Lessons from the Spanish Banking Crisis

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In the first years of the global financial crisis of 2007 to 2009, financial institutions in the United States, the United Kingdom, and Germany were hit harder than those in Spain. But as the crisis intensified, Spain's banking sector could not escape deteriorating economic conditions and the implosion of the real estate bubble. Spanish financial institutions were especially vulnerable due to dependence on wholesale funding, bad lending practices, a weak national regulatory framework, and poor choices by the government and of the Bank of Spain. Spain's membership in the Euro zone, previously a blessing in many regards, magnified the downsides of the financial crisis. Our research seeks lessons from the crisis in Spain to better understand what fueled the global crisis and offer tools and reforms that may help prevent future recurrences.

Roots of Financial Crisis in Spain

Prior to the most recent crisis, Spain had a history of real estate bubbles (the previous one unfolded from 1986 to 1992) and banking crises (the last systemic one happened in 1977-1985, followed by the 1993 nationalization of Banesto, a large private bank). The country's vulnerability led the Bank of Spain to try to limit escalating real estate prices and adopt reforms intended to prevent banks from lending recklessly. Unfortunately, these steps proved insufficient.

Our analysis of the Spanish case confirms a long-standing tenant – financial systems collapse when two things happen: 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. The 2009 to 2012 crisis in Spain was rooted weak regulation and policies that eroded underwriting standards. Many cajas – that is, savings and loans banks – failed to manage risks from unwise lending and thus found themselves with inadequate levels of backup capital.

Although many Spanish actors understood that a potential collapse of the banking system could drag down the national economy, there was a strong sense of complacency because the country had weathered relatively unscathed the first phase of the global financial crisis starting in 2007. Complacency preceded the crisis, because even though the risks were understood by some public officials – including congressmen and senators, regional parliamentarians, local authorities, bank supervisors and regulators – they had little incentive to change the rules of the game. The costs of their inaction might materialize in the future but there were immediate benefits from looking away and allowing risky practices to continue.

What Spain Reveals About Steps to Avert Coming Crises

The Spanish case illustrates why regulators and policy-makers in the European Union, United States and elsewhere need to be ready to act decisively when economic and financial indicators suggest unsustainable factors in financial markets. Perhaps more important, they must be able to overcome differences and outlook

and withstand political pressures to preserve a risky status quo.

Although each case is unique, the Spanish instance makes clear that regulators need to expand crisis management toolkits to be better prepared for any contingency. They can hope for the best, but prepare for the worst. In Spain, regulators claimed that they lacked the tools and authority to intervene with bankers, politicians, and regulators, yet in actuality, once interest rates were determined by the European Central Bank, Spanish regulators could have deployed macro-level tools – for example, raising bank capital requirements, capping loan-to- value ratios, and capping the proportion of large mortgages allowed relative to borrowers' income.

Financial crises are both periodic and inevitable. They are the natural result of the intrinsic instabilities of the capitalist system, and new ones will certainly happen in the future. The Spanish case illustrates that there are political and technical actions governments and civil society can take to minimize the damaging effects of inevitable financial crises.

- **Ongoing supervision of financial institutions is as important as regulation**, yet shared responsibilities for such supervision can falter in the face of political influence and interference from elites at the regional or local level. Spanish savings and loans banks engaged in such influence. Authorities charged with supervision must therefore enjoy full independence and be able to act quickly when a bank of any kind experiences problems paying its debts.

- **Supervisors and regulators must act early on, as soon as problems in the banking sector appear.** Early interventions can reduce the final bill of the crisis and also avoid turning highly leveraged banks into zombie institutions that restrict credit and deepen the national economic recession. In Spain, unfortunately, incentives for delay were built in the system, making the crisis more costly. Multiple veto points, fear of damaging confidence, and reluctance to use public funds to recapitalize banks were crucial causes of delay in the Spanish case. Looking forward, it is essential to develop clear resolution mechanisms, transparent and automatically enforceable, to depoliticize crisis responses and minimize the waste of taxpayers' money.

- Ultimately, the Spanish case shows that a **credible fiscal backstop is crucial for maintaining confidence in the system once a banking crisis happens.** Such a backstop has to be in place and fully funded beforehand, not tossed together amid a deepening crisis. Belatedly in the recent crisis, Spanish authorities created the Fund for Orderly Bank Restructuring, because the Deposit Guarantee Fund previously used to inject funds into troubled savings and loans banks had run out of resources. They also had to request external assistance because markets perceived that the Spanish Treasury would not have the capacity to recapitalize the banking system. Clearly, a hefty fiscal backstop should have been in place prior to any crisis – not only to maintain market confidence but also to sustain deposit insurance.

Taking these steps, especially creating a credible fiscal backstop, presents a challenge for nations in the Eurozone. Establishing a sufficiently large fiscal backstop requires more political integration of financial policy among member nations than is currently possible in the Eurozone. Overall, Spain failed to develop adjustment strategy needed to succeed within the single currency. Unfortunately, domestic policies and the imperatives of participating in a single currency union have long stood in an uneasy relationship to one another. The recent financial crisis was the tipping-point that brought this inconsistency to the fore.

Read more in Sebastián Royo, Lessons from the Economic Crisis in Spain, (Pelgrave, 2013).