

Some Lessons Learned from the Spanish Financial Crisis

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Abstract

During the last years, several countries around the world have been harmed by financial and economic crisis. Although there are some lessons we can learn from the global financial situation, there are some particularities that need to be studied from each country. This paper analyzes in detail the role played during the last ten years by some of the main bodies that constitute the financial system in Spain, namely: the Spanish banking system; the regulatory financial system and the economic agents in Spain. After a deep analysis of the role that each of them has played to contribute to the Spanish property bubble, some lessons can be learned, among them: 1) a need to increase Spanish banks efficiency; 2) a need to increase financial transparency and regulation and, maybe the most important, 3) an urgent need to change economic and social policies aiming to incentivize a culture of entrepreneurship, innovation and competitiveness.

Keywords: financial crisis, Spanish banking system, transparency, regulation

JEL codes: G01; G18; G21; G24; G28

1. Introduction

During the last years, several countries around the world have been harmed by financial and economic crisis. It was on September 2008 when the global financial disaster was unavoidable: on September 7th, Fannie Mae and Freddie Mac announced to be nationalized; on September 14th, Lehman Brothers filed for bankruptcy while Bank of America announced to buy Merrill Lynch; on September 16th, the Federal Reserve attempted to rescue the American International Group (AIG) by creating a \$85 billion credit facility to prevent it from collapse. The same day, U.S. President George W. Bush announced a \$700 billion financial aid package. On September 28th, Fortis was semi-nationalized by Belgium, Luxembourg and Netherlands; on September 29th, Iceland nationalized Glitnir. That month was just the beginning: the list goes on and on.

The costs and consequences of the global financial crisis of 2008 have not yet been completely quantified. To have an idea, Swagel (2009) accounted the economic cost for the United States financial crisis as trillions of dollars plus millions of jobs lost. Even worst, since then until now, financial aid packages and bailouts granted from the International Monetary Fund and the European Central Bank to some Euro-zone countries do not cease to increase, leaving an endless nightmare to all participants of the economy: governments, households and corporations on all economic sectors. Financial regulatory reforms, austerity government programs and privatizations of some public services have not been good enough to boost the economy to levels reached before the crisis.

Although general lessons from the global financial crisis have been drawn, see for example Crouhy et al. (2008) and Goddard et al. (2009), some particularities need to be analyzed from each country. This paper summarizes the causes and consequences of the Spanish financial crisis, the lessons learned and the reforms that still need to be followed.

The paper is structured as follows. Section 2 analyzes the role played by some of the main bodies that constitute the financial system in Spain: the Spanish banking system; the regulatory financial system and the economic agents in Spain. Section 3 discusses the main lessons and recommendations addressed specifically to Spain: 1) a need to increase banks efficiency; 2) a need to increase financial transparency and regulation and, maybe the most important, 3) an urgent need to

change economic and social policies aiming to incentivize a culture of entrepreneurship, innovation and competitiveness.

2. Causes and Consequences of the Spanish Financial Crisis

As pointed by Goddard et al. (2009), the Spanish banking system, unlike other countries, has been distinct by two important features that have been acted as a shield against more financial serious damages. The first feature concerns the dynamic provisioning regime introduced in 2000 with the goal of reduce pro-cyclicality of bank lending. The second feature was the abstention of most Spanish banks unlike USA banks for instance, from creating the so-called Structured Investment Vehicles (SIV). However, the Spanish financial system has been seriously weakened due to the collapse of the real state bubble. Almost all commercial and savings banks in Spain have held high levels of loans granted to builders and households as mortgages. The number of non-performing loans ratios continue to increase while capital buffers continue to decrease dramatically. Mortgage lending to households has been excessive, but what it seems to be of more concern is that loans to builders and property developers are much more higher which makes Spanish banks to be heavily risk-exposed, and low liquid, especially savings banks. For that reason, the new government rule of 2011 created the Fund for Orderly Bank Restructuring (FROB) which mandate is to restructure savings banks.

