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Lessons for the European Banking Union

Miguel Otero-Iglesias
Sebastián Royo
Federico Steinberg

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Real Instituto Elcano - Madrid - España
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C/ Príncipe de Vergara, 51
28006 Madrid
www.realinstitutoelcano.org

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EXECUTIVE SUMMARY

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In the first years of the Global Financial Crisis (GFC), Spanish financial institutions **were not as severely affected** as those of other countries. However, their apparent success was **short-lived**. As the crisis intensified, Spain's banking sector could not escape its dramatic effects. Total capital needs in the banking system ended up at around €150 billion. Ultimately, over €60 billion were provided by taxpayers, of which almost **€42 billion came from the European bail-out.**

Several **reasons** explain the magnitude and intensity of the Spanish banking crisis. The following all contributed to the collapse and restructuring of important parts of the Spanish financial system: **deteriorating economic conditions**, **the implosion of the real-estate bubble, weaknesses in the regulatory framework, bad lending practices** –especially in the savings banks, the cajas– and the **passivity of the Bank of Spai**n. In addition, there were serious **governance problems** in the cajas sector during the run up to the crisis, **misdiagnoses** by the political authorities in its early and medium stages, **slowness in reacting throughout the process, vulnerabilities** associated with heavy investment in the real estate sector**, dependency on wholesale markets** for funding and an element of bad luck from the **deterioration of the external environment** (ie, the unanticipated Eurozone debt crisis double-dip recession in 2011). Finally, **euro membership**, a blessing for Spain in so many regards, made the financial crisis more acute due to the Eurozone's **design failures**.

In the end these problems led to the 2012 **European financial bail-out**. The rescue marked a turning point in the crisis. Only when the European Commission, the European Central Bank (ECB) and the European Stability Mechanism (ESM) entered the game and the Spanish Memorandum of Understanding (MoU) was signed, was there **decisive action** to pursue an external, transparent and independent audit of the financial institutions, fully recognise losses, recapitalise effectively the damaged banks, create a 'bad bank' and restructure the system. All this happened in a relatively short period of time (the Spanish 'programme' stretched over 18 months, ending in January 2014).

Our analysis of the Spanish crisis confirms a long-standing tenet: **financial systems collapse** when they **take on too much risk** and when they **do not have sufficient capital in reserve** to absorb the losses of their risky investments and loans.

This report examines the Spanish banking crisis and uses it to extract valuable lessons for the construction of the European Banking Union (EBU), which is a complex process that resembles in some respects the variety of actors and preferences encountered in the Spanish case.

Key findings

The years that preceded the crisis were marked by a **securitisation frenzy**, a significant **expansion of branches** (particularly among the *cajas*) and an **expansion of credit** largely financed through **wholesale inter-bank funding**. These elements made the 'traditional' banking business model vulnerable. The **vulnerability** was intensified because **lending to non-financial corporations** was high, and it included a large proportion of property developers, as well as mortgages to consumers. This led to an **increase in house prices** of over 180% between 1997 and 2007.

As the financial crisis unfolded in Spain, **the problems facing the banking sector were misdiagnosed**. Initially, the resilience of Spanish financial institutions led to complacency and the belief that they had sufficient capital. As the crisis intensified, the depth of its impact was minimised. Later, when dealing with its impact became unavoidable, **it was initially treated as a problem of liquidity, rather than solvency**. This led to decisions (like the mergers of damaged financial institutions overburdened with bad loans) that only intensified the problem, rather than addressed it. In the end, the 'good *cajas*' were not good enough, so when they were merged with the 'bad *cajas*', the results were large weak entities that did not offer sufficient trust to private investors, who eventually refused to buy their shares once they became banks. In addition, **the European debt crisis worsened**, thus precipitating the second recession in Spain in less than two years. Eventually, the increase in **non-performing loans** made it more difficult for all financial institutions to ensure their solvency.

The political economy analysis that we present in this report shows the crucial importance of **timely and decisive action to respond to a banking crisis**. One of the most striking factors of the Spanish banking crisis was the **delay in taking key decisions**. Indeed, in Spain, the response was too timid and took too long. This was compounded by the existence of different actors with divergent preferences, which worsened the crisis. Our analysis shows that **regulators and policy-makers need to be ready to act decisively** when economic and financial indicators show unsustainable imbalances and, perhaps more importantly, **they need to withstand the political pressures that protect the *status quo***.

It is important to highlight that **Spain had a dual banking system** of (private) commercial banks and (public) savings banks, the *cajas*, which were not listed on the stock market and accounted for half of the financial sector's assets. They did not have formal shareholders, did not distribute profits and were governed by a broad range of private and public stakeholders. These ***cajas* were the financial institutions to be most severely affected by the crisis**. The **larger banks**, which had diversified and internationalised their operations in the years before the crisis, **were able to weather its effects more effectively**.

Related to that, a crucial problem in Spain was that **banks and *cajas*** were **subject to different regulatory frameworks**. The *cajas* were regulated by both the national government (in charge of basic norms) and by the regional governments (in charge of the application and development of the norms). Thus, the Bank of Spain had limited supervisory competences over them. As a result, the *cajas* were highly **politicised institutions**. Although some of them were well-managed and their social prestige was high, most of them engaged in malpractice, failed to provision for losses and betrayed their original purpose by expanding their activities both geographically and by sectors. In doing so, they became instruments of political parties and other civil-society actors.

The crisis eventually exposed **the role of the Bank of Spain**, which was initially perceived very positively. In hindsight, the financial crisis has shown that there were other actions that the Bank of Spain could have taken to reduce the risk from and dependence on the construction sector, such as **increasing the required provisions** together with the ECB or **strengthening the regulatory framework**. In the end, the Bank of Spain chose the path of least resistance: **timidly alerting about the risks but failing to act decisively**.

Finally, when addressing financial crisis it is important to **consider both financial and macroeconomic factors.** Spain found itself trapped in a 'doom loop' in which the financial crisis and the fiscal crisis became intertwined. The experience shows that countries need to **develop an appropriate adjustment strategy** to succeed within the single currency, and ensure that **domestic policy choices are consistent with the transnational constraints** imposed by euro membership.

Recommendations

Our analysis of the Spanish financial crisis suggests we put forward a number of recommendations in order to build a more robust EBU:

(1) The **timing** of the response was a crucial problem. Therefore, the first recommendation is that it is **necessary to act early on, as soon as problems in the banking sector are detected**. This is important both to **reduce the final bill** and to **prevent highly leveraged banks turning into zombie institutions** that deepen the economic recession by restricting credit.

(2) The Spanish case also shows that there could be important **incentives built into the system that might delay action**, making the crisis costlier. Therefore, once the crisis starts it is absolutely vital that the **government generates the political measures necessary to challenge the vested interests** (sectoral or regional) that cling to the *status quo*. It is also important for politicians to **avoid creating false expectations** that cannot be fulfilled. This can undermine the credibility of the crisis-management authorities.

(3) **Inertia, complacency** and **group thinking** were also serious problems in Spain. By mapping and identifying the preferences and incentives of the key actors involved in the process, we show **how rational actions by each individual actor led to a collective failure**, whose real impact only became evident once the European institutions in 2012 put an end to the 'war of attrition' that domestic players had been conducting since 2008. Therefore, a third recommendation to extract from the Spanish experience is that **regulators and supervisors should be sceptical of the prevailing *zeitgeis*t**. They should also have the power to, if not switch off the music, at least be able to turn it down at the right moment.

(4) Another lesson that can be learnt is that **every crisis is different** and that **the authorities need to expand as much as possible their anti-crisis and crisis-management toolkit in order to be best prepared for any contingency**. In particular, they need to understand that once they join a monetary union, they have to articulate original (sometimes heterodox) strategies to avoid excessive growth in credit that emanates from a monetary policy they cannot control. The fourth recommendation is therefore that policymakers need to **be prepared for the worst** in theory (black swans cannot be avoided) and practice (have the resources and people ready) to deal with the crisis.

(5) Another lesson from the crisis is **that banks that are too big to fail can generate a number of structural problems** likely to foster the creation of another crisis, disrupt the level playing field and expose the taxpayer to higher costs. Therefore, these **banks need clear resolution plans**, also called living wills, which need to specify the rapid and orderly restructuring, resizing and even closing down of the bank in the potential event of financial distress.

(6) The sixth recommendation is that the **members of the Eurozone will eventually have to pool their fiscal sovereignty** in order to effectively deal with future European banking crises. The current **bailing-in regime** (if it is effectively implemented) **might be robust enough for individual bank failures but not for a systemic crisis** engulfing some of the biggest banks in Europe, which, if the European banking union deepens, are very likely to be operating transnationally across European borders in a few years from now.

(7) Finally, the Spanish case shows that **supervision is as important as regulation**, and that **sharing responsibilities in supervision tends to be problematic**, especially when there is political influence and interference at the regional or local level, as was the case with the Spanish *cajas*. In the end, the **politicisation of the *cajas*** was a crucial issue to explain their misconduct in the years before the crisis. The flaws in the **institutional governance played a critical role** in the Spanish crisis. Therefore, the Single Supervisory Mechanism (SSM) at the EU level is most welcome, but it remains to be seen if the ECB has the capacity to, over time, supervise the large majority of European banks and not only the systemically important financial institutions.

INTRODUCTION

INTRODUCTION

This report examines the Spanish banking crisis –which eventually led to the European bail-out of 2012– and uses it to extract valuable lessons for the construction of the European Banking Union (EBU).

In the first years of the Global Financial Crisis (GFC, 2007-09), Spanish financial institutions were not as severely affected as those in the US, the UK or Germany. However, their apparent success was short-lived. As the crisis intensified, Spain's banking sector could not escape its dramatic effects. Deterioration of economic conditions, the implosion of the real-estate bubble, the dependence on wholesale funding, weaknesses in the regulatory framework, bad lending practices (especially in the *cajas*) and the role of the government and of the Bank of Spain all help to explain this reversal. In addition, euro membership, a blessing for Spain in so many regards, made the financial crisis more acute due to its design failures.

While there were elements of the crisis that were particular to Spain (for instance, the differentiated regulatory framework and oversight of the *cajas*), the Spanish banking crisis was in many ways a traditional one, driven by excessive leverage caused by the real-estate bubble and the over dependence for funding on wholesale international markets. Indeed, paraphrasing Reinhart & Rogoff (2009), 'this crisis was not different'.

Indeed, it was not different. But it was deeper, longer and more intense. Spain had a history of real-estate bubbles (the previous one in 1986-92) and of banking crisis: the last systemic one in 1977-85, with the last significant rescue being the nationalisation of *Banesto* in 1993. It was precisely such proneness to crisis that led the Bank of Spain to try to build barriers against the rising tide of real-estate prices and to adopt policies to try to prevent banks from lending recklessly. Unfortunately, they proved insufficient.

Our analysis of the Spanish crisis confirms a long-standing tenet. Financial systems collapse when they meet two conditions: they take on too much risk, and they do not have sufficient capital on reserve to absorb the losses associated with their risky investments and loans (Calomiris & Haber, 2014, p. 207). Indeed, the 2009-12 crisis in Spain was rooted in policies that eroded underwriting standards and weak prudential regulation. In many Spanish *cajas* there was a failure of risk management, which led to an increase in risky lending and to inadequate capital cushion levels.

The Spanish case illustrates why regulators and policy-makers need to be ready to act decisively when economic and financial indicators show unsustainable imbalances.

