without saying that this story is an allegory. Bridge symbolises the traditional values of the Swedish banking system, while poker represents the new rules and regulations. None of us would dream of starting to play poker - which is after all a risky game - without first knowing the rules, and yet this is exactly what happened in Sweden in the eighties after the deregulation of the financial services sector.

What were the circumstances that led to deregulation ? Firstly, we can point to the globalisation of banking operations with multinationals, capital markets, and so on. This had been a growing trend for several decades. Strangely enough, it was partly the result of over-restrictive regulations on the American market which had forced the American banks to expand into closely-linked operations abroad. One consequence of this move towards globalisation was an increase in competitiveness between the major financial centres: New York, London and Singapore, as well as Paris. Secondly, we can note increasing faith in market forces in sectors such as health and education that had previously been cushioned by the public sector. Finally, we should acknowledge the remarkable boom in the sixties and seventies in disciplines like management and economics. All these changes brought with them mounting pressure for deregulation, especially since the 'modern' way of thinking was to follow the trends set by other countries. Consequently 1978-90 saw the end of a large number of regulations, most of which had been around since the thirties:

Swedish deregulation measures

1978	Regulation of interest on deposits removed
1983	Liquidity quotas abolished
1985	Regulation of lending rates eliminated
1985	Limits on lending in SEK removed
1985	Foreign bank subsidiaries permitted
1989	Currency exchange controls abolished
1990	Foreign bank branch offices permitted

At first glance, the results surpassed all expectations. During the eighties, the Swedish banks did so well that it became a political problem. Towards the end of the eighties, it even came to the Minister of Finance and the President of the banking association signing an agreement obliging the banks to contribute funds for university equipment. But at the beginning of the nineties, a sharp turnaround put an end to the euphoria. In 1992, losses from debts had risen to over 70 billion Swedish Crowns. The country's entire financial structure was under threat: banks are closely-linked structures and people feared a domino effect. The situation was not helped by the general mood that takes over in cases like these.

What reasons have been given for the recession? First of all, there's the classic explanation that bad management was to blame: the banks had been led to disaster by incompetent directors. Secondly, some pinned the blame on the real-estate market which took a drastic downturn after the boom years, after the banks had granted a great deal of loans linked to the market. A third way of interpreting the events was to point the finger at the recent fiscal reform.

I would like to suggest a fourth reason, simply that organisational constraints were neglected during the deregulation. Deregulation was introduced in the mistaken belief that it's possible to switch from one state of equilibrium to another overnight. Of course, in practise the process takes a little longer, despite what classic micro-economic models predict. Why is this? Firstly, organisational constraints come into play and secondly, there are limits to managers' rationality. The first point goes back to classic ideas from the theory of organisations: an organisation's performance on the learning curve is affected by its environment, technical culture and history. The second point (see Simon for example) refers to the incompleteness of the available information, as well as shortcomings in the tools we use to deal with it. These imperfections increase in any situation where several actors interact.

Both these limitations must be taken into account whenever major changes are made to a system. You then realise that it's a mistake to try to use the same solutions in very different contexts: you don't run a bank like a Hoover factory! Another implication is that adapting to new work conditions can be problematic.

A banker is not a Hoover salesman!

Allow me to say few words on the specific nature of the banking world. First of all, customers do not pay for the bank's product at the time of delivery but in instalments and the product has to be returned to the bank after an agreed period of time. The first major difference between banking and the Hoover trade is that once you sell a Hoover, that's it! Another difference is that you don't need to know very much about the customer when you sell him or her a vacuum cleaner; on the other hand, a bank does have to be careful about who it lends money to. Knowing the customer is a fundamental part of banking: customers know themselves better than the bank does and they are unlikely to tell it all their bad points. It's in the bank's interest to establish long-term relationships with customers so that it can reach a better balance in this 'asymmetrical information' system.

Finally, money, the raw material which keeps the banks in business, can be withdrawn by customers at any time. This makes it vital for the banks to foster relationships based on mutual trust, if only with a few of its major 'suppliers', so that it has a minimum of security against other customers' whims.

Now that we've set the scene, what changes did deregulation bring about in the way banking organisations operated ? The recruitment policy changed, switching quickly from the traditional model - employing recent graduates who would be trained by a bank and then stay for their whole careers - to the practice in vogue at the time. This meant that the banks routinely recruited highly-qualified new blood, whilst the veterans were being pushed out. Although the average level of qualification went up, the new recruits knew nothing about banking. You can imagine the effects this must have had on the atmosphere at work and staff morale. The sad thing is that the banks often realised their mistakes only when it was too late. With reengineering, they desperately needed the people they had let go only a short time earlier.

