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When and how?

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THE SAVINGS BANK CRISIS IN SPAIN: WHEN AND HOW?

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The present financial crisis has severely hit the Spanish savings banks sector. Of 45 savings banks in 2007 by the end of 2012 the number had dropped to only 13. Most of the institutions that disappeared were consolidated into major groups, either by outright purchase by banks or as a result of merging operations among individual savings banks. The Bank of Spain and the FROB[1] have bailed out seven savings banks or groups of savings banks, and four of them have been nationalised. Moreover, nearly all merger operations have required public resources, which in turn have increased the already large government budget deficit.

As indicated, the resolution of the overall financial system crises, savings banks included, has required massive financial support from the Spanish government, which in June 2012 was forced to request external assistance from the European Financial Stability Facility (EFSF). A Memorandum of Understanding was signed on 20 July that included financial aid of €100 billion to cover losses and to capitalise all of Spain's viable banking institutions still in need of completing the restructuring process. By December 2012 the funds channelled to the banking sector amounted to the staggering figure of €61.2 billion euros, or about a 5.8% of GDP; 36.5% of these funds has come from the FROB, the rest, 63.5%, from the EFSF. The amount of help received by the Spanish banks in terms of GDP was the second largest of the European Union and the United States, and only after the assistance received by the Irish financial system (see table 1). Never before the present crisis was the Spanish savings banks sector subjected to such financial turmoil. On the contrary, 150 years of fi-nancial history show that until the 21st century all crises affected commercial and investment banks, but not savings banks.

1 Fondo para la Reestructuración Ordenada Bancaria (Fund for the Orderly Restructuring of the Banking Sector) created in July 2009.

Table 1: Public aid to all the banking system: bank and savings banks ranked by % of GDP

Countries	Aid (€ billions)	Percentage of GDP (%)
Ireland	21.2	13.3
Spain	61.2	5.8
UK	72.9	4.2
Belgium	12.2	3.2
US	327.6	3.0
The Netherlands	16.1	2.6
Germany	46.5	1.8
France	15.7	0.8

Source: International Monetary Fund.

Between 1800 and 2000, according to a recent study, Spain suffered eight banking crises, five in the 19th century and three in the 20th century.[2] Many of them coincided with international banking crises. In the 19th century the worst was in 1866, when half of the credit companies and banks created just one decade earlier were liquidated. In the 20th century the most severe crisis took place in 1977 and lasted nearly five years, and again half the existing banks were dissolved or merged with other banks. The overall cost of the rescue operation was about 5% of GDP.

The history of Spanish savings banks, however, shows no record of any serious crisis after the 1835 establishment of the first institution, Caja de Ahorros de Madrid (now integrated into the infamous Bankia Group). From that date onward the number of savings banks increased as new institutions were founded by wealthy local patrons, the church and charitable organisations. By 1900 there were about 55 savings banks scattered throughout the country. In this long half century no major incident occurred and only ten small savings banks disappeared, absorbed by larger institutions within the same territorial area of influence.

2 Concha Betrán, Pablo Martín-Aceña y María A. Pons, "Financial Crises in Spain. Lessons from the last 150 years", Revista de Historia Económica. Journal of Iberian and Latin American Economic History, 30, 3, 2012, pp. 417-446.

Between 1900 and 1935 the number of savings banks increased to 171, due to new foundations promoted by local public entities, such as municipalities and provincial councils. In this period, which was turbulent for commercial and investment banks, there is no record of difficulties for the savings banks sector. In the 1931 crisis four small savings banks suffered liquidity difficulties, although only one of them had to be rescued by a joint operation orchestrated by the *Confederación Española de Cajas de Ahorros* (Confederation of Spanish Savings Banks) – CECA – created in 1926,[3] and a group of institutions rooted in the same geographical area. Thereafter, the *Instituto de Crédito de las Cajas de Ahorros* (Institute of Credit for Savings Banks) – ICCA – created in 1933, did not undertake any rescue operation as "lender of last resort", precisely the function for which it had been established. Savings banks specialised in mortgage credit and in personal short-term loans of small amounts. They also held treasury bonds of differing maturities in their portfolio, and a limited volume of major company securities listed on the stock exchange. Their holdings of both public and private securities were then quite safe investments. On the other hand, the source of their financial resources consisted basically of time deposits and accumulated reserves.[4] They did not depend at all on the domestic or international capital market to finance their financial operations. They restricted their activities to their own local market and had a good knowledge of their customers (firms and families) to which they lent. Management was usually prudent and conservative, and not subjected to the pressure of stakeholders demanding high returns for their share. The principle of territoriality was paramount, and hence their operation restricted generally to a single province.