While many actors understood the risk that a potential collapse of the banking system would represent to the Spanish economy, there was a strong sense of complacency because the country had weathered relatively well and emerged unscathed from the first phase of the GFC. However, the problem preceded the crisis. Some public officials (members of the Congress of Deputies and senators, regional parliamentarians, local authorities, and bank supervisors and regulators) understood the risks, but they had little incentive to change the rules of the game. In other words, the costs of their (non)decisions would potentially materialise in the future but the benefits of looking elsewhere and allowing the party to continue were immediate.

Therefore, the Spanish case illustrates why regulators and policy-makers need to be ready to act decisively when economic and financial indicators show unsustainable imbalances and, perhaps more importantly, they need to withstand the political pressures that protect the *status quo*. The political economy analysis that we present in this report highlights precisely how the existence of different actors with divergent preferences can worsen the crisis. We aim to provide some valuable lessons for the construction of the EBU, which is a complex process that resembles in some respects the variety of actors and preferences that we encounter in the Spanish case.

While every crisis has some elements that are different, the Spanish case makes clear that regulators need to expand as much as possible their anti-crisis and crisis management toolkit in order to be better prepared for any contingency. In other words, they need to hope for the best but to be prepared for the worst. In Spain, however, regulators claimed that they lacked the tools and authority to intervene further and unlock the 'war of attrition' that the main actors (bankers, politicians and regulators) were entangled in. Yet the reality is that they still had macro-prudential policies and regulatory tools (ie, raising bank capital requirements, caps on loan-to-value ratios and caps on the proportion of large mortgages relative to borrowers' income) that they could have used once interest rates were determined by Frankfurt.

Overall, Spain failed to develop an appropriate adjustment strategy to succeed within the single currency, and it ignored the imperative that domestic policy choices have to be consistent with the transnational constraints imposed by euro membership. Unfortunately, domestic policies and the imperatives of participating in a single currency union stood in an uneasy relationship to one another. The crisis was the tipping-point that brought this inconsistency to the fore.

This report begins by outlining the chronology of the Spanish banking crisis. It then analyses the crisis from a political-economy perspective and examines the political and economic factors that led to the crisis. Its final section describes the main lessons that can be learned from the Spanish experience for the newly created EBU.

THE EVOLUTION OF THE SPANISH BANKING SYSTEM IN THE CONTEXT OF THE CRISIS

THE EVOLUTION OF THE SPANISH BANKING SYSTEM IN THE CONTEXT OF THE CRISIS

The GFC resulted in a fully-fledged economic crisis across much of the EU and a sovereign debt crisis in the euro area's periphery. In the case of Spain, given the shortcomings in both the international and European financial systems, as well as the weaknesses of the economic and monetary union's (EMU) architecture, the European sovereign debt crisis initiated in Greece evolved into a second-wave banking crisis that forced a bail-out of the Spanish financial system in 2012.

In order to understand the interaction of international events and the Spanish financial system, it is necessary to examine the idiosyncratic features of the Spanish banking system and how these evolved as the crisis unfolded. This is what this section attempts to do. First, it describes the structure and main characteristics of the Spanish financial system. The second part analyses the initial impact of the global financial crisis on Spanish financial institutions. The final part examines the reasons for the deterioration of the situation, which led to the financial bail-out by the European Stability Mechanism (ESM).

1. Structure, behaviour and peculiarities of the Spanish financial system

In the run up to the GFC, Spanish banks had a 'traditional' business model, as compared to other European banks. This did not impede, however, that the years that preceded the crisis were marked by a securitisation frenzy, a significant expansion of branches (particularly among the *cajas*) and an expansion of credit largely financed through wholesale funding. These elements made this 'traditional' business model vulnerable.

In Spain, the majority of banks' assets were loans to customers, and a significant part of these assets involved government securities, which at that time were considered among the safest possible investments (Royo, 2013b). Lending to non-financial corporations (NFCs) was high in Spain, especially by the *cajas*, and it included a large proportion of property developers. Moreover, loans made to consumers for the purpose of house purchases were the vast majority of the total loans to consumers. This led to an increase in house prices of over 180% between 1997 and 2007. In this regard, Spain stood out *vis-à-vis* other European banking systems. For instance, unlike Spanish banks, Italian, French and German banks did not fuel a property bubble. They lent to households less frequently than both Spanish and Greek banks, and they predominantly lent to NFCs in the services and industry sectors, and not to construction. Furthermore, in Italy and Germany there was no significant rise in consumer lending by banks in the years preceding the crisis (Quaglia & Royo, 2015). On the liabilities side, Spanish banks had a broad and stable funding base. Funding from retail customers (considered more stable than wholesale funding) constituted half the total liabilities.

The complexity and sophistication of the securitisation market in Spain was less developed than in the US, among other things because the Bank of Spain did not allow synthetic securitisation.

Another important development in the years prior to the crisis was the growth of securitization (Losada López, 2006). According to data from the *European Securitisation Forum* by 2005 securitisation in Spain represented 13.3% of the European total (the second largest after the UK's 45.5%), and the total value of securitised assets multiplied almost by six between 2001 and 2005, reaching €71.75 billion. Of these, the most important ones were the securitised assets derived from mortgages loans, which was not surprising given the very rapid growth of mortgage credit in Spain (Maudos Villarroya & Fernández de Guevara Radoselovics, 2008, p. 122-23). Securitisation weakened credit risk controls in the years leading to the crisis in Spain, but also across Europe. As a paper by the European Central Bank (ECB) points out, 'the reasoning tends to be that by creating informational distance between the loan's originator and the ultimate bearer of the loan's default risk, securitisation reduces lenders' incentives to carefully screen and monitor borrowers' (Carbó-Valverde *et al*., 2011, p.11). The complexity and sophistication of the securitisation market in Spain was less developed than in the US, among other things because the Bank of Spain did not allow synthetic securitisation, which was widespread in the US (Losada López, 2006). But even in the Spanish basic securitisation chain, a growing distance between the origin of the loan and the bearer of the risk certainly developed.

Another feature of the Spanish banking system was that banks depended strongly on wholesale inter-bank funding. Indeed, Spanish banks borrowed in the international interbank market and channelled this funding to the construction sector through mortgage loans and loans to property developers. Hence, the

Spain had a dual banking system of (private) commercial banks and (public) savings banks, the cajas, which were not listed on the stock market and accounted for half of the financial sector's assets.

banking system in Spain intermediated capital inflows, sustaining a massive construction boom (Gros, 2012). This was a crucial difference with other European banks. Indeed, the dependence of Spanish banks on wholesale lending for liquidity since the crisis started made them increasingly vulnerable. In particular, they relied on international wholesale financing (40% of their balance depended on funding from international markets, particularly from the ECB through the TARGET2 system).[1] Their debt with the ECB reached €81.88 billion in March 2010 (it was 12.3% higher than in March 2009 and it accounted for 15% of the total debt of the Eurozone with the ECB). Moreover, Spanish banks increased their ECB borrowings by more than six times from June 2011 to April 2012, to the highest level in absolute terms among the Euro area banking system (in March 2012, for instance, they borrowed a record €316 billion from the ECB, 28% of the Eurozone total).

In this regard, it appears that in order to be able to borrow larger amounts from the ECB throughout the crisis period, especially between 2008 and 2010, Spanish banks increased considerably their mortgage-backed (MBS) and asset-backed securities (ABS) deals. With the difference that while before the crisis the banks sold these securities to outside investors, during the crisis they retained them (and the underlying risks) on their balance sheets in order to use them as collateral to obtain further liquidity from the ECB. Thus, during the period there was a clear correlation between increased securitisation and underlying banking weaknesses (Carbó-Valverde, *et al*., 2011, p 24).

Besides these general features, it is important to highlight that Spain had a dual banking system of (private) commercial banks and (public) savings banks, the *cajas*, which were not listed on the stock market and accounted for half of the financial sector's assets.[2] They did not have formal shareholders, did not distribute profits and were governed by a broad range of private and public stakeholders. The *cajas* were peculiar credit institutions, a combination of a commercial bank and a foundation, which dedicated a significant portion of their provisions (usually over 20%) to social causes: their profits reverted to a foundation which funded socially-minded projects such as cultural activities, social assistance programmes and research-related activities.

1 TARGET2 is a Eurozone payments system that allows for the settlement of national and cross border payments in central bank funds.
2 The IMF split Spanish banks into different risk categories drawing a distinction between the cajas and the commercial banks, which up to this day have not received any European loans; back then the government insisted that the problem only affected 'about 30% of the Spanish banking system'. See 'Spain to accept European rescue for ailing banks,' *The New York Times*, 10/VI/2012.

The politicisation of the cajas was a crucial issue to explain their actions in the years prior to the crisis.

The 1977 and 1985 laws that subsequently regulated the governance of the *cajas* enshrined the principle of local political representation and participation of local governments, which were quick to take charge of their regulation in order to further increase their control over them. In fact, over time they became the instrument to fund the many real-estate projects that created the prosperity that helped local government officials get re-elected (Santos, 2014). Political control of the *cajas* was one main reason for their troubles.[3]

In sum, the *cajas* were subject to a distinctive regulatory framework. They were regulated by both the national government (in charge of the basic norms) and by regional governments (in charge of the application and development of the rules established by the central government), and the Bank of Spain had limited supervisory competences over them. The division of supervisory responsibilities between the Bank of Spain and regional governments complicated their oversight, and interference from political stakeholders also adversely affected their financial stability. The *cajas* had limited ability to raise external equity, which contributed to inadequate capital buffers in the run-up to the crisis (Santos, 2014). In the end, the politicisation of the *cajas* was a crucial issue to explain their actions in the years prior to the crisis: their decision to invest in often-questionable projects was largely driven by political considerations. Indeed, the institutional governance (or lack thereof) played a critical role in the Spanish crisis. The more politicised the leadership, the worst their performance (Garicano, 2012).

2. Enter the global financial crisis

Initially, after the US collapse of the subprime market in late 2007 and the bankruptcy of the US investment bank Lehman Brothers in October 2008, Spanish banks, unlike their counterparts in most parts of the advanced world, seemed to weather the crisis rather well. They experienced no major losses and required no state recapitalisation (see next section). Most of their assets were customer loans and mortgages, they had a limited amount of market-based assets and they had not invested in highly sophisticated financial products that later proved to be ‘toxic’. Crucially, Spanish banks had indeed participated in the securitisation mania that took place in the run up to the crisis, but, since there were no subprime

3 Cuñat & Garicano (2009) have shown that cajas with politically connected chief executives with no previous banking experience and no graduate education did substantially worse in the run up to the crisis (ie, the executives granted more loans to real estate developers, up to half of the entire loan book, in some instances).

loans in Spain, securitisations had not been structured around them, which made them less vulnerable.

Moreover, the Bank of Spain, a pioneer in macro-prudential regulation, had imposed a regulatory framework requiring higher provisions thereby providing cushions to Spanish banks to initially absorb losses caused by the outset of the global financial crisis (Royo, 2013a). In this regard, the single most important factor to account for the positive performance of the Spanish financial system during the initial stages of the crisis was the implementation prior to the crisis of a 'dynamic provisioning system', which established a counter-cyclical capital regime for banks (García-Herrero & Fernández de Lis, 2012). Starting in 2000, the Bank of Spain forced banks to make provisions for latent portfolio losses, defined as those likely to occur, but which may be undetected by conventional accounting. This method allowed for the creation of a buffer in the form of a reserve deducted from capital in good times and released in times of downturn. At the same time, the central bank also prevented the provision of dividend increases at times of growth, which could undermine banks' solvency in the long-term. Finally, the central bank, through its directives, prevented banks from developing highly complex and synthetic off-balance sheet activities (which sunk banks elsewhere) and forced Spanish banks to stay away from such toxic assets.

