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## Financial Market Special

### Spain's *cajas*: deregulated, but not depoliticised

- The deregulation of the Spanish financial market since 1977 has led, as hoped, to higher efficiency and greater competition among the country's credit institutions. Today, Spain's banking industry is very competitive by international standards. However, the efforts to depoliticise its savings banks (*cajas de ahorros*) have not succeeded yet, and this is an obstacle to further efficiency gains.
- Spain's newly established democratic government decided to embrace market economics and seek closer ties with the European Communities – moves which triggered the liberalisation of the economy. The financial market was also gradually deregulated within this framework. Competition was boosted by extending the *cajas*' operating licence to allow them to engage in all types of banking activity. The regional principle was abolished.
- The combination of deregulation and economic growth fostered the development of Spain's credit institutions. Capitalising on the new business opportunities, the savings banks significantly expanded their shares of, for example, the lending and deposit-taking markets.
- The "ownerless" legal form of the *cajas* remained untouched. The *cajas* are "not-for-profit private foundations", so they do not compete for equity capital (from external sources). They are able to plough back a large share of their profits. At the same time, the *cajas*' legal form restricts the possibility of raising equity externally.
- The political parties, as backers of the holders of public office, still have strong influence over the *cajas*: one way is through direct representation in their governing bodies; another is through indirect control since the regional authorities have supervisory rights and legislative powers over the savings banks in their jurisdiction. It therefore remains dubious whether the management of a *caja* can be free of political influence and act solely in the *caja*'s interest. Additionally, the legal form of the *caja* prevents external control by market forces, e.g. via stockmarket listing or takeover by a third party.

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## Historical background

### Spain's first savings banks and how they developed

The first *caja de ahorros* (savings bank) in Spain was established in 1838 by wealthy citizens of Madrid. Shortly before, the Spanish crown had appealed to the citizenry to foster the establishment of *cajas* in every province. Inspired by liberal principles, the monarchy sought to achieve several objectives at once: the poor were to be given the chance to build up savings to provide for their own needs and to improve their living conditions. Moreover, the stabilisation of social conditions and the accumulation of savings were expected to encourage economic development. Nearly all the first *cajas* arose as private institutions, e.g. they were founded by the *Reales Sociedades de Amigos del País*<sup>1</sup> or the Roman Catholic church, and were welcomed and promoted by the local administrations. Unlike in other countries, though, the deposits taken were not invested in government bonds; instead they were used for lending at pawnshops – known as *montes de piedad*. This link between the *cajas* and the local *montes de piedad* was ordered in 1839 by royal decree; later the *montes* were often subsumed in the *cajas*. The *montes de piedad* dated back to the beginning of the 18th century. They were also founded as charitable foundations which granted small loans to the poor in return for collateral, their purpose being to fight usury and poverty. Savings deposited with the *cajas* earned interest, while loans granted by the *montes* were subject to debit interest. The increasing wealth of the lower and middle classes led to a surge in the deposits lodged with the *cajas*, so the volume of savings eventually outstripped the needs of the *montes*. The deposit surpluses at the *cajas* led in 1853 to the first comprehensive regulation of these bodies, which hitherto had only been required to comply with their own articles of association and the objective of safe, profitable management of the deposits. A law reduced the scope of the *cajas*' independence: the interest rate for deposit-taking business was set at a fixed rate, and the *cajas* were forbidden to grant loans for commercial investment projects. Surplus deposits were to be paid into an interest-bearing state fund. To raise the safety of the deposits the state introduced a requirement that 80% of the profits be retained, with the remaining portion to be used for charitable works and bonuses for depositors. Finally, the *cajas* were declared to be charitable organisations and their management was assigned to a body whose members were to be appointed by the national or local administration. Since this law encountered stiff opposition from the *cajas* and the depositors, it was only partly implemented by the authorities. Nevertheless, regulations pertaining to lending and deposit-taking, appropriation of profits, and management positions were reflected to differing degrees in all subsequent legislation. It was not until 1977 when Spain was being turned into a democracy that the new political forces liberalised the economy. This meant greater business scope for the *cajas*, too.

**Origin of *cajas de ahorros*: citizens movement**

**Objective: improve the lot of the poor**

**Economic success and initial state regulation**

### Legal situation before the reform

Towards the end of the Franco regime in the mid-1970s the overall financial sector was subject to strong state regulation. Restrictions on establishment, as well as fixed interest rates and constraints on the use of deposits, narrowed the decision-making scope for all credit institutions. With few exceptions, foreign banks were not given

**Up to 1977: strict state regulation and steering of the financial sector**

<sup>1</sup> Associations of wealthy citizens to promote local economic and social development.



an operating licence. The government used the *cajas* in particular as an instrument to finance its economic and social programmes. By setting rules on how to use profits and deposits in the lending business, the state largely steered the activities of the savings bank sector. Regulations called *coeficientes de inversión obligatoria* required that the savings banks invest 50% of their deposits in government paper and earmark another 30% for loans for set purposes. The *cajas* were not allowed to do business with companies; this was the domain of the banks. The savings banks concentrated as a result on deposit-taking business on the liabilities side and private mortgage loans on the assets side. The *cajas* financed their business from deposits and reserves; there were no state guarantees to fall back on. A limited, state-controlled opening of new branches became possible within narrowly defined geographical boundaries from the middle of the 1960s. The function of central institution was assumed by the Spanish Confederation of Savings Banks (CECA), with membership obligatory for all *cajas*. The savings banks were required to use a part of their profit to fulfil their social mandate, known as the *obra social*. They were subject to a strong degree of control by the competent authorities and the finance ministry, with the latter also having the right to veto appointments to the office of *caja* president or director and stop the adoption of the articles of association.

### Business situation before the reform

The market shares of the various institutional groups reflect the state-prescribed focus on certain business areas. In the mid-1970s the banks were the dominant force among the institutional groups, accounting for 63% of the aggregate balance sheet for the financial sector.<sup>2</sup> The banks were particularly strong in lending business: 73% of all loans to residents were on their books. However, the market share for deposits was also very high at 64%. The savings banks accounted for 22% of the aggregate balance sheet of all the credit institutions, but in their traditional business line, deposits, they held a market share of 33%. They claimed only 18% of the lending market. The cooperative banks (*cooperativas de crédito*) were mainly rooted in the agricultural area, often calling themselves *cajas rurales*. The scope of their business was small in comparison with that of the banks and the *cajas*, with 3% of deposits and 2% of lending. This was reflected in their balance sheet, which accounted for 2% of the sector total. The remaining 13% of the pie was attributable to state and specialised credit institutions.

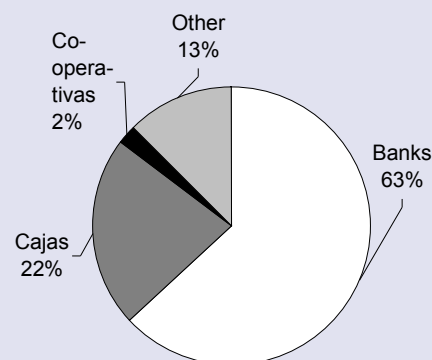
Towards the end of the Franco period the banks had the most far-flung network, with 9,098 branches. The *cajas* operated 6,818 branches, and the *cooperativas* 2,137. When all three institutional groups are taken together, this means Spain had a branch density<sup>3</sup>, of 0.5, i.e. one outlet for every 2,000 inhabitants. No records were kept on the number of credit institutions until 1981. In that year, the

<sup>2</sup> The statistical data in this section are for the end of 1976. As defined by Banco de España, lending and deposit-taking business with residents (*otros sectores residentes*) cover transactions with all residents excluding public administrations, i.e. private individuals resident in Spain, non-financial private and public companies, financial intermediaries excluding credit institutions (e.g. insurance companies, pension funds), non-monetary financial services, and not-for-profit private organisations.

By public administrations (*administraciones públicas*), Banco de España means administrations at the levels of central government, *comunidades autónomas*, local authorities and social-security system.

