Institution: London School of Economics and Political Science

Unit of Assessment: 19: Business and Management Studies

Title of case study: Reforming the Spanish savings banks

1. Summary of the impact

The Spanish *Cajas* [savings banks] are being radically reformed with explicit reference to research that Vicente Cuñat and Luis Garicano undertook from 2009-2012. The research found that: (a) many Cajas´ managers were politically appointed and poorly qualified in terms of relatively low educational attainment and no previous banking experience; and (b) the presence of such managers substantively and negatively impacted the Cajas' performance during the financial crisis. Emergency government legislation (Royal Decrees in 2010 and 2013), and the July 2012 Memorandum of Understanding between Spain and the Troika that includes a specific requirement for Spain to reform the sector, rely explicitly on this research.

2. Underpinning research (indicative maximum 500 words)

Research Insights and Outputs:

Garicano's fundamental proposition is that a key role of hierarchy is to utilize human capital efficiently (see 1). Much of his work has aimed to test the robustness, assess the boundary conditions, and expand the applicability of this organisational theory proposition. Vicente Cuñat and Luis Garicano (both from LSE) undertook the initial empirical research on human capital in the Cajas sector, exploiting a unique quasi-experimental feature of this sector while addressing an economically, and indeed societally, important issue (2, 3). Jesús Fernández Villaverde (U Pennsylvania), Luis Garicano and Jesús Santos (Columbia) then expanded this research to explain the interaction between the macroeconomic environment and the political economy (4). Garicano (5) used the insights of this research to elaborate recommendations for the governance of financial institutions.

Garicano has shown that the matching of talent with positions plays a crucial role for the performance of firms and economic growth. An empirical question that follows from this research is to understand the implications (i.e., cost) of the counterfactual—the absence of a match between hierarchy and talent. If hierarchy were about providing only good incentives, and not about talent and knowledge, placing less talented agents at the top of organizations would not lead to lower growth and inferior firm performance as long as adequate incentive systems are in place. Obviously, it is impossible to test this hypothesis experimentally as no firm will want to "trial" the human capital of its CEO to obtain the experimental ideal of randomization. However, the ostensibly non-optimal allocation of managers to jobs in the Spanish Cajas offered the near-ideal field laboratory to test the costs of ill-matched talent within the hierarchy, which Garicano and Cunat (2, 3) explored.

Specifically, Cuñat and Garicano collected data on the CVs of every top executive in the almost fifty such institutions and created variables on their educational attainment, experience, and other human capital aspects. They also collected data on each Cajas' lending decisions and the subsequent (non-)performance of the loans. They found that Cajas managers who were politically connected, had low education, and no previous banking experience negatively impacted the Cajas' crisis performance in all dimensions. Specifically, the worse the human capital of the Cajas CEO, the worse the lending decisions. Cajas led by Chairmen without graduate studies extended 7% less loans to individuals and 5-7% more to real estate developers. Consistent with this, as of July 2009, they had over 1% more non-performing loans. Given that the average in the sample is around 5%, this represents an economically significant 20% deterioration just related to this aspect of performance. Despite the fact that they were more aggressive during the boom, these Cajas also had 0.2% lower return on assets in 2006, suggesting that they were badly managed rather than taking larger risks. The role of banking experience was also highly significant: Cajas led by executives without banking experience had a 1% increase in non-performing loans. This also partly reflected a larger portfolio allocation to real estate, of around 6% more. When Cuñat and Garicano were conducting this analysis, no similar research existed. Indeed, at the time, the regulator insisted that the Cajas were sound and posed no threat to the Spanish economy or the Euro. Garicano and co-authors Fernández Villaverde and Jesús Santos also identified (4) what they called a "Political Credit Cycle" maintaining that bubbles make governance harder and implying that bad selection and poor incentives which follow from the bubble become a source of persistence of the shock.

Key Researchers: Professor Garicano has been at LSE since 2007. Dr Cunat has been at LSE since 2007.

