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Summary and conclusions

4.1. INTRODUCTION

The banking crisis that has developed in Norway
in the past five years is one of the most dramatic events
in the country's economy since the second world war. Its
impact both on the authorities and the general public was
all the more forceful because the country had not
experienced a banking crisis since the 1920s and because
economic fluctuations had been modest right from the
start of the 1950s.
Another reason was that in its initial years the
crisis appeared to be a distinctly Norwegian
phenomenon. This is no longer the case, and the crisis
would perhaps have been viewed as less dramatic had it
arrived concurrently with or after the crisis in Sweden
and Finland. Today many countries are experiencing
banking crises. Besides our closest neighbours one could
mention the United Kingdom and France, the United
States and Canada, Australia and Japan.
The crises in all these countries share some
common features. We will outline the common features
first and subsequently examine the specifically
Norwegian features.
Among the main shared features the following
may be highlighted:

a. Symptoms and immediate causes of the crisis

The crisis showed that a period of sharp lending
increase is followed by weaker bank results, especially
among commercial banks because of their heavier losses
on loans, securities and own properties, and poorer
interest revenues as a result of a greater number of non-
performing loans. This reflects reduced profitability in
business and industry, to some extent also a less
conscientious attitude to loan repayment. In Norway
estimated losses grew to a point where the equity capital
of several banks was exhausted.

b. Connection with the business cycle

The sharp upturn as from 1983 was a
phenomenon common to all industrialised countries. It
was stronger and of longer duration than previous
cyclical upturns. It was accompanied in the first half of
the 1980s by strong inflationary expectations and an
expansionary credit trend. OECD member countries'
gross national product expanded at an annual rate of

between 2.5 and 4 per cent in fixed prices. The banking crisis largely coincided with the turnaround in economic activity. The decline in domestic demand emerged three years earlier in Norway than in most countries.

c. Decline in private saving

The cyclical upturn had led to a steady rapid climb in private incomes. Private consumption, which rose even more quickly, was increasingly credit-financed so that private saving showed a lasting decline for much of the 1980s. Households' financial position accordingly weakened. Chart 4.1 shows this trend in a number of countries. Together with vigorous business and industry demand for loans, this led to a strong increase in bank lending.

d. Collapse in the real estate market

The vigorous cyclical upturn and credit expansion in the 1980s led to heavy investment in dwellings and commercial real estate and an enduring rise in apartment and office prices. This laid the basis for additional borrowing. With the cyclical turnaround the upturn was transformed into a downturn. The collapse of the real estate market, which was a feature in very many industrialised countries, led to financial problems for many bank customers and reduced the value of collateral for banks' loans. This necessitated larger provision for losses.

e. Stronger internationalisation of financial markets

In the 1980s, financial markets in industrialised countries became more closely integrated. This was due to the fact that national foreign exchange controls were - or had been - phased out and that major companies and financial institutions were to a larger degree operating internationally. This led to greater harmonisation of interest rates and probably stronger cross-border psychological impulses. Further foreign bank entry and greater use of currency instruments tied countries closer together financially. Financial market efficiency improved as a result, at the same time as national freedom of action diminished.

f. Deregulation of credit markets

In the ensuing decades the stringent controls of the initial postwar period were gradually phased out in all industrialised countries. The timing and pace of this process varied from country to country. A number of countries had completed the process by the start of the 1980s. In Norway and certain other countries this point was reached only after the international cyclical upturn was under way. Deregulation was a precondition for the strong increase in lending.

g. Larger interest burden for enterprises and households

Enterprise and household borrowing rose in the 1980s. The burden of increased indebtedness was compounded by rising interest rates. In Norway household interest outlays as a share of disposable income rose from 7.6 per cent in 1979 to 20.6 per cent in

1988. Since then the figure has fallen somewhat, currently to 17.3 per cent in 1991, according to preliminary national accounts. In most countries the fall in the inflation rate in the latter half of the 1980s led to a marked rise in real interest rates, coincident with stagnation or reduction in turnover in many trades. The combination of weaker turnover, higher financial costs and lower real estate values led to weaker results and a very high rate of business closures.

The household sector's increased burdens in the form of debt interest and principal repayments have resulted in slow growth in recent years. Given the turnaround from negative to high positive real post-tax interest rates, households have opted to pay off debt.

In the 1980s leveraged buy outs whereby major enterprises changed hands and the new owners borrowed heavily in order to buy up large portions of the share capital - were common in the USA and certain other countries. When these enterprises were subsequently hit by crisis they had little to fall back on and the holders of the enterprises' junk bonds and the banks suffered heavy losses. Such factors have played a negligible role in the Norwegian banking crisis.

The same is true of the dramatic expansion of limited partnership companies. A large number of them were founded for tax reasons and they were fervently marketed by the various financial institutions. The projects involved shipping in particular, and more than a few were compelled to call in more capital from the owners than the latter were given to understand at the outset. In some cases the entire start-up capital was lost, inflicting losses on a number of banks. This too played little role in the Norwegian banking crisis.

The evolution of the Norwegian banking crisis fits nicely into the international pattern, although there are specifically Norwegian features:

a. Low interest rate policy
b. Weaker capital base
c. New rules on loss provisions
d. Lack of effective bank supervision

These factors will be considered in the following.
In conjunction with the discussion of credit policy we will also examine the growth of competition in the credit market and financial institutions' credit assessment.

Kapittel 4 Summary and conclusions
4.2 Credit policy

4.2. CREDIT POLICY

The removal of the supplementary reserve requirement as from 1 January 1984, which laid the basis for a strong increase in bank lending, marks a watershed in credit policy. In the space of two years the increase in bank lending quickened from about 15 per cent to almost 35 per cent per year. Part of this credit would very likely

have been mediated through other channels if banks had continued to be subject to constraints. Such a strong increase in lending was not possible without a substantial price rise. With hindsight it is easy to point out that a slower increase would have been desirable. The authorities' failure to check the trend was primarily due to their reluctance to change the tax rules and abandon the policy of low interest rates.

