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# War of Attrition and Power of Inaction: The Spanish Financial Crisis and its Lessons for the European Banking Union

## *La guerra de trincheras y el poder de la inacción: la crisis financiera española y sus lecciones para la Unión Bancaria Europea*

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Abstract

The aim of this paper is to analyse the main causes of the Spanish financial crisis (2009-12). Risk mismanagement in the saving banks was the main culprit but the intensity of the crisis was due to the "war of attrition" between the main stakeholders (the central and regional governments, the Bank of Spain and the *cajas*), which was further reinforced by the "power of inaction" of the big Spanish banks: Santander and BBVA. Ultimately, an external actor resolved the stalemate: the European Stability Mechanism, which was able to introduce the necessary reforms after successful completion of the Memorandum of Understanding. The paper sheds new light on the Spanish case by analysing the political and economic factors that led to the crisis. Furthermore, rather than examining the financial crisis from a purely domestic perspective, the paper emphasizes the interplay between domestic and European factors. It closes with lessons for the European Banking Union that can be extracted from the Spanish experience.

*Keywords*: Spain; Banking Crisis; Supervision; Eurozone; European Banking Union.

## Resumen

El objetivo de este trabajo es analizar las principales causas de la crisis financiera española (2009-12). Aunque identificamos la mala gestión de las *cajas* como la principal causa de la crisis, su intensidad se debió a la "guerra de trincheras" entre los principales actores, reforzada por el "poder de inacción" de los grandes bancos españoles (Santander y BBVA). En última instancia, solo la entrada de las instituciones europeas permitió romper el bloqueo. El artículo arroja nueva luz sobre el caso español analizando los factores políticos y económicos que llevaron a la crisis. Además, en vez de analizar la crisis financiera desde una perspectiva puramente nacional, el trabajo hace hincapié en la interacción entre factores internos y europeos. Se cierra con lecciones para la Unión Bancaria Europea que pueden extraerse de la experiencia española.

Palabras clave: España; Crisis bancaria; Supervisón; Zona euro; Unión bancaria europea.

## 1. Introduction

In the initial years of the "great recession", the Spanish financial system was considered a model one worldwide. Indeed, as opposed to many of its European and US counterparts that had to be rescued and bailed out with public funding, Spanish financial institutions had weathered the initial stages of the crisis far more effectively, no financial institutions had to be bailed out, and no public money had to be spent. However, all this changed after 2010 and eventually Spain was forced to request a bailout from its European counterparts in 2012 to rescue several financial institutions, notably most of the *cajas*. This puzzle needs to be addressed.

In order to do that, this article examines the 2009-12 Spanish banking crisis and uses it to extract valuable lessons for the construction of the European Banking Union (EBU). It shows that the crisis was rooted in policies that eroded underwriting standards and weak prudential regulation. In many Spanish *cajas* there was a failure of risk management, especially in the real estate sector, which led to an increase in risky lending and to inadequate levels of capital cushions.

While many actors understood the risk that a potential collapse of the banking system would represent for the Spanish economy, there was a strong sense of complacency because of the prevalent pro-market zeitgeist and due to the fact that the country had weathered relatively unscathed the first phase of the Global Financial Crisis (GFC). This positive performance can be explained by the implementation of a 'dynamic provisioning system', which established counter-cyclical capital buffers for banks. However, these mitigating measures were not enough. The causes of the crisis were of structural nature. Some public officials (congressmen and senators, regional parliamentarians, local authorities, bank supervisors and regulators) understood the risks brewing in the real estate sector, but they had little incentives to change the rules of the game. In other words, the costs of their (non)decisions would potentially materialize in the future but the benefits of looking elsewhere and allowing the party to continue were immediate. Unfortunately, this procrastination meant that Spain's financial sector had to be rescued by the European Stability Mechanism, an external, and more centralized, actor with the means to introduce the necessary reforms.