Similarly, the banks adopted a more aggressive strategy with customers. No more the image of the banker granting or refusing loans at will to a grovelling customer ! All of a sudden the bank manager became a sales representative for consumer products. Some years on, during a courtcase involving a bank director, reference was made to a song that had been played outside branches to attract passers-by. That song seems ridiculous now, but everyone found it quite normal at the time. Of course, turnovers were very high all throughout this period. In the eighties, the huge increase in the number of people working in marketing, as opposed to auditing and management control, gives an idea of the euphoric atmosphere that went with the changes.

Trouble and copy-cat behaviour

I believe two more general features sum up the whirlwind of changes during the shake-up. The first could be called the "Follow my leader !" attitude, referring to the way that the different banks followed each other like sheep. This general tendency to follow a select group of trend-setters was accentuated by the small number of players on the Swedish market. The problem was that during the shake-up, some of the banks that had previously operated on a rather small-scale got it into their heads that they were going to become big fish like the others. These are the banks that really lost out later on. When you try to expand too quickly, you can’t be choosy about your customers, and as I said earlier, the selective information given to the banks can really go against them. Suddenly, banks that had only ever had Swedish customers were creating foreign subsidiaries and starting to finance American companies. The directors continually wanted more customers. These subsidiaries have generally had problems.

There is plenty of evidence of this copy-cat behaviour, from globalisation to diversification into products like insurance. I think this can easily be explained by theories on what economists call oligopolies. One thing that aggravates the situation is the fact that it’s extremely hard to keep a cool head when you’re under what I call "organisational stress". The few directors who tried not to follow the crowd ended up giving in to pressure from shareholders who wanted to be in on the action. For example, the whole sector got caught up in a craze for insurance. Suddenly, every bank had to own an insurance company. Nobody wanted to lose out in the game of musical chairs for buying the existing companies.

I’ll finish with a few conclusions on the work we started doing with the banks in 1985, when deregulation was introduced. We’ve been carrying on ever since. For example, I recently took part in a government commission on the recession in banking:

• firstly, with or without deregulation, precise rules are fundamental in guiding the players’ behaviour; if rules are not laid down by the government, then they are set by the players themselves;
• however, a certain amount of time is needed for them to adapt to new rules: you end up paying the price if you try to rush things; in this case the Swedish tax-payers have had to make significant contributions in order to save a system that was going downhill fast, so much so that a special government body has been created to this effect ;
• the higher the liquid assets of an industry’s main product, the higher the risks implied by introducing fast institutional changes ;
• the stress created by competitive activity is proportional to the uncertainty within an organisation.

It’s also interesting to note that the media could have criticised the sometimes kamikaze changes but instead they actually gave the process a helping hand. One example of this is that they routinely depicted the most aggressive managers as heroes.

Finally, I could sum up as follows : the banks must be seen as groups of human beings and not as mere curves of supply and demand.

DEBATE

Some technical details

A participant : *How many major banks are there in Sweden ?*

Lars Engwall (L.E.): At the moment, we're down to four major banks. Actually, this is quite an interesting point. Part of our research project involved studying the evolution of the banks from 1830-92. After a sharp rise at the beginning of the century, there was a clear decline in the twenties and thirties, followed by a second decline phase in the nineties, where three or four major names disappeared. Having said this, very few banks have actually gone bankrupt: they have generally made smooth exits, thanks to the government arranging mergers. Some of these mergers have been very recent. Sometimes a public-sector bank has merged with a private bank; often, there have been attempts to breathe new life into a number of struggling banks by merging them into one single organisation. However, the customers don't generally lose any money in the process. There has also been a trend for concentration in Stockholm, with the capital's banks taking over the others.

Participant : *Could you be specific about the types of credit that were agreed by the banks: commercial, industrial, real-estate, credit granted through capital markets, etc.? Were the losses made on credit granted to companies, individual consumers or institutional collateral ?*

L.E. : The problems occurred mainly in financial and real-estate services and were nearly always linked to new customers. In a way, the problems stemmed from the banks' own 'speculation'. This is particularly clear in certain regions of Sweden, around Göteborg for example, where the fight to attract new customers reached ridiculous proportions. Small and medium-sized businesses were largely responsible for the losses, since the larger companies had less need to rely on the banks as they expanded.