Higher interest rates would have moderated the demand for loans. The question is what level of interest rates would have been required. To put the matter in perspective, the present real after-tax interest rate in Norway (slightly in excess of 7 per cent) would have corresponded to a nominal rate of almost 30 per cent in 1986. The high figure is certainly due to the higher inflation rate at that time, but the most significant difference is that tax-treatment of interest payments was far more favourable for the ordinary borrower in 1986. Experience in Sweden suggests that the chances of a sufficiently large interest rate increase were limited. Unlike the Norwegian authorities, the authorities in Sweden had no wish to pursue a policy of low interest rates. Indeed the interest rate had been deregulated. Even so the country experienced a surge in lending and an ensuing banking crisis. The same was the case in the United Kingdom. All in all it is reasonable to assume that a rise in Norwegian interest rates would have moderated the rapid increase in lending, but would scarcely have prevented it. An even greater moderation would have been achieved by a tax increase on the scale that ensued in the following years.
The alternative was to desist from deregulation. The Commission believes that this would not have been practicable. Experience with strict quantitative regulation of the credit market showed that the system did not function as intended and that it certainly did not have the effects that were desired when it was introduced. The system had outlived its usefulness, inter alia because it squandered resources by fostering a parallel market and because it failed to ensure that the most profitable investments received the finance available. Moreover, the regulatory system had unfavourable effects both for the authorities and for the banks.
For the authorities the fact that every credit control led to adjustments in the market, whereby the regulation had a different effect from the one intended, was a source of constant frustration. If one type of institution - e.g. banks - was regulated, credit found its way to another type of institution, e.g. finance companies. When they imposed stricter reserve requirements on banks in southern Norway than in northern Norway, the authorities found that banks in northern Norway responded by rapidly increasing their loans to customers in southern Norway. On or around the dates for inspection of balance sheets, financial institutions would make major adjustments. Balance sheets could be shrunk on precisely the dates in question, and expanded back to a "normal size" shortly afterwards. Not all adjustments by financial institutions were undesired by the authorities. The clearest example of a very substantial readjustment came as early as at the start of the 1970s. At that time the reserve requirements on foreign currency loans prevented the commercial banks from competing on an equal footing with foreign banks

in the market for foreign currency loans to shipping companies and large enterprises. Foreign banks did not face this burden. The authorities found that they could not comply with the banks' wish to free foreign currency loans from reserve requirements, and agreed that banks set up their own branches abroad to arrange such loans. On this background, the major commercial banks, including Union Bank which was owned by the savings banks, were authorised to establish operations abroad, and they opened subsidiaries in Luxembourg. Regulation of foreign currency lending was abolished in 1978, but the banks remained in Luxembourg.

At times the adjustments to controls were a strain on the financial institutions. Not only did repeated readjustments lay claim to management time and inventiveness and involved direct costs; they also undermined general business ethics. Although financial institutions adhered to the letter of the law, and kept within the law, clearly many adjustments were in breach of the spirit of the law. Financial institution managements were aware of this. Moreover, there were examples of asset sales carried out by banks in a way deemed by the authorities to constitute contraventions.

In the spring of 1986, after the reintroduction of reserve requirements, several banks wished to shrink their balance sheets to avoid the high costs the reserve requirements entailed. Using finance companies and other brokers as intermediaries, these banks sold loans to other banks and finance companies. However, instead of entering these loans as loans to non-financial institutions, the recipient institutions entered them as loans to banks - which were not included in the measurement base for the supplementary reserve requirement. Norges Bank concluded that the responsibility for erroneous entry lay with the recipient banks, and these banks were required to pay retrospective interest corresponding to the costs they had saved by avoiding the supplementary reserve requirement.1 In several cases substantial amounts were involved, and in one case a very substantial amount. A discussion arose between the banks and brokers in question about who was responsible. "This led to considerable tensions within the financial system and a number of intense behind-the-scenes confrontations among the institutions. Those implicated ended the year rather vexed over what had happened", writes an observer who was close to the events.2

4.3. BANKING COMPETITION AND EVALUATION OF CREDIT QUALITY

Deregulation of the credit market was a precondition for the surge in bank lending. A similar expansion took place in other countries after deregulation: it was suddenly possible to meet the pent-up credit demand. A surge in lending appears to be a

general concomitant of this type of policy revision, but it is particularly strong during an economic boom.

The sudden opportunity to expand their lending prompted the banks to employ a hard-sell approach, and the competition for borrowers was intensified. This was in a market in which there was a heavy demand for credit. Many persons and enterprises whose credit demand had remained unsatisfied under the previous rationing system could now be accommodated by the banks. Moreover, finance companies had already made inroads in banks' markets, and the banks wished to recoup the ground lost, especially in the field of leasing and personal loans. For their part, finance companies, which had benefited from the controls on bank lending, now encountered stronger competition from the banks both for borrowers and in the funding market. In 1986 and ensuing years the companies put their poor results down to dearer purchase money owing to stronger competition from the banks.
During the period of strong lending growth, banks' evaluation of borrowers' creditworthiness became laxer. This was due to several factors. It was difficult to recruit experienced bank staff in the tight labour market. The banks therefore took on young personnel, often trained in business economics and administration but lacking experience in assessing creditworthiness. This was especially marked in new banks and new branches. For these new recruits the idea of a serious economic recession was very distant, and often equally distant as for the borrower.
Moreover, after several decades of negligible losses the banks had probably gradually transferred priority from credit evaluation to growth and immediate earnings on charges and commissions. Since the advent of the banking crisis, the annual reports of virtually all banks and finance companies have stated that the management have taken steps to tighten up their lending routines. This is a clear admission that things had run out of control. Storebrand's finance company, Custos Finans Øst, probably went furthest in its annual report for 1988. After stating that the year proved a very poor one for the company owing to heavy losses and loss provisions, it says:

During the current year the loan portfolio has been scrutinised, with ensuing large provision for losses. One reason for the increased loss provisions has been a steep fall in the value of collateral. Substantial loss provisions have been made both on corporate and personal loans.
Although many of the losses must be ascribed to weakened paying power on the part of several of our customers, the company has to concede that the main reason for the losses has been poor-quality credit evaluation. This is especially true of loans granted in the period when the financial market was overheated. The company has accepted the consequences and has introduced stricter credit routines, and concurrently given close attention to improving the quality of administrative procedures.

Several banks and finance companies stated that losses incurred by new branches were especially heavy. In its annual report for 1988, Den norske Creditbank

states:

A large share of losses on loans and guarantees refers to loans granted in the period 1984-87 and especially to loans from branches established in this period.