Therefore, the Spanish case illustrates why regulators and policy-makers need to expand their crisis prevention and crisis-management toolkit and be

ready to act decisively when economic and financial indicators show unsustainable disequilibria, and perhaps more importantly, they need to withstand the political pressures, both at the central and local levels of administration and supervision, that protect the *status quo*. Based on the conceptual devices of the "war of attrition" between key stakeholders when it comes to structural reforms, and the "power of inaction" of the banking sector, especially when the main banks are not affected by the crisis, the political economy analysis that we present in this article highlights precisely how the existence of different public and private actors, with divergent preferences can prolong and worsen financial crises. Had the Spanish authorities acted swifter and more forcefully, the final bill for the taxpayer would have been smaller. Bailing out banks is always unpopular, but in systemic crises resolution and recapitalization through public funds is the lesser of two evils. The alternative, letting the troubled *cajas* fail, would have been a far riskier approach, as it would have likely increased uncertainty about the state of the whole financial sector with likely contagion effects, and it would have also likely led to a full-blown country bailout with far larger negative implications not just for Spain, but also for the Eurozone. Effective crisis resolution and recapitalization, however, require a strong fiscal backstop. And this is as valid for the national as for the European level.

The article begins with a theoretical and conceptual overview, and continues with 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.

## 2. Theoretical framework: war of attrition and the power of inaction

The political economy of economic reform has long been a widely studied topic, both in political science/International Political Economy and in economics. In the 1990s, however, the experience of structural adjustment in Latin America and of Easter European transitions to democracy and the free market allowed scholars to complement their theoretical analyses with vast empirical work (see Haggard & Kaufman (1995), Williamson (1994), Tommasi & Velasco (1996), Rodrik (1996)).

While the political economy literature is broad and often contradictory, and it is frequently split along ideological divides, one key insight from this literature is that domestic political factors are essential in understanding the dynamics of public policy reforms and outcomes. Moreover, when the policies that are required to solve a crisis have redistributive consequences (i.e. they create winners and losers), conflicting domestic interests often make political decisions more difficult and, in certain contexts, block solutions and delay actions (Alesina *et al*. 2006). As Frieden (2015:11) highlights: "Especially in the case of financial crises, delay can be extremely costly. Bad debts accumulate, dragging the economy further and further down and retarding a possible recovery". The Spanish financial crisis is a case in point. It was only solved in 2012 when

the Spanish government requested a bail out from the European authorities. Little was done until that point. Procrastination from 2007 till 2012 meant that banking losses were much larger than if the authorities had intervened earlier on. In addition, by the time the restructuring of the largest institutions took place, the country's fiscal position had severely weakened.

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 and Drazen (1991). Although this model attempts to explain why macroeconomic stabilizations are delayed, its logic applies to the stabilization of the financial sector as well. These authors argue that stabilizations 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 wait the other out. Stabilization occurs when one group has been particularly weakened and it coincides with a political consolidation, with one side becoming politically dominant. As a result, stabilization costs are quite unequally distributed and the most weakened group bears the largest share of the adjustment burden. In the Spanish case restructuring occurred not because one of the key groups was substantially weakened, but because in the context of the monetary union external (European actors) forced policy changes when the Spanish banking crisis threatened the entire euro project.

This brings us to the second pillar of our theoretical framework: the power of inaction, as developed by Woll (2014). She explains that we need to take into account but go beyond the lobbying capacity and institutional centrality of the banking sector in order to understand the massive bailouts of the financial system that happened in Europe and the US after the GFC. Of course, the institutional importance of the banking sector is key in any capitalist society and therefore it will always receive special treatment from politicians, particularly in the baking-based financial systems predominant in Continental Europe, including Spain. Thus, the financial sector has structural power because the state depends on it. But the influence of the banking system is broader than that because it translates into productive power. As Woll (2014:51) explains, "the most important effect of revolving doors is not that public officials are more likely to grant political favors to former colleagues, as is widely believed. It is the production of worldviews, meanings, and interpretations that develop from shared experiences". This is what Lukes (2004) has broadly defined as preference-shaping.

The importance of the banking sector for the society develops through this socialization process and, ironically, in moments of crisis it is reflected not so much in the capacity of the bankers to proactively determine outcomes but rather in that they can afford to act passively in the war of attrition between the key stakeholders because they know that the Government will step in to stabilize the sector. This is essentially the power of inaction. Again, we draw here on Woll (2014:58-9):

> During a banking crisis, neither the financial industry nor the government wants to see the economy collapse. But if the financial industry

> knows that the government will not let this happen, their best strategy is to be uncoordinated and benefit from a bank bailout scheme financed entirely through the public budget. [In other words], because of their structural importance the capacity to be collectively inactive determines the degree of domination of a small banking minority over the general public.