In essence, this mandate provided Spanish banks with a countercyclical mechanism that helped them to navigate through the first phase of the crisis. For instance, Banco Santander built more than €6 billion in generic loan-loss provisions. However, the provisions proved to be insufficient once the economic crisis intensified and the real-estate sector collapsed.

Furthermore, as noted above, when looking at the performance of the Spanish financial system it is important to distinguish between the large banks and the *cajas*: the former performed relatively well while the latter suffered from a traditional financial crisis. Indeed, Spain was also unique in that the largest banks did not face significant problems (Santos, 2014). BBVA and Santander diversified internationally, gaining access to funding that allowed for liquidation of toxic property assets at a lower price compared with their rivals and with limited damage to their earnings. Even before the crisis, this internationalisation strategy was an attempt by the largest banks to diversify their portfolios and increase profits (Guillen, 2011). For instance, Santander went on to acquire Abbey National in 2004, and in 2007 a joint take-over of ABN AMRO gave Santander the opportunity to acquire the Brazilian subsidiary of the Dutch bank,

The Bank of Spain, a pioneer in macro-prudential regulation, had imposed a regulatory framework requiring higher provisions.

The real-estate boom-bust cycle, which materialised in particular in the cajas sector, exposed the weaknesses in the policy and regulatory frameworks.

Banco Real. BBVA acquired a majority stake in Bancomer in 2000 to become a dominant player in the Mexican banking system (BBVA Bancomer). Hence, for the largest Spanish banks, geographical diversification helped counterbalance domestic losses.

Initially, as we have seen, their problem seemed largely containable given the relatively low bank-asset to GDP ratio for Spain, but over time the situation worsened. Indeed, when the economic crisis deepened in Spain after 2009, and access to wholesale funding dried up, a traditional banking crisis caused by the collapse of the real-estate market unravelled. Unemployment and public debt started to grow and the financial system was unable to decouple itself from the business cycle.

3. The crisis intensifies

In late 2009 major financial problems began for many of the *cajas*. They had financed real-estate developers that started to go bankrupt and they found increasing difficulties in accessing wholesale markets to roll over their debts. In response, in 2009 the government created the Fund for Orderly Bank Restructuring (FROB in Spanish) to recapitalise them (the Deposit Guarantee Fund, which had been used previously to inject resources into the first *cajas* that required help, such as Caja Castilla la Mancha, had run out of resources). The *cajas* were particularly dependent on wholesale funding, which had been central to their efforts to expand and strengthen their national presence after the 1988 Royal Decree that lifted their geographical limitations, as illustrated most visibly by a rapid growth in the number of employees and branches.[4] Consequently, their market share measured in terms of total assets increased from around 20% in the 1980s to 40% in 2010. Most of them did not have the financial muscle or technical expertise to undertake such an expansion.

The real-estate boom-bust cycle, which materialised in particular in the *cajas* sector, exposed the weaknesses in the policy and regulatory frameworks, as well as the sector's over-reliance on wholesale funding. The turbo-charged lending, funded by the interbank-market on the liability side of the Spanish banks' balance sheets, is crucial to understanding the banking crisis, as is the depth of the economic recession: by mid-2012, unemployment stood at over 24%; government

4 Of the 9,000 new branches opened by the *cajas* between 1985 and 2004, almost 70% of them were established outside of their original Autonomous Community, especially through the national expansion of the Catalan La Caixa.

debt reached 79% of GDP; and non-performing loans reached 8.16%, the highest level in 18 years.[5]

> *Spanish banks' dependence on international wholesale funding, intensified their vulnerability.*

The crisis in the financial sector was intensified by the collapse of the real-estate sector, which constituted 60% of banking loans: by the end of 2011, land prices, adjusted for inflation, had fallen around 30% from their 2007 peak, and home prices were down by up to 22%. As a result, the quality of Spanish banks' assets continued to plummet. By the end of 2011 Spanish financial institutions accumulated €405 billion in loans associated with the real-estate sector given to developers and companies, and, of those, €188 billion were considered at risk of default. The *cajas* had to write down €50 billion in their property portfolios in 2011, and as property prices continued to fall and bad-loan ratios to increase, the Bank of Spain classified €180 billion as troubled assets at the end of that year.[6] Additionally, Spanish banks' dependence on international wholesale funding, with 40% of their balance dependant on funding from international markets in 2012 (Royo, 2013c), intensified their vulnerability. As credit dried up, it affected their liquidity and in some cases their solvency. Finally, Spain suffered a *de facto* sudden-stop, which fortunately was mitigated by the TARGET2 balance of the Eurosystem.

Throughout this period, the crisis eventually exposed the role of the Bank of Spain, which initially was perceived very positively. In hindsight, the financial crisis has shown that there were other actions that the Bank of Spain could have taken to reduce the risk from and dependence on the construction sector, such as increasing the required provisions together with the ECB or strengthening the regulatory framework. In the end, the Bank of Spain chose the path of least resistance: timidly alerting about the risks but failing to act decisively.

4. The banking bail-out

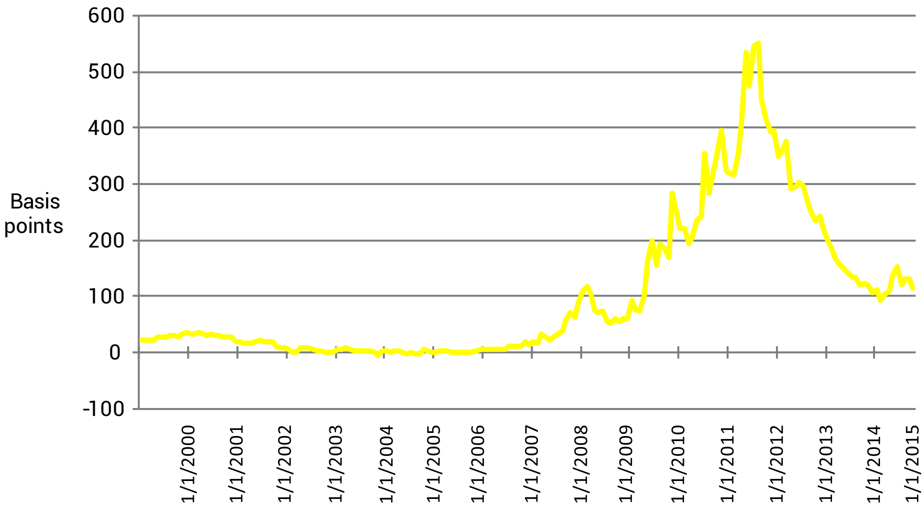
By June 2012 the situation had become untenable and Spain was forced to seek a rescue amid growing fears that the financial crisis could drag down its entire economy and lead to a sovereign crisis that threatened the euro. Spain's borrowing costs had been increasing, with the country's interest rate on its 10-year bond rising to 6.18% on 7 June, a level that was seen potentially unsustainable at the

5 Spanish banks increased their ECB borrowings by more than six times between June 2011 and October 2013. In March 2012 they borrowed a record €316 billion from the ECB, 28% of the Euroarea total, the highest level in absolute terms among Eurozone banking systems (Royo, 2013b).

6 'España, duda permanente', *El País*, 20/V/2012.

time (see Graph 1). Credit ratings downgrades also intensified the pressure on the government to act.

Graph 1. Spain-Germany 10-Year Bond Spread, 2000-15



Source: Bloomberg.

On 9 June, in response to a Spanish request, the Eurogroup offered an aid package of up to €100 billion as a bail-out for Spain's cash-starved banks. This decision made Spain the fourth and largest European country to agree to accept emergency assistance. Two events in particular prompted the outcome. First, the collapse of Bankia, the country's largest real-estate lender, created by the merger of several ailing *cajas*, which was nationalised in early May.[7] Secondly, a few days before the aid package was approved, the International Monetary Fund (IMF) (2012) published its assessment of Spanish banks and projected that they would need at least €37 billion in additional capital, thus providing a rationale for the rescue deal (the report followed previous assessments by the Bank of Spain and the Spanish Ministry of Economy that were overly optimistic and hence softer). The severity of the crisis was only acknowledged once the IMF report was published (De Juan *et al.*, 2013).

7 Bankia ended up requiring a €24 billion capital injection. It had lost almost €3.75 billion in 2011 but it had reported a €388 million profit. Its bail-out was the largest bank nationalisation in history of Spain.

The failure of Bankia validated concerns regarding insufficient regulatory oversight,[8] as well as the perception that Spanish banks and the Bank of Spain had downplayed the risk posed by real-estate loans. Since the inception of the crisis, Spain adopted five financial reforms in three years and implemented three rounds of bank mergers, dropping the number of *cajas* from 45 to nine (which by now are almost all banks).

The Memorandum of Understanding (MoU) established the bail-in of some junior creditors. It was the first time that a bail-in was used in the crisis.

The Spanish government repeatedly increased capital provisions, and those banks unable to meet the new standards could borrow additional money in state-backed convertible bonds carrying a 10% interest rate. Furthermore, banks could transfer their riskiest assets to state-guaranteed asset-management companies to help hurry the sale of real-estate assets the bank held. Each bank was forced to create a bad bank into which it put physical property assets at devalued prices, in preparation for potential sales to outside investors (Royo, 2013c).

In August 2012 a new financial reform was approved in response to the EU's financial rescue package. The Memorandum of Understanding (MoU) established the bail-in of some junior creditors (holders of the so-called *participaciones preferentes* –ie, preferred shares–), which was significant because it was the first time that a bail-in was used in the crisis (there was no bail-in in the Irish rescue) and it was subsequently used in the Cyprus bail-out, incorporating it into the rules of the EBU.

As a result of the MoU, the Spanish government created a 'bad bank' (called SAREB), which absorbed the toxic assets from the real-estate sector and acquired the authority to buy and sell a variety of assets, as well as issue bonds. It also established a new process to restructure and liquidate financial institutions, giving a central procedural role to the FROB, which had not been employed at its maximum capacity because of legal restrictions. However, the reform effectively gave the Ministry of Finance more control (and less to the Bank of Spain) over the FROB that, in turn, might politicise its decisions. Finally, the reform reduced the role of the regional governments in the restructuring and liquidation of the *cajas*.

8 Bankia's irregular activities are still pending in court. The collapse in the value of Bankia' shares that followed the lender's bail-out in 2102 led to a lawsuit in which investors sued Bankia for over €800 million over allegations of fraud. On 27 January 2016 the country's Supreme Court threw out two appeals by Bankia against claims by small shareholders relating to the 2011 flotation. This decision by the Supreme Court leaves the door open to potential thousands of individual lawsuits against the bank (see *Reuters*, "Spain's Supreme Court rejects Bankia appeals on compensation claims", 27/I/2016.

The crisis has led to a larger concentration in the financial sector, which will intensify further the challenge of 'too big to fail'.