During Franco's long dictatorship savings banks were subject to strict government control, even more extreme than the surveillance exerted over commercial banks. However, despite all the restrictions on their operations, the savings banks sector expanded considerably, not in number (88 in 1975), but in share of the national credit market, to 30%. However, they lost the autonomy they had enjoyed since their origin.

3 F. Comín, Historia de la cooperación entre las cajas de ahorros. La Confederación Española de Cajas de Ahorros, 1928-2003. Madrid, Confederación Española de Cajas de Ahorros.

4 As elsewhere, savings banks were originally non-profit institutions (charitable institutions, private foundations, and mutual aid funds) without neither capital nor shareholders. Hence, they do not have, strictu sensu, owners, and profits must either be invested or used to promote community welfare programmes.

First the Ministry of Labour, then the Ministry of Finance after 1957, oriented savings banks resources towards the economic and industrial priorities of the dictatorship. Their portfolio was loaded with government bonds and public enterprise securities, and the rest of their investments consisted of long-term credit to the building sector at official interest rates. The number of savings banks decreased, not owing to bankruptcies but to diverse processes of strategic alliances. The absence of crises during this period was the result of the strict regulations imposed on the financial system. As in the rest of Europe, mergers and acquisitions of troubled banks and savings banks by sound institutions, with the fiscal support and under the auspices of the supervisory authorities, were the alternatives used to avoid chaotic liquidations. The absence of crises was also the result of the savings banks low risk investment profile. Moreover, CECA promoted a policy of internal cooperation and a self-defence strategy of "internal solidarity": a so-called competitive collaboration which allowed participants to internalise competencies and also learn from their associates, while cooperation aimed to overcome regulatory and environmental restrictions to market penetration.[5] This implied that when any member of the group was temporarily in trouble, CECA discretely mobilised the sector to avoid a possible failure. On the other hand, ICCA was the institution that provided the resources, if necessary.[6]

The late 1970s and early 1980s saw the largest failures of the Spanish financial system since the crash of 1866. Twenty-four institutions were rescued, four were liquidated, four merged, and twenty small and medium-sized banks were nationalised. These 52 banks out of 110 represented 20% of the deposits of the entire banking system.

The crisis also affected a number of savings banks. The impact was less severe and more gradual and this, together with the solidarity of these institutions, meant that the problems were born and resolved discretely.

5 B. Bátiz-Lazo, "Strategic Alliances and Competitive Edge: Insights from Spanish and UK Banking Histories", Business History, 46, 1, 2004, pp. 23-56; F. Comín, "Spanish saving banks and the competitive cooperation model, 1928-2002", Revista de Historia Económica. Journal of Iberian and Latin American Economic History, XXV, 2, 2007, pp. 199-230; and J.C. Maixé-Altés, "Competition and Choice: banks and saving banks in Spain", Journal of Management History, 16, 1, pp. 29-43.

6 F. Comín, "The Saving Banks, 1900-1975" in J.L. Malo de Molina and P. Martín-Aceña (eds), The Spanish Financial System. Growth and Development since 1900. Palgrave-Macmillan, 2012, pp. 145-181.