After analyzing the six banking bailouts in the US, UK, France, Germany, Ireland and Denmark, Woll comes to the conclusion that private participation (and therefore a fairer burden sharing) in the rescue operations was higher where the biggest banks were threatened by the crisis, this was specially the case in France and Denmark, and less so in the US, UK and Germany, being Ireland a special case because of its overblown financial sector in relation to its national GDP. This leads her to state: "what is pivotal is the health of the leading financial institutions. If the most significant ones or a significant portion of a country's financial industry has no need for government support, individually, this is likely to lead to collective inaction. The healthy institutions can simply walk away from the negotiation table" (Woll, 2014:172). We argue below that this is precisely what happened in Spain given that in this particular case the small *cajas* were in trouble while the national giants Banco Santander and BBVA were not. This means that comparatively speaking Spain is quite a unique case if one looks at the countries studied by Woll.

## 3. The evolution of the Spanish banking system in the context of the crisis

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.

The banking crisis in Spain was deeply intertwined with the boom of the real estate sector. The uniqueness of the Spanish housing boom was the consequence of the interaction of a number of economic, social and demographic factors. Housing demand, the motor of the boom, was triggered by population growth (driven primarily by the baby boom of the 1960s-70s, and immigration, which reached 3 million people in the 1990s), employment generation (the participation rate grew driven by women integration in the labor market, and between 2001 and 2006 employment increased by 3.6 million jobs), the increase in the number of households (32.2% between 1996 and 2006; from 12.2 to 16.1 million households), as well as the increase of per capita income and favorable financial conditions. Furthermore, the scale of foreign involvement in the housing market far exceeded any other experience in Europe. Finally, an important driver of Spanish housing demand was the expectations of

substantial capital gains in an environment of cheap and easy borrowing that followed Spain's entry into the Eurozone (i.e. in the early 2000s 87% of households' wealth was held in property). Not surprisingly, supply reacted in a very flexible manner and Spain witnessed historic levels in residential construction funded by banks.

Unlike many other countries in the European Union (EU), Spain embarked, through its banking sector, in a lending spree fueled by the European Central Bank's (ECB) lax monetary policy that ended up in the housing bubble and the subsequent deep recession (Huerta de Soto, 1997, 2006). As noted by Agnese and Hromcová (2016) there was an important misdirection of resources into the construction industry during the pre-crises years mainly fueled by excessively low real interest rates**.**

Indeed, 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, 2013). Lending to non-financial corporations (NFCs) was high in Spain, especially by the *cajas*, and it included a large proportion of property developers (see Table 1)

Table 1: Spanish bank loans distribution by customer segment of economic activity

| | September 2007 | October 2008 , |
|---|---|---|
| TOTAL LOANS (million of euros) , | 1,747,148, | 1,907,070, |
| SEGMENT OF ECONOMIC ACTIVITY, | | |
| General government, | 41,022, | 46,401, |
| Other resident sectors | 1,706,126 | 1,860,669 |
| **of which*: Industry | *140,332* | *155,481* |
| Construction | *150,341* | *156,363* |
| Services | *594,243* | *667,233* |
| Households (consumption) | *768,197* | *816,752* |
| * *of which* mortgages | *577,337* | *617,904* |
| **Agriculture | *25,085* | *26,593* |

Source: Bank of Spain (2008). *Statistical Bulletin 2008 (December)*, Section B: Breakdown of lending and deposits of credit institutions, quarter, pp. 57-61 (from Quaglia and Royo 2015)

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 (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.

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. Securitisation weakened credit risk controls in the years leading to the crisis in Spain, but also across Europe (Carbó-Valverde *et al*., 2011:11). 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 securitization, 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. This led to systemic risk undervaluation.

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.[1] 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 profits (usually over 20%) to social causes.

The *cajas* became the instrument to fund the many real-estate projects that created the prosperity that helped local government officials get re-elected (Santos, 2014). They were regulated by both the national government and by regional governments, and the Bank of Spain had limited supervisory competences over them. This complicated their oversight, and interference from political stakeholders also adversely affected their financial stability. The politization of the *cajas* was a crucial issue to explain their actions in the years prior to the crisis. The more politicised the leadership, the worst their performance (Garicano, 2012).[2]

### *Enter the global financial crisis*

Initially, after the bankruptcy of Lehman Brothers in September 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 recapitalization. This positive performance can be explained by the implementation of a 'dynamic provisioning system', which established counter-cyclical capital buffers for banks (García-Herrero & Fernández de Lis, 2012). The central bank also prevented banks from developing highly complex and synthetic off-balance sheet activities, which sunk banks elsewhere.