Participant : *How was the banks' capital spread out? Was it mainly in institutions ? Was it very scattered ? In other words, what pressure did shareholders put on the management?*

L.E. : Actually, I took an interest in Swedish banks' boards of directors while I was working for the government commission. They're strange beasts, I can tell you! The countries largest bank, SE-Banken (the Wallenberg bank) had a board of 50 members, so you can imagine just how difficult it was to reach any decisions! But in general, it's not the owners who sit on the board but the bank's most important customers: this is a way of putting them off working with rival banks. The board of directors is first and foremost used as a tool for the bank's development policy.

To go back to the distribution of capital, let's take the three major banks as an example. In the case of the Wallenberg bank, many of the shares are held by family members, or rather by the Wallenberg foundation. However there are nonetheless restrictions on the volume of shares that the foundation can hold, especially since this is a politically delicate matter.

At the second bank, which currently has the leading edge, the employees hold a significant number of shares. This is because a foundation was set up twenty years ago to put away a share of annual profits for the employees. Each employee can collect their share when they retire.

The third largest bank belongs to the State, and you know how the shareholder-management relationship works in these cases. At the end of the day, you've guessed it: there hasn't been a proper relationship between shareholders and the directors. In other words, the State didn't play the moderating role that can normally be expected of shareholders. They did indeed put a fair amount of pressure on the bank, but not for conservative measures. What they wanted were more and faster changes! Once again, 'modernity' was the key word:

certain banks even dropped the accents from the 'o' in their name, to give a more international image!

The State Guardian ?

Participant : *In France, a certain amount of problems, for example at Crédit Lyonnais, are put down to the unhealthy relationship that exists between bankers and the Ministry of Finance. What role does the Ministry of Finance play in Sweden ?*

L.E. : The Ministry of Finance was very active during the deregulation. The banks had been crying out for deregulation, and it has to be said that the system had been so centralised that it was bordering on the ridiculous. The director of the central bank only had to raise his little finger for the banks' directors to come running and line up to take a beating. Then in the eighties there were congratulations all round for the Minister of Finance, a social democrat (!), who led the reform. At the beginning of the nineties, the government, no longer socialist, had to be very interventionist, if only to save the whole ship from going under. This is one of Sweden's great paradoxes: every time we have a government that isn't socialist, something gets nationalised! Last time it was the ship-building industry.

I can tell you an anecdote to show how active the government has been whenever things have had to be knocked back into shape after a recession. A major American consulting group had helped several banks to reengineer and modernise. Alas, we can doubt the value of their advice, since it was precisely these banks that got into the most trouble. However the consulting group was back at the start of the nineties, this time commissioned by the State to help with its big clean-up operation.

Participant : *Do you think that it took the recession for the banks to adapt to the new system or could the government have avoided it?*

L.E. : I don't think it's a good idea to dwell on the past, but we can certainly try to learn from our experience. For example, it seems better to take gradual steps rather than try to change such a complex system all in one go unless an eventual about-turn is what's needed. The Swedish banks learnt their lesson during the recession and now seem to be more traditional than ever in their dealings with customers.

Participant : *The whole fun of banking is in being able to play with other people's money! And the charm of the old European countries like France is that you can always count on the taxpayers to bail you out, even if your bank is Crédit Lyonnais! Is it like this in Sweden ?*

L.E. : It's true that we've only recently joined the European Community. The fact that the government was able to intervene wasn't seen as a problem. The real issue was how to save the small operators and avoid a whole string of bankruptcies and even the downfall of the entire financial community. Of course, this has had its price. In Sweden we say that "If you arrange a loan of 100,000, that's your affair. 100 million and it's the bank's problem. A billion and it's the State that carries the can."

Participant : *I have a more technical question for you. I believe that the public debt is currently very high in Sweden. How are the banks reacting, given that interest rates are also very high as a consequence?*

L.E. : Certainly, the high interest rates are causing what I'd call a state of "overliquidity", or surplus liquid assets, and this can become a problem. The banks have trouble investing when they have too much money. In the seventies, when they had to invest all the petrodollars that were circulating, they made a series of bad real-estate investments, questionable loans to developing countries, and so on.

At the moment I think people are content to hope that interest rates will go down again. The Minister of Finance is conducting a very active policy to reduce the debt, and the social-democrat government is in a position to carry out reforms that would be impossible for a non-socialist government.

Participant : *Comparing the charts of losses on debts with the timing of the deregulation measures, I've noticed that while the losses start in 1990, most of the measures were taken several years earlier.*

This makes me wonder how far the losses can be put down to 'organisational' phenomena, in keeping with your hypothesis, and how much can simply be put down to the recession. I'd be more inclined to believe that there was indeed a wave of money madness during the first period, but the organisations adapted very well (and very quickly) to the changes, even though this meant taking big risks. Afterwards we saw a turnaround, but this was due to macro-economic factors that were beyond the banks' control.