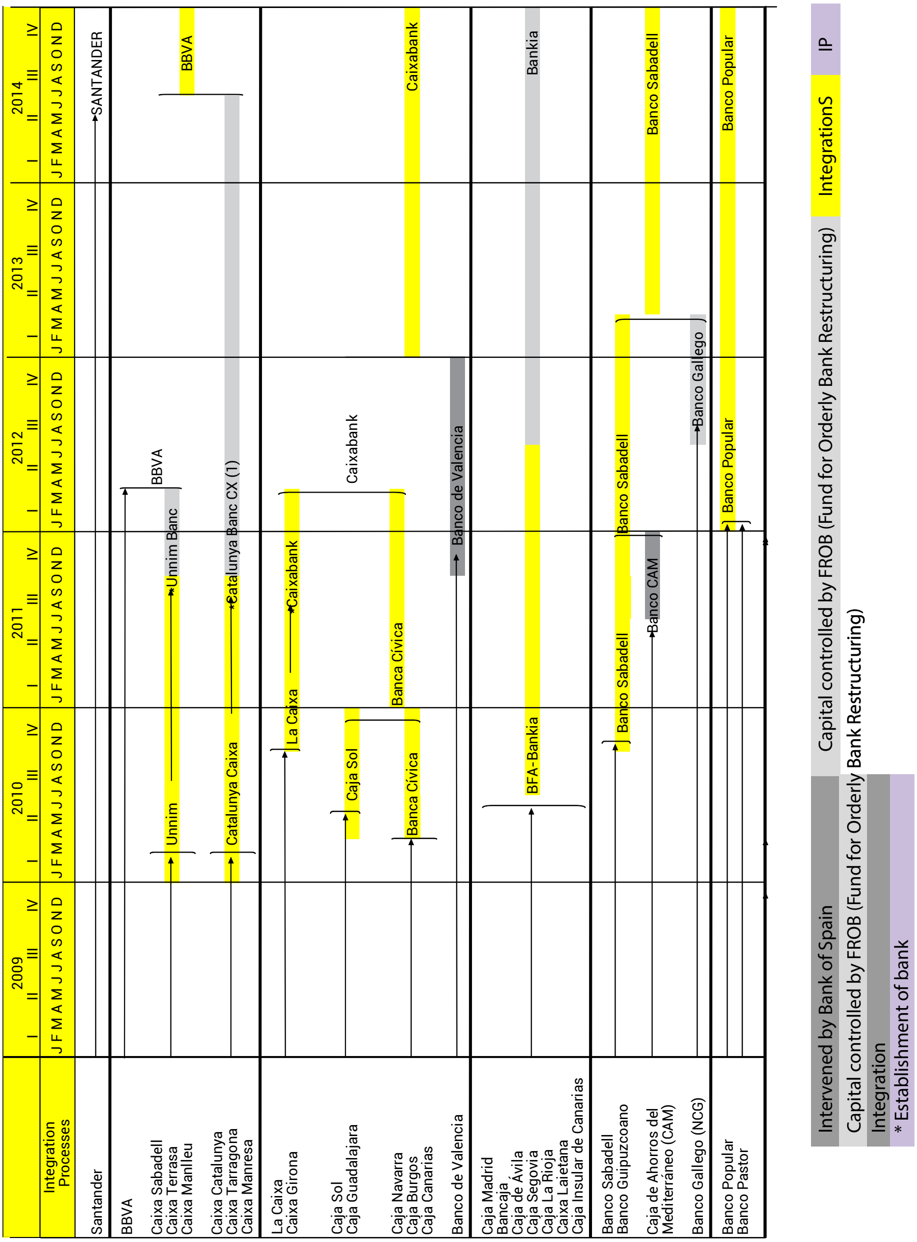
Needless to say the crisis has been particularly devastating for the *cajas*. The government had to intervene, force into mergers and/or nationalise nine institutions: Catalunya Caixa, Nova Caixa Galicia, Caja España-Duero, Bankia, Mare Nostrum, Cívica, Cajasur, CAM, and Unnim (see Table 1).

The dual regulatory framework that existed prior to the crises, wherein the supervisory power over the *cajas* was shared between the Bank of Spain and the autonomous governments; together with the politicisation of their boards (and sometimes the lack of professionalism among their top management) and the *cajas*' risky business strategies contributed to this negative development. Their decision to expand beyond their traditional regions, to intensify lending to developers and mortgages and to embark on securitisation (even if it was of the simple sort) proved to be fatal for many of them, as they were ill-equipped to assess and monitor the creditworthiness of the new borrowers. Nonetheless, it is worth noting that not all *cajas* suffered the same problems. Notably, the largest one, La Caixa (and its bank CaixaBank), is still doing relatively well and has not requested state support. The Basque *cajas* also performed well. They did not lend excessively to property developers, recognised that retail banking is not a low-risk activity and avoided over-concentration in property loans. In other words, there was nothing predetermined about the outcome that befell many other *cajas*.

In contrast, as noted above, the large commercial banks (such as BBVA and Santander), proved resilient and performed comparatively well. In addition to their internationalisation they stood out for their low borrowing from outside the EU (ie, non-Euro). Indeed, only 19.4% of their wholesale lending was external to the EU, which stood in contrast with other countries like Germany (60.4%) and Ireland (56.9%). Finally, on the liabilities side, their market-based borrowing was actually relatively low compared with other countries (most obviously international inter-bank borrowing which was only 26.7% of GDP and stood in contrast to countries such as Ireland at 108.8% and Denmark at 55.7%) and even where market-based borrowing was relatively high (like securitisation), it had longer maturity than inter-bank borrowing, so the Spanish banks were not caught in the early waves of panic in the inter-bank market. All these factors help explain why larger Spanish banks were not affected by the crisis as much as the *cajas*.

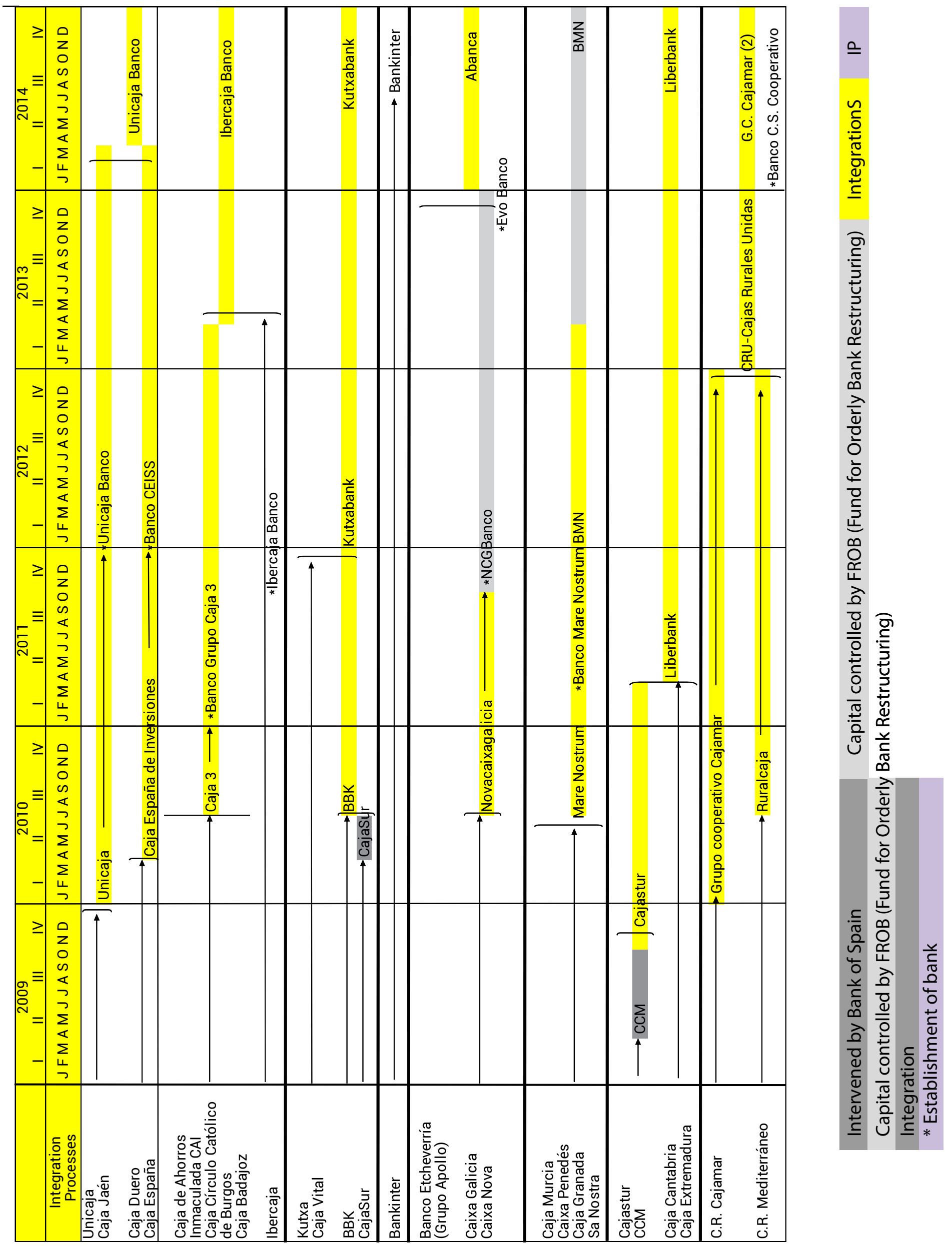
The MoU was followed by significant reforms of the financial system and economic recovery and, as a result, access to credit was largely restored by 2015. Yet, as in most other countries, the crisis has led to a larger concentration in the financial sector, which will intensify further the challenge of 'too big to fail'.

Table 1. Evolution of the main Spanish banking groups, 2009-14



(1) The Commission of the FROB approved on 21 July 2014 the sale of Catalunya Banc to BBVA, although the integration process is not yet complete.
(2) Integration process which started in 2009, in which 26 cooperatives have been involved in different phases (mergers and new incorporations), which has meant, after the creation of a bank (Banco de Crédito Social Cooperativo), the establishment of a new SIP (Grupo Cooperativo Cajamar) which groups together 19 credit cooperatives plus the new bank which is the head of SIP.
Source: the authors with Bank of Spain data.

Table 1. Evolution of the main Spanish banking groups, 2009-14



Source: the authors with Bank of Spain data.

THE POLITICAL ECONOMY OF THE SPANISH BANKING CRISIS

THE POLITICAL ECONOMY OF THE SPANISH BANKING CRISIS

As seen in the previous section, several reasons explain the magnitude and intensity of the Spanish banking crisis. Serious governance problems in the *cajas* sector during the run up to the crisis, misdiagnoses by the political authorities in the early and medium stages of the crisis, slowness in reacting throughout the process, vulnerabilities associated with heavy investment in the real-estate sector, dependency on wholesale markets for funding and a significant element of bad luck that came from the deterioration of the external environment (ie, the unanticipated Eurozone debt crisis that generated a double-dip recession in 2011) all contributed to the collapse and restructuring of important parts of the Spanish financial system.

After the first more chronological part of this paper, this section attempts to make sense of these developments by exploring the political economy of the Spanish banking crisis. By mapping and identifying the preferences and incentives of the key actors involved in the process we show how rational actions by each individual actor led to a collective failure, whose real impact only became evident in 2012 once the European institutions put an end to the 'war of attrition' that domestic players had been conducting since 2008.

1. How conflicting interests delayed reform: the 'war of attrition' model

One of the most striking factors of the Spanish banking crisis was the delay in taking the key decisions to tackle the problems. Moreover, it was only when Spain needed (or believed it needed) external help that the full restructuring of the financial sector, including bank recapitalisation and the creation of a 'bad bank' took place. Limited action from 2007 to 2012 meant that banking losses were much greater than if the authorities had intervened earlier on and that, by the time the restructuring of the largest institutions took place, the country's fiscal position had severely weakened. The Spanish case contrasts with the US and German cases, where early action (especially in the form of recapitalisation/ nationalisation) was carried out at a high relative cost but did not lead to a fully-fledged financial bail-out like in Spain. The early response to the crisis in these countries also contributed to reduce the impact of the financial crisis on the real economy. In fact, as Spain became the epicentre of the European storm in a period where most large western countries had already restructured their banking sectors and ensured financial stability, the Spanish crisis received much more attention and ended up being much more costly than if it had exploded earlier.