[1] The IMF split Spanish banks into two categories drawing a distinction between the *cajas* and the commercial banks, which up to this day have not received any public 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.

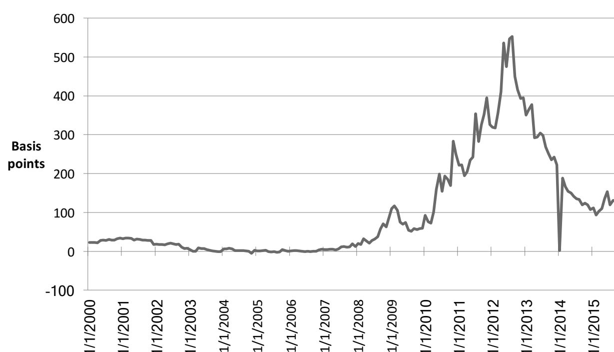
[2] Cuñat & Garicano (2009) have shown that *cajas* with politically connected chief executives with no previous banking experience and no graduate education did substantially worse in the run up to the crisis.

In late 2009, however, 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 *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.[3] 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*, exposed the weaknesses in the policy and regulatory frameworks, as well as the sector's over-reliance on wholesale funding. 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 plummeted. At that point, Spanish financial institutions accumulated €405 billion in loans associated with the real-estate sector given to developers and companies, and, almost half of them were classified as troubled assets by the Bank of Spain.[4] As credit dried up, it affected the liquidity of the *cajas* 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.

By June 2012 the situation had become untenable and Spain, whose borrowing costs had skyrocketed, 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 (see Graph 1).

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




Source: Bloomberg.

[3] Of the 9,000 branches opened by the *cajas* between 1985 and 2004, almost 70% of them were established outside of their original Autonomous Community.
[4] 'España, duda permanente', *El País*, 20/V/2012.

The Eurogroup offered to bail out the financial system with up to €100 billion, of which €42 billion ended up being used. Spain had adopted several financial reforms, but the conditionality attached to the rescue triggered the most aggressive one, which included 32 specific measures to clean up the financial system. Insolvent banks were recapitalized, a "bad bank" was created and the process of mergers and acquisitions was completed, reducing the number of *cajas* from 45 to nine (which by now are almost all banks, see Table 2). Finally, the European bail-out established the bail-in of some junior creditors. It was the first time that haircuts to creditors were used in the crisis, and it was subsequently used in the Cyprus bail-out, and latter incorporated into the rules of the EBU.

By 2015 access to credit was largely restored. 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' in the future.

## 4. The political economy of the Spanish banking crisis

As seen in the previous section, multiple reasons explain the intensity of the crisis. After the first more chronological part, this section attempts to make sense of these developments by exploring the political economy of the Spanish banking crisis. By mapping 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 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.

### 4.1 Actors, incentives and preferences

A striking factor of the Spanish banking crisis was the delay in taking key decisions. 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. As mentioned above, the Spanish case contrasts with the US, UK and German cases studied by Woll (2014) 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 bailout 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 epicenter of the European storm in a period where most large western countries had already restructured their banking sectors, the Spanish crisis received more attention and ended up being more costly than if it had exploded earlier.