There were no threats of collapse, but by 1986 the Savings Banks Deposit Guarantee Fund (FGDCA – Spanish acronym) had granted a large volume of resources to sustain four institutions in difficulties. Throughout the rest of the decade, some continued to record difficulties, and even to need further assistance. In many instances insolvent small and medium-sized savings banks were absorbed by larger and better managed institutions. In other cases, merging was the procedure used to solve the problems. All in all, between 1977 and 1986 more than a dozen savings banks closed. Thereafter, in 1991 and 1992 came a wave of savings banks mergers with support from the FGDCA, which reduced their number to 51 but maintained their market credit share. By 2007, before the present crisis, they accounted for about one half of the Spanish financial system.[7]

The severity of this first 21st century crisis in the savings banks sector is therefore a new phenomenon, with no historical antecedent. As we have seen, savings banks weathered better than the banking system most of the crises since 1850. Not anymore. Large and medium-sized institutions have been rescued with taxpayer (Spanish and European) money, and many small size institutions have been merged with others or absorbed by the few financially solid savings banks which have surmounted the convulsions with their own means.

Why has the Spanish savings banks sector collapsed? Why have so many long-standing institutions gone bankrupt? What are the causes of this ongoing savings banks crisis?

The first explanation has to be found in some of the unexpected consequences of the sector's reforms undertaken in 1977 and thereafter. In 1977, when the banking sector crisis began to unfold, savings banks went through a period of notable institutional changes. The functioning of the old and traditional savings banks was made comparable to that of the commercial banks. Its financial activities were liberalised and the range of their operations enlarged. In 1988 they were also allowed to open branches all over the country, which put an end to the territoriality principle. Also in 1988 a new financial instrument was created, the so-called "*cuotas participativas*" (non-voting shares), specific titles issued by the savings banks to increase their resources.

7 R. Poveda, "Banking Supervision and Regulation over the Past 40 Years", in J.L. Malo de Molina and P. Martín-Aceña (eds), The Spanish Financial System. Growth and Development since 1900. Palgrave-Macmillan, 2012, pp. 219-271.

Holders of "*cuotas participativas*" could participate in the benefit obtained by the institutions but they had no voting rights. The reform of 1977 modified as well the government structure of the savings banks, which until then was determined, according to their particular statutes, by a small number of individuals and composed almost exclusively of the original members of the founding institutions and corporations. The reform was intended to democratise the composition of the boards of directors by including members representing the interests of various stakeholder groups: founding entities, depositors, employees, trade unions, and public authorities. It also aimed to professionalise the governance of the institutions by reinforcing the role of the general managers in charge of the day-to-day operations and of the financial strategy. But in 1985 a new act altered the composition of the governing bodies by increasing the presence of the public authorities. The boards of directors fell into the hands of the local and regional (Autonomous Communities) corporations controlled by the political parties and the trade unions connected to them. Moreover, the powers of the general managers were curtailed and some of their functions assumed by the president of the board of directors, usually a person appointed by the local or regional governments. For a time (during the economic expansion of the late 1990s and early 2000s), this peculiar arrangement coupled with free competition (after the removal of the financial differences with the commercial banks) served well the desires and goals of both savings bank managers and their "political supporters". For a decade the savings banks were very successful in capturing the excess resources of small and medium-sized investors and lending to small and medium-sized firms. They multiplied their presence by opening branches all over the country (from 9,386 in 1979 to 24,202 in 2009), as well as by expanding beyond their traditional business products to reach new customers.

While the economic cycle lasted the savings bank sector showed its better face and all entities, whether big or small, seemed to have a bright future. During the so-called Great Moderation and thanks to the early integration into the Eurogroup, the Spanish economy enjoyed a decade of steady growth. Fuelled by low interest rates and a constant flow of external capital, the financial sector expanded and a huge amount of resources were channelled to building development and construction. The boom in the building sector was comparable to the boom in the UK and the US. With easy access to the international financial market the savings banks participated in the building boom of the 2000s, either by financing new developments or granting mortgage credit.

Total credit to the private sector in 2007 was four times greater than in 2001, and the share of loans to building and development companies in their books at the onset of the crisis ranged from just over 10% to almost 50%. To finance the expansion of their balance sheets, instead of reinforcing their own resources or increasing the volume of deposits, they resorted to the wholesale international financial market, primarily based on the emission of mortgage bonds, endorsed by their portfolio of mortgages, and also based on an array of new instruments.