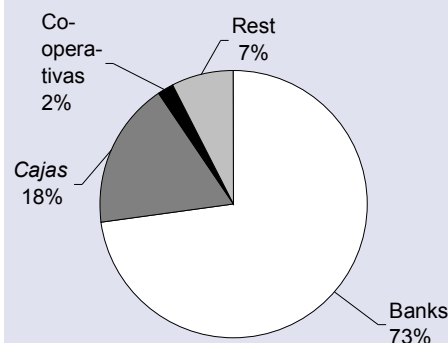
<sup>3</sup> Branch density: number of bank outlets per 1,000 inhabitants.

**Breakdown of aggregate balance sheet of all credit institutions by group (1976)**



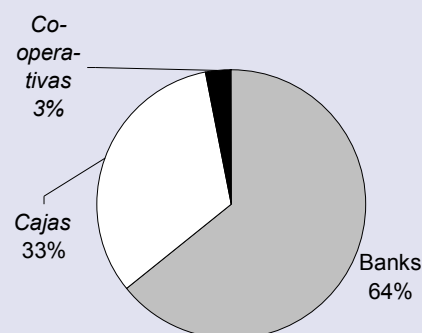
Sources: Banco de España, DB Research

**Breakdown of total lending to residents (1976)**



Sources: Banco de España, DB Research

**Breakdown of resident deposits (1976)**



Sources: Banco de España, DB Research

*cooperativas* headed the list with a total of 147, followed by 128 banks and 82 savings banks. Owing to the comprehensive regulation of the financial sector, efficiency and profitability figures before 1977 do not really show the success attributable to entrepreneurial decisions. Rather, the cost/income ratio, interest margin and return on assets reflect the state steering via, for example, price caps and *coeficientes de inversión obligatoria*. Savings banks and cooperative banks operated comparatively efficiently: their cost/income ratios were roughly equal at around 62%. By contrast, the banks registered costs of nearly 70 pesetas for every 100 pesetas of income. *Cooperativas* and banks achieved a higher pre-tax profit than the savings banks. The *cooperativas* were particularly successful, generating a return on assets of 1.24%. The average interest margin<sup>4</sup> in the financial sector was 3.2%; the *cooperativas* and banks performed much better here than the savings banks. By and large, the *cajas* posted the poorest profitability readings among the different institutions. The relatively low cost/income ratio suggests that the *cajas* had a thin cost base at the time, since the interest margin on the income side was below average by market standards.

## Legal changes pertaining to the banking sector

### Catalyst

Political upheaval after the death of Franco in 1975 and the economic difficulties between 1974 and 1984 paved the way to a fundamental reform of the general economic and political environment in Spain. The new political forces remodelled Spain into a democratic and social constitutional state. Despite considerable debate, representatives of the various factions agreed in 1977 in the *Pactos de la Moncloa* to introduce principles of market economics. To implement the principles in the financial system, the recently elected government passed a law in the same year to reform the financial market. The aims were to introduce the element of market pricing and to strengthen the forces of competition. In the financial sector, price caps and the *coeficientes de inversión obligatoria* were gradually eliminated, although the latter were not fully abolished until 1992. The strengthening of competition was meant to raise efficiency in the Spanish financial market and make it more compatible with market principles. This second aim was more difficult to achieve since, on account of the economic difficulties, it was not that easy to increase the number of competitors. With an eye to the plight of the ailing domestic banks, the government opted against the obvious route of opening the market to foreign banks. Instead, the political leaders decided to boost domestic competition by abolishing state regulation of the savings banks. To this end, the operating licence of the *cajas* was deemed to match that of the banks and their governing bodies were reformed so they could compete in the liberalised market. Previously, the *cajas'* managerial bodies had been subject to substantial political influence. They were now to be opened to the public and made more democratic by embracing depositors, founders, and other cultural, academic and charitable organisations. Since this reform, the savings banks have been allowed to engage in all types of transaction that used to be the prerogative of the banks, and they have successfully tapped the new room for manoeuvre. Finally, the regional principle was abolished in 1988, with the result that the savings banks have since been free to expand into all regions of Spain and abroad. This

### Returns & efficiency, 1976 (%)

	Banks	Cajas	Co-operativas
Interest margin	3.3	2.9	3.4
Return on assets	1.05	0.91	1.24
Cost/income ratio	69.9	62.3	62.5

Sources: Banco de España, DB Research

### Political decision to embrace market economics

### Liberalisation of the financial sector

### Regional principle abolished

<sup>4</sup> Interest margin: net interest income as a percentage of balance sheet total.



touched off a strong expansion process; however, only a few *cajas* have built up nation-wide branch networks.

The constitution of 1978 granted the various regions and nationalities in Spain a certain degree of autonomy. This produced a new level of public administration with legislative competences, the *comunidades autónomas* (autonomous communities). The division between national and autonomous level became more concrete over time thanks to the negotiation of autonomous statutes and the rulings of the constitutional court. The *comunidades autónomas* have powers in respect of, for example, internal organisation of the local *cajas*, but within fundamental norms set out in the national legislation. Unlike the banks, the *cajas* are subject not only to the supervision of the central bank, but also to supervision by the *comunidades autónomas*.

### Legal status

The *cajas* are “not-for-profit private foundations”; they channel at least half of their after-tax profit into revenue reserves, with the rest going towards projects that fall under their social mandate. As the savings banks are not set up with a “legal owner”, they cannot be taken over by purchase. Savings banks are allowed, however, to acquire other companies and credit institutions – except *cajas*. Mergers among different *cajas* are possible as long as the competent authorities of the relevant *comunidades autónomas* give their approval.

The norms valid for the *cajas* derive from various laws which came into force mainly after the 1920s at national level and later at the *comunidades autónomas* level. Given this rather complicated legal situation and in the light of the economic success of the *cajas* and their present significance in the Spanish financial system, discussion over the *cajas*’ legal form flares up continually. A central issue is the yawning gap between the *caja*’s function as a credit institution in a market economy and its position as a social foundation which is exposed to political influence. The aims of the body politic must not always dovetail with those of the *caja*. Also at issue is whether the savings banks belong to the public or the private sector, which is significant under EU law.

In a ruling from 1988, the Spanish constitutional court denied the *cajas* the status of foundation under the respective article of the constitution, but accepted the civil-law classification as a foundation for lack of a better categorisation. The supreme court considered the savings banks’ activity as credit institution in conformity with market norms to be their main focus and confirmed their private nature. However, owing to the absence of profit-making intentions it said the *cajas* are not companies.<sup>5</sup> This ruling leaves room for various interpretations. However, one legal interpretation has become widespread. It classifies the *cajas* under the legal form of private *fundación-empresa* (foundation company), although this is not explicitly anchored in Spanish law. The *fundación-empresa* is understood to mean a legal person who acts in entrepreneurial fashion and is organised accordingly in order, for example, to fulfil a social function.<sup>6</sup>

To classify whether a company or “undertaking” is public or private, EU law applies the criterion of how much influence public authorities can exert on it. “Public undertakings’ means: any undertaking over

**New legislative level: the *comunidades autónomas***

**“Not-for-profit private foundations“**

**At issue: yawning gap between function as credit institution and social foundation**

**EU law limits the public sector’s role**

<sup>5</sup> Tribunal Constitucional, judgment 49/1988 dated March 22, 1988.

<sup>6</sup> See Anabelén Casares Marcos: *Cajas de Ahorro: Naturaleza jurídica e intervención pública*, Valencia, 2003, p. 728.

which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it.”<sup>7</sup> A dominant influence shall be presumed, for example, “when these authorities, directly or indirectly in relation to an undertaking: ... can appoint more than half of the members of the undertaking’s administrative, managerial or supervisory body”.<sup>8</sup> Since the public authorities accounted for more than half of the representatives of the relevant bodies in many *cajas* over the years, the latter risked being defined as a public institution under EU law. As a consequence, some of the corporate loans granted by the *cajas* might have been classified as state aid, which in a few cases could have been in violation of the EU’s competition policy. To avoid this risk, a law on financial market reform – referred to as the *Ley Financiera*<sup>9</sup> – was passed in 2002 which capped the number of representatives of public authorities in the savings banks at a maximum of 50% of the governing-body members. However, this allowed the political forces to maintain a strong position in the various bodies of the *cajas*.