The timing of the transformation of the Spanish financial sector during the crisis can helpfully be understood through the lens of the interest-group model put forward by Alesina & Drazen (1991). Although the model attempts to explain why macroeconomic stabilisations are delayed, its logic applies to the stabilisation of the financial sector as well. These authors argue that stabilisations are often delayed because specific actors attempt to shift the burden of adjustment onto one another and endure a 'war of attrition' in which each group/actor attempts to wear the other out. Stabilisation occurs when one group has been particularly weakened and it coincides with a political consolidation, with one side becoming politically dominant. As a result, stabilisation costs are quite unequally distributed and the most weakened group bears the largest share of the adjustment burden. In the Spanish case, the 'war of attrition' was also prolonged by the fact that all actors (from the bankers to the government, as well as the regulators) unrealistically expected the overall economic and financial situation to improve due to exogenous factors such as a speedy recovery from the crisis (the 'extend and pretend' strategy). Finally, restructuring occurred not because one of the key groups was weakened but because external (European actors) forced policy changes in the context of the monetary union once the Spanish banking crisis threatened the entire euro project. Hence, Alesina & Drazen's framework is useful for understanding key decisions and turning points in the crisis.

The policies implemented through the crisis reflected the intention of minimising the use of taxpayer's money to bail out banks.

Two different governments, one from the centre-left Partido Socialista Obrero Español (PSOE) led by José Luis Rodriguez Zapatero and the other from the centre-right Partido Popular (PP) led by Mariano Rajoy, were in power during the global financial crisis, its aftermath and the restructuring of the Spanish financial system. The primary goal of any government is always to gain re-election (Downs, 1957; Riker, 1962). Therefore, the policies implemented through the crisis reflected the intention of minimising the use of taxpayer's money to bail out banks because that strategy was expected to generate wide resentment within voters. Citizen's resistance to banking rescues is a universal phenomenon, but in the case of Spain the electorate was even less prepared to accept it since the authorities had repeatedly stated that the Spanish banking system was one of the most resilient in the world. For instance, Prime Minister Rodríguez Zapatero said in New York in

September 2008, just after Lehman Brothers had collapsed, that 'Spain probably has the most solid financial system of the international community. It has an internationally celebrated model of regulation and supervision for its quality and rigour' (*Expansión*, 2008).

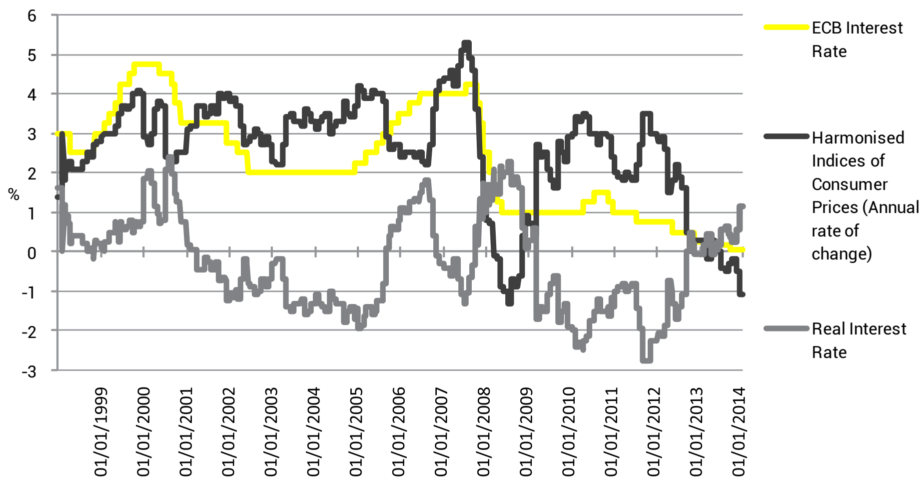
Moreover, both the PP and PSOE governments repeatedly emphasised that the restructuring of the Spanish financial system would not entail the use of public funds, which led them to pursue strategies that aimed at reducing capital needs (especially in the *cajas*) by promoting mergers and acquisitions, as well as promoting the entry of private capital in the vulnerable institution. Unfortunately, these strategies subsequently proved to be misguided. In addition, instead of choosing a systematic approach for solving the weaknesses of the financial system, a policy that would have required large quantities of funds, they opted for reacting to the *cajas* failures *ad hoc*, which minimised the short-term use of public funds but delayed the embracement of a comprehensive approach to 'clean' the system.

Another important motivation that guided Rodríguez Zapatero's government's (in)actions was to maintain the credibility that the Spanish financial system had acquired in the initial steps of the GFC through the practices of dynamic provisioning, regarded as examples of good supervision at the G-20 meetings of 2008 and 2009. Recognising the vulnerabilities of the system could have generated a loss of prestige for Spain within the international community when the country was undertaking intensive diplomatic efforts to become a permanent invitee to the G20 meetings, and it could also have triggered dangerous capital outflows. Finally, since few people anticipated that from 2010 the GFC would turn into a European sovereign debt crisis, the government had a strong incentive to expect that there would not be a double-dip recession in Spain (as it finally did) and that the external environment would be conducive to the rolling over of debt and reduce the amounts of bad loans within the *cajas*, inducing it to favour the process of mergers and acquisitions instead of recapitalisation or resolution. This strategy was also supported by the idea (widely held both in the Government and at the Bank of Spain) that the problematic *cajas* mainly had a liquidity problem that could be solved by the ECB, and not a solvency one that required additional capital (De Juan *et al*., 2013).

Instead of choosing a systematic approach for solving the weaknesses of the financial system they opted for reacting to the cajas failures ad hoc.

A second crucial actor, as noted in the previous section, has been the Bank of Spain, whose strong credibility has been seriously undermined by the Spanish banking crisis, especially in its latest stages, when it was decided that the recapitalisation needs of the system had to be calculated by the IMF and private consultancy companies and not by its own staff. The government appoints the Governor of the Bank of Spain, but the bank has statutory independence. However, as is the case with other independent Spanish institutions, for key decisions it operates under political pressure from the government. For instance, when Jaime Caruana was at the helm, its staff alerted about the formation of a real-estate bubble between 2000 and 2006 due to excessive credit growth, but no decisive action from the Bank's board was taken (Bolaños, 2011). To be fair, it is important to remember that monetary policy was decided by the ECB and not the Bank of Spain, and that as a consequence real interest rates were negative in Spain for several years in the run up to the crisis (see Graph 2). Later in the process, when real solvency issues started to emerge in some *cajas*, the Bank of Spain was finally compelled to act. That was the moment when it launched a process of consolidation of *cajas*, but unfortunately it tended to underestimate the capital needs of the troubled institutions.

Graph 2. Real interest rates in Spain, 1999-2014



Source: European Central Bank and Eurostat.

As explained in the previous section, the *cajas* were highly politicised institutions, and although some were well-managed and their social prestige was high, most of them engaged in malpractice, failed to provision for losses and betrayed their original purpose by expanding their activities both geographically and sectorally, and in doing so became instruments of political parties and other civil-society actors. Their main goal throughout the crisis was to maintain the *status quo*, and that required a variety of actions: from distorting financial statements to hiding losses or exercising political influence *vis-à-vis* the central government to ensure that their activities were not under full scrutiny.

Since some regions had governments from political parties that were different from that of the central government the dialogue between the two was complex. The central government and the Bank of Spain decided not to intervene in the *cajas*, while the regional governments were very reluctant to act because the *cajas* had become cash-flow instruments for their infrastructure and public projects, as well as tools of political patronage. The interplay between the central and regional government was so difficult that it even included the blocking of mergers during the resolution phase of the crisis.

There was a wrong diagnosis by which a solvency problem was taken as a temporary liquidity problem.

Finally, the European institutions were also key players in the crisis. Although a large part of the restructuring took place before European intervention, its institutions triggered the completion of the restructuring of the Spanish financial sector through the MoU as a condition for the banking bail-out and ended up providing two thirds of the funds that were injected in the financial institutions (almost €42 billion). However, they only intervened once the strategies undertaken by the Spanish government had failed and once it became clear that the insolvency of some *cajas* was threatening the solvency of the Spanish state, which, in turn, was putting at risk the future of the Eurozone since the Spanish sovereign was too big to fail, but also too big to rescue.

2. Turning points

Throughout the crisis, there were a number of key decisions (most of them mistakes) that determined the future evolution of events. We now review them through the lenses of the key actors involved and extract lessons that will be further developed in the following section.

(a) Wrong diagnosis

As it is the case in many banking crises, there was a wrong diagnosis by which a solvency problem was taken as a temporary liquidity problem or, to be more precise, in which the (Spanish and European) initial response to the crisis ended up generating a solvency problem in many financial institutions that perhaps could have been avoided with a different strategy. Total capital needs in the banking system ended up being around €150 billion (de Juan *et al.* 2013). In the end, over €60 billion were provided by taxpayers, of which almost €42 billion euros came from the European bail-out. The rest was recapitalization through private capital. Confusing liquidity with solvency led to wrong decisions that ended up dramatically increasing the final bill of the crisis. The incomplete design of EMU also contributed to make the crisis worse by generating destabilizing capital flows from the periphery to the centre.

The idea that injecting large quantities of liquidity would be enough to stabilize the situation was widely held (especially given that the liquidity had dried up and the ECB had been providing liquidity to the European banking system since 2007) in the expectation that the crisis was an Anglo-Saxon phenomenon that would not affect the Eurozone´s financial system. In addition, since the position of the large Spanish banks was relatively sound (mainly due to their international operations), there was a resistance to increase or call for the increase of provisions that could undermine their strength. The view was why stigmatize the entire Spanish system, if the problem affected only up to 40% of the sector.

This 'wait and see' strategy rapidly turned into a policy of 'extend and pretend'.

In this context, both the government and the Bank of Spain decided not to take decisive action at an early stage. Its belief was that the Spanish banking sector was facing a temporary liquidity crisis generated by the contagion from the global financial crisis. The fact that there were no toxic assets in the banks and *cajas* balance sheets and the good reputation of the Bank of Spain as a supervisor contributed to the idea that Spain could circumvent the financial problems related to the collapse of the real estate bubble with a quiet and restricted process of simple consolidation, as had been the case in previous crises.

In addition, given that from 2008 to 2010 there was a G-20 agreement to implement expansionary fiscal policies, that the Greek crisis had not yet fully materialized, and that the July 2010 stress tests did not reveal capital needs, it was 'rational' for the government to maintain its optimism and to pursue a strategy of 'wait and see'. Needless to say, the *cajas* were more than pleased with this strategy because it enabled them to continue with business as usual, while the local and regional governments were also happy because they would remain in control of them. Finally, European institutions were not a relevant actor at this point: Spain still had relatively low financing costs; supervision remained national because the banking union had not even started and most European efforts were concentrated on Greece.

However, this 'wait and see' strategy rapidly turned into a policy of 'extend and pretend'. In mid-2009, with the first symptoms of the European debt crisis, the collapse of *Caja Castilla La Mancha* and the double-dip recession, rolling over debt and betting on a rapid recovery were seen as the best alternative to avoid using large quantities of taxpayer´s money for either nationalizations or the creation of a bad bank. As de Juan *et al.* (2013) critically emphasize, the prevalent attitude was to ignore the problem because there was no clear solution. Having mentioned this, not all was inaction. Positive decisions during this period included the creation of the FROB early on in 2009 and the initial steps to merge the *cajas* and transform them into banks.