Before long, an important segment of the sector accumulated imbalances of various kinds whose magnitude was evident when the economic environment changed. The most serious problems were its high exposure to real estate development and construction, dependence on wholesale external financial markets, an excess capacity relative to the sector's demand, and the fragmentation of the industry into a large number of small entities. And although Spain's banking institutions avoided the worst excesses of the originate to distribute model, the truth is that savings banks had made widespread use of securitisation and covered bonds to refinance mortgage portfolios. When the real estate boom collapsed, it left in its wake a huge amount of unsold housing and unfinished development and a mountain of unrecovered loans.

A second explanation to understand the crisis of the savings banks has to do with their peculiar nature. Savings banks are (or rather were) not banks. Their mission, the outcome of a historical evolution from institutions, was focused on providing financial services to avoid financial exclusion, conducting community welfare activities, and pursuing the economic development of the region in which they operate. Their internal organisation is complex and rigid and far from the international practices of corporate governance. With the impetus of their founding fathers long gone, the process of appointments of senior executives degenerated into corruption, nepotism and inefficiency. Although attempts were made to remedy the situation with well-meaning formulas, the fact was that representatives of regional and local governments gained a significant presence in their governing bodies, a situation which, apart from creating occasional tensions when it came time to renew these appointments, affected investment policies.

On the other hand, legal restrictions to obtaining core capital posed a serious obstacle to their urgent need of capitalisation in order to raise their solvency ratios. As the crisis deepened, their profit margins declined and so did their accumulated reserves, the most important source of core capital, since savings banks, which are basically foundations, cannot issue shares. While the savings banks maintained a business model based on the geographical proximity to their customer, marketing of non-complex financial products, and moderate growth strategies, it was sufficient to obtain equity by capitalising self-generated profits. But when they deviated from this model, traditional funding sources were insufficient.

The difficulties began in March 2009 when the Bank of Spain rescued the first savings banks (Caja de Castilla-La Mancha). To avoid a catastrophic liquidation the FGDCA bought €593 million in non-performing assets. Later the sale of the Caja required additional aid of €2.5 billion. It was then that the financial authorities realised that this was not an isolated case and that they might have to face problems in some other institutions with deteriorated balance sheets and low capital to assets ratios. They also realised that, after a decade of uncontrolled expansion, the savings banks structure was oversized. According to various consulting firms the excess capacity required closing 10,000 branches and cutting 35,000 jobs. A list was made with undercapitalised institutions (low solvency ratios). The list included the four giants Bancaja, Catalunya, Caja del Mediterráneo and Caixa Galicia, which a year later were bailed out by the FROB.

The constitution of the FROB in July 2009 put into motion a consolidation process which required a significant volume of public funds. In 2010 there were four big merging operations and three outright purchases of small entities by larger and financially sound entities. In several cases, the merger did not follow the classic formula, but instead used Institutional Protection Scheme (IPS), an atypical EU banking regulation unknown to date in Spain. Savings banks that joined an IPS maintained their legal personality, community welfare projects and retail business, but they had to sign a long-term agreement, meaning the creation of a central unit and strong mutual solvency guarantees between member institutions. All in all, 22 savings banks were involved in the formation of five new IPSs.

Notwithstanding these operations, the general macroeconomic evolution of the country, with negative rates of growth and increasing unemployment, worsened the financial position of the majority of the savings banks, no matter their size. The proportion of non-performing assets and loan defaults in their balance sheets rose. In May 2010 the Bank of Spain intervened again to rescue a second institution (Cajasur). At the same time the European Supervisory Authority undertook the first of a series of "stress tests" to examine the financial strength of the Spanish banking system. Almost all entities (banks and savings banks) were under the close scrutiny of the Committee of European Banking Supervisors. The results of the "stress tests" revealed that banks were in a solid financial situation to absorb potential losses in an adverse macroeconomic scenario. However, the results also revealed that five big savings banks were in a very fragile position, with very low solvency ratios and in urgent need of capitalisation.