Table 2. Evolution of the main Spanish banking groups, 2009-14

| Integration Processes | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Santander | | | | | | SANTANDER |
| BBVA | | | | BBVA | | BBVA |
| Caixa Sabadell<br>Caixa Terrasa<br>Caixa Manlleu | | Unnim | *Unnim Banc | BBVA | | BBVA |
| Caixa Catalunya<br>Caixa Tarragona<br>Caixa Manresa | | Catalunya Caixa | *Catalunya Banc CX (1) | | | BBVA |
| La Caixa<br>Caixa Girona | | La Caixa | *Caixabank | Caixabank | | Caixabank |
| Caja Sol<br>Caja Guadalajara | | Caja Sol | | Caixabank | | Caixabank |
| Caja Navarra<br>Caja Burgos<br>Caja Canarias | | Banca Cívica | Banca Cívica | Caixabank | | Caixabank |
| Banco de Valencia | | | Banco de Valencia | | | Caixabank |
| Caja Madrid<br>Bancaja<br>Caja de Ávila<br>Caja Segovia<br>Caja La Rioja<br>Caixa Laietana<br>Caja Insular de Canarias | | BFA-Bankia | | | | Bankia |
| Banco Sabadell<br>Banco Guipuzcoano | | Banco Sabadell | | Banco Sabadell | | Banco Sabadell |
| Caja de Ahorros del Mediterráneo (CAM) | | | Banco CAM | | | Banco Sabadell |
| Banco Gallego (NCG) | | | | Banco Gallego | | Banco Sabadell |
| Banco Popular<br>Banco Pastor | | | | Banco Popular | | Banco Popular |
| Unicaja<br>Caja Jaén | | Unicaja | | *Unicaja Banco | | Unicaja Banco |
| Caja Duero<br>Caja España | | Caja España de Inversiones | | *Banco CEISS | | Unicaja Banco |
| Caja de Ahorros Inmaculada CAI<br>Caja Círculo Católico de Burgos<br>Caja Badajoz | | Caja 3 | *Banco Grupo Caja 3 | | | Ibercaja Banco |
| Ibercaja | | | | *Ibercaja Banco | | Ibercaja Banco |
| Kutxa<br>Caja Vital | | | | Kutxabank | | Kutxabank |
| BBK<br>CajaSur | | BBK<br>CajaSur | | Kutxabank | | Kutxabank |
| Bankinter | | | | | | Bankinter |
| Banco Etcheverría (Grupo Apollo) | | | | | *Evo Banco | Abanca |
| Caixa Galicia<br>Caixa Nova | | Novacaixagalicia | *NCGBanco | | | Abanca |
| Caja Murcia<br>Caixa Penedés<br>Caja Granada<br>Sa Nostra | | Mare Nostrum | *Banco Mare Nostrum BMN | | | BMN |
| Cajastur<br>CCM | CCM<br>Cajastur | | Liberbank | | | Liberbank |
| Caja Cantabria<br>Caja Extremadura | | | Liberbank | | | Liberbank |
| C.R. Cajamar | | Grupo cooperativo Cajamar | | | CRU-Cajas Rurales Unidas | G.C. Cajamar (2) |
| C.R. Mediterráneo | | Ruralcaja | | | CRU-Cajas Rurales Unidas | G.C. Cajamar (2)<br>*Banco C.S. Cooperativo |

Intervened by Bank of Spain | Capital controlled by FROB (Fund for Orderly Bank Restructuring) | Integration | SIP | * Establishment of bank

(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

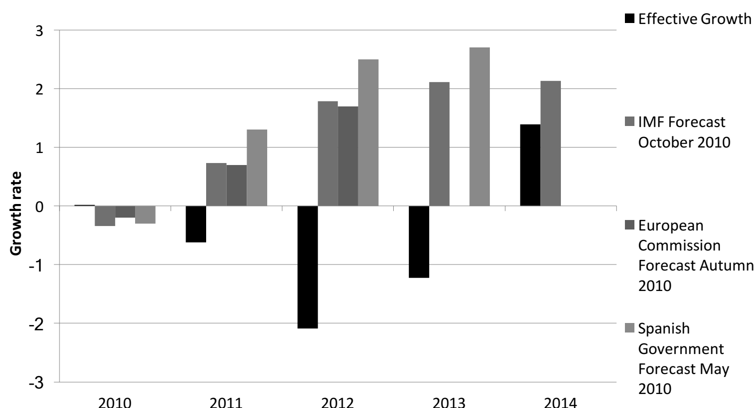
Two different governments, one from the centre-left Partido Socialista Obrero Español (PSOE) led by José Luis Rodriguez Zapatero and the other from the centre-right Partido Popular (PP) led by Mariano Rajoy, were in power during the global financial crisis, its aftermath and the restructuring of the Spanish financial system. The policies implemented by both throughout the crisis reflected the intention of minimising the use of taxpayer's money to bail out banks. 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 rigor" (*Expansión*, 2008).