### Deposit insurance

Spain’s savings banks have operated since their founding without state guarantees to underpin deposits or individual institutions. Between 1977 and 1982 a separate deposit guarantee fund (*fondos de garantía de depósitos*) was set up for each group of deposit-taking institutions in Spain. The deposit funds for banks, for *cajas* and for *cooperativas* have identical duties. The funds have two functions. One is that if a deposit institution should become insolvent or default on its payment obligations they guarantee every depositor a sum of EUR 20,000. The other is that they play an active part in crisis management in the event of a bank failure. Every year, the member institutions have to pay an amount into their fund that equals a share of their customer deposits which is set by the ministry. The amount can differ from fund to fund. If, for instance, an insolvency weighs on one of the funds, the contribution to be paid by the other members of this institutional group may be raised. As the deposit insurance is fundamentally identical for all three institutional groups, there is *prima facie* no reason to suspect that the savings banks sector is privileged in any way. However, customers might perceive the close ties between the savings banks and political and state officials as implicit state cover.<sup>10</sup>

### Appointments to governing bodies

The government started to liberalise the financial market from 1977. One of its moves was to create a legal norm which standardised the internal structure of the *cajas* nationally besides transferring management responsibility to their founders, depositors and staff. Representatives of local academic, cultural and charitable organisations also started to play a part in the savings bank institutions. Initially, the public sector appeared only in the function of founder – at *cajas* where this was the case – or on behalf of the founder as that entity’s representative in the *caja* management. However, the influence of the public sector was reinforced from 1985 by the LORCA law<sup>11</sup> and autonomous laws, so in some cases the local authorities and the autonomous authorities held a

### Groups of deposit-taking institutions maintain deposit guarantee funds

### No explicit state guarantees for *cajas*

### National standardisation of the *caja* structure

<sup>7</sup> Commission Directive 80/723/EEC of June 25, 1980.

<sup>8</sup> Commission Directive 80/723/EEC of June 25, 1980.

<sup>9</sup> Ley Financiera: 44/2002 of November 22, 2002.

<sup>10</sup> See Santander Central Hispano European Equity Research: Banking in Spain: Las Cajas, April 2003.

<sup>11</sup> LORCA: Law 31/1985 of August 2, 1985.



combined share of over 70% of the voting rights in the *caja's* governing bodies. Since 2002, the *Ley Financiera* has supplemented the LORCA law; it caps the overall say of all public bodies at 50% of voting entitlement. The current form of the *cajas'* internal organisation is based on the LORCA law and the *Ley Financiera*. The law on the improvement of transparency and governance<sup>12</sup> adopted in July 2003 provides, moreover, for organisational enhancements at the management level.<sup>13</sup>

The nationally compulsory framework for the organisation of every Spanish savings bank regards the *asamblea general* (general meeting) as the fundamental body of a *caja*. The members of the *asamblea – consejeros generales* (delegates) – are selected by the factions which they represent, with the national government setting bandwidths for the percentage distribution of power: local authorities (maximum 50%), founders, depositors (25-50%), and employees (5-15%). Furthermore, other factions may be accepted into the *asamblea*. The *asamblea general* is ultimately responsible for the internal supervision of the *caja* and the strategic orientation of business. From their midst the *consejeros generales* elect the *consejo de administración*<sup>14</sup>, which manages the *caja's* operations and is its legal representative. The voting power structure of the groups in the *asamblea* must be reflected in the *consejo*. Besides its management mandate, the *consejo* is also responsible for the social mandate (*obra social*). The *consejo* can delegate most of its duties and competences to a *comisión ejecutiva* (steering committee) and/or *director general*. The latter should be a person with professional qualifications and experience; he is appointed by the *consejo* and has to be confirmed in office by the *asamblea*. Moreover, the *consejo* elects a president from its ranks who simultaneously becomes president of the *asamblea* and the *caja*. The law on transparency and governance of July 2003 additionally requires the *consejo de administración* to instal a *comisión de retribuciones*, whose job is to provide information about compensation and incentive policies for the members of the *consejo* and the other management officers. Furthermore, the management must constitute a *comisión de inversiones* which submits proposals to the *consejo* on strategic investments and divestments and keeps it abreast of the financial performance of the existing corporate stakes. In this context, the *comisión de inversiones* must additionally prepare an annual report for the *consejo* in which it also reviews the compatibility of the holdings with the *caja's* purpose as a foundation. The distribution of seats in both the *comisión de retribuciones* and the *comisión de inversiones* must be in line with the voting structure in the *consejo de administración*.

Under the LORCA law and the *Ley Financiera*, the *asamblea* does not only choose the members of the *consejo de administración*. It also elects the *comisión de control* from its midst, paying heed here too to the distribution of voting power. This supervisory body ensures that the management works efficiently, pursues the given business strategy and complies with legal guidelines. Besides reporting to the *asamblea*, the *comisión de control* also informs the supervisory authorities (Banco de España, *comunidad autónoma*)

**Asamblea general – strategic business orientation**

**Consejo de administración – board of directors**

**Comisión de retribuciones – compensation policy**

**Comisión de inversiones – investment policy**

**Comisión de control – internal supervisor**

<sup>12</sup> Law 26/2003 of July 17, 2003.

<sup>13</sup> The rules differ slightly for the three *cajas* associated with the Roman Catholic church (CajaSur, Cajacírculo and Caja Inmaculada).

<sup>14</sup> The *asamblea* may elect to the *consejo* at most two representatives each from the ranks of the depositors and the local administrations without their being members of the *asamblea*.

semi-annually about the *caja's* financial and business situation. A further responsibility is to monitor elections to the different bodies. To fulfil its duties the *comisión* de control can insist on receiving all the information it considers relevant from the managing *consejo de administración*.

On the basis of these national standards, the *comunidades autónomas* can adapt the rules for the *cajas* to the conditions in their respective region. Deviations from the national norm are mainly permissible in respect of the absolute number of representatives, the exact percentage representation of the groups within the given ranges, and the inclusion and selection of other factions of regional interest for appointments to the *caja* bodies. In addition, the *comunidades autónomas* have the right to pass their own legislation for bestowing powers on the *director general* and shaping the processes for selecting members of the *asamblea*.

The appointments of representatives of different interest groups to the governing bodies appears at first glance to be a way to ensure mutual control and prevent the instrumentalisation of the *caja* by a dominant group. The establishment of committees which serve to heighten the transparency of decisions and internal control reinforces this impression. In reality, however, the public sector – and thus the political parties – often have the upper hand in the *asambleas* of the *cajas*.<sup>15</sup> Moreover, the power structures in the *asamblea* resurface in all the management and supervisory bodies. The efficiency and independence of internal control at a *caja* therefore remains dubious. There is no external market assessment of a *caja's* personnel and business decisions. Since *cajas* are not listed companies<sup>16</sup>, besides not being purchasable, it is not possible to sanction them effectively through the capital market. A governance report that has to be published for the first time for 2004 and then annually in future is expected to introduce transparency into the management structure and into the remuneration of management and supervisory board positions. Transactions between them and the *caja* will have to be disclosed publicly, as will the *caja's* transactions with political groups represented in public authorities or parliaments of the *comunidades autónomas* that have participated in elections to the *asamblea general*. The same applies to *caja* loans to public institutions that participated in the election. However, only the *cajas* that have issued securities traded on the stock exchange are subject to this reporting requirement. The report has to be made available to the public on the *caja's* website. This represents an attempt to establish transparency and governance over the bodies of the securities-issuing *cajas* without the disciplining power of the market. The extent to which political patronage and influence can be checked remains to be seen.