The year 2011 was frantic. The FROB had to engage in four massive rescue operations with an astonishing consumption of public resources. The nationalisation of institutions and the array of measures implemented by the Bank of Spain, raising capital ratios and the provisions for potential defaults in order to strengthen banks' balance sheets, did not dispel the mistrust in the Spanish financial system. The lack of confidence in Spain's economy and in Spain's banks closed the internati-onal market for new issues, increased the risk premium and generated serious liquidity problems. All Spanish financial institutions came under suspicion.

The year 2012 was even more complicated. The pressure exerted on savings banks by the Bank of Spain and the European Supervisory Authority intensified. Provisions to cover the credit granted to construction and property development firms were increased and the capital-to-asset ratio was elevated once again. A new "stress test" was conducted in order to determine the financial needs of the entire financial sector (table 2). In July, a Memorandum of Understanding was signed between the EFSF and the government of Spain according to which the latter was to receive €100 billion in financial aid to capitalise institutions in need of core resources and to wrap up the restructuring process of the savings banks sector. It was also agreed to establish a special institution (an Assets Management Company, with private and public capital) that would receive foreclosed real estate assets of the financial entities subject to the process of capitalisation and restructuring.

Table 2: Stress test, capital needs (€ millions)

Institutions	Baseline scenario	Adverse scenario
Santander	19,181	25,297
BBVA	10,945	11,183
Caixabanc	9,423	5,720
Kutxabank	3,132	2,188
Banco Sabadell	3,321	915
Bankinter	393,0	399
Unicaja	1,300	128
Ibercaja	389	-226
Caja3	-188	-779
Liberbank	103	-1,198
BMN	368	-2,208
Banco Popular	677	-3,223
Banco de Valencia	-1,846	-3,462
Novagalicia Banco	-3,966	-7,176
Catalunya Banc	-6,488	-10,825
Bankia-BFA	-13,230	-24,743
Total system needs	**-25,718**	**-53,840**

Source: CECA, Restructuring Process. Spanish Savings Banks. Progress Report (19 April 2013).

The websites of the Bank of Spain and CECA offer detailed and up-to-date information of the restructuring process and of the aid channelled to the financial sector as a whole, and to each of the institutions that have required funds. The financial aid has sprung from three sources: FGD (Deposit Guarantee Fund of Credit Institutions), FROB and ESM (European Stability Mechanism, the successor of the EFSF). All in all, the Spanish financial system by the end of 2012 had received €61.2 billion, of which 63.5% came from the ESM. The Bankia-BFA holding company (which includes the old Caja de Madrid) alone has taken the astronomical figure of €22.4 billion. The rescue of Catalunya Caixa has so far required €12.052 billion in public support. And the third major bailout, that of Caja del Mediterráneo, has consumed €5.2 billion of European and Spanish taxpayer money.

Spain has not been the sole country to use public financial resources to rescue its financial system from collapsing, as table 1 shows. In absolute terms, banks in the US and the UK have needed more money to survive. German and French entities have been bailed out as well, with an enormous cost to taxpayers. Nevertheless, relative to each nation's GDP, after Ireland, with an astonishing 13.3%, Spain, with 5.8%, stands in second place.

The impact of the economic and financial crisis on the savings banks sector has been devastating, if measured in the number of entities that have been rescued by the government, and in the number of units: from 45 independent savings banks of various sizes in 2010, the sector now has only 13 institutions (eleven groups and two small savings banks). The consolidation process has entailed a substantial increase in the average size of the remaining entities: from €29.4 billion in assets in 2009 to €89.5 billion in December 2012. As of December 2012, the number of branches had decreased to 18,409, a reduction of 20.5%, and employment had been cut by 20%, representing a loss of 24,313 jobs.

The impact of the crisis can also be gauged by looking at the volume of troubled assets in the portfolio of all savings banks. Table 3 shows that they represent more than half of total assets. In December their coverage was a mere 29%, while one year later the coverage had increased to 54%, owing to higher provisions and higher solvency requirements.