Another important motivation that guided 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. These were seen as examples of good supervision at the G-20 meetings in 2008 and 2009. Thus, recognizing the vulnerabilities of the system could have generated a loss of prestige for Spain vis-ã-vis the international community when the country was undertaking intensive diplomatic efforts to become a permanent invitee to the G20 meetings. Furthermore, 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 (see Graph 2), the government had a strong incentive to expect that there would not be a double-dip recession in Spain (as it finally did). The hope was that a more positive external environment would be conducive to the rolling over of debt and reduce the amounts of bad loans within the *cajas*, inducing the Government to favor the process of mergers and acquisitions instead of recapitalization or resolution. This strategy was also supported by the idea (widely held at the Government and 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).

A second crucial actor was the Bank of Spain, whose strong credibility was seriously undermined by the Spanish banking crisis, especially in its latest stages, when it was decided that the recapitalization 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 is statutory independent. However, as is the case with other independent Spanish institutions, for key decisions it operates under political pressure from the Government. For instance, when Governor Jaime Caruana was at the helm its staff alerted about the formation of a real state bubble between 2000 and 2006 due to excessive credit growth, but no decisive action by 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

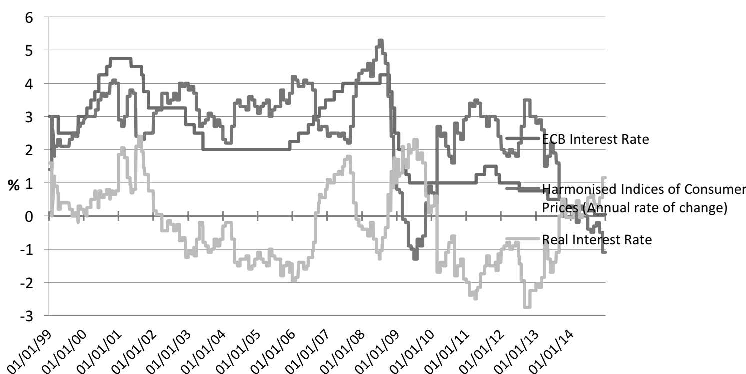
as a consequence real interest rates were negative in Spain for several years in the run up to the crisis (see Graph 3). Later in the process, when real solvency issues started to emerge in some *cajas*, the Bank of Spain was finally compelled to act. That was the moment when it launched a process of consolidation of the *cajas*, but unfortunately its assessment tended to underestimate the capital needs of the troubled institutions.

Graph 2. Spanish economic growth as forecasted in 2010




(1) The Forecasts of the European Commission only ran to2012.
(2) The forecasts of the Spanish Government only ran to 2013.
Sources: International Monetary Fund, European Commission and Spanish Government.

Graph 3. 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. Their main goal throughout the war of attrition of 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, 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. The attrition war was constant.

Conversely, the big banks, especially Santander and BBVA, had relatively solid balance sheets and good management. Even though they were also exposed to real estate, they had lower levels of non-performing loans, and their international expansion ensured a diversified base for profits, which proved crucial for maintaining stable cash-flows throughout the crisis. Their main goal was to maintain their credibility and to show investors that their business model was distinct from that of the *cajas*. Given their size and influence, the government considered essential to isolate them from the solvency problems of the rest of the system. This meant that the financial reforms aimed at increasing capital requirements were always done with the goal of not compromising their solvency. In addition, in order to protect their balance sheet, their involvement in the mergers and acquisitions process was limited. They were not asked, as in the US case, to participate in the bailout of weaker institutions, nor were they required to take public funds. They could essentially utilize their power of inaction.

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 bailout 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.

### 4.2 Turning points

Throughout the crisis, there were a number of key decisions (most of them mistakes) that determined the future evolution of events.

*(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. Total capital needs in the banking system ended up being around €150 billion (de Juan *et al.* 2013). Over €60 billion were provided by taxpayers, of which almost €42 billion euros came from the European bailout. The rest was recapitalization through private capital. Confusing liquidity with solvency led to wrong decisions that ended up dramatically increasing the final bill for the taxpayer (by far the weakest actor in this game). 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 ECB had been providing liquidity 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, 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 reinforced the power of inaction of the big banks.