2.1 The Dynamic Provisioning Regime

On July 1st 2000, in addition to the generic and specific provisions already required by supervisors, Spain adopted a new regulation based on dynamic provisioning, also called statistical provision. Under this scheme, the necessarily provision for loans losses are built at the inception of the loan because loan losses risks exist from the very moment the loan is granted. This risk should be reflected on the risk premium included in the price of credit, which is also reflected in the income stream since the beginning of the loan, allowing to build-up the provision for loan losses during the whole grant period. This strategy was overwhelmed by the European Central Bank as an excellent mechanism to reduce pro-cyclicality of bank lending as it was emphasized in Trichet (2009) speech.

Fernandez et al. (2001) stress that "this mechanism should reduce the cyclical behavior of loan loss provisions, correcting the resulting bias in the profit and loss account, decreasing bank profit volatility and improving bank managers' awareness of credit risk. This provision should also be regarded as a mechanism to overcome the coordination problems of individual banks at the peak of the cycle and to reinforce medium-term bank solvency".

Under the new system, (see Poveda (2000) and Bank of Spain (1999) for a full description of the methodology), annual total provision consists on the sum of generic, specific and statistical provisions. For those Banks that did not develop their own internal credit risk models, a standard approach was assigned, based on a set of coefficients established by the regulator.

A latent risk measure is defined as $L_r = s * L$, where s denotes the average risk coefficient to be between 0% and 1.5% and L denotes total loans. Coefficients correspond to the risk level categories provided in Table 1. An important drawback of the system is precisely that the risk classification is static falling to capture the evolution of risk over time. For instance, during the current recession period, mortgages may not been classified as "low risk", neither public sector as "without risk". Another important drawback of the methodology is that risk classification relies on the grades rating agencies attribute to them, which may result on a conflict of interest problem.

2.2 The Structured Investment Vehicles

Spanish banks have been characterized by pursuing a traditional retail banking model. The regulatory and supervisory authorities at the Bank of Spain stipulated that Structured Investment Vehicles (SIV) to be consolidated have to satisfy some capital and provisioning requirements. As a result, unlike other countries, Spanish banks did not create an off-balance sheets structure neither were contaminated with the so called financial derivative toxic products. Indeed, during 2007 and 2008, the two largest Spanish banks, BBVA and Banco Santander, wrote off smaller proportions of their loans portfolios than many of their European competitors.

Table 1: Risk Categories

	CATEGORY	s %	RISK DESCRIPTION
1	Without risk	0.0%	Risks involving public sector
2	Low risk	0.1%	Mortgages with outstanding risk below 80% of the property value Firms whose long-term debts are rated at least A
3	Medium-low risk	0.4%	Financial leases Other collateralized risks
4	Medium risk	0.6%	Risks non mentioned above
5	Medium-high risk	1.0%	Personal credits to finance purchases of durable consumer goods
6	High risks	1.5%	Credit card balances, current account overdrafts credit account excesses

Source: Fernandez et al. (2001).

2.3 The Spanish Property Bubble

Although dynamic provisioning mechanism prevented Spanish banks to fail at the very beginning of the crisis, most of the loans quality were deteriorated due to the highly dependency on the real estate sector. Several factors contributed to create the property bubble. In one hand, low interest rate levels and tax-benefits encouraged households to demand mortgages; on the other, short-term profits incentivized bank managers to grant loans even knowing that the borrowers would not be able to repay unless real estate prices continued to grow incessantly. During this granting process, risk was not transferred outside the banking system, but was rather largely absorbed by the banks themselves directly through their trading book.