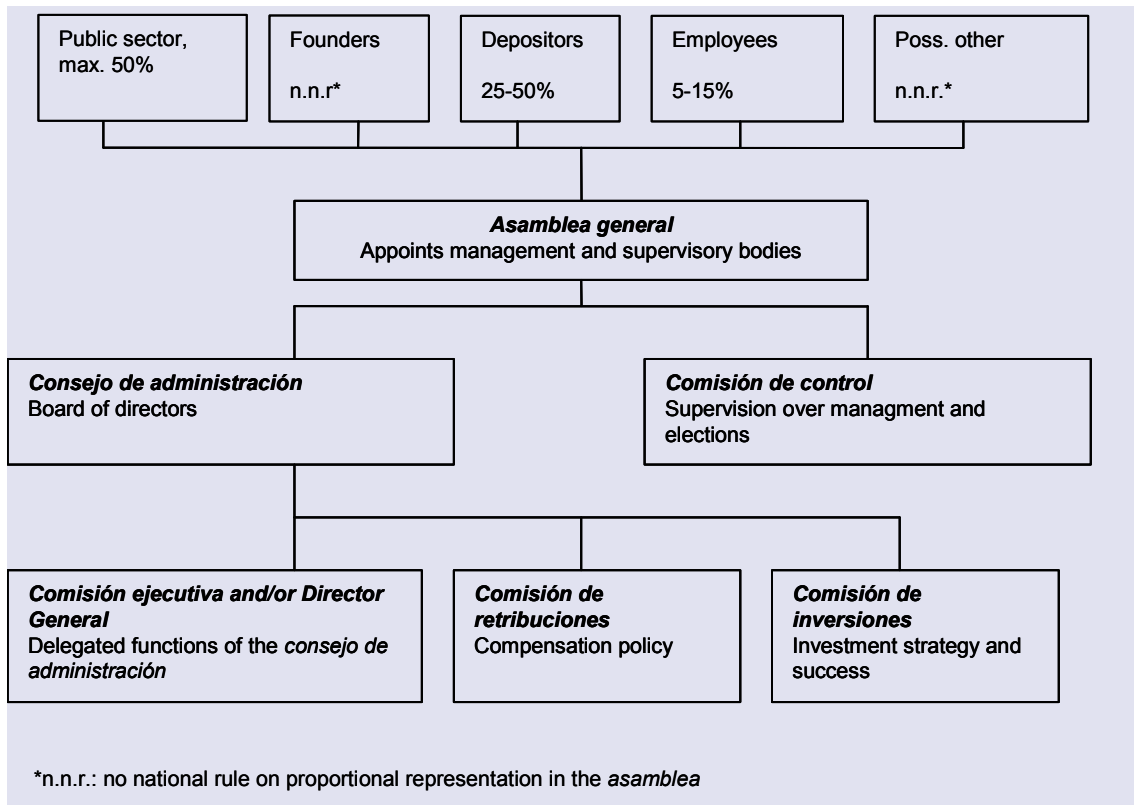
### **Possibility for the *comunidades autónomas* to adapt the rules shaping the *caja* bodies**

### **Weak internal control**

### **Absence of external market control**

<sup>15</sup> See Álvaro Cuervo García: El buen gobierno de sociedades y las cajas de ahorros. In: *Economistas*, September 2003, No. 98, pp. 68-81. Also, see section below entitled "Remaining scope for public-sector influence".

<sup>16</sup> The quoted debt instruments and preference shares issued by the *cajas* can mirror the market valuation of specific *cajas* only to a limited degree on account of the restricted ownership rights and the low issue volumes.

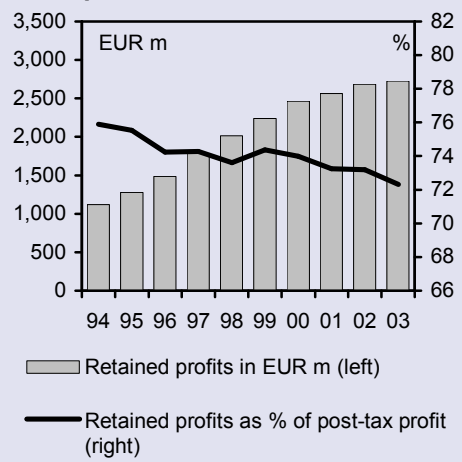


### Raising capital

Given the *cajas'* ownerless legal form they were traditionally only able to strengthen their equity base by ploughing back profits. Over the past ten 10 years the *cajas* channelled a good 70% of after-tax profit into their revenue reserves every year, with the cumulative total coming to roughly EUR 20 bn.<sup>17</sup> In 1985, the savings banks were given the opportunity, in the first step of several, to broaden their capital base by issuing subordinated debt (*financiaciones subordinadas*). The paper has to meet certain criteria in order to be recognised by Banco de España as such. For example, it demands a minimum maturity of five years, the exclusion of premature redemption and notice of the status as subordinated debt in the terms and conditions of issuance. The *cajas* – like the banks – are also free to issue preference shares (*participaciones preferentes*), a vehicle used intensively by some *cajas* especially during the years 1999-2001.<sup>18</sup> It was during this period that mortgage business started to boom and the *cajas'* loan portfolios exhibited strong growth. At the same time, though, the central bank issued a recommendation to cap the share of *participaciones preferentes* at 30% of equity.<sup>19</sup>

This triggered renewed debate over the savings banks' capital-raising practices, as some of them had already reached or exceeded the recommended limit. The core point of the discussion pertains to the difficulty of obtaining equity capital without changing the "ownerless" legal form of the *cajas* and having to grant potential

**Cajas: capital raised by ploughing back profits**



<sup>17</sup> In the same period, the *cajas* made available the remaining nearly 30% (over EUR 7 bn) for social, cultural or academic purposes in the framework of their *obra social*.

<sup>18</sup> Preference shares (without voting rights) and subordinated debt are considered part of Tier 2 capital, not Tier 1.

<sup>19</sup> Law 19/2003 of July 4, 2003 makes it compulsory to limit preference shares to 30% of the equity base.

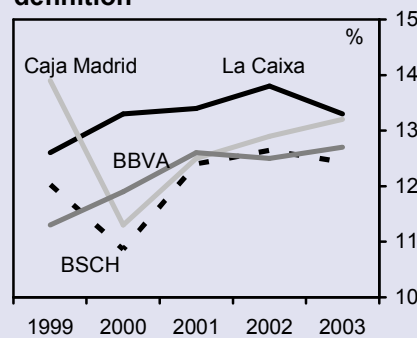
investors rights to exercise influence on the *cajas*. Many voices – including those of the big political parties – demanded an instrument to strengthen the *cajas*' Tier 1 capital. However, the big savings banks post capital ratios similar to or above those of the big banks. As an institutional group, too, the *cajas* report a higher ratio than the banking sector in terms of both Tier 1 capital and total equity. This contradiction might be explained by the fact that attempts were to be made to prevent a potential future squeeze on capital at the expanding *cajas* and to create scope for capital-intensive lending activities. The parliamentary debate over the *Ley Financiera 2002* did not only concern the reform of capital raising. It was also closely linked with the debate over the legal form and internal structure of the *cajas*. The ruling conservative party, the *Partido Popular* (PP), ultimately pushed through a reform of the *cuotas participativas*: non-voting equity units which the *cajas* could issue to raise equity capital. The opposition party, *Partido Socialista de Obreros Españoles* (PSOE), accused the PP of opening a back door to the privatisation of the *cajas* with the reform of the *cuotas participativas*. This instrument had been in existence since 1988, but had not been used by any of the *cajas*. Their reluctance is explained by provisions of the 1988 law which made its application rather impracticable and which kindled fears that the private sector could start to exercise influence on them. The revision of the law therefore took particular account of the existing legal form of the *cajas*.

