The 2008–14 banking crisis in Spain[1]

Executive summary

This paper covers the banking crisis in Spain that started in 2008. The crisis had severe repercussions for the Spanish economy and public finances for several years. The financial cost of the crisis can be currently estimated at around €80 billion; slightly less than three quarters of this were covered by the state, and the rest by the banking industry through its contribution to the deposit guarantee scheme.

The weaknesses in the Spanish banking sector stemmed from a combination of conjunctural and structural factors. Starting in the mid-1990s, the Spanish economy had experienced rapid credit growth and banks' balance sheet expansion, amid favourable financing conditions triggered by the convergence process and the adoption of the euro in 1999. Credit was especially directed to the real estate sector, and a construction boom ensued. The rapid expansion of savings banks that had started in the mid-1980s generated additional financial stability risks as many of these firms were characterised by little market discipline and poor governance, which led to weak risk management and a deficient selection of investment opportunities. Savings banks also became increasingly dependent on relatively unstable wholesale funding sources. In addition, constraints in the charter of these banks implied a very limited capacity to increase capital.

The vulnerabilities in the Spanish banking sector – which were not sufficiently addressed by the regulatory and supervisory framework – became apparent at the time of the Great Financial Crisis (GFC). Against the backdrop of tightening global liquidity and increased risk aversion at the start of the GFC, the Spanish banking sector experienced considerable stress. Although it was not directly exposed to the US subprime market, turbulence in global financial markets highlighted its weaknesses, setting in motion a deep reassessment of the riskiness of Spanish banks.

Starting in 2009, Spanish authorities gradually introduced response measures, which proved insufficient. Considering the weaknesses of many savings banks, the authorities initiated a reform of their governance. They also attempted to steer a consolidation process in the banking sector, with the support of a dedicated fund (the Fund for Orderly Bank Restructuring (FROB)). The gradual approach taken since 2009, possibly the only one that was economically and politically feasible at the time, was predicated on the assumption that conditions would ease in the following years. However, the recovery did not materialise. On the contrary, starting in 2010, Europe faced a sovereign crisis that directly affected a few euro area countries, including Spain, and the situation deteriorated in July 2011 following the Greek crisis. This led to the pricing of currency redenomination risk, due to the perceived challenges for the continuation of the monetary union.

In 2011 and the first half of 2012, as the situation worsened, Spanish authorities took actions that were bolder but which failed to stem the crisis. These included the injection of public resources in weak banks, the expansion of the FROB's powers to deal with banking crises and additional

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capital and provision requirements for exposures to the real estate sector. But, as became increasingly clear in the assessments performed at the time, including by the IMF in the first half of 2012, these measures were insufficient to restore confidence in Spanish banks and address the root cause of a crisis that was contributing to instability in the euro area.

In mid-2012, the Spanish government formally requested financial assistance from the European authorities, opening the way for the introduction of deeper reform measures, which successfully contained the crisis. Faced with some Spanish banks' mounting recapitalisation needs, a weakened fiscal capacity and the stressed sovereign bond markets, the Spanish authorities opted to request a programme of financial assistance. This was accompanied by both bank-specific and sector-wide conditionality contained in a memorandum of understanding (MoU) agreed between Spanish and European authorities. The MoU envisaged: (i) the conduct of an asset quality review and stress test for the large majority of banks in Spain; (ii) the recapitalisation, restructuring and/or resolution of weak banks; and (iii) the transfer of problem assets to an asset management company (AMC). The MoU also entailed the performance of a burden-sharing exercise that imposed losses on junior bank creditors – mostly retail investors – and a downsizing of the banks requiring public support. Sector-wide conditionality involved several measures to strengthen the regulatory and supervisory framework.

The banking crisis in Spain raises several important general lessons, for both crisis prevention and crisis management. In terms of crisis prevention, the conditions in the sector before the crisis highlight how determined supervisory action is essential to identify, and foster a swift correction of, unsustainable business strategies and poor governance. Addressing these weaknesses in a timely way cannot rely solely on standard instruments, such as minimum capital requirements or loan-loss provisions. Rather, this requires supervisors to also be empowered to directly induce adjustments in business models and management procedures through appropriate corrective measures. When the crisis unfolds, the speed and intensity of intervention need to achieve an adequate combination of determination and pragmatism. In this phase, the available fiscal room plays a key role. Separately, macroprudential instruments – of which Spain was an early adopter with dynamic provisions – can increase banks' resilience, but those based on countercyclical bank buffers have a limited capacity to address macro-financial imbalances.

For crisis management, the Spanish approach, as agreed with European authorities, offers lessons for the design of the response strategy. Its success requires an internally consistent package of measures addressing both the urgent needs and the sector's structural weaknesses, together with adequate funding. At the national level, the feasibility and credibility of the response require broad political and social support. For a euro area country, support at the regional level is equally important – the involvement of the relevant European bodies and their explicit endorsement of the reforms is essential. Adequate communication – with the right combination of rigour and depth – plays a key role in helping to restore market confidence and to provide transparency. More broadly, authorities should make full use of systemic crises to adopt ambitious reforms that may have been long overdue.

The Spanish case also sheds light on the performance of some resolution tools. Resolution actions, including creditors' bail-in, can satisfactorily be implemented– ie with no or little successful litigation – if supported by sufficiently robust legislation and careful implementation. Yet hybrid capital and subordinated debt instruments lose much of their ability to provide gone-concern resources when retail investors hold them. Creating an AMC can be a very powerful tool in a crisis as it helps to clean up banks' balance sheets, but it is not cost-free. Depending on its design, it may help spread over time the costs for the state. The restructuring of the sector should primarily be led by efficiency and financial stability considerations while minimising, to the extent possible, the competitive distortions created by providing public support to weak entities. As for exit strategies, a relatively rapid disinvestment of public stakes in banks subject to resolution, when feasible, is generally preferable.