The high social prestige that the *cajas* enjoyed made the Bank of Spain pursue the strategy of trying to convince the different political actors of the need to proceed with mergers before the Greek crisis and the double-dip recession started, as will be explained in more detail in the next section. However, this proved to be a very hard process because once again politics got in the way. For instance, in the region of Galicia there was strong resistance first to merge the different *cajas*, and later to allow its acquisition by the Catalan *La Caixa*. At a later stage, Madrid also blocked the merger of *Bankia* and *Caixabank* for political reasons, an event that would trigger the European bail-out. In sum, no comprehensive plan was put in place at an early stage and the politics of mergers and acquisitions was so complex that precious time was lost.

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(b) Tactical errors when addressing the problems of the *cajas*

Once it became apparent that the impact of the crisis had led to substantial capital needs in many of the *cajas*, the government and the Bank of Spain started to realize that there had been a deep problem of mismanagement in this sector, hidden for years by abundant liquidity and inefficiency. At that point, the Bank of Spain took the lead in proposing a number of mergers between the different *cajas*.[9] The objective was to create bigger institutions, which would be the result of the absorption of the 'bad *cajas*' by the 'solvent *cajas*', while injecting the minimum possible amount of public funds. Some banks were also involved in this process, as had been the case in prior restructuring processes. The government agreed with the strategy, as it was expected that larger and stronger institutions would be more capable of attracting private capital at a later stage. This approach also diluted political tensions, since each *caja* would be allowed to maintain its brand name and continue with its activity (but in a context of a more efficient business model), which was something in which regional governments had insisted. As noted before, given the complex legal status of the *cajas*, which were not private entities and had no shareholders (and therefore no access to private capital markets precisely when Basel III capital requirements forceed them to increase capital and reserves), this process required creating new entities that grouped existing *cajas*. Varying degrees of public funds or guarantees (through the FROB and the Insurance Deposit Fund) were used in the process.

However, since there was a failure in recognising that in the long run 'a good recapitalisation of the banking system is not spending, but an investment' (De Juan *et al*., 2013, p. 201), the reluctance to fully anticipate losses and calculate capital needs correctly before the mergers took place led to increased problems.

9 The strategy was based in the so-called 'cold fusions' (fusiones frías), a kind of merger by which each *caja* maintained its name, brand, legal stature and autonomy, but allowed the 'group' to perform some actions in common, such as raising capital in international markets or centralising costs to increase efficiency.

The 'good cajas' were not good enough, so when they were merged with the 'bad cajas' the results were large weak entities.

The 'good *cajas*' were not good enough, so when they were merged with the 'bad *cajas*' the results were large weak entities that did not offer sufficient trust to private investors who eventually refused to invest in them once they became banks. In addition, the European debt crisis worsened, thus prompting a second recession in less than two years. And the increase in non-performing loans made it more difficult for all financial institutions to ensure their solvency.

Bankia is paradigmatic of this failed strategy. It was the bank that resulted from the merger of the largest *caja* (Caja Madrid) with six other smaller *cajas*, that went public in July 2011 and that ended up requiring a €24 billion capital injection that prompted the Spanish banking bail-out by the European Stability Mechanism (ESM) in mid-2012. Despite the strong consolidation process, mismanagement and misreporting of its financial statements continued and political tensions arose between Bankia's board chaired by Rodrigo Rato (a former Vice-president and Finance Minister of the Spanish Government under the PP and Managing Director of the IMF) and the PP government led by Rajoy. When the government approved another law that required the banks to increase their provisions, losses became evident. The attempt to merge Bankia with La Caixa, the other largest *caja*, which had a relatively sound financial position, was torpedoed by political interference (Sarries Menéndez, 2015). Finally, less than two years after Bankia had gone public, its insolvency was disclosed and the Spanish authorities had to request a credit line of up to €100 billion to its European partners.

(c) Grey areas of the bail-out

The European bail-out marks a turning point in the crisis. Only when the European Commission, the ECB and the ESM enter the game and the MoU is signed, there is decisive action to pursue an external, transparent and independent audit of the financial institutions, fully recognise losses, recapitalise effectively the damaged banks, create a 'bad bank' and restructure the system. All this happened in a relatively short period of time (the Spanish 'programme' lasted 18 months, ending in January 2014). This means that, unfortunately, the incentives and constraints generated by the domestic political and economic system in Spain that have been described earlier made it impossible to find a way out and properly address the problems of the financial sector. An external actor, whose power came from the fact that it was lending funds, and whose legitimacy was loosely defined in terms of technical capacity and political independence, was the one that finally forced the adoption of a comprehensive strategy and the implementation of most of the necessary measures (the MoU included 32 specific actions). In addition, many features of the Spanish banking bail-out were later introduced in the architecture of the EBU, especially the bail-in provisions, which aim to minimise the use of taxpayer's money.

The bail-out can be regarded as a success (IMF, 2014). Together with the launch of the banking union and with the pledge by the ECB in July 2012 to do 'whatever it takes' to save the euro, it contributed to the stabilisation of the European financial markets and triggered substantial reforms in Spain. However, it was not completely successful in resuming credit to the private sector. It also contributed to seriously undermine the credibility of the Bank of Spain, which was removed by the government from the assessment of capital needs of the Spanish banking sector. Such assessment was conducted by the IMF first and later by Oliver Wyman and Roland Berger, two private consulting companies, which in June 2012 estimated the capital needs of the system between €51 billion and €62 billion (slightly over what was finally needed).

The Spanish government aimed at recapitalising financial institutions directly with ESM funds, as this was seen as the only strategy to break the 'doom loop' between banks and the sovereign. However, since the banking union had not been created yet, the direct bank recapitalisation instrument had not been approved, largely due to the reluctance of creditor countries (mainly Germany) to use European funds to address capital needs generated by legacy assets. In the end, the ESM made a 'relatively cheap' loan of €41 billion (with a variable interest rate of about 1%) to the Spanish treasury, which used this money to recapitalise the banks through the FROB, increasing Spanish external liabilities by about 4% of GDP.

One of the most controversial issues of the bail-out was the bail-in provision, by which junior creditors, especially holders of *participaciones preferentes* (preferred shares) suffered losses. Its goal was to reduce the use of public funds, so it subsequently became one of the pillars of the EBU and was also a cornerstone of the Cyprus bail-out in 2013. Even though its logic is sound, especially in cases where a small number of financial institutions require recapitalisation, it is dubious if it could be implemented in the event of a systemic crisis, since losses (and thus capital needs) would be multiplied (see next section). In addition, in the Spanish case, the bail-in process, which imposed hair cuts of up to 60% to junior creditors, precipitated complex litigations by which eventually most creditors were able to be paid in full because they could claim that they were misled in buying subordinated debt without their acknowledgement.

The bail-in process, which imposed hair cuts of up to 60% to junior creditors, precipitated complex litigations.

Finally, even though the restructuring of the Spanish financial sector implied the elimination of 36 *cajas*, no institution was allowed to go under. As is often the case in banking crises, the fear of the authorities that allowing systemic institutions to fail could trigger a panic and worsen the crisis, led to the questionable decision of bailing out the entire system. The only novelty of the Spanish case was the inclusion of bail-in provisions, something that had not been done in the Irish case. As De Juan (2013, p. 155) puts it ‘during banking crisis, it is unavoidable to adopt repugnant measures, but the consequences of not doing it are even more repugnant’. Full bail-out is probably a case in point.

SPANISH LESSONS FOR THE EUROPEAN BANKING UNION

SPANISH LESSONS FOR THE EUROPEAN BANKING UNION

After presenting in the first part of this paper the chronology of the Spanish banking crisis, and in the second the analysis from a political economy perspective, in this third section we aim to extract the main lessons that can be learnt from the Spanish experience for the newly created EBU. We believe that there are six main teachings that need to be taken into account.

1. This time was no different…

As Reinhart & Rogoff (2009), and previously Kindleberger (2005) and Minsky (2008) have convincingly demonstrated in their review of financial history, banking crises are as old as capitalism and the striking fact is that we do not seem to learn from them. Patterns are repeated. The feeling during the euphoria phase preceding any systemic credit crisis is that 'this time it is different', that the previous experiences of boom and busts do not count and that we have entered a new era of permanent growth and ever rising asset prices. In principle, Spain should have learnt from its recent past. It experienced unsustainable real-estate bubbles and consequent banking crises in the 1980s and 1990s and thus it should have been well positioned to withstand the most recent one. Unfortunately, it was not.

The international environment did not help. The first years of the new millennia will be remembered as a time of 'irrational exuberance' (Schiller, 2015) based on the widespread belief that the global financial markets are efficient and rational (Wolf, 2014). The power of market-friendly ideas, based on the Efficient Market Hypothesis (EMH), promoted first by powerful vested interests in the financial markets but then developed into a pervasive group-thinking which engulfed policymakers, academics and pundits, should not be underestimated (Blyth, 2002; Kirshner, 2003; Rodrik, 2014). The *laissez-faire* self-regulatory regime of Basel II and the strong consensus among economists, policymakers and rating agencies that business cycles were something from the past, and hence that growth would be permanent and sustainable, contaminated Spanish society. Many

When troubles arise, the sovereign does not want to intervene in its banks because this would undermine the confidence in the national economy.

analysts and commentators presented Spain's spectacular growth during the first years of the 2000s as a role model. It is worth remembering that the Spanish sovereign had a credit rating of AAA, and that most Spanish banks and their securities (MBS and ABS that were sold to the international wholesale markets) also received the same top credit assessment. This lets many people, from the ordinary man in the street in Madrid and Valencia to the top bankers in London and Frankfurt, to believe that house prices would always rise in Spain.

In fact, the Bank of Spain, fully aware that Spain is a country prone to real-estate bubbles, the previous one being between 1986 and 1992 (Montalvo, 2003; Montiel Márquez & Naredo, 2011), tried to build barriers against the rising tide. Since 2003 it recognised that house prices were up to 20% overvalued (BdE, 2003; Barrón, 2011) and explicitly warned the Spanish banks about their excessive leverage (making them too dependent on the international wholesale markets) and their overexposure to the real-estate sector. Its actions went beyond mere advice by going one step further and introducing countercyclical dynamic provisions (which are now widely seen as the first measures in macro-prudential regulation). In hindsight it can be argued that these provisions were insufficient because they did not effectively slow down the real-estate bubble (the Bank of Spain could also have increased the capital requirements of the banks or tighten the credit flow in other more innovative ways) but it should be borne in mind that in the years just before the GFC, the Bank of Spain was openly criticised in different international forums and explicitly by the European Commission for these provisions because they went against the international supervisory and accounting consensus of in-house modelling and risk-assessment by the banks. Therefore, back then the debate was not whether the Bank of Spain should reduce or increase the provisions, but rather whether it should enforce them at all.[10]

Two more features of previous crises were apparent in the Spanish crisis. The first relates to the very close connection that exists between the sovereign and the national banking system. Often, when troubles arise, the sovereign does not want to intervene in its banks because this would undermine the confidence in the national economy and the credit rating of the sovereign itself. Indeed, a certain element of national pride is always involved in these circumstances, hindering a speedier reaction. This hesitation connects with the second oft-repeated pattern. Usually, public authorities intervene too late and, hence, get the timing wrong. In order to regain the confidence of domestic and international market operators it

10 This aspect was highlighted by several former senior officials from the Bank of Spain interviewed for this research paper.

is sometimes better to act boldly and fast. This might create instability and uncertainty in the short-term but ultimately the quicker the problems are tackled the faster will be the recovery. Of course, getting the timing right is not easy since in every system there are a number of vested interests and veto players that oppose swift government action that can potentially lead to the transformation of the *status quo*.[11]

Regulators and supervisors should be sceptical of the prevailing zeitgeist. They should also have the power to, if not switch off the music, at least be able to turn it down at the right moment.