Similar conditions apply in the other large banks, suggesting that new branches' evaluation of customers' creditworthiness was particularly weak. This is a recurrent feature internationally and has natural explanations:
When a bank opens a new branch it must build up a customer base that will enable it to operate profitably. Corporate customers who previously dealt directly with the new branch's head office or regional head office, can be transferred to the new branch. Other customers must be acquired in the open market. There is no problem attracting customers who are dissatisfied with the locality's existing banks which, for instance, may not have granted them the loans or terms they desired. Loans to such customers often involve a high degree of risk. It is suspected that new branches acquired a substantial element of such customers after deregulation. This again can be put down to optimistic credit evaluation and to pressure from the top management to achieve profitability in the shortest possible time. Since fixed costs are relatively high, branches must work up a considerable volume of loans quickly.
There are examples of new bank branches that very rapidly increased their lending and whose procedures for verifying collateral were flawed. The losses suffered by these banks after a few years can be readily put down to "bad banking". A further factor is the use of an arrangement fee. So long as the income deriving from such fees was not distributed over the term of the loan it served as an extra incentive to expand lending. Banks generated sizable income by this means in the year loans were granted.
The developments described above were especially evident in towns which anticipated benefits from the petroleum activity. In Kristiansund and other towns which expected to become oil bases, there was a gold-rush mood to which recently established banks contributed and for which they subsequently had to pay a heavy price.
The heavy bank losses can partly be ascribed to poor evaluation of customers' creditworthiness. On the other hand, it is clear that the heavy losses after 1987 were strongly influenced by the marked turnaround in domestic demand and by the steep rise in the real cost of borrowing. Whereas demand in the mainland economy in the years 1984-86 rose as much as 17 per cent in fixed values, it fell in the following three years by 10 per cent. Real after-tax interest rates for the average borrower rose from about 1 per cent in 1986 to a little over 4 per cent in 1989/90.
The steep fall in domestic demand naturally led to reduced turnover and poorer profitability in many industries. The collapse of the real estate market reduced the value of collateral for many bank loans. Finally the steady increase in rate of return required of business and industry investment since the early 1980s put banks' finance costs on a continual rising trend. These three factors combined meant that bank customers found the

going tougher than at any time in the post-war period. The Norwegian banking system would have recorded heavy losses after 1987 even in the absence of vigorous bank entry in the early 1980s.

The stiffer competition in the Norwegian credit market after deregulation has obvious international parallels. In October 1991 Salomon Brothers, the US investment bank, presented a study of commercial banks' position and development in recent years. (Bank Asset Quality: A Global Profile). Based on information from inter alia the United States, Canada, the United Kingdom, France, Spain, Germany, Sweden, Japan, Australia, Hong Kong and the Scandinavian countries, the study described shared features and differences among the countries.

In many of these countries, lending had grown very strongly during the boom in the 1980s and the quality of banks' loan portfolios had deteriorated. According to the study there is a clear-cut connection between the two phenomena. The author is struck by:

the admission by many bank managements that many of the most grievous wounds have been self-inflicted in the form of weak control systems, lack of credit training and the unexpected emergence of potentially dangerous loan concentrations. Deregulation has also proved to be an unexpected source of problems: In retrospect, banks paid too little attention to the negative aspects of exploiting new market opportunities. Management culture has also played a role in the form of widely different attitudes toward assuming risk. Ownership - particularly the presence of performance-minded institutional investors - has also influenced management attitudes toward risk, while regulators, with few exceptions, have rarely played a proactive role in deflecting asset problems. Finally, the culture of the clients themselves, usually in the form of willingness to assume debt burdens, must also be factored into the equation. (p.1).

The study states that the best way to uncover a deterioration in the quality of a loan portfolio is to look at the growth of lending in preceding years. Virtually all problem loans could be traced back to earlier periods when growth rates had exceeded 20 per cent per year. Such strong growth was almost a guarantee that the banks would encounter problems. The study also finds that banks with the most highly sophisticated analysis systems were not the ones to come out best. It was the small banks which had operated on the principle of knowing one's customers that avoided heavy losses.

The study finds that German and Swiss banks have managed far better than banks in other countries, and attributes this to (a) the relationship between bank and customer and (b) the relationship between banks and financial institutions. There is a tradition of very close cooperation between bank and customer in Germany. This is reflected in the high degree of customer loyalty and in the fact that the bank is represented on the enterprise's governing bodies. In this way spheres of interest are formed around the large banks; virtually all major industrial groups are associated with one or other commercial bank. Moreover, the cautious and conservative culture of German commercial banks is reflected in the borrowing behaviour of the corporate

sector: the banks act as a brake on enterprise indebtedness.
Competition among banks in Germany and Switzerland has to a greater degree than elsewhere been marked by stability. There is a high degree of consensus among banks about what is appropriate behaviour. This fact, which is suggestive of a cartel system, prevented the outbreak of "destructive competition". The banks are less inclined to accept small margins and scant information in order to win customers.
A characteristic feature of the 1980s was the growing media focus on banks and industry and the latters' heightened awareness of the importance of a "good profile". Newspapers, economic journals, TV and radio evidently considered this to be good material, especially if dramatic events and persons could be highlighted. Bank managements also became aware that a favourable position in the eyes of the public was important for their employees' job satisfaction and thus for their motivation and performance. Creating a winner-culture was all-important.
Banks contributed to this culture. They believed it to be important to create a favourable profile in the eyes of the public and the authorities. They therefore put increasing emphasis on this aspect of their activity and the number of press relations staff increased appreciably. Banks thus sought to "plant" news and stories that were flattering and to suppress bad news and poor decisions.
This trend added a new dimension to banks' decisions. In addition to the economic effects of their decisions, managements increasingly attached importance to how the particular decision would be construed in the media and to what was the best way to present it. It may well be the case that the potential public relations gain played a part in the wishes of some banks to achieve vigorous expansion in the 1980s, since the banks believed that expansion in its own right was construed as "positive". Moreover, several bank managements tended to hold back measures that could be viewed as negative. This could help to explain why some banks postponed loss provisions to rather a late stage.

Kapittel 4 Summary and conclusions
4.4 Bank's financial strenght

4.4. BANKS' FINANCIAL STRENGTH

As we have explained, the requirements attached to banks' equity capital in the narrow sense - share capital plus reserves - were lowered in 1972. The reduction in the equity capital requirement from 8 to 6.5 per cent meant in reality a reduction of 25 per cent, since the measurement base was changed at the same time. With unchanged equity capital the a bank's potential total assets increased by 33 per cent. This created the potential for a substantial increase in lending.

Even more important was the ability to include

subordinated loan capital in the capital base. Subordinated loan capital with a limited term could be included at up to 50 per cent of share capital and perpetual subordinated loan capital at up to 100 per cent. This yielded a pro rata increase in the banks' lending capacity. Together with relatively frequent share issues, the incurrence of subordinated debt lay the basis for the strong lending growth. The authorities approved the raising of such loans and by no means opposed the trend. In Report no. 99 to the Storting on Bank Democracy (1973-74), the government came out in favour of subordinated loan capital as an alternative to share capital. In view of their policy of low interest rates the authorities were concerned that banks' share issues should neither be too large nor too frequent since this could exert pressure on interest rates. It is doubtful whether the banks could have achieved the strong growth in lending in the 1980s if their only means of building up capital had been through retained profits and share issues. Being able to raise subordinated loan capital was a partial precondition for the surge in lending.