The financial stability report of the Bank of Spain (2011) emphasizes that the downturn in the real economy impacted Spanish banks directly to their balance sheets, in particular those assets linked to the real estate development sector. In a European report, IMF (2011) declared that growth in the current account deficit was increased driven by sectors such as construction and financial intermediation. Economic growth was not a result of the industry sector. Bank of Spain (2011) pointed that real estate sector is not expected to recover significantly in the coming months due to the weakness of the real economy and the difficulties on funding markets, and to the natural reduction of debt by Spanish households and firms following its notable increase during the economic boom years. Resident private sector doubtful assets are growing less sharply than in previous years, although in the closing months of 2010 there was a slight rise in this variable. As a consequence of this process, banks have been required to be restructured.

2.4 The Fund for Orderly Bank Restructuring

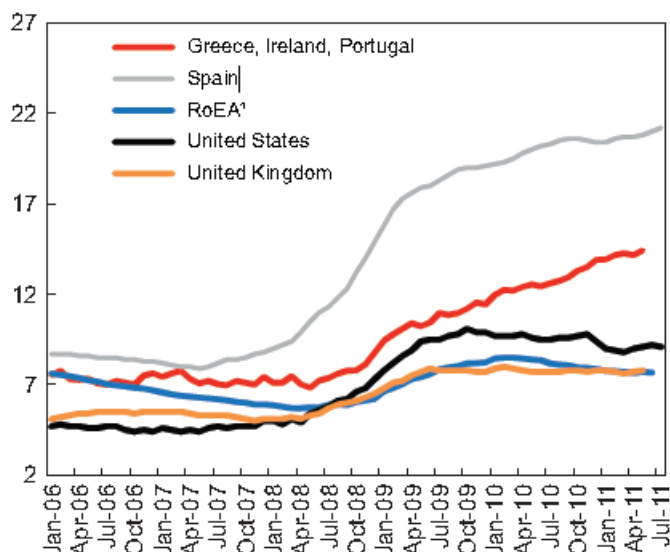
The Fund for Orderly Bank Restructuring (FROB) was created by the Spanish Royal Decree-Law 9–2009 as a mechanism to help banks to be restructured. Since the new law requires Spanish banks to operate with core capital ratios around 8% to 10%, some banks, mostly savings banks, have needed to be restructured in order to be able to raise the mandatory capital. The purpose of the savings banks restructuring was to provide the necessarily law conditions to encourage and promote the entry of private investors with fresh capital, aiming to make bank management to be more efficient by imposing a market discipline over banks.

The restructuring plan was not free of cost. On March 2010, FROB agreed to give financial support to several savings banks (Caja Manlleu, Caja Sabadell, Caja Terrassa, Caja Catalunya, Caja Tarragona, Caja Manresa, Caja Duero and Caja España) for an amount that exceeded two billion of euros. Three months later, on June 2010, FROB agreed to finance the integration process of several savings banks in a form of mergers and acquisitions, which had a cost amount of 8 billion of euros. (See www.frob.es for a summary of capital injections financed by the FROB).

Unfortunately, those measures have not been enough to boost the Spanish economy which unemployment rate remains the highest among the European countries and USA since 2007 and has reach exorbitant levels of 20% as it is showed in Figure 1. Again, the high degree of dependence that

has been put in the construction sector has made the process of reviving the economy as a painful one or nonexistent at all.

Figure 1: Selected European Countries and the US: Unemployment Rate.



Source: IMF (2011) Regional Economic Outlook. Europe Navigating Stormy Waters

Under a new attempt to activate the economy the recent Spanish Royal Decree-Law 2–2011 and 9–2011 establish a set of measures looking forward to reinforce the financial system through a new recapitalization plan and new regulations concerning the corporative government of the financial institutions.

3. Some Lessons Learned from the Spanish Financial Crisis

Despite the efforts of banks to convince regulators about the solidity of the Spanish banking system, five Spanish banks (Banco Pastor, Caja de Ahorros del Mediterraneo, Catalunya Caixa, Unnim and Caja3) failed the stress tests performed on July 2011. Regulators found that these banks didn't have enough capital in case an adverse scenario would arrive.