The practice of issuing preference shares, which some *cajas* exploited heavily until Banco de España stepped in, is no longer possible to the same degree owing to the 30% ceiling, so it would have been logical to expect the *cajas* to switch to the revamped *cuotas participativas* as an alternative way to raise capital. Surprisingly, though, no *cuotas participativas* have been issued yet. This may suggest that – as indicated earlier – the equity resources of the *cajas* are indeed plentiful enough at present for them to get by without having to seek new ways to raise capital. Besides, the *cuotas*, which would be regarded as Tier 1 capital, appear to be seen by many as the beginning of a possible change in the current savings bank model, despite the exclusion of ownership rights.<sup>20</sup> The decision-making bodies of the *cajas* seem to fear a creeping change in the legal form. This could lead to the political powers seeing their influence weakened, or even allow the takeover of *cajas* by stronger competitors.

As long as the *cajas* issue no *cuotas*, the question of just how interested investors are in this instrument will remain open. For even if an issuing *caja* has good earnings prospects, the basic conflict for the investor remains: full liability by virtue of Tier 1 capital, but no say in business policy or appropriation of profit. It could therefore prove more attractive for investors to pour capital into shares of joint-stock companies – unless the *cajas* are prepared to pay higher dividends on the *cuotas*. Without a clear overhaul of the legal form to allow private, share-based ownership of the *cajas*, the collection of equity capital from potential investors is likely to be difficult and expensive. However, the fundamental question remains as to whether it is necessary to raise equity capital externally in the first place. The *cajas* can plough back a large percentage of their profits – 70% on average. By contrast, the banks are required to pay out competitive dividends to their owners.

<sup>20</sup> This was the nature of comments by, for example, Ricardo Fomesa, president of La Caixa, on March 1, 2004. (El País, March 2, 2004: La Caixa no emitirá cuotas participativas al menos hasta 2006).

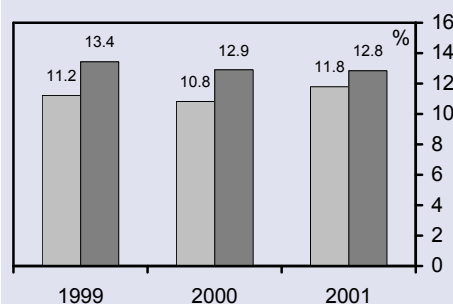
**Equity ratios according to BIS definition**



Caja Madrid 1999, only parent company (incl. retail business)

Sources: Company data

**Spanish credit institutions: capital ratios (Tiers 1+2)**



Sources: OECD, DB Research



## Remaining scope for public-sector influence

There are two channels through which political influence can be exerted over the *cajas de ahorros*: via membership in their governing bodies, and via an additional supervisory authority at the level of the *comunidades autónomas*. The Spanish banks, in contrast, do not have to observe detailed regulations on appointments to their governing bodies and are accountable only to Banco de España as supervisory authority.<sup>21</sup>

Since the public-sector representatives are selected by the municipal councils and autonomous parliaments, the power structures there are usually reflected in the bodies of the savings banks. Before the governing bodies were reformed under the *Ley Financiera* of 2002, a change of party in power brought a political reallocation of seats at the *cajas*. To deal with this, the law stipulated that the mandate of the *consejeros generales* in an *asamblea* is irrevocable during their term of office. The same applies to mandates in the *consejo de administración*. Despite this, a look at the Spanish press shows that appointments to positions at savings banks are still decided by the political parties. The parties fight fierce battles over them, as was seen, for example, in the wrangling over business planning and personnel policy at the PP-controlled Caja Madrid in late 2003. Weakened by election defeats and scandals, the PP sought to keep “its” president of Caja Madrid in office by negotiating with the PSOE on a stronger presence of the PSOE in the *comisión ejecutiva*, the key governing body of Caja Madrid<sup>22</sup>.

The *Ley Financiera* limited the number of public-sector representatives to a maximum of 50%. But it needs to be borne in mind that party-political influence can still be exercised through the other groupings of the *asamblea*. Since the individual depositor rarely bothers about the lists of candidates to be drawn up, or exercises other, similar rights of savers, saver associations – some of which have party leanings – take care of such matters. Other organisations, e.g. consumer protectors, sometimes also play a part. In most of the *comunidades autónomas* the rules for the election of employee representatives to the *asamblea* stipulate that the trade unions, as representatives of the staff, elect the *consejeros generales* of this group. And the various trade unions have party-political affinities.<sup>23</sup> The *comunidades autónomas* also have the right to permit other institutions or organisations to participate in the governing bodies of *cajas*, provided they represent social and collective interests in the region where the savings banks conduct business. The autonomous laws regarding the selection of these additional interest groups vary. But they often define which organisations the savings banks can elect to their decision-making bodies. Here again the parties are able to exert influence on the political orientation of a savings bank’s *asamblea*.

In seeking to make the savings banks more democratic, the reforms started in 1977 made their governing bodies more political. The stronger the political influence exercised by direct representatives, or indirectly through other groups, in the bodies of a *caja*, the greater the scope to influence the savings bank’s strategic and operational

## Cuotas participativas

Bearers of *cuotas participativas* are granted economic rights but no voting rights as tentatively proposed in the original bill drafted by the PP. The *cuotas participativas* issued must not exceed 50% of the value of the equity capital, and no natural or legal person may acquire more than 5% of the units issued. Besides, the issue has to be paid for immediately in cash. The bearers’ economic advantages are not confined to profit participation. They also cover the preferential subscription of new *cuotas participativas* and redemption at market value should the *caja* call in the units upon a merger. However, the *caja* can exclude the right to preferential subscription when issuing new *cuotas* provided that certain conditions are met. In case of losses, the capital obtained by means of *cuotas participativas* is liable on a pro-rata basis. Similarly, in the case of liquidation it is considered to rank equally with the initial capital and the revenue reserves. As the *cuotas* function as equity, they have no set lifespan. The nominal amount of the capital obtained by issuing *cuotas participativas* is booked in a special reserve fund (*fondo de participación*). The share of profit attributable to the bearers of the *cuotas* but not distributed is booked to a further new reserve category (*fondo de reserva*). There is also the option of forming a provision to smooth out fluctuations in the dividend over time (*fondo de estabilización*). The *cuotas participativas* must be traded on an organised secondary market, the idea being that the market will assess a *caja*’s prospective success and efficiency. So far, no *cuotas participativas* have been issued, so the level of market acceptance cannot be gauged yet. One possible difficulty might be that the size of the actual payout of the dividend depends not only on the economic success of the *caja*. The *asamblea general* has a degree of latitude to decide the size of the payout attributable to the *cuotas participativas*. It determines the amount to be assigned to the *fondo de reserva* and the *fondo de estabilización* and the amount of the actual payout to the bearers of the *cuotas*. However, the bearers have no voting rights in the bodies of the savings banks. Still, the government legislation provides that a *caja* can allow the bearers of said equity units to form a company. Its president would have the right to voice opinions at the *asamblea general*, but not to participate in voting.

<sup>21</sup> The Ministry of Economy also has certain supervisory powers over banks. But Banco de España is the central supervisory authority.

<sup>22</sup> El Mundo, June 18, 2004: El PP negocia dar al PSOE más presencia en Caja Madrid. El País, March 20, 2004: El PP acepta el regreso del PSOE a la comisión ejecutiva de Caja Madrid.