One reason for the authorities' acceptance of a large volume of subordinated debt was that a similar development was under way in the banking systems of other countries. The authorities considered it difficult to be more stringent than the authorities in other countries. In fact the Norwegian rules proved more lenient than the BIS rules and the rules practised, say, in Denmark. Subsequently it became clear that such borrowing diminished banks' financial strength, because loan capital was not truly synonymous with equity capital. If banks were to retain their credibility in international capital markets, the loans would have to be serviced.

Another factor was that allocation to loan loss reserves did not keep pace with the increase in lending. At the end of 1988 commercial banks' loan loss reserves measured 3.3 per cent of loans and were therefore some way short of the maximum of 5 per cent.

The Commission on Bank Democracy discussed in its recommendation (NOU 1976:52, part VIII) banks' capital in relation to banks' risk exposure. It distinguished among three sources of loss: 1. imprudent business conduct on the part of the individual bank, 2. local or industry crises and 3. general recession. The Commission concluded that a bank's own reserves could hardly be large enough to cover more than losses resulting from 1. As regards the two other causes the Commission asserts:

Based on a rough assessment of the conditions the Commission expects that, if a crisis were to develop unhindered, the losses incurred by banks catering to specific industries and regions could easily rise to a larger share of loans than the capital ratios which may reasonably be expected. However, there is currently little reason to believe that it would be left to the banks alone to cope with problems in the local environment or particular trades if such problems were to acquire any scope. The authorities would have to step in, either with direct support to the business in question or with support to the banks. There is also the possibility that other and stronger banks could step in.

As regards the third cause of bank losses, a far-reaching cyclical downturn, the banking system as a whole will suffer. Such a recession, were it allowed to

develop unhindered, could be expected to lead to heavy losses for a large number of banks. Equity capital requirements of the scope envisaged will hardly suffice to ensure continued operation. On the other hand it should be clear today that the responsibility for combating a recession lies primarily with the public authorities. Although it may be difficult to prevent the direct effects of a recession, a recession can be prevented from developing into and being augmented by a general banking crisis. (p.155-6).

The present Commission believes that the Commission on Bank Democratisation placed too little emphasis on banks' reserves. A commercial bank and a savings bank should be able to handle either a local crisis or a recession without receiving government support. Nothing less than a veritable earthquake in the financial system should warrant an extraordinary infusion of capital.

Kapittel 4 Summary and conclusions
4.5 Loss regulations

4.5. LOSS REGULATIONS

There is reason to believe that the way the Banking, Insurance and Securities Commission's implemented the loss regulations of 1986/87 increased the drama of the banking crisis. It may be argued that the new regulations did not tighten the requirements as to banks' loss provisions, but that they clarified how the general accounting rules required assets to be valued. On the other hand, many banks at the time clearly failed to comply rigorously with this requirement as to asset valuation. They had a tendency to defer entry of losses until the latter were confirmed, and to write down asset worth by too small a margin, because they believed the loan loss reserves to be sufficient. Christiania Bank's annual report for 1987 states:

The losses are computed pursuant to the Banking, Insurance and Securities Commission's new regulations (of 10 December 1987) governing the entry of non-performing loans in the accounts. The new regulations mean that losses must be entered at an earlier point than under the old rgime.

After the introduction of the new regulations in 1986/87, bank auditors in particular felt it to be their task to get the banks to make provision for losses in accordance with the regulations. The result was a change of rgime in the banks. This came in addition to an increase in actual, confirmed losses and therefore strengthened the impression of bringing the losses forward. For this reason alone it would be interesting to take a look at how the new loss regulations came into being.
According to information received by the present

Commission, the regulations were drawn up by a group of bank auditors. For almost 30 years the chief auditors in the ten largest commercial banks, and in the course of time in a number of the largest savings banks, had collaborated professionally on a regular basis. In 1982 a member of the circle, an auditor at a troubled bank, raised the question of whether the banks' loss provisions were adequate. He himself had problems in persuading his management to accept the need for larger, more realistic provisions. The circle appointed a working group to look into the matter, and in the following year the group proposed a set of rules. This was deliberately made as inflexible as possible in order to pre-empt differing practice and competitive distortions among the banks. The draft was discussed at the circle's annual meeting in Trondheim in 1983. The members agreed with the proposed guidelines, but saw that the proposal contained much that was new and controversial. The question was whether the rules would be acceptable to the banks. The annual meeting decided that the draft should not be presented to member banks with a recommendation to apply the rules. The members feared that dissension might result because the legal basis for the guidelines was unclear.

In accordance with usual practice, representatives of the Bank Inspection attended the annual meeting. They were therefore acquainted with the draft guidelines and with the discussion among the chief auditors. When the loss trend became increasingly serious some years later, the Banking, Insurance and Securities Commission concluded that the rules on losses should be tightened up. They found the working group's draft and made it, word for word, into the Commission's regulations. The regulations were thus actually drawn up by leading bank auditors.

The bank auditors undoubtedly considered that there was some need for new, clearer rules, but they baulked at the thought of the opposition they might well face when presenting the guidelines in their respective institutions. A set of rules drawn up by the auditors themselves would not necessarily be acceptable to bank managements in the same way as rules drawn up by a body with greater weight and authority such as the Banking, Insurance and Securities Commission.

The supervisory authorities had the power to introduce loss regulations. The reason why they did not do so as early as in 1983 must be that they were content with the status quo. With hindsight their view may be regretted. Had the loss regulations been introduced in 1984 instead of in 1986, the authorities, bank managements and auditors would have been able to discuss the impact of the regulations at a stage when losses were relatively moderate. Furthermore, the larger loss provisions would have weakened banks' profit and loss accounts at an earlier point. Moreover, the regulations would probably have changed the banks' views on their increased lending volume in the mid-80s.

Even the new rules provide bank managements with wide scope for discretion with regard to provision for losses. This applies inter alia to the value at which real estate is entered in the accounts. The market value of real estate reflects what buyers are willing to pay for it. Their appraisal will be based both on the situation at the time of purchase and on the probable future trend of real estate values. Hence market values are not normally

subject to rapid variation. However, situations arise in which a market has dried up: no buyers are to be found. In that case the rules do not require real estate to be written down by a very large margin. If a bank believes that the value of the asset is very likely to recover somewhat in the course of two to three years, it may be reasonable to take this into account.