3. References to the research (indicative maximum of six references)

1. Garicano, Luis and Esteban Rossi-Hansberg, 2012a "Organizing Growth" *Journal of Economic Theory*, 147:2623-656. DOI 10.1016/j.jet.2009.11.007 http://eprints.lse.ac.uk/37002/

2. Garicano, Luis and Vicente Cuñat, 2010, "Concedieron las cajas "buenas" créditos "malos"? Gobierno corporativo, capital humano y carteras de créditos?", Chapter 6 in FEDEA Monograph *La crisis de la economía española. Análisis económico de la gran recesión*, edited by Samuel Bentolila, Michele Boldrin, Javier Díaz-Giménez y Juan J. Dolado. http://eprints.lse.ac.uk/51252

3. Cuñat Vicente and Luis Garicano, 2009. "Did Good Cajas Extend Bad Loans? Governance, Human Capital and Loan Portfolios," *Working Papers 2010-08*, FEDEA. Presented at the Bank of Spain in October 2009 with the attendance of top Bank of Spain management. http://mpra.ub.uni-muenchen.de/42434/

4. Villaverde, Jesus , Luis Garicano, and Tano Santos, 2013, "Political Credit Cycles: The Case of the Euro Zone", *Journal of Economic Perspectives* 27 (3): 145-66. http://www.nber.org/papers/w18899

5. Garicano, Luis. 2012b "Five lessons from the Spanish Cajas debacle for a new euro wide supervisor" *in Beck, Thorsten ed., Banking Union for Europe: Risks and Challenges,* VoxEU eBook*, October.* Available from LSE.

Evidence of Quality: 1 and 4 are top, peer-reviewed journals

4. Details of the impact (indicative maximum 750 words)

Nature of the Impact: LSE research provided evidence that the presence of Cajas managers who were politically appointed and poorly qualified in terms of education and experience negatively impacted the performance of the Cajas during the financial crisis (as well as through the business cycle). During this period, the Cajas accounted for half of Spain's deposits but these savings were being put at risk by poor lending decisions leading to non-performing loans. Other banks with stronger management remained profitable during the crisis. This research explicitly informed government and international policy to rescue and reform the Spanish financial system, as documented below.

A. Impact on Spain's Legislation: Government legislation in the form of Royal Decrees in 2010 and 2013 introduced a broad reform of governance practices in the sector. A substantial component was what the government called "reinforcement of the competence and professionalism" of Cajas managers, including specific requirements in terms of experience and education. No other research, apart from Garicano and Cuñat, has specifically targeted these issues. A personal statement from the Secretary of State in charge of the reforms confirms that this research provided the crucial underpinning for the legislation: “The empirical finding of Cunat and Garicano that there was a clear link between the quality of the management of the Cajas and their bad loan positions contributed to the regulatory move towards the professionalization and strengthening of the independence of the Cajas boards" (Secretary of State for Economic Affairs, Spain 2009-2011) (6). The Bank of Spain’s Chief Economist elaborates on this impact (7): “The paper by Garicano and Cuñat (2) on the performance of Spanish Savings Banks argues that the lending practices of these banks during the expansion period previous to the crisis and the amount of their non-performing loans during the crisis were more related to the political and academic background of the banks' chairmen than either to formal governance institutions or to the composition of the board. Upon its presentation at a conference hosted by Banco de España, it was quite influential and generated interesting debates in political and academic circles about how that association should be interpreted and to what extent it had important implications for the origins of the crisis and for the regulation of financial institutions. In my view, it contributed significantly to shape discussions in this regard that eventually led to some changes in the regulation of this part of the Spanish financial system.*”*

B. Impact on IMF's diagnosis of Spain’s problems and on the subsequent Memorandum of Understanding: The IMF’s Technical Report (8) issued in June 2012, just before the MoU that was signed between Spain and the Troika, included the IMF’s analysis of Spain’s financial system. This motivated the decision to force a restructuring of the Cajas sector, and contained an explicit reference to Garicano and Cuñat´s research: “Empirical evidence shows that SSBs whose chairman was previously a political appointee and, in many cases, lacking proper banking experience, have had significantly worse performance” (footnote to Cunat and Garicano, 2009 in IMF, 2012, p10). Directly following from this analysis, according to the IMF Spain Desk chief personal testimony (9), was the contemporaneous Memorandum of Understanding (10) on Financial-Sector Policy Conditionality (2012) between Spain and the Troika (IMF, ECB, EU). This contains the following provision in point 23, which is an obligatory condition for Spain: “The governance structure of former savings banks and of commercial banks controlled by them will be strengthened. The Spanish authorities will prepare by end-November 2012 legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Furthermore, authorities will propose measures to strengthen fit and proper rules for the governing bodies of savings banks and to introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Moreover, authorities will provide by end-November 2012 a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process.”