Thus, the first lesson to extract from the Spanish experience is that regulators and supervisors should be sceptical of the prevailing *zeitgeist*. They should also have the power to, if not switch off the music, at least be able to turn it down at the right moment.

2. But it was different in some ways

Although banking crises are recurrent, it is also true that they always come in different shapes and sizes. The Spanish authorities thought that they could handle this crisis like the others. They attempted to consolidate further the Spanish banking sector by promoting mergers through which stronger institutions would buy the weak. They did not realise that this crisis was fundamentally different in a number of ways, some of them more of a domestic nature and some due to the changes in the international and European context.

Starting with the internal dimension, unlike in the previous crises in Spain, this time the main problems were in the publicly-run regional and local *cajas* and not in the private banking system. This was a new phenomenon. The *cajas* were traditionally more conservative in their business strategies and therefore required less attention. This lack of strict supervision, partly consequence of the dual regulatory regime explained in the first part of this paper, was a mistake. The interference of regional and local political authorities was also a hindrance to achieve the best possible mergers from an economic point of view. In addition, as a consequence of

11 The January 2016 crisis of the Italian banking system, which forced the country to seek a deal with the EU to approve a new government guarantee scheme to address the country's banks large number of non-performing loans illustrates, yet again, the difficulties of getting the timing right. In Italy a tradition of conservative lending allowed the country's banks to weather the GFC in better shape than their European counterparts (Quaglia & Royo, 2015). Italian banks, as opposed to banks in most other European countries, did not benefit from large injections of public funds during the GFC. However, they were still saddled with a huge volume of non-performing loans (around €350 billion), and the 2015-16 turmoil in global financial markets left them vulnerable to a sharp sell-off. This meant that the country addressed the problem of the financial sector after the other countries did so. This inaction during the GFC on the part of the Italian authorities eventually led to the recent crisis.

Every crisis is different in its nature and the authorities need to expand as much as possible their anti-crisis and crisis-management toolkit.

the mergers emanating from the previous financial crises (1977-1985 and 1993), the Spanish private banking system had reached a level of consolidation and maturity (Villaroya & Guevara. 2008; Ontiveros Baeza & Valero López, 2013) that discouraged the remaining private banks from buying out the ailing *cajas*.

Looking at the external dimension, another difference with previous crises was the overdependence on the international wholesale credit markets. This did not happen to such an extent in previous crises. Here it is worth recalling that just before the GFC, Spain's private indebtedness was 230% of GDP, while the average in the rest of the Eurozone was 165%. In 2008 Spain had, and still has, one of the worst net international investment positions (NIIP) in Europe (European Commission, 2014). Membership of the Eurozone was thus a double-edged sword. It reduced the cost of credit significantly but it also reduced the toolkit in the Bank of Spain's hands to tackle the crisis. It did not have the capacity to decide its own monetary policy, so consequently was unable to devalue the currency, to offer liquidity to the illiquid but solvent banks and *cajas* or apply quantitative easing as the Fed in the US and the Bank of England in the UK did. In addition, the new resolution procedures and mergers needed to be authorised by the European competition authorities in Brussels. Finally, unlike in the last banking crisis in Spain, which happened at the beginning of the 1990s, this time there was a complete free flow of capital within the Eurozone and in and out of it, which meant that the Spanish authorities were more exposed to the threat of contagion and the negative sentiment of the markets in regard to the Spanish economy. All these new structural conditions meant that the Spanish authorities were totally unprepared for the huge storm emanating from the GFC. As the former Governor of the Bank of Spain acknowledged: 'The task was not only to manage the rescue of a sinking ship, but that at the same time we had to build the lifeboats' (Fernández Ordoñez, 2014).

The second lesson that can be learnt is, therefore, that every crisis is different in its nature and that the authorities need to expand as much as possible their anti-crisis and crisis-management toolkit in order to be best prepared for any contingency. In particular, they need to understand that once they join a monetary union they have to articulate original (sometimes heterodox) strategies to avoid the excessive growth in credit that emanates from a monetary policy that they cannot control.

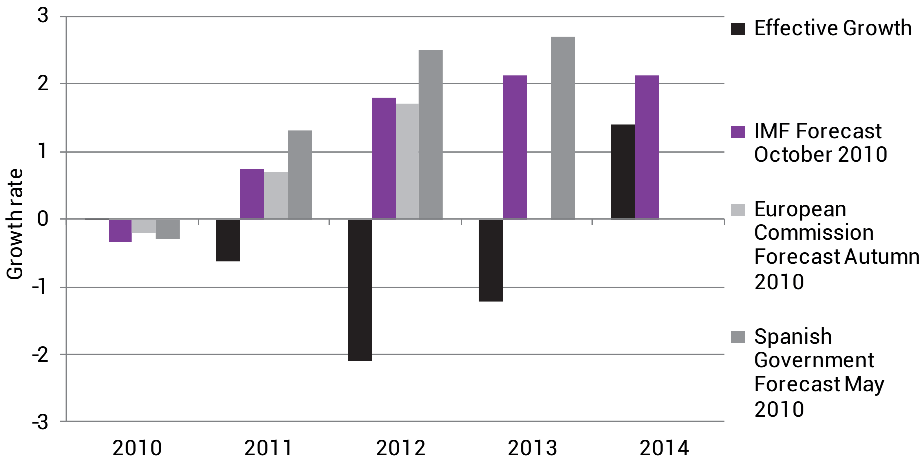
3. Be prepared for the worst

Another lesson that needs to be learned is the importance of being prepared for the worse before and during the crisis. Before, because this will help regulators and supervisors detect possible black swans (unforeseen events, see Taleb, 2007) early on. If this is done, it will also be easier to come up with a more accurate diagnosis of the crisis. When managing the crisis it is also important to be ready for the worst because in many occasions the first diagnosis is not accurate and policymakers need to be able to change the pace and direction of their crisis-management policies. In the case of the Spanish crisis, the national authorities considered three possible options. The first was to intervene the ailing *cajas* and liquidate those that were insolvent. The second was to recapitalise them, and the third to start a new phase of mergers and consolidation. As mentioned in the previous section, the Spanish authorities (the government under the advice of the Bank of Spain) opted for the third in the belief that the Spanish economy would come out of the 2009 recession following a V-shape.

They were encouraged to do so by reading the forecasts of the majority of domestic and international experts. As shown in Graph 3, in 2010 most forecasts indicated that the recession would end by 2010 and that growth would consolidate in 2011 and the following years.

Events turned out to be very different. The black swan of the GFC was followed by the black swan of the Greek sovereign-debt crisis, which attracted the third black swan: a double-dip recession in Spain. Policymakers in Spain were not ready for this. That was the reason why the crisis resolution dragged on for so long (De Juan *et al*., 2013). The second recession made the volume of non-performing loans larger by the day, which in turn meant that the provisions calculated during the first recession were overly optimistic. This, on the other hand, was undermining the credibility of the Bank of Spain as a regulator and that of the Spanish government as a crisis manager. Ultimately, the piecemeal approach of trying to resolve the problematic *cajas* one by one turned out to be expensive for the Spanish taxpayer.

Graph 3. Spanish economic growth as forecasted in 2010



(1) The Forecasts of the European Commission only ran to 2012.
(2) The Forecasts of the Spanish Government only ran to 2013.
Sources: International Monetary Fund, European Commission and Spanish Government.

In hindsight, perhaps the combination of the first two crisis-resolution strategies (intervene and liquidate and/or recapitalise) would have been better. For that to have been effective, however, the Spanish authorities would have needed to have the legal power to do so (which they did not until the FROB was created), and to have the resources and manpower to take action. To resolve and capitalise more than a dozen *cajas* in a short length of time and without triggering market panic is not easy. For that, a state, or a group of states such as the EU, needs to have deep pockets and show that it is ready to spend big money (Paulson's big bazooka) to save the banks and calm the creditors, but it also needs a great number of bank resolution experts able to come up with the right diagnoses in order to effectively separate the illiquid from the insolvent institutions.

Once the crisis starts it is absolutely vital that the Government generates the political measures necessary to challenge the vested interests (sectoral or regional) that cling to the status quo.

Thus, the third lesson is to be prepared for the worst in theory (black swans cannot be avoided) and in practice (have the resources and people ready) to deal with the crisis. Furthermore, once the crisis starts it is absolutely vital that the Government generates the political measures necessary to challenge the vested interests (sectoral or regional) that cling to the *status quo*. It is also important for politicians to avoid creating false expectations that cannot be fulfilled. This can undermine the credibility of the crisis-management authorities.

4. Regionally fragmented oversight is problematic

The Spanish example shows that sometimes it is the small or savings banks that can bring the greatest problems.

One of the biggest problems for the Spanish authorities was to deal with the dual regulatory framework that existed in Spain for the private banks, regulated by the government and supervised by the Bank of Spain, and the *cajas*, which were regulated and supervised by the regional and local authorities. Proper *in situ* supervision of the *cajas* by the Bank of Spain only occurred from 2008 onwards when the global financial crisis initiated in the US arrived at Europe's shores. This meant that when the crisis hit, the Bank of Spain had only a partial assessment of the management of the *cajas*. Furthermore, when the crisis erupted and the Bank of Spain started with its strategy to encourage the *cajas* to voluntarily merge with each other, local and regional politicians started to oppose the mergers on electoral and identity grounds.

The best example of this behaviour can be found in how the *cajas* of Galicia, the region in the north-west corner of Spain, were resolved. Both Galician *cajas*, Caixa Nova, based in Vigo, and Caixa de Galicia, based in A Coruña, were in a very difficult financial situation, but both resisted a merger with each other because their boards did not want to be seen to be bought up by the *caja* from the 'rival' city. As was predictable, there was a big row as regards the location of the new headquarters. Finally, after being pressured to reach an agreement by the regional government, the Galician *cajas* reluctantly merged, but their union was doomed from the start because both were insolvent institutions. This failed merger happened only because the government of Galicia wanted to retain a Galician *caja*. It thought (perhaps rightly) that voters would punish any sell-off of the Galician *cajas* to a *caja* or a bank from another region of Spain. Eventually, although there were offers from other Spanish institutions, in order to avoid regional embarrassment, the Galician government agreed to sell *Nova Galicia Banco*, the bank emanating from the two Galician *cajas*, to a foreign bank.

Parochial attitudes like this of defending on nationalistic grounds one's local turf are likely to appear in the European banking union. Although there is a regulatory rulebook for all the banks operating in the Eurozone, supervision will be fragmented between the 130 biggest banks, which will be supervised by the ECB, and the rest, which will be controlled on a daily basis by national or even regional authorities. This might lead to unforeseen difficulties. The Spanish example shows that sometimes it is the small or savings banks that can bring the greatest problems. Identity politics might also be a problem when it comes to one of the 130 big banks, most of them national champions. The European resolution mechanism remains an intergovernmental construct, hence it has to be seen whether at times of crisis, when public scrutiny is at its highest and nationalistic feelings are running high, a

The lesson is that to avoid double standards, regulation, supervision and resolution should be centralised.

smooth resolution and take-over of a big bank from France and Germany by a rival bank from Italy, for example, would be possible. This is the reason why the rapid creation of a capital markets union with cross-border mergers would be desirable.