The story is repeated again and again: inject capital to rescue banks that have been poorly managed is not the solution. What should the Spanish banks need to do to pass the stressing tests? What does Spain have learned three years after financial crisis started? What remains to be improved and solved? Some lessons can be learned, among them: 1) a need to increase financial transparency and regulation; 2) a need to increase Spanish banks efficiency; and, maybe the most important, 3) a change on economic and social policies aiming to incentivize a culture of entrepreneurship, innovation and competitiveness.

3.1 A Need to Increase Financial Transparency and Regulation

International financial authorities such as the International Monetary Fund, the European Central Bank, the World Bank, the Organization for Economic Co-operation and Development and the Bank of International Settlements, have strongly recommend that:

- The financial resources provided by the FROB should be seen as a temporary support to help banks to be restructured and become stronger, but not as a replacement of financial market participation.
- Savings bank governance must be improved by increasing the number of independent members on executive boards and reducing political representation avoiding corruption issues.
- Banks must continue building up capital, liquidity, and provisions in line with emerging international best practices. Provisioning must take into account cyclicity: buffers have to increase in good times to provide sufficient support when cycle turns.

- Stress test, their methodology and data employed should be fully disclosed, in order to strengthen market confidence. Relevant authorities and institutions should work together to exchange information.
- Transparency should become a permanent feature of the Spanish system. The scope, granularity, and comparability of disclosed information by individual institutions should be improved under the supervision of the Bank of Spain.

3.2 A Need to Increase Spanish Banks Efficiency

Another set of recommendations aiming to improve Spanish banks efficiency are:

- To develop macro prudential policy frameworks. To stimulate research on nexus between financial markets and macro-economics.
- To establish specific requirements on boards of directors concerning their understanding of the use of financial derivatives.
- An urgent need to reform executive compensation. Incentives need to be aligned, all financial agents market participants, traders, loan managers and board of directors, should not be compensated on short-term basis.
- Financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed amount, such that employees would lose their holdbacks if the firm goes bankrupt or receives extraordinary government assistance.

Those recommendations are well known among financial institutions and government regulators; however, they have not been proved to be enough measures to provide a definitive solution to the financial crisis. Indeed, Spanish banks have been re-capitalized through endless bailouts and restructuring mechanism, measures that have been excessively costly to households. Therefore, structural reforms on the economy are required urgently.

3.3 An Urgent Need to Incentivize a Culture of Entrepreneurship, Innovation and Competitiveness

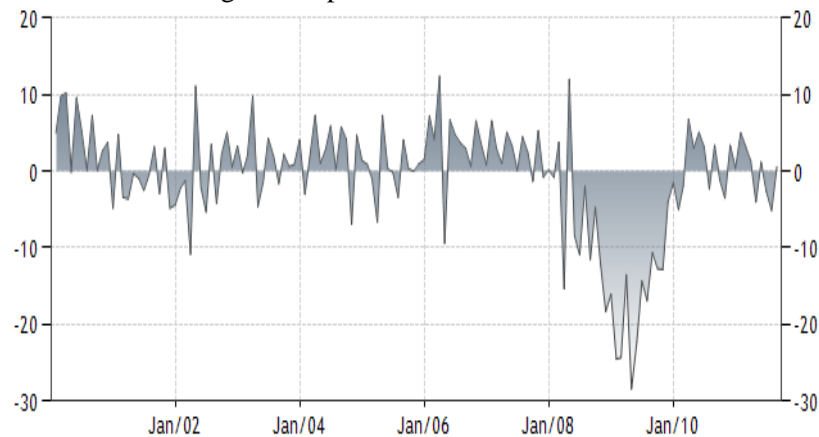
Before the financial crisis started, Pin et al. (2005) already recommended to the government to implement some measures in order to boost Spain's competitiveness. Among them, they pointed that government should increase the investment in R+D+I, adopt a budgetary discipline; promote labor market flexibility and promote investment in emerging countries. Some years later, Trichet (2009) declared that the pattern of growth of Spain was not sustainable: the aggregate demand on real estate supported a wage-setting environment that did not correspond to the underlying gains in productivity.