<sup>23</sup> See Juan Antonio Ureña Salcedo: La influencia pública en las cajas de ahorros, Valencia, 2004.

decisions via the *asamblea* and the *consejo de administración*. The members of the *asamblea* decide each year on the strategic business orientation of the savings bank, and the *consejo* and the *comisión de control* work on this basis. In practice the strategic business plan is often worked out by the management and put to the *asamblea* for approval. The *asamblea* also approves the management report, balance sheet and profit and loss account, and ratifies the acts of management of the *consejo de administración*. Amendments to the articles of association, decisions on mergers or liquidation and on the appropriation of profits are also the responsibility of the *asamblea*. Since profits must either be ploughed back into the *caja* or used for social purposes, the amount of profit that is retained determines *uno actu* the budget of a savings bank's *obra social*. The selection of projects for the *obra social* also requires the approval of the *asamblea*. The representatives of different political hues in the *asamblea* and the *consejo de administración* also participate in all decisions that, according to the statutes, are to be taken in one or other of these bodies, e.g. decisions on the issuance of *cuotas participativas*, bonds or securities to raise capital, or on the *caja's* portfolio of corporate holdings. The director general – who by law has to be chosen on purely professional criteria – needs the support of the *consejo de administración*. The influence of the political forces thus potentially extends into all important decision-making bodies.

The *Ley Financiera* states that the representatives in bodies of a *caja* are bound to observe only the interests of the savings bank. In view of the possibilities for exerting influence and the energy the political parties put into wrangling over how positions should be allotted, it seems doubtful that this brief is being fulfilled.

### Political influence of the *comunidades autónomas*

The savings banks are also subject to external political influence, as the *comunidades autónomas* have supervisory rights and legislative powers. The dividing line between the regulator and those being regulated is thus blurred in the governing bodies of the *cajas*.

Since the *coeficientes de inversión obligatoria* expired, the autonomous governments no longer have the right to steer the funds of the *cajas* into certain types of assets-side business. Even so, some *comunidades autónomas* still give recommendations as to how the savings banks' funds should be used, in order to support their own regional economic goals. Many *comunidades autónomas* tighten the rules of Banco de España – which apply to all credit institutions – for the *cajas* in their region. This gives the autonomous authorities greater influence on the savings banks' business policies. In order to limit the concentration of risk, especially counterparty risk, Banco de España requires credit institutions to adhere to supervisory rules and appropriate internal procedures. Many *comunidades autónomas* have laws, however, that require savings banks also to obtain permission from the autonomous authorities before granting large loans. Similarly, many *comunidades autónomas* demand that the *cajas* obtain prior authorisation before investing in corporate holdings.<sup>24</sup> Since Banco de España evidently considers the national supervisory rules for credit institutions to be sufficient, one wonders whether the additional requirements imposed by the autonomous authorities on the *cajas* are really

**Political representation in *asamblea* enables influence on strategic decisions**

**Influence of *comunidades autónomas* on use of funds**

<sup>24</sup> See Juan Antonio Ureña Salcedo: *La influencia pública en las cajas de ahorros*, Valencia, 2004.



intended to enhance supervision, or whether they are not in fact a means of exercising influence.

The appropriation of the savings banks' profits can be influenced directly by the autonomous authorities as the *cajas* have to have their budget for the *obra social* and new projects approved. The articles of association of the individual savings banks are also subject to approval by the autonomous authorities. When *cajas* are to be set up, dissolved or merged the *comunidades autónomas* have the right to carry out inspections and grant or withhold approval. To date, there has been no merger between *cajas* based in different *comunidades autónomas*.<sup>25</sup> Such a merger would mean a loss of power for the authorities of the *comunidades autónomas* involved. Under the *Ley Financiera*, a merger between *cajas* from different *comunidades autónomas* must be approved by the governments of both *comunidades*. The authorities must also decide the distribution of the seats held by the public sectors of the two regions in the governing bodies of the new savings bank.

The wrangling among the political parties for influence over the *cajas* sometimes leads to national legislative powers being used as a means of intervening at the autonomous or local level. The conservative PP, then in office in the national government, pushed through a clause in the *Ley Financiera* which permits the three church savings banks to place themselves under the supervision of the national ministry of economy instead of the *comunidad autónoma*. This was sparked by a tussle over CajaSur in Andalucía. Andalucía's Socialist government wanted to create a strong regional savings bank, but such a merger would have threatened the rights of the church in CajaSur. After winning the elections to the national parliament, the PSOE now wants to restore responsibility for supervision of the church *cajas* to the *comunidades autónomas*.<sup>26</sup> The modification of the LORCA law by the PP at the end of 2003 is another example: it altered geographical representation in the *cajas*. A savings bank's *asamblea* now has to include representatives of the savers and local authorities from all *comunidades* in which the bank does business. "El País" newspaper pointed out that this alteration gave the PP, in particular, greater presence and affected La Caixa most.<sup>27</sup>

In essence, it can be said that the LORCA law (which broadened public representation in *caja* governing bodies) and the creation of the *comunidades autónomas* strengthened political influence on the *cajas*. The *Ley Financiera*, which is supposed to limit public influence on the *cajas* and increase efficiency in Spain's financial sector, has not yet significantly reduced political penetration of the top *caja* bodies. The 1977 reform was originally intended to free the *cajas* from political influence. But the plan was torpedoed by the LORCA law. The goal has not been achieved.

The savings banks' origins as charitable institutions, their *obra social* and their local roots are cited as justification for public interest in their operations, and the public authorities and other groups are seen as looking after the public interest. As backers of the holders of public office, however, the political parties have enormous clout that extends far into the decision-making on personnel and business. In no way, though, does the savings banks' social mandate justify

### **Powers of *comunidades* regarding *obra social* and mergers**

### **Political parties fight over influence in *cajas***

### **Efforts to depoliticise *cajas* failed**

### **Common interest claimed to justify political influence**

<sup>25</sup> Exception: merger of Caja de Ceuta with Caja Madrid.

<sup>26</sup> El Mundo, April 6, 2004: El PSOE pretende devolver el control de las *cajas* de la Iglesia a las autonomías.

<sup>27</sup> El País, November 14, 2003: El PP usa su mayoría para cambiar la representación en las *cajas*.

political influence being brought to bear on their business decisions, when they are in fact supposed to compete with other banks on equal terms. It would be easier for the savings banks to concentrate solely on optimising their business results if they were split into a non-profit *obra social*, possibly in the form of a foundation, and a private-sector bank whose owners stake their capital on the performance of the management.

## How changes in the savings bank sector affect the banking market

In 1977 the *cajas* were put on an equal operational footing with the banks as universal banks, and in 1988 the regional principle was revoked. This strengthened the savings banks' position in the Spanish market. When the restrictions on investment (*coeficientes de inversión obligatoria*) were discontinued and free pricing was introduced, this led to greater competition among the individual credit institutions, and increased efficiency in the financial sector. The customers are also among the winners. The 1977 drive to reorganise the financial sector in line with market principles was thus largely successful. But there are still some competitive distortions that can be traced back to the legal form of the *cajas*. Unlike banks, the *cajas* do not have to achieve and distribute a return on their equity that makes them attractive in competition with other credit institutions. The *cajas* are protected against being taken over. Also, they are exposed to strong political influence that restricts their freedom in doing business and is not compatible with market principles.

### a) A domestic perspective

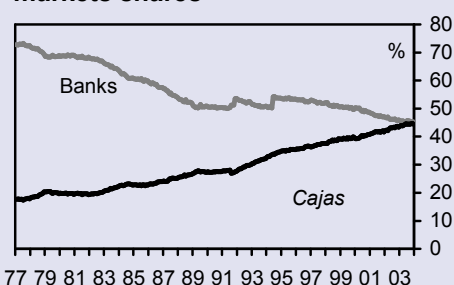
The *cajas de ahorros* have been very successful in taking advantage of the liberalisation of the financial sector and the removal of restrictions that applied specifically to themselves. They still concentrate primarily on retail banking, their traditional business model. Since 1976 the *cajas* have doubled their market share in lending to the resident sector to 45%, which has brought them almost level with the banks. Banco de España is now watching the strong expansion of the savings banks' lending very carefully.<sup>28</sup>

One way in which the *cajas* have caught up in credit business has been by expanding their mortgage lending to households. In the past ten years Spain has experienced a construction boom driven by falling interest rates, growing prosperity and greater housing demand from large birth cohorts. The banks have also benefited from this boom, enlarging their building financing by EUR 91 bn between 1992 and 2003; this pushed their market share from 25.1% to 38.8%. But the *cajas* increased their volume by EUR 119 bn and dominate the market with over 53%. In total, the Spanish market for household mortgage lending rose sixfold between 1992 and 2003, from EUR 44 bn to EUR 263 bn. Over this period mortgage loans expanded from 12.4% to 25% of the savings banks' assets. In the banks' balance sheets at the end of 2003 mortgage loans made up 12.4%.