This fragmentation and regulatory problems have not merely been a problem in Spain. Indeed, Italian financial institutions, particularly smaller and medium-sized ones, have also been hampered by poor and fragmented governance structures, a problem that has also been a leading cause of the recent late 2015 and early 2016 crisis. As in Spain, the fragmentation of their co-operative banks –the small and medium sized *popolari*– that like many Spanish *cajas* are rooted in local communities and are controlled by regional politicians, has also been another contributing factor to the crisis.[12]

In this case, the lesson is that to avoid double standards, lack of information about how the banks are run, parochial attitudes and multiple veto players; regulation, supervision and resolution should be centralised, and central governments and regulators have to be willing to counter the parochial tendencies of regional politicians.

5. The 'too big to fail' problem is getting worse

As in previous occasions, after this financial crisis the Spanish banking system has undergone a new round of consolidation. From 45 *cajas* before the crisis, there are only nine left, and all of them are now banks. Another seven private banks went under also. This means that the remaining banks are now bigger and therefore more powerful and systemically important. This is especially the case for the three biggest banks, BBVA, Santander and Caixabank. If before the crisis they were generally perceived as too big to fail, the feeling has been enhanced in the aftermath of the crisis.

Bigger and stronger institutions are certainly not bad *per se*. The economies of scale that they generate can be very positive. Santander and BBVA, for instance, have shown that a highly professional management and staff, a well-designed internationalisation strategy with regional diversification and the experience gathered by operating in different cultural environments and dealing with multiple setbacks make a bank more competitive and resilient. These big Spanish banks

12 As in Spain the Italian government has been trying to consolidate them (it approved a law in 2014 to force the 10 largest banks to convert into join stock companies by the end of 2016), but the process has been stalled by court challenges and opposition from many shareholders and executives (see 'Renzi's short-term fix to Italy's banking challenge', *Financial Times*, 27/I/2016).

have also shown that focusing mainly on retail banking and not on investment banking can be less complex and dangerous but still a very profitable business strategy. However, there are a number of structural problems that large banks generate. First of all, their lobbying and influence in the regulatory and supervisory regime might be too great (Wolf, 2014; Kirshner, 2015). This can lead to excessive regulatory capture and ever-turning revolving doors. Consequently, this might induce the regulators and supervisors to soften their stance and weaken their monitoring zeal.

Secondly, the very big banks can generate certain distortions in the market. Knowing the taxpayer will save them because they are too big to fail, they might enter into more risky activity, especially if we return to a period of 'irrational exuberance'. By being so big, they are also likely to attract a lot of depositors and be in a stronger position to decide to whom they lend. They might be less interested in the social groups with lower credit scores, such as farmers, the unemployed, micro enterprises, single parents and immigrants, who will have fewer options to obtain a loan than the social groups with higher credit scores. Traditionally in Spain, before the crisis the weaker social groups were financed by the publicly-owned *cajas*. It has to be seen whether in the future the remaining private banks can successfully fill this void, and whether competition in the banking sector as a whole is sufficiently broad to avoid cartelist behaviour.

Banks that are too big to fail can generate a number of structural problems likely to foster the creation of another crisis, disrupt the level playing field and expose the taxpayer to higher costs.

The third problem might arise in the crisis-management phase. Usually it is believed that the banking system has enormous structural power because it is such a vital sector for the economy, and therefore it can generate immense active power to shape to its favour the regulatory and supervisory framework. While this is certainly true, the banking sector has also a lot of structural power because of its capacity of inaction (Woll, 2015). Because banks, especially the big ones, know that the government is unlikely to intervene and liquidate a big chunk of the banking sector, they can sit on their hands and only contribute to the resolution of the problem via mergers once the government has agreed to put taxpayer's money on the table to sweeten the deals. The resolution of the banking crisis in Spain has been yet another example of this phenomenon.

The lesson to extract here is that banks that are too big to fail can generate a number of structural problems likely to foster the creation of another crisis, disrupt the level playing field and expose the taxpayer to higher costs. Therefore, these banks need clear resolution plans, also called living wills, which need to specify the rapid and orderly restructuring, resizing and even closing down of the bank in the potential event of financial distress.

6. A large fiscal backstop is absolutely necessary

The last lesson that can be learned from the Spanish banking crisis is that ultimately in a systemic crisis the only actor that can stabilise the financial system is the sovereign by using taxpayer's money. Of course, having a central bank that can act as lender of last resort also helps. The Spanish recovery started precisely when the European leaders decided to create a banking union and offered up to €100 billion of European taxpayers' money to Spain, and when Mario Draghi declared that the ECB was ready to do whatever it takes to save the single currency. History shows that money is a social relationship between creditors and debtors and when trust between them breaks down because of a systemic shock, it is the state, both with its monetary and fiscal arms, which restores the necessary confidence (Otero-Iglesias, 2015).

Unfortunately, the euro is still an orphan currency without a state, and this makes it a fragile construct. The European banking union is only a half-built house. It has a single supervisory mechanism, it has a common (not a single) resolution mechanism (because a single one would mean establishing a fiscal union by the backdoor) and it still lacks a single deposit guarantee scheme. For a considerable number of policymakers in the creditor countries, especially in Germany, this arrangement based on the principle of the bail-in regime should be enough to withstand future crises. This view seems to overlook the history of finance (Reinhart & Rogoff, 2009; Kindleberger, 2005; Minsky, 2008). The bail-in regime, under which the creditors pay first and the taxpayers pays last, might be working for smaller banks, similarly to the Federal Deposit Insurance Corporation (FDIC) regime in the US. But for big banks, threatened by the shocks of a systemic crisis, the Eurozone will need to have a larger fiscal backstop than the one envisioned so far.

In a systemic crisis the only actor that can stabilise the financial system is the sovereign by using taxpayer's money.

The possibility of bailing-in, resolving and liquidating a big bank will certainly appear in the future. This might also be a good opportunity to generate cross-border pan-European mergers. The Spanish example shows just that, although it also demonstrates how difficult it is. But the most likely scenario is that politicians will look at this and be afraid of provoking uncontrolled bank runs and panic (De Grauwe, 2013). In order to avoid this they will need to bail-out the banks and save the senior creditors and the deposit-holders. This is what happened in the US after the fall of Lehman Brothers in 2008. When this happens the important thing is to have as few veto players as possible so that action can be taken swiftly in one weekend to avoid further market panic. Here again, the European resolution mechanism is weakly conceived not only in regards to the lack of firepower but also when it comes to deciding how to use the European taxpayers money. The threat is that yet again the ECB, which has no legitimacy to do so, might have to clean up the mess left by elected politicians. This is a sub-optimal arrangement.

The final lesson, therefore, is that the members of the Eurozone will eventually have to pool their fiscal sovereignty in order to effectively deal with future European banking crises. The current bailing-in regime might be robust enough for individual bank failures but not for a systemic crisis engulfing some of the biggest banks in Europe, which, if the European banking union deepens, are very likely to be operating transnationally across European borders in a few years from now.

CONCLUSIONS

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In 2009-13, Spain suffered its worst financial crisis in decades. Spanish financial institutions were able to circumvent the crisis in its first phase. However, the huge real-estate bubble that Spain experienced in the decade that followed the creation of the euro, the Great Recession precipitated by the GFC, the doubts about the sustainability of the euro and the mismanagement of the *cajas*, all made the banking crisis in Spain inevitable.

In the end, Spanish financial institutions required around €150 billion, including €60 billion ultimately provided by the taxpayer (€42 billion of which came from the 2012 European bail-out fund), the financial sector was completely restructured, and most of the centennial cajas disappeared. At the time of writing, Spain is recovering from a five-year double-dip recession. Confidence has returned, exports are booming and, following the recapitalisation of the financial system, credit slowly has recovered. However, the economy still suffers from high levels of unemployment and debt, and the consequences of the crisis (in terms of inequality, underinvestment and long-term unemployment) will be deeply felt for years to come.

This report has presented a novel narrative of the Spanish financial crisis, and has used a political economy analysis of its dynamics to illustrate some key points that should be taken into account in the on-going design of the EBU. As our 'lessons learned' section makes clear, financial crises are both periodic and inevitable. They are the natural result of the intrinsic instabilities of the capitalist system. Moreover, given that recent calls from a variety of experts (Wolf, 2014; Turner 2015) in favour of drastically increasing capital requirements and reducing the probability of rapid credit growth are unlikely to be followed, we should expect more crises in the future. However, the Spanish case illustrates that there are actions that governments and civil society can take to minimise the damaging effects of financial crises, both at the technical and at the political levels. Specifically, since Spain is divided into regions that have a significant degree of political and regulatory autonomy, just like EU member-states have, the politics of the Spanish banking crisis can lead to interesting insights that should be included in the architecture of the EBU.

First, the Spanish case shows that supervision is as important as regulation, and that sharing responsibilities in supervision tend to be problematic, especially when there is political influence and interference at the regional or local level, as was the case with the Spanish *cajas* (but not with the Spanish banks). Therefore, the Single Supervisory Mechanism (SSM) at the EU level is most welcome, but it remains to be seen if the ECB has the capacity to, over time, supervise the large majority of European banks and not only the systemically important financial institutions. Hence, it is very important that the supervisor enjoys full independence and that it has the instruments to act when a bank experiences solvency problems.

The second conclusion, linked to the first, is that it is necessary to act early on, as soon as problems in the banking sector appear. This is important both to reduce the final bill of the crisis and to avoid that highly-leveraged banks turn into zombie institutions that deepen the economic recession by restricting credit. The Spanish case, however, shows that there could be important incentives built into the system that could delay action, making the crisis more costly. Multiple veto points, fear of damaging confidence and reluctance to use public funds to recapitalise banks were crucial in explaining the delay in the Spanish case. Therefore, a clear resolution mechanism, with transparent and automatic enforceable bail-in rules to minimise the use of taxpayers' money and as de-politicised as possible, is essential. The current structure of the EBU scores well on the technical design of the bail-in framework, but in practice its performance is still questionable. Italy's late 2015 and early 2016 bank restructuring process shows that the bail-in process will always be met with fierce resistance by small investors and (sometimes) very powerful interest groups.

Furthermore, it remains to be seen whether the newly created single resolution mechanism (SRM) can effectively deal with a systemic crisis. In principle, the resolution of any European bank, even large banks such as Société Générale, UniCredit, Deutsche Bank or Santander, should be undertaken in a weekend, but in the current structure there are around 100 decision-makers involved and, more worryingly, the arrangement is mostly intergovernmental, which means that national politicians (under the pressure of national interest groups) will have the last word in deciding the future of banks that are in most cases national champions. The Spanish case shows that identity politics is always part of the game. It is important to bear this in mind since the SRM will for the foreseeable future be compartmentalised into national funds, which does not break the doom-loop between national sovereign and national banks, and therefore creates even more incentives for national policymakers to delay any action that might undermine the reputation of their banking system, and by extension, that of their economy.

Ultimately, the Spanish case shows that a credible fiscal backstop is the key to maintaining confidence in the system once a banking crisis hits. And it has to be in place (and fully funded) *ex ante*. Spanish authorities had to create new institutions such as the FROB as the crisis unfolded because the Deposit Guarantee Fund, previously used to inject funds in some *cajas*, had run out of resources. They also ended up having to request external financial assistance because markets perceived that the Spanish Treasury would not have the capacity to raise sufficient funds at a reasonable cost to recapitalise the banking system. Therefore, the lesson that should be taken at the EU level is that a sufficiently large fiscal backstop to maintain market confidence during banking crises has to be established. And it should cover not only resolution, but also deposit insurance. This, of course, presents a political problem because a large fiscal backstop for financial crises can be regarded as a fiscal union through the back door, and a fiscal union requires a political union, which is non-existent in the Eurozone. At the time of writing, the EBU is incomplete because the common insurance deposit guarantee scheme has not yet been established. Further work needs to be done on this front. We hope that this is not delayed until the next big crisis hits Europe's banking system.

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