Table 3: Performing and non-performing assets in savings banks' portfolio (€ millions)

	Total balance	Coverage December 2011	Coverage December 2012	Coverage %
Troubled assets	184,000	54,000	99,000	53.8
Non-troubled assets	123,000		37,000	30.1
Total assets	**307,000**	**54,000**	**136,000**	**44.3**

Source: CECA, Restructuring Process. Spanish Savings Banks. Progress Report (30 November 2012).

The nature of the savings banks has been radically altered. A main reform took place in November 2010 introducing new organisational models and affecting the governance of the institutions. With the new corporate formulas saving banks may choose to exercise their financial activity directly, indirectly through a bank, or by becoming a foundation and transferring their financial business to a bank. The reform also changed the composition of the board of directors, reducing the weight of public authorities, weather national, autonomous or municipal, and the presence of representative of political parties and trade unions.

Although these changes have yet to prove their virtues, it is apparent that the crisis has in fact dismantled the old savings banks system. Its present structure hardly resembles the structure in place before the crisis. The main features of what five years ago defined a "savings bank" are no longer there. It is true that both the surviving savings banks and those that have been consolidated into a major group retain their old and traditional denomination as "*cajas de ahorros*", but they are in fact "*bancos*". As a matter of fact, the difference between banks and savings banks has been blurred. The crisis has meant the liquidation (by transformation) of a financial sector with more than 150 years of existence.

What lessons can be learned from the crisis? Are there any lessons that should be taken into consideration in order to prevent a repetition of what has happened? What has the experience of these last five years taught us?

The crisis has demonstrated once again the relevance of the financial system in a modern economy. When it breaks down, the economic system collapses. When credit stops flowing, the economic body is paralysed. A solid economy requires an efficient and profitable banking sector. And a well-functioning banking sector requires expert managers and well-informed public supervisors to detect any wrongdoings in the administration of financial resources. Banks are not like any other private companies. The crisis has taught us that the banking system needs to be regulated and needs to be closely supervised. Another lesson is that the management of the savings banks should be in the hands neither of the political class nor of parvenus and adventuresome entrepreneurs. The crisis has highlighted the need to strengthen the governance of the savings banks, by reinforcing internal and external control mechanisms and shielding them from political interference. It has also revealed the need to equip them with mechanisms to increase their capital.

The restructuring process of the Spanish savings banks sector has been complex, time-consuming and costly. At the dawn of the crisis in 2007 the Spanish authorities did not recognise the magnitude of the international events and potential contagion effects, and believed that the country's banking system was solid and well prepared and would avoid the banking failures that were taking place in the US and Europe. It was thought that the building boom would peter out slowly and gently, and the Spanish supervisor delayed the recognition of deterioration taking place in the savings banks' books as the recession deepened. Instead of anticipating the obvious solvency problems of many entities, highly indebted in the wholesale external market and with a large volume of credit committed in the construction sector, they attributed the difficulties of the savings banks to the liquidity issues of a few institutions. That forecast was plainly wrong. The problems were general and caused by solvency. Due to the delay in admitting the poor financial position of the savings banks, the cost of the rescue operations has been staggering. The lesson to be learned is that the sooner the illness is admitted, the better for the patient. An earlier and quicker intervention in the first phases of the crisis, as in the US and other European countries, would have been less costly.

The supervision has proven to be inadequate. There are therefore lessons from the crisis for regulators. First, the excess reliance on wholesale funding is dangerous. Second, regulators need to pay attention to a concentration of risk in a single sector (in this case the real estate sector) and act quickly and effectively as soon as the institutions face solvency problems. Once the crisis has erupted regulators must be particularly vigilant to ensure that banks recognise their losses and that balance sheet reorganisation is not postponed. The latter has been a recurrent problem in financial crises and makes them last longer and raises their cost. Finally, regulators must recognise the need to promote transparency, raise capital requirements and impose credible and safe liquidity ratios.

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