It has been pointed out that the buffer now provided by the provisions for future, expected losses in several banks far exceeds the loan loss reserves which even the financially strongest banks had prior to the banking crisis. However, it should be recalled that banks had far fewer non-performing loans in earlier good years than in recent years.

The question has been raised of whether it was appropriate to introduce and apply the new loss regulations. It has been asserted that the regulations have exacerbated the loss crisis and necessitated greater state involvement than would otherwise have been the case.

This question must be differentiated. A first question is whether the new loss regulations reflect what, in terms of business economics and accounting, may be considered to be a "correct" entry of losses and of the loss potential of the banks' loan portfolios. The Commission has found no ground for objections to the loss regulations and their application in this respect.

Quite another problem is whether the subject matter of the regulations, and in the event their application by the banks, could have been used as an instrument to moderate the banking crisis. If less stringent requirements had been imposed on banks' loss provisions, the losses on loan portfolios would not have come to light in their accounts, and this would have made it easier for them to meet the formal capital adequacy requirements.

The Commission is aware that the supervisory authorities in several countries, but particularly the USA, faced the same problem with their banks' sizable loans to Latin America and other developing countries. The value of these loans rapidly fell and a valuation of the banks' assets in real terms would have revealed major solvency problems in many large banks. In the circumstances the supervisory authorities accepted that the regulations were not being complied with to the full. The authorities and bank managements allowed the banks to operate with higher-than-real values in their balance sheets because refusal to allow them to do so could have precipitated a major financial crisis.

The same question has been posed in the debate in Sweden. One analysis of the Swedish banking crisis asserts that banks have probably entered non-performing loans and loans on which they have granted a temporary moratorium on interest payments, altogether totalling SEK 65 billion, at SEK 15-20 billion higher than their real values:

However, the supervisory authority has decided that such stringent entry of losses should not be applied. The analogy with the major international banks' claims on Latin America at the beginning of the 1980s is evident. Had the authorities decided at that stage that the banks should bear the full weight of all estimated credit losses in the year the banks realised that the race had been run, almost all the world's large banks would have gone into liquidation. The banks were permitted to

spread their losses over the rest of the 1980s and set off the "one-off loss" against following years' profits. Something akin to this is now happening to the Swedish banks' "black hole". Their approach to loss entry is unsatisfactory but it is the only practicable one. The alternative, i.e. to shoulder the losses right now, would throw the banking world into total chaos.

(Per Afrell and Sven-Ivan Sundkvist:

"Bankkrisen har inte ens nått halvvgs", Dagens Nyheter, 14 June 1992. Excerpt from an article of 14 June 1992 by Per Afrell and Sven-Ivan Sundkvist in the Swedish daily Dagens Nyheter entitled "The banking crisis not even half-way yet")

This article illustrates clearly the difference between the two alternative principles for loss provisions. There have been similar debates in Norway and in other countries with banking crises. The Norwegian and Danish authorities decided at an early stage to require full provision to be made for estimated losses. The debate in Sweden may be expected to prompt the authorities to give a closer definition of the guidelines to be followed by Swedish banks.
The question of how the loss regulations are to be applied reflects a choice between what is "correct" by the standards of business economics and what might be expedient based on broader social assessments. The Norwegian loss regulations aim at ensuring that the banks enter real values in their balance sheets. Only by this means can the banks fulfil accounting legislation's basic requirements as to correct accounts, which are in turn a precondition for the world at large, for bank staff and board members etc., to be able to form a correct picture of the banks' position.
A social assessment might be to the effect that demanding "correct accounts" would have undesired effects, and that the disadvantage entailed by the latter would be greater than the disadvantage of allowing the banks to continue operating with erroneous asset values. This assessment builds on specific scenarios resulting from the two alternatives. In the Norwegian situation critical weight was attached to the confidence Norwegian banks needed in international markets in order to obtain credit. If Norway introduced more lenient rules for loss provisions, or interpreted the rules more liberally, this would immediately become known in international markets. What consequences this would have had for banks' creditworthiness is not easy to say. The Norwegian authorities chose to steer clear of this situation by maintaining the loss rules and concurrently supplying capital to the banks.
The choice between the two approaches did not emerge clearly until the banking crisis was well under way. Had the question been raised as early as in 1987 it would have been perceived differently. Then the question would have been whether the new loss rules should be implemented wholesale or step by step. In 1991/92, when this question was raised, the situation was different inasmuch as the rules had already been in effect for some years. A relaxation at that point would have entailed putting the rules out of commission. The banking crisis arrived later in Sweden. The authorities and bank managements there were able to see what had

happened in Norway and other countries and take this
into consideration.

The present Commission believes Norway's approach, i.e. to operate and practise loss regulations that are in accordance with the basic principles of accounting legislation, to be the correct one. The question of temporary departure from these rules has no relevance today. The Commission would also point out that relaxation of the loss regulations is a question of spreading losses over time. Relaxing the requirements as to provisions would enable the banks to conceal their inadequate capital ratios, at any rate for a time. But this would not change the underlying realities.

Kapittel 4 Summary and conclusions
4.6 The role of the banking,incurance and securities commissions

4.6. THE ROLE OF THE BANKING, INSURANCE AND SECURITIES COMMISSION

The Banking, Insurance and Securities Commission (Bank Inspection) is interposed between the Ministry of Finance and the institutions under its supervision. Section 3 of the Financial Supervision Act provides that the Commission shall oversee that supervised institutions function in an expedient and satisfactory manner. Historically speaking, safety has been the prime concern. When, at an earlier stage, banks were weak and many banks managements were unprofessional, and before the guarantee funds were set up, it was vital to see to it that the banks were run in such a way that depositors and other creditors were protected against loss.

Today the Commission has the same basic obligations, but the setting in which it operates has changed somewhat. There is an understanding that the State and Norges Bank in effect guarantee that banks will not be liquidated on a scale that threatens the entire country's financial system. This guarantee and the existence of the commercial and savings banks' guarantee funds implies a de facto protection of depositors that is stronger than what the Banking, Insurance and Securities Commission alone can provide. We will come back to this point in the following.
The Banking, Insurance and Securities Commission maintains supervision of the banks, draws up regulations and establishes standards. Moreover, it will issue warnings and instructions when developments take turn for the worse; cf. chapter 3.
As far as drawing up regulations is concerned, we have already indicated that it would have been an advantage if the loss regulations of 1987 had been implemented a couple of years earlier. The pre-legislative history of these regulations shows that this could have happened. It would clearly also have been an

advantage if the Bank Inspection's (Banking, Insurance and Securities Commission's) requests to the Ministry of Finance to raise the limit on banks' tax-exempt allocations to loan loss reserves had been acted on.