In corporate finance<sup>29</sup>, where the *cajas* have been free to operate without restriction since liberalisation, the savings banks have increased their lending by EUR 117.8 bn while the banks have registered expansion of EUR 111.9 bn. Even though the difference is

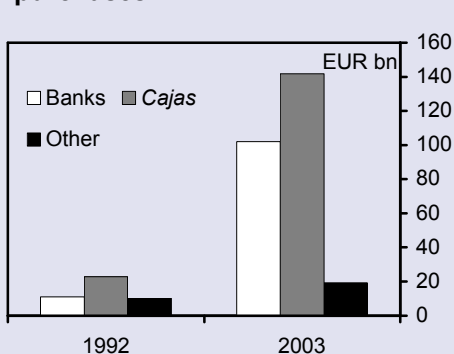
## Liberalisation strengthened competition and efficiency

### Lending to residents - change in markets shares



Sources: Banco de España, DB Research

### Credit to households for house purchases



Source: Banco de España

<sup>28</sup> Address by the governor of Banco de España, Jaime Caruana, at the annual meeting of CECA in 2001.

<sup>29</sup> In May 2004 total corporate loans outstanding in Spain came to EUR 412 bn.



not as pronounced as in the case of mortgages, the *cajas* have here again captured more of the growth of market volume than has the competition. Their share of the market in corporate lending has risen to 37.9%, compared with 52.5% for the banks (May 2004).

The savings banks have continuously raised their share of the market for resident deposits (May 2004: 56.5%). Since 1993 they have been ahead of the banks (35.4%) in this segment. However, the *cajas* lag far behind the banks in attracting savings through investment funds. For years their share of investment fund assets has stagnated at somewhat over 25% whereas the banks have around 65% under management. The volume accumulated in investment funds in Spain has risen continuously (except in the years 2000-2002) from EUR 5 bn in 1989 to over EUR 200 bn. Parallel to this, funds have gained in importance relative to traditional forms of saving. So far, the *cajas* seem to have had comparatively little part in this trend: their business is concentrated in traditional savings deposits. Taking traditional savings and investment funds together, the *cajas* manage 48% of the total and the banks 44%.

Some savings banks, especially the larger ones, also operate in the capital market: in trading, securitisation of claims (especially mortgage loans) and issuance of securities. The *cajas* focus mainly on domestic business. As yet they do practically no branch business abroad, and transactions with non-residents make up only 7% of their assets.<sup>30</sup> The banks use 19% of their assets for business with non-residents; this includes the Latin American operations of the two big banks. Many *cajas* have built up a large portfolio of strategic corporate holdings. They hold stakes particularly in companies in the energy, telecoms and infrastructure sectors, and also in finance. Unlike the banks, the *cajas* are extending their holdings. La Caixa alone has a portfolio with a book value of EUR 10.5 bn; and the market value of only its holdings in listed companies came to EUR 12.9 bn at the end of 2003.

The expansion of the *cajas*' business has bolstered their share in the aggregate balance sheet of all credit institutions. In May 2004 it reached 37.5%, up from 22% in 1976. The share of the banks came to 54.4% and that of the cooperativas 3.7%.

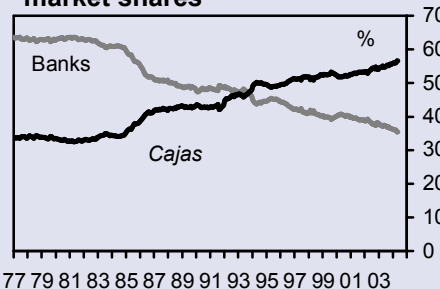
The savings banks are profitable; taken as a group, their return on equity has been well above that of the banks since 1995.<sup>31</sup> Expressed as return on assets, their profits have been higher and less volatile than those of the banks since 1976. The interest margin of the *cajas* (2.2%) is higher than that of the banks (1.8%). This may be due to the savings banks' access to favourably-priced savings deposits. Besides, the *cajas* use a smaller proportion of total assets than the banks for interbank business, where margins are traditionally lower than in business with non-bank customers.<sup>32</sup> In 2003 the *cooperativas* achieved an interest margin of 2.8%. Since 1976 Spain's credit institutions have become more efficient. But their cost-income ratios have not developed evenly. A breakdown by group shows that the *cajas* operated more efficiently than the banks

<sup>30</sup> The *cajas* have started to woo foreign customers, particularly in Spain's holiday regions, by providing information in several languages, for example.

<sup>31</sup> For 2002 and 2003 there are figures from CECA and AEB which also show the *cajas* to have earned a higher return on equity than the banks. Unlike the OECD, CECA and AEB calculate ROE on the basis of a narrow definition of equity.

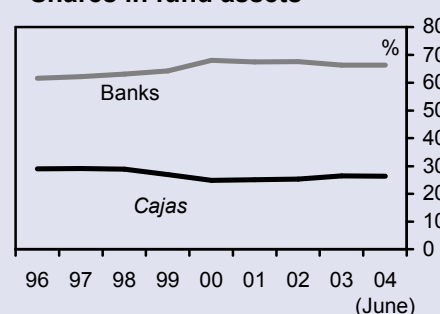
<sup>32</sup> According to Banco de España, interbank business made up 8% of assets and 6.1% of liabilities at the *cajas* at end-2003, but 15% and 16.1%, respectively, of balance sheet total at the banks.

Resident deposits - change in market shares



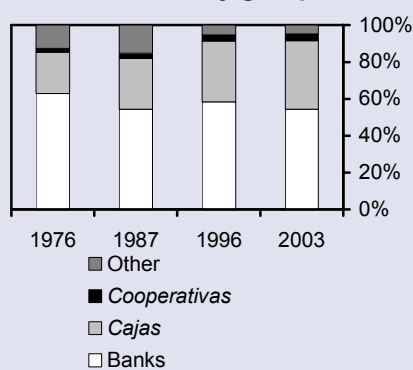
Sources: Banco de España, DB Research

Shares in fund assets



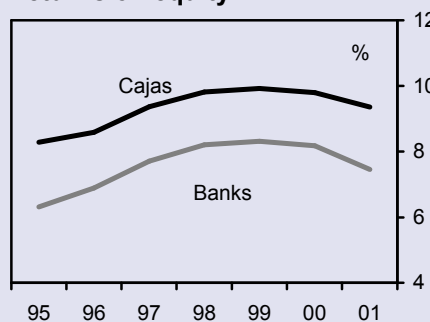
Sources: Inverco, DB Research

Shares in aggregate balance sheet, by group



Sources: Banco de España; DB Research

Returns on equity



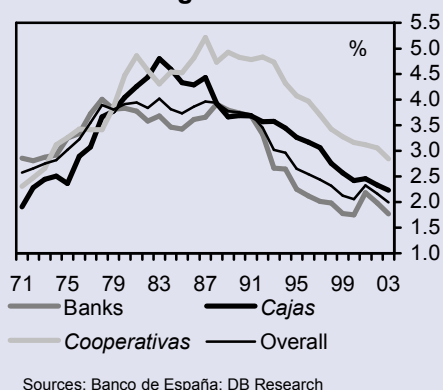
Sources: OECD, DB Research

in the early 1970s and in the second half of the 1990s. In the final quarter of 2003 the cost-income ratio for all credit institutions together was 57.6% (compared with 67.9% at the end of 1976). The banks had reduced their ratio to 55.1%, while the figure for the savings banks was 60.1% and for the *cooperativas* 62.3%.