Investments on productivity growth have been significantly lower in Spain than in other developed countries. As a matter of fact, technological investment drive was undertaken with imbalance between public and private financing according to the report of the Bank of Spain (2009). The public budget for spending on R+D+I showed growth rates of 25% per annum in the period from 2004 to 2008 while private sector spending on R+D+I was almost null for the same period. Indeed, private financing on R+D+I as a proportion of total investments fell from 48% in 2004 to 45% in 2008 which was far from the target of 66% established on the Lisbon Strategy.

Unlike other countries, the booming period that the Spanish economy experienced previous the crisis, did not result on a growth on productivity, innovation, nor competitiveness. As a consequence, the industrial production in Spain was particularly damaged as it is showed on Figure 2.

According to the OECD (2009), the measures adopted by the Spanish government to stimulate demand in the short term attempting to re-activate the economy, consisted on a high spending on public works, a special help to the automobile sector and modernizing basic structures such as transportation, energy, services and telecommunications. Despite the good intentions, those measures failed to meet the targets. As an example, millions of euros funded mostly by taxpayers were wasted in unused infrastructures as the airports in Castellón and Ciudad Real (the Telegraph, October 5th 2011), or the overstock of highways and high speed trains.

Figure 2: Spain Industrial Production



Source: TradingEconomics.com

Some measures aiming to grow innovation and competitiveness on the long term are:

- Support for R+D+I activities. Invest in human capital. Develop research and knowledge in collaboration with companies and institutions. Improve quality of education.
- Banks must grant loans more actively to firms that reduce its costs by implementing new technologies, knowledge or that invest on human capital, which will be translated to competitiveness.
- Companies should aim to achieve a sustainable growth on the long term.
- A reform on the labor market should not wait to allow gain competitiveness.
- Support for innovation, entrepreneurship, investment on small-medium size firms, venture capitals, etc.

3.4 Rethinking the real problem

In addition to implementing the above measures, it is necessary to rethink the problem of the financial crisis by approaching it from a different point of view. Two aspects are of most relevance:

3.4.1 Incentives and cost of failures

Based on the report of the Squam Lake Working Group on Financial Regulation (2010), robust financial institutions should promote economic growth and employment. As it has been seen during the crisis of 2008, this often causes governments to intervene when their financial systems are threatened. The result is privatized gains and socialized losses. Therefore, if the economy does well, owners of banks and managers claim the profits, but if the results are poorly, the society subsidizes the losses. Because the owners and managers of financial firms do not bear the full cost of their failures, they have great incentives to take more risk than they otherwise would. As a consequence, this increases the chance of bank failures, systemic risk, and taxpayer costs.

3.4.2 Instead to shield the financial system against perverse scenarios, get rid of them

Until now, Spanish government, financial regulators and banks have been concentrated on the task of increase capital buffers at any cost in order to signal to investors about their solvability under any possible adverse scenario. In theory, this goal should help to attract fresh capital that may lead to reactivate the Spanish economy. But this argument should be reformulated. The problem should be addressed under a different perspective: the goal should not be the increase of capital to face undesirable adverse scenarios, but rather, the goal should be precisely to reduce the probability that such adverse scenarios could arrive. Therefore, the priority for Spain should be to stop financing banks that have no prospect of covering their capital shortfalls from the market. Spain government should

rather look to finance economic decisions that could make the country to become efficient and competitive aiming to reduce the exorbitant unemployment rate that has reach 21%.

4. Conclusions

This paper has analyzed the role played by the Spanish banking system, the regulatory financial system and the economic agents in Spain how they contributed to the real-estate bubble. It also summarizes some of the lessons learned and some of the measures to be implemented. Among them, the necessity to increase financial transparency and regulation, the necessity to increase Spanish banks efficiency and, maybe the most important, the urgent need to implement structural reforms aiming to incentivize a culture of entrepreneurship, innovation and competitiveness. Without this last measure, banks capitalization is meaningless.

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