C. Initial impact on press and public opinion: The original ‘governance of the Cajas study’ was, on the day of its release on 30 October 2009 at the Bank of Spain, prominently covered (one page) in *EL Pais*, Spain's leading daily newspaper (11). It is important to note that prior to the study there was no body of evidence arguing for a link between the financial crisis and the governance or human capital of the Cajas. After the study, Cunat and Garicano produced a stream of op-eds (12,, 13, 14) in the Spanish press, including several articles in *El Pais* and multiple blog postings on *NadaEsGratis* (No Free Lunch), edited and founded by Garicano, insisting on the importance of governance reforms in order to solve the Cajas problem.

Wider Implications: on-going reform of Spain’s savings banks is central to the defence of Spain’s financial and sovereignty systems. However, poor management of savings banks remains a problem in other parts of Europe. Indirectly, therefore, but not trivially or wholly at the margin, the research reported above has relevance to the financial standing of the wider Eurozone region.

5. Sources to corroborate the impact (indicative maximum of 10 references)

All Sources listed below can also be seen at: https://apps.lse.ac.uk/impact/case-study/view/27

Impact on Spain's legislation:

6. Personal Testimony from Secretary of State for Economic Affairs, Spain 2009-2011. This source is confidential.
7. Personal testimony from Chief Economist, Bank of Spain. This source is confidential.

Impact on IMFs position and on MoU:

8. IMF Technical Report on the Reform of Spain's savings banks: "Spain: The Reform of Spanish Savings Banks Technical Notes "June 2012 IMF Country Report No. 12/141, cites Garicano and Cuñat (2009). https://apps.lse.ac.uk/impact/download/file/1413

9. Personal Testimony, IMF Spain Chief**:** **"**The work of Garicano and Cunat on Spanish savings banks significantly influenced the IMF's analysis of the Spanish banking system" (e.g. see citation in the 2010 IMF Article IV staff report on Spain and the 2012 Technical note for the Financial System Stability Assessment). This source is confidential.

   This was also reflected in the IMF's advice to the Spanish authorities, in particular, in the design of the 2012 ESM-supported financial sector support program. As per the *Memorandum of Understanding* for this program: "The governance structure of former savings banks and of commercial banks controlled by them will be strengthened. The Spanish authorities will prepare by end-November 2012 legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Furthermore, authorities will propose measures to strengthen fit and proper rules for the governing bodies of savings banks and to introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Moreover, authorities will provide by end-November 2012 a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process." This conditionality is currently in the process of implementation via a draft law under discussion by Parliament." IMF Chief, Spain Desk.

10. **"**Memorandum of understanding on financial-sector policy conditionality", 20 July 2012 https://apps.lse.ac.uk/impact/download/file/1419

On impact on Public opinion: *Selected Press Sources*

11. La politización eleva la morosidad de las *cajas* en 12.000 millones. Iñigo Barrón, *El Pais,* 31. October 2009. https://apps.lse.ac.uk/impact/download/file/1422

12. ¿Para cuándo la restructuración del sistema financiero español OpEd by Vicente Cuñat and Luis Garicano, *El País,* 13 September 2009. https://apps.lse.ac.uk/impact/download/file/1423

13. Un estudio culpa de la morosidad de las cajas a la politización de sus gestores La Nueva España. https://apps.lse.ac.uk/impact/download/file/14234

14. La *cajas* con presidentes que han sido políticos sufren una mayor morosidad. elEconomista.es. https://apps.lse.ac.uk/impact/download/file/1425