As regards bank supervision it is important for the purpose of rough and ready sorting to employ appropriate indicators. The most important signs of an unhealthy trend in a bank are: (a) a strong increase in lending, (b) weak earnings, (c) large short-term borrowing in the money market and (d) dubious loans. Earnings depend on income and costs, which in turn can be broken down into a number of sub-groups. These items can be read off in banks' profit and loss accounts. Together with the balance sheet they can provide a basis for identifying such signs of unfavourable developments as indicated above.

In order to examine the quality of a bank's loan portfolio the supervisory body must as a rule carry out an on-site inspection. This will bring to light the spread of loans on trades and customer groups. Strong concentration of loans on a particular trade, such as fishfarming, construction etc., may be a danger sign. On the other hand it will be difficult to a avoid a certain concentration so long as many of the banks cater to a narrow local market. Moreover, it is clearly difficult for a supervisory body to step in and review a competent bank management's own credit assessment. The larger banks employ staff who specialise in assessing loans to industries and trades such as the fisheries, wholesale and retail trade, shipping, specific branches of manufacturing etc. It would be difficult for a supervisory body to furnish resources and expertise capable of seriously reviewing banks' assessment of individual loans. Nor, in the present Commission's view, can building up a supervisory body to check the minutiae of banks' credit assessments be a worthwhile objective. What the supervisory authorities can do is to evaluate the largest loans, and make random checks elsewhere in the bank's loan portfolio. Even so, there must be no doubt that the responsibility for satisfactory credit routines within the individual institution rests fairly and squarely with the management of the institution in question.

Furthermore, a supervisory body's responsibilities will include overseeing that banks have proper credit manuals, routines for credit assessment and internal control. During the surge in lending it happened more often than earlier that credit routines were haphazard, that not all controls were carried out, and that mortgaged objects were not registered as required. A stronger on-site inspection facility in this period would have been better placed to uncover this type of flaw. In the mid-1980s the Banking, Insurance and Securities Commission carried out very few on-site inspections.

However, losses can be incurred even on loans that have been sanctioned by specialists. There is no way to predict, say, shipping crises, a drop in aluminium prices, trade policy action by other countries against Norwegian pulp and paper products, a collapse of the real estate market and the like. Because the Banking, Insurance and Securities Commission has carried out an on-site inspection of a bank and found everything to be in order, this does not amount to a guarantee that losses cannot arise. The pre-legislative work on the Financial Supervision Act confirmed that excessive steering or persuasion on the part of the Commission would be

incompatible with its position as a control agency. Banks and other institutions are themselves responsible for the business side of their activity.

Partly as a result of the desire for increased "local self-government" on the part of banks' branches, the limits on the lending powers of local bank boards and "lower level" bank managers were raised on a scale beyond that warranted by adjustment for inflation. Some of these lenders lacked the necessary competence, or failed to display the required prudence in their credit assessments. Moreover, several banks have asserted that the presence of local politicians on a number of boards led to excessive accommodation of projects which would have major importance for the local community but which would only provide the required rate of return under very optimistic assumptions. A stronger focus on on-site inspection could have brought several of these cases to light, and moreover put in question the extended delegation of credit decisions to local boards and "lower management levels".

The Banking, Insurance and Securities Commission is required to report on developments in the entire financial sector in its annual report and by other means. The banking crisis shows that greater importance should perhaps now be assigned to this aspect of the Commission's activity and to the Commission's relationship to the authorities. The fact that the Storting's financial affairs committee criticises the Banking, Insurance and Securities Commission for not mentioning the banking crisis until 1990 indicates a feeling that the authorities could have handled the crisis more successfully if they had been alerted at an earlier stage. The Commission has, in the annex to its annual report for 1991, refuted the finance committee's assertion.

To the extent it is possible after the event to point to what should have been done differently, we would point to inadequate resources, lack of qualified personnel at the initial stage, and possibly to communication problems between the Banking, Insurance and Securities Commission and the Ministry of Finance. This latter factor focuses attention on the Commission's reporting to its superior authority. Based on the nature of its activity, the Commission should have been the first to report untoward developments. Probably the most important gauge of a detrimental trend is the rate of lending increase. When this reaches 20, 30, 40, ... per cent, there is cause to sound the alarm. The Commission should have been in a position to do this both in the case of banks and finance companies in the mid-1980s.

Had such an alarm been sounded, the authorities would have become aware of the dramatic increase in financial institutions' risk exposure at an earlier stage. They would then have had a greater incentive to realign credit policy and the rules for tax treatment of interest expenditure, possibly also to review the arrangement involving perpetual loan capital. The Commission should use its insight to communicate its impression of how the credit policy functions in practice, i.e. in relation to the individual financial institution. Had it done so, the Commission would have lit a warning lamp for the Ministry of Finance, a task that also rests with Norges Bank.

4.7. STATE INVOLVEMENT

The quotations in the foregoing show that it is commonly recognised that the state is responsible for maintaining a safety net, at any rate for the largest banks. In particular, the central bank responsibility for supplying liquidity to solvent banks is well established internationally. The central bank is the lender of last resort. However, when the liquidity supply is insufficient because of banks' solvency problems it is usually held that the state is responsible for maintaining the central pillars of the domestic credit system, because a collapse would have grave knock-on effects.

To put this in perspective it may be recalled that the state also contributes to resolving crises in other industries: drought damage in agriculture, harsh years in the fisheries etc. Another example is the shipping crisis of 1975, which prompted the government to set up the Guarantee Institute for Ships and Drilling Platforms. The Institute was intended in part to protect national assets represented by the modern tanker fleet, in part to protect shipbuilders' financing institutions and guarantee employment at shipyards.
There is a consensus that the state should intervene to prevent a collapse of the Norwegian financial system. This accords with the prevailing view internationally.
Another question concerns what form state support should take. Since the interwar period the traditional solution for distressed banks has been to seek to merge them with banks with sufficient strength to take them over. The authorities have assisted such mergers in the case of both savings banks and commercial banks. As a rule the government support required has been confined to liquidity from Norges Bank in a transitional situation. Such a solution would evidently not be realistic for the distressed large commercial banks. Indeed the authorities' assessment was that these banks could only be salvaged by state infusions of fresh capital, in the form of preference share capital or ordinary share capital.
A variation of this model has been applied in Sweden, in Finland, and in a number of cases in the USA in which capital contributions go to establishing a "bank for bad loans", i.e. the bad bank model. This arrangement may take three forms: (a) transfer of loans to a subsidiary with its own accounts and organisational set-up (b) direct state takeover of the loans, and (c) collective sale of the loans on the private market.
In the case of the hard-hit Swedish bank Nordbanken, the government stepped in with fresh capital and simultaneously accepted that the bank hived off non-performing and other problem loans into a separate company, Securum. The idea is to enable the remaining section of the bank to operate profitably and