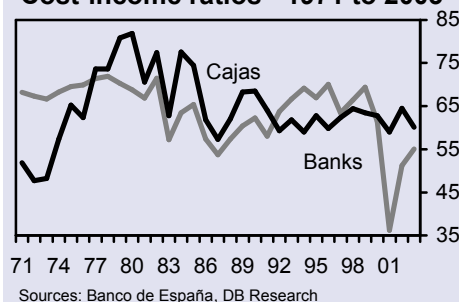
The liberalisation of the financial sector triggered changes in the number of credit institutions. Mergers in the savings bank sector have reduced the *cajas* from 81 at the end of 1981 to 46, not counting the umbrella organisation CECA. The greatest number of mergers took place between 1990 and 1995. The *cooperativas* have also decreased steeply, from 147 to 84. Several *cooperativas* have been absorbed by *cajas*. Some savings banks also grew in size by buying into the bank sector, especially in the period from 1996-2000. The number of banks fluctuated in the past; since 1981 it has increased by 10 to 138. There were mergers among the big banks, however, which led to the creation in 1999 of Banco Santander Central Hispano (BSCH) and Banco Bilbao Vizcaya Argentaria (BBVA). The two big banks have a strong market position. Together they accounted in 2003 for 38% of lending to non-banks (private and public-sector, domestic and foreign), and 47% of non-bank deposits. When the third-largest bank – Banco Popular – is included the figures rise to 44% of loans and 52% of deposits. And if the circle is widened to comprise the two savings banks La Caixa and Caja Madrid, this gives the market share of the five largest Spanish credit institutions. In 2003 it came to 60% of lending and 71% of deposits. Although still high, these figures represent a decline in the degree of concentration compared with 1999.<sup>33</sup> Banco de España puts concentration in the Spanish market at 49.4% in 2003 (calculated as the share of the five biggest institutions in the aggregate domestic balance sheet of all deposit institutions). When foreign operations are factored in, it rises to 56.7%.<sup>34</sup>

The abolition of the regional principle strengthened competition. The *cajas* now compete directly with each other, as reflected, for instance, in the fact that they have different logos. Many savings banks have extended their branch network beyond their home region whereas in 1985 seventeen still had branches only in their home *comunidad autónoma*, and not a single *caja* was represented nation wide. By 2002 six *cajas* had national branch networks and only five restricted their business to their home region.<sup>35</sup> The total number of branches in the savings bank sector was continuously increased from 6,818 in 1976 to 20,871 at the end of 2003. The banks, which had expanded their networks from the middle of the 1970s, reduced their branch numbers again in the 1990s. In 2003 they had 14,074. Today, the 46 savings banks have over 53% of all branches, while the share of the banks has fallen to 35.7%. The *cooperativas* have expanded their branch network, but have not gained in importance as their share has remained at around 10%. The *cajas*' expansion strategy has paid off. An examination shows that, over time, there is a definite positive correlation between shares in total branch numbers and shares in total lending and

Interest margins - 1971 to 2003



Cost-income ratios - 1971 to 2003



Number of *cajas de ahorros* per *comunidad autónoma*

	1988	2002	Diff.
Andalucía	14	6	-8
Aragón	2	2	0
Asturias	1	1	0
Baleares	2	2	0
Canarias	2	2	0
Cantabria	1	1	0
Castilla y León	11	6	-5
Castilla-La Mancha	4	2	-2
Cataluña	11	10	-1
Extremadura	4	2	-2
Galicia	4	2	-2
Madrid	1	1	0
Murcia	1	1	0
Navarra	2	1	-1
País Vasco	6	3	-3
La Rioja	1	1	0
C. Valenciana	9	3	-6
Ceuta y Melilla	1	0	-1
Total	77	46	-31

Source: Economistas, 09/2003, Nr. 98

<sup>33</sup> The concentration levels in lending and deposits are calculated on the basis of data from annual statements of accounts, DB Equities, CECA and Banco de España.

<sup>34</sup> Banco de España: Memoria de Supervisión 2003, pp. 25-27. Deposit-taking institutions: banks, *cajas* and *cooperativas*; no specialised credit institutions.

<sup>35</sup> The figures for both years are based on the 46 *cajas* that now exist, i.e. the 1985 figures notionally anticipate all mergers that have taken place since then.



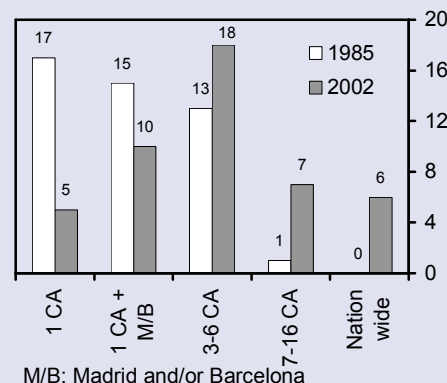
deposits.<sup>36</sup> Since local customer contact has proved to be very important, the big banks are now considering opening new branches.

The individual *cajas* differ considerably as regards balance sheet total, business model and geographical coverage. The two largest, La Caixa and Caja Madrid, make up one-third of the aggregate balance sheet total for the sector; nine *cajas* account for a further one-third; and the balance sheets of the 36 smallest *cajas* (including CECA) also add up to one-third. Although in competition with each other, the *cajas* also have the possibility of cooperating either directly or via their umbrella institute CECA. CECA provides many services, enabling *cajas*, particularly the smaller ones with a lower volume of business, to operate more efficiently on the cost side. In some cases it is their only means of attaining critical mass. CECA functions as both central institution and association of the savings banks. It offers its members financial, administrative and IT services, as well as economic analysis, legal and operational advice, and a staff training academy. CECA's services in the financial sector include a trading room (through which the *cajas* can trade small amounts of foreign exchange, derivatives or government paper at lower cost), services in the payments and securities sectors, and a communal connection to the SWIFT network. The *cajas* can use IT services at CECA instead of setting up and maintaining capacities of their own. As savings bank association, CECA naturally also represents the interests of the *cajas*, especially vis-à-vis the legislative and authorities. CECA and *cajas* have joint subsidiaries that engage, for example, in insurance, fund management, equity trading and leasing. In 2002 the *Ley Financiera* explicitly permitted the outsourcing of *caja activities* to joint ventures between different savings banks. There are no joint ventures between *cajas* or CECA and the bank sector.

**b) An international comparison**

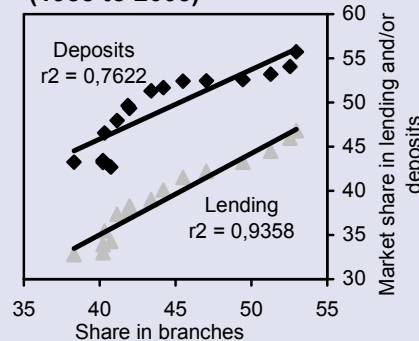
Owing to the strong expansion of the branch networks Spain has a very high number of branches per thousand inhabitants. Its figure of 0.96 is far above the average for other large European countries.<sup>37</sup> This top position is partly due to the choice of business model, though. According to OECD data, the average number of employees per branch works out at 6 in Spain. In countries with a lower branch density, there are more employees per branch, e.g. 40 in the UK (0.18 branches per 1,000 inhabitants), or 19 in Germany (0.45 branches per 1,000 inhabitants). However, the number of bank employees per thousand inhabitants is surprisingly similar in all of the countries compared, namely 6 or 7 (except in the Netherlands and Germany). In Spain the *cajas* are not alone in believing that, in the Spanish market, personal contact with the customer is very important; and this is maintained through a large number of relatively small branches. A very different structure is found in the United Kingdom, where the number of branches is low in relation to the population but the number of bank employees is even higher than in Spain. This leads to the question of the cost of the different business models: with a cost-income ratio of 55.5% in 2001, Spain comes out slightly better than the UK with 57.4%, according to OECD data.

**Cajas with offices in "n" comunidades autónomas**