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 overcome 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 pursue a strategy of 'wait and see'. Needless to say that in this war of attrition game, the *cajas* were more than pleased to play along because it enabled them to continue with business as usual, the local and regional governments were also happy because they would remain in control, and BBVA, Santander and CaixaBank were also content because they did not have to contribute to solve the problem. 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 turned into a policy of 'extend and pretend', intensifying even further the war of attrition game. 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. Not all was inaction, though. Positive decisions during this period included the creation of the FROB (a fund created by the government to recapitalize banks) 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. 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 a non-Galician player: 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 bailout. 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.

*(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 hidden for years by abundant liquidity. At that point, the Bank of Spain took the lead in proposing a number of mergers between the different *cajas*.[5] 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, but to a much lesser extent than before. Inaction was rather prevalent.

The Government agreed with the strategy, as it was expected that larger and stronger institutions would be more capable of attracting private capital once they became private banks. This approach also diluted political tensions, since each *caja* would maintain its brand name, which was something in which regional governments had insisted. Varying degrees of public funds or guarantees (through FROB and the Insurance Deposit Fund) were used in the process.

However, since there was a failure in recognising that 'a good recapitalisation of the banking system is not spending, but an investment' (De Juan *et al.*, 2013:201), the reluctance to fully anticipate losses and calculate capital needs before the mergers took place led to increased problems. The big banks, exercising their power of inaction, were reluctant to buy and the 'good *cajas*' were not good enough, so when they were merged with the 'bad *cajas*' the results

[5] The strategy was based on 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 or centralising costs to increase efficiency.

were large weak banks that did not offer sufficient trust to private investors. In addition, the European debt crisis worsened, thus prompting a second recession in less than two years. The consequent 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*, which went public in July 2011. 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 (former 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. Finally, Bankia declared insolvency, and ended up requiring a €24 billion capital injection that prompted the Spanish €100bn banking bailout by the European Stability Mechanism (ESM) in mid-2012.

*(c) Grey areas of the bailout*

The European bailout marks a turning point. Only when the European Commission, the ECB and the ESM enter the game and the MoU is signed, is there decisive action to pursue an 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 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 (the MoU included 32 specific actions).

The bailout can be regarded largely 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, as noted by Royo (2015), 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; and unemployment remains still very high (18% in 2017).

One of the most controversial issues of the bailout 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, which subsequently became one of the pillars of the EBU and was also a cornerstone of the Cyprus bailout in 2013. 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. Again the burden of these costs fell on the tax payer.

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. As De Juan *et al*. (2013: 155) put it: 'during banking crisis, it is unavoidable to adopt repugnant measures, but the consequences of not doing it are even more repugnant'. Full bailout is probably a case in point.

## 5. Conclusions: Spanish Lessons for the European Banking Union

After presenting the theoretical framework of our research, the chronology of the Spanish banking crisis and our analysis from a political economy perspective, in this final section we summarise the conclusions that can be extracted from the Spanish experience for the newly created EBU.

In many ways the reforms implemented to deal with the financial crisis in Spain are not unique. As in many other countries, Spanish banks have been forced to take on more capital and liquidity, and shrink their balance sheets. At the same time, new rules have been put in place to constrain banks' risk-taking, which have placed limitations around their activities, and there have been changes to their operations and governance (i.e. the *cajas*). In this regard, the changes after the crisis are in many respect consistent with demands from some scholars for treating banks more like public utilities that provide a service to society and that therefore should be regulated more heavily (Molyneux 2017). According to this view, big banks have all the features of public utilities: there is a growing trend towards natural monopoly, evidence of regulatory capture, and rent-seeking and cross-subsidization are widespread. Hence, this justifies increasing regulation, that should cover not merely financial features like capital of liquidity, operations and governance, but also their pricing and returns. All this would reduce the likelihood of excessive bank risk taking.

Yet, there are still elements that made the Spanish case unique and required different responses. For instance, one of the biggest problems in Spain was the dual regulatory framework that existed for the private banks and the *cajas.* This required specific reforms to align the operations and governance of the *cajas* with that of the banks.