the bad loans to be better taken care of by a separate company.
The same arrangement has been adopted for the Swedish savings banks. When the new national Swedish savings bank was established, the state injected, and furnished a guarantee for, SEK 7.3 billion and accepts that SEK 3 billion will go to a separate company for bad loans.
The transfer of bad loans to a separate institution signifies in a sense a once-for-all solution for the state, since the remaining "healthy bank" should be able to manage on its own. The company responsible for the bad loans probably also represents a less direct involvement for the state than injection of capital.
Furthermore, it is asserted in banking circles that partitioning may have a salient effect on the motivation of bank staff. As falling real estate values and other factors led to the banking crisis, work on loan losses laid claim to increasing numbers of staff and more and more management time. This had a depressive effect on morale, and it has been asserted that staff expended less effort to recover losses on a loan once provision for losses had been made. Managements also had less time and energy available to stake out a course for the future.

On the other hand, the management of an institution dealing exclusively with bad loans would have an appreciable incentive to salvage the maximum volume of assets. Upon transfer to the new institution, the loans taken over would be entered in the books at written down values. Thus there should be a strong possibility of disposing of them at a surplus-to-book value. Moreover, these specialised institutions will be administering a very large stock of real estate, and they should therefore be able to employ a highly competent staff.
An alternative to infusions of state capital into distressed banks could be a state guarantee. A guarantee could take the form of a general guarantee in respect of the bank's entire loans or of a more specific guarantee, although neither could replace share capital under the provisions of the Commercial Banks Act. Rather than go into detail here, we will compare two alternatives: state contributions and state equity capital guarantees. Each will have a different effect on the distressed bank's capital adequacy and on its liquidity position.
If the capital of a bank that has followed the rules governing loss provisions is exhausted, an infusion of fresh equity capital by the state will restore its position. The bank will again attain a satisfactory capital ratio.
If the bank instead receives a state guarantee, its accounts have to show that it fails to meet the capital requirements, while at the same time making it clear that its capital has been replaced by the state guarantee. It is not easy to say whether the latter solution would in general be acceptable on an equal footing with the former solution in international capital markets.
An injection of capital into a distressed bank concurrently improves the bank's liquidity position. This would not be the case with a guarantee. In the latter case the bank has to obtain such liquidity as it requires by borrowing in the market. In all probability it would be possible to formulate the state guarantee in such a way that the bank is able to fund itself in international markets.

The difference between the two solutions is that in the first case the bank receives capital which it is under no legal obligation to pay interest on, whereas this will not be the case with loans it raises (against a state guarantee). The first solution is therefore more favourable for the distressed bank than the latter since it yields a better operating result than the second.

In 1992 this gave rise to a debate on whether state capital injections have distorted competitive conditions. Banks that had received no assistance, particularly savings banks, accused some distressed banks of engaging in "competitive dumping" and alleged that they were able to do this because they had received "free capital" from the state.

Capital on which no return is required is undeniably of benefit to the bank in question. This applies regardless of the source of the capital - whether it be subscription for shares by the ordinary shareholders or by the state, infusions by the state or by the guarantee fund, or previous retained profits.

A state guarantee without guarantee commission will also be of advantage to a bank. It could put the bank in a position to borrow funds on more favourable terms than would have been the case without a guarantee. Situations may arise in which the guarantee enables banks to borrow on more reasonable terms than non-distressed banks. Hence competitive distortions can arise in this case too. Both state capital injections and government guarantees entail a form of subsidisation that can distort competition among banks.

Judged by the effects on banks' operating results there are appreciable differences between the two types of support. Given the same liquidity need, the bank that receives an infusion of state capital will show a better result than the bank that receives a guarantee. The difference lies in the interest burden on the capital which in the one case is in the form of equity participation by the state and in the other in the form of funds borrowed in the capital market. It is not easy to say what emphasis the market will place on this difference. Accounts analysts will probably "look past" the figures at the underlying realities. However, the possibility cannot be ruled out that the market will be influenced by the figures presented, and regard a bank supported by state capital as better and financially stronger than a bank with a state guarantee.

The next question is whether this will be of consequence for a distressed bank's activity. It could be asserted that pressure on a bank management to improve the operating result will be greater when the accounts show a deficit than when they are at break-even point or in surplus, even if the latter is with the aid of subsidised capital. Such pressure will probably cause the management to be more inclined to shrink the balance sheet and reduce staff, and less inclined to accept unprofitable business.

On the other hand it may be asserted that the state could attach conditions to its supply of capital in regard to the above factors. For the management of a bank that has been taken over by the state, the desire for reprivatisation may be a powerful motive to achieve profitable operation. The present Commission is not disposed to give an overall assessment of the effects of the various forms of state involvement in distressed banks, but believes that these questions should be given

substantial weight and closer consideration in the further treatment of the state's involvement in distressed banks.

Kapittel 4 Summary and conclusions
4.8 The future

4.8. THE FUTURE

Results so far in 1992 show that losses and loss provisions remain high, but that the volume of new non-performing loans has fallen substantially. Moreover, recent years' cutbacks in staff and other operating expenses have led to improved operating results. So long as the cyclical picture does not deteriorate, the banks can be expected to have put the crisis behind them within a few years.

The question is what will be the new "normal level" of bank losses. In the banking industry it is generally agreed that 0.2 to 0.4 per cent, which was the norm while the credit market was closed and regulated, is a thing of the past. It is probably more realistic to expect annual losses of the order of 1 - 2 per cent. Figures from other countries suggest this is a plausible estimate. If the banks are to achieve satisfactory profit levels, net interest income including commissions will then have to be far higher than was previously the norm.
A question of relevance for the immediate future concerns the reprivatisation of those banks of which the state is now the sole owner or in which it has a controlling interest. The Revised National Budget for 1992 discusses this question:

The Government Bank Insurance Fund is intended to be of limited duration. The Fund's varying participation in the banks either directly or through the banks' own guarantee funds must be gradually phased out once the banking crisis is behind us and deposit insurance can again be based on capital generated by the banks.
It is planned to apply a more long-term aim to state ownership based in the investor role of the Government Bank Investment Fund. This Fund, together with other state and private investors, will help to secure a substantial element of national ownership in Norwegian banks. The Fund can apply a commercial long-term perspective to its investment decisions.
Once the situation in those banks which are currently wholly-owned by the Government Bank Insurance Fund has normalised and become clear-cut it may be desirable to transfer part of the portfolio of the Government Bank Insurance Fund to the Government Bank Investment Fund. (p.128)

This statement gives no clear indication of whether the authorities desire the commercial banks to be wholly taken over by private shareholders at an early

stage or whether the state will retain interests in the banks for a more extended period. This is a political question which falls outside the remit of the present Commission.

