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The Spanish Financial Sector: Where We Came From, Where We Are Going

The first steps towards modernising the Spanish financial system were taken at the start of the 1980s. Firstly, the Central Bank of Spain supported mergers among banks, intended to create large corporations – or in some instances, holding companies – which would be more competitive and could enter into international markets. Secondly, the Central Bank of Spain lifted territorial restrictions on two other types of Spanish financial institutions. These were savings banks (which are non-profit organisations) and credit co-operatives. Until this point, these institutions were restricted to operating in the provinces or regions in which they were based. In spite of these new measures, their association with their respective regions continued to be very strong due to the presence of local administrators in their governing bodies (both regional government and municipal authorities were represented).

Following these changes, a new era for the Spanish financial system began. The following decade was characterised by the spread of Spanish banks to international markets (initially to Latin America, then to other markets), a general opening towards international markets, and an increase in internal competition and business diversification. However, it was during the period 1996-2006 that the Spanish financial sector went through its period of maximum growth. This was due both to the opening up to new markets and to the unrestrained growth in the property sector which drove increased demand for credit. In combination with the low interest rate policy set by the European Central Bank, this led the borrowing and saving rates to become significantly out of step with each other. In fact, at the end of the 1990s, credit granted by the banking system grew at an annual rate of between 7% and 10%, while the saving rate not only failed to increase but started to decline. This meant that banks' financing became increasingly more dependent on capital markets and external finance.

In spite of these issues, there did not appear to be grounds for concern. In 2007 Spain had GDP growth of 3.8% and a budget surplus of 1%. By mid-2007, the US financial crisis had started to spread to other developed countries; the Spanish financial sector, however, appeared to be unaffected by these problems. Initially, the sector presented a picture of a robust financial system.

The first signs that the situation was not as it first appeared emerged in March 2009, when the Central Bank of Spain took control of a savings bank. At this point the government started to publicly confront the less-than-healthy situation of a number of institutions. Many of these institutions, especially savings banks, were closely linked with the property and construction sectors at a time when the property bubble was starting to deflate. Added to the above, risks were increasing due to a progressively higher default rate and a tightening of conditions for obtaining finance in the international interbank market.

In June 2009, in order to address this situation, the Spanish government created the Fund for Orderly Bank Restructuring (known by its Spanish initials FROB). As its main objective, the FROB supported mergers between institutions that were, in principle, viable; this should have led to more robust and competitive institutions, in some cases changing the legal status of these institutions (creating commercial banks by merging

savings banks). In order to deal with clearly non-viable institutions, the FROB drew up a process in which the management of these institutions was replaced by FROB staff. This would lead to a restructuring of institutions either through mergers or by taking control of institutions through partial or complete asset transfer.

In theory, the number of institutions that would have to be taken over by the FROB would be small. However, since 2009 the FROB has provided capital for mergers leading to the creation of eight institutions and has had to take over five more. And this has not always been a smooth process. The most revealing example was probably that of Bankia. This bank was set up in 2010 as a result of public funding provided by the FROB (more than €4bn), enabling the merger of seven savings banks to create a large new bank. On flotation, there were genuinely positive expectations around Bankia, given that the institution had posted net profits of €305m during 2011. However, only a few weeks later, following a change of management and an external audit, the annual accounts were revised and now showed a loss of €2.98bn.

The consequence of the "Bankia affair" has been not only to revive the lack of confidence in the Spanish financial sector; it now seems difficult to know what these institutions' real debts are. To this backdrop of widespread suspicion can be added evidence clearly showing the mismanagement of many institutions – savings banks in particular – where it appears that good professional practices have not been a main priority, possibly due to the increasing politicisation of their management structures since the 1990s.

Faced with such a challenging situation, Spain has had to turn to the EU to attempt to solve the crisis of confidence that started to spread rapidly to the markets. In July 2012, the Eurogroup has approved the recapitalisation of the Spanish banking sector. Through this agreement, a total of €100bn was made available to Spain, which could be used for other projects as well as bank recapitalisation. The banking sector is forecast to require €62bn. If this prediction is correct then the remaining €38bn will be available to the Spanish government as a rescue fund.

The key question is whether €62bn is enough for the Spanish banking sector to resuscitate itself. On 31 July the result of four external audits commissioned by the Central Bank of Spain will be published. These will analyse the portfolio of every Spanish financial institution. The IMF estimates that the Spanish financial system requires €40bn to recover completely. If these audits do not reveal any further surprises, then it is reasonable to expect that the EU rescue package should allow the Spanish financial sector to end the vicious circle in which it finds itself.

However, in spite of the above, it is difficult to determine whether these problems will be permanently resolved. The rescue package will probably stop the symptoms of this condition, but can it also make an impact on the causes? The factors which led to this situation remain: the Spanish financial system has had to operate in the midst of a general economic depression, it is difficult to access credit, the default rate for private individuals is likely to continue increasing and there are fresh bankruptcies in the property sector. If the allowances for risks now being made are sufficiently robust to be able to confront these problems, their impact can be reduced.

Nevertheless, at the time of writing, in spite of the drastic measures taken by the Spanish government, the clouds above the economy are getting darker by the day. Leaving aside what this means for people in their daily lives, it is clear that only a return to growth in the Spanish (and European) economies can rid the financial sector of the spectres which continue to haunt it.

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