### 5.1 This time was no different…

As Reinhart & Rogoff (2009) have demonstrated, banking crises are as old as capitalism and patterns are repeated. The feeling during the euphoria phase

preceding any systemic credit crisis is that 'this time is different' and that this is a new era of permanent growth and ever-rising asset prices. In principle, Spain should have learnt from its past. It experienced unsustainable real-estate bubbles and consequent banking crises in the 1980s and 1990s and thus it should have been prepared for this 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 global financial markets are efficient (Wolf, 2014). The productive 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, was one of the main causes of the crisis (Woll 2014). The majority of analysts presented Spain's spectacular growth during the first years of the 2000s as a role model. The Spanish sovereign had a credit rating of AAA and most Spanish banks and their securities also received the same top credit assessment. This let many people 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, tried to build barriers against the rising tide. Since 2003 it recognised that house prices were up to 20% overvalued (BdE, 2003) and explicitly warned the Spanish banks about their excessive leverage and their overexposure to the real-estate sector. Its actions went beyond mere advice by introducing countercyclical dynamic provisions (which are now seen as the start of 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 international fora and by the European Commission for these provisions because they went against the international Basel II supervisory and accounting consensus of in-house modelling and risk-assessment by the banks. The debate back then was not whether the Bank of Spain should reduce or increase the provisions, but rather whether it should enforce them at all.[6]

Two more features of previous crises were apparent in the Spanish crisis. The first relates to the structural power of the 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 degree of national pride is always involved in this doom-loop, hindering a speedier reaction. This hesitation connects with the second oft-repeated pattern.

[6] This aspect was highlighted by several former senior officials from the Bank of Spain interviewed for this research.

Usually, public authorities intervene too late and, hence, get the timing wrong and consequently make the final bill bigger. This is especially the case when none of the big banks is in trouble, as happened in Spain. At the time of writing (March 2017), the Spanish taxpayer has only recovered 5% of the bailout funds, and the Bank of Spain has already recognised that €26 billion (roughly 2.6% of Spanish GDP) will be lost for ever (Barrõn 2016). In order to regain quickly the confidence of domestic and international market operators and to avoid even bigger losses for the taxpayer it is better to act boldly and fast in restructuring and recapitalising the banks. 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 to transform the *status quo*.[7]

Thus, the first conclusion 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.

## 5.2 Regionally fragmented oversight is problematic

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 and the *cajas*. Proper *in situ* supervision of the *cajas* by the Bank of Spain only occurred from 2008 onwards when the global financial crisis started. 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 Bank of Spain started with its strategy to encourage the *cajas* to voluntarily merge with each other, not only was there little appetite by the big banks to step in (utilising so their power of inaction); local and regional politicians started to oppose the mergers on electoral and identity grounds too.

Parochial attitudes of defending 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 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 and that when the biggest banks are not affected by the crisis a private sector solution is more difficult to achieve. Identity politics might also be a problem when it comes to resolving one of the 130 big banks, most of them national champions. The European resolution mechanism remains an intergovernmental construct, hence

[7] The 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.

it has to be seen whether at times of crisis, when public scrutiny is at its highest and nationalistic feelings are running high, a smooth resolution and take-over of a big bank from France and Germany by a rival bank from Italy, for example, would be possible.

In this case, the lesson that we draw 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 parochialism of regional politicians.

### 5.3 A bigger 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 a bail out, 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 (Goodhart 1998).

Unfortunately, the euro is still an orphan currency without a state, and this makes it a fragile construct (Otero-Iglesias 2015). The EBU is a half-built house. It has a single supervisory mechanism, a common (not a single) resolution mechanism and it still lacks a single deposit guarantee scheme. For a considerable number of policymakers in the creditor countries, especially in Germany, the bail-in regime should be enough to withstand future crises. This view seems to overlook the history of finance. The bail-in framework, under which the creditors pay first and the taxpayers pay 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.

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 that. Although it also demonstrates how difficult it is. The most likely scenario is that politicians will look at the problem and be afraid of provoking uncontrolled bank runs and panic. In order to avoid this they will need to bailout 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 it is important to have as few veto players as possible so that action can be taken in one weekend to avoid further market panic. Here again, the European reso-

lution 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 on this matter, might have to clean up the mess left by elected politicians. This is a sub-optimal arrangement.

Ultimately, as noted by Quaglia (2013), "the EU is still poorly equipped to deal with (or to prevent) future financial crises mainly because of the political constraints encountered during the reform process." In this regard, one of the most important lessons that we draw from the paper is that political factors are as important as (if not more important than) economic factors in shaping financial reforms and supervision both in member countries and in the EU. 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.

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