Participant :*I'd like to add that we talk about the recession of 1990-92, but when we look closely at the figures, we can see that consumer spending didn't really drop during this period. It was more a question of an economic crisis.*

L.E. : I didn't say that organisational problems were the only explanation: the recession did of course play an important role. I'm just trying to underline that when we try to impose major changes, it would be helpful to make allowances for the limitations of the humans that make up organisations. Is it really useful to insist on ranking the reasons for the crisis in the banking sector? On the other hand, we could perhaps learn a few lessons on the way in which the State should intervene in the industries it supervises. We've had similar problems in other industries: the deregulation of the taxi business in Stockholm has been a disaster. The prices have gone up, not down, and the market's become a jungle! People are asking similar questions in the ex-Soviet Union at the moment. To sum up in a few words, we'd be better off trying to understand the role played by the rules that regulate a market.

Participant : *Have you noticed any real changes in the way the banks manage customer relations, particularly in terms of the banks' internal structure ?*

L.E. : Yes, certainly. The three banks that suffered the greatest losses had been reorganised into divisions on the advice of American consultants, with one division for consumers and one for business customers. On the consumer side, they could operate like Hoover salesmen. In other words, they had extremely sophisticated marketing systems that could work on a large scale. But this way of approaching the business seemed to contaminate the other division.

What's more, our study has revealed that the banks least affected by the crisis had some characteristics in common: they had mostly been stable, decentralised structures since the sixties and were organised into geographic divisions (one for each region) that were linked to a global system of control. The banks that tried to copy this system later on decentralised their structures but neglected the control system. And look what happened!

... but above all, humans

Participant : *(em*ployed by one of the major French *banks). We used to have a subsidiary in Sweden. These days we're under the impression that the situation has calmed down a bit. Do you think that now's the time to go back ?*

L.E. : I don't know if there is a right time! It always takes a long time to set up operations abroad because you have to forge partnerships and make a name for the company. If you do decide to go back, you ought to concentrate on working with your French customers that have operations in Sweden. The risk is being forced to do what I criticised earlier on, i.e. build a rather dubious customer base. It's particularly risky since some of your colleagues have stayed in Sweden and occupied the territory since you've been away.

While we're on the subject, the French banks provide some interesting examples of copy-cat behaviour. They all came to Sweden during the good years. Then many of them left.

Participant : *Is the level of directors' education in Swedish banks adequate? Did they have the skills needed to deal with deregulation? In a similar vein, is there any relationship between the directors' degree of competence and the losses their banks made ?*

L.E. : It's difficult to answer the last part of your question. But it's true that the average level of education has risen considerably in the banks, particularly in management. What's more, this has become a battleground between the banks. Ten years ago they used to send their managers out to attend the same seminars, but they now organise their own in-company training. It's also true that the companies least affected by the crisis were often those with real systems for developing a company culture.

Another point is that the media is currently obsessed with chasing out the crooks. Their theme is "Where has all the money gone?" In the ensuing court cases, the accused has typically been an average banker who obeyed his bosses and simply tried to act in the bank's interest without having the skills needed to carry off all the changes.

And what about France. Do you have special qualifications for the banking profession ?

Participant : *The banking profession puts a lot of money into training. But the problem is matching the training to the deregulation mechanisms. We have the impression that people who've worked for twenty years in a fairly regulated organisation are completely incompetent when the environment changes. This wouldn't be the case for people who've had special training.*

Participant : *Going back to the card-game metaphor, it's not the rules that count in poker - they're easy ! - but the practise.*

L.E. : The rules of poker are easy, but only when you know them ! It's not enough just to know them or even to put them into practise. You also have to understand them.

Participant : *Do any other people in Sweden, especially bankers, think like you that it's important to place "personal development" above training in more classic subjects ?*

L.E. : The banking profession is largely dominated by the classic "economic" theories of organisations. Of course, I'd be delighted if people paid more attention to my sort of approach. But then we're talking about the age-old battle between economics and management.

Participant : *At least after this episode we know what kind of people we should hope for: calm heroes, patient media and careful politicians. How are we doing at the moment ?*

L.E. : The heroes have been ousted from the banks so they're no longer in the running! I'm not sure if the media have learned anything from the events. During the last press conference on the subject, the journalists mainly wanted to know who the crooks were and where the money had gone to, but they didn't seem very interested in the influence of organisations' operations on the crisis.