In June 1992 former shareholders in Christiania Bank were offered a call option on up to 25 per cent of the state shareholding at NOK 16 per share. The government had paid NOK 46.73 for these shares, but immediately wrote them down to face value, NOK 25. The offer to former shareholders therefore entailed a discount of 66 per cent relative to their purchase price and 36 per cent relative to their book value. Only a small portion of the shares offered found buyers. On what terms the state will sell its shares in the future is a moot question. The Revised National Budget for 1992 states:

In the Ministry's view it is too early to settle on a strategy about how and when private interests should be brought into the commercial banks. Further privatisation of state assets, beyond that resulting from the offer of call options in Christiania Bank and Fokus Bank, must be based on commercial principles. This requires buyer and seller to agree on a price for the shares. Accordingly, such privatisation cannot take place until the bank's earning potential and value as a going concern can be assessed with greater certainty than is the case today. (p.128-9)

There is room for some speculation about loss provisions. According to the regulations, banks must make specific and non-specific loss provisions, and, moreover, general provisions. If a bank's losses are on a flat trend, the loss provisions will cover actual losses in a particular period. A portion of these losses have yet to be confirmed, so that the item non-specific loss provisions, in particular, may contain a reserve. However, based on experience hitherto, part of the reserve that this item has carried over from previous years will be depleted in the course of the year.

Against this background there is reason to assess the need for general provisions. There will evidently be a need for such an item should the loss trend in the future prove worse than at the time the provisions are made. Based on a stylised cyclical path spanning five "good/normal" years and three "poor" years, it would be logical to accumulate general provisions in each of the three first years at 3/5 of the extra loss accruing in the poor years. Instead of an annual loss provision of 1 - 2 per cent, there may be reason to allocate a further 0.5 per cent in the good years.

The vigorous increase in lending after deregulation accelerated the expansion of banks' capacity. The number of staff and branches rose. The turnaround in economic activity was followed by consolidation. Branch closures and staff cutbacks have already come a long way; the question is, how far this process will continue.

Efforts will probably be made to carry through new mergers. There is still some potential for amalgamations among savings banks. This is a recurrent topic on the agenda of the savings banks' own governing bodies and representative organisations, and the objective of concentration around regional savings banks has yet to be fully achieved. Concentration in our neighbours has progressed much further. In Sweden and

Finland it has been decided to create one national savings bank by merging a very large share of the present savings banks.
The situation of the commercial banks is less clear. It is reasonable to envisage some of the smaller commercial banks joining one of the three large banks. On the other hand, the fact that new banks are being established and that some mortgage companies are being converted to banks, thereby actually increasing the number of commercial banks, gives grounds for apprehension. One reason this happens is that new banks are automatically included in the guarantee fund arrangement and enjoy the guarantee inherent in the central bank's role as lender of last resort. Some increase in the number of commercial banks does not mean that the commercial banks' capacity rises at the same rate. For mortgage companies, conversion to bank status may mainly mean access to a new source of loan funds. On the other hand a mortgage company that has been granted bank status would be unlikely to desist from traditional banking activity.

Kapittel 4 Summary and conclusions
4.9 Conclusion

4.9. CONCLUSION

Financial crises are a familiar phenomenon in all industrialised countries in modern times. An expert on the subject, Professor R. W. Goldsmith defines the phenomenon as follows:

A financial crisis is defined as a sharp, brief, ultra-cyclical deterioration of all or most of a group of financial indicators - short-term interest rates, asset (stock, real estate, land) prices, commercial insolvencies and failures of financial institutions. (From Charles P. Kindleberger: "Financial crisis" in The New Palgrave. A Dictionary of Economics, London 1987)

Financial crises are, in the nature of things, not foreseen. Their potentially dramatic unfolding ensues from their shock effect.
Although each crisis has its special characteristics, there are certain recurrent features. The first is that they follow when a sharp upturn, often featuring inflation, has been replaced by a sharp fall in asset values and incomes. During the upturn economic agents form expectations about the future. These often take the form of a straight-line extension of current trends; growth to date is expected to continue. When real estate values have been on a persistent rising trend for some time, very few people can conceive they could abruptly fall. Investment calculations are based on historical events. Only after the turnaround does it become clear that this was a hazardous assumption. What appeared reasonable while the upturn lasted smacks of rashness once the turnaround has taken hold. It is easy to

find examples of both public authorities and private enterprises that initiated construction projects during the boom in the 1980s which would have been considerably cheaper had they been deferred for a few years. The same applies to housing cooperatives and private house construction. Neither the housing organisations nor the consumer authorities warned against the forthcoming crisis. Nor is it difficult to find examples of investment projects that turned out to be based on far too optimistic assumptions.

The same applies to public institutions. It was clearly unfortunate that the banking crisis occurred at a time when the Banking, Insurance and Securities Commission was at a low ebb. Staffing at the Bank Inspection was geared to the need existing when bank losses were small and financial positions sound. Resources were insufficient to handle a crisis. Moreover, reorganisation overtaxed these resources at a time when the tight labour market made it difficult to recruit competent personnel. Possibly the Commission spent too much time and effort in the initial period drawing up rules and regulations, and an excessive share of the staff who had experience of supervision may have been assigned to administrative problems.

Where economic policy is concerned, there can be no doubt that the authorities underestimated the strength of the latent credit demand prior to the deregulation of the credit market. The marked decline in private saving came as a big surprise and the fact that so much time elapsed before the Central Bureau of Statistics and the Ministry of Finance captured what had actually transpired did nothing to ease the situation. Moreover, in chapter 2 we showed that fiscal policy had a tendency to lag in relation to what the situation demanded.

Neither the Central Bureau of Statistics' annual economic outlook nor Norges Bank's cyclical indicators suggested an impending financial crisis. This begs the question of whether economic statistics, on which policy has to be based, are satisfactory and sufficiently timely. Furthermore, doubts may be raised about whether the models used by the authorities have a sufficiently sound basis in Norwegian economic agents' behaviour. Asset and debt conditions were absent in the models and almost absent in Norwegian macroeconomic thinking. Hence insufficient weight was given to the dramatic rise in the ratio of consumer debt to consumer income. Nor was much attention given to the increased indebtedness in the corporate sector. With hindsight it is easy to see that a period of vigorous debt accumulation must either level off or be reversed. The upturn generated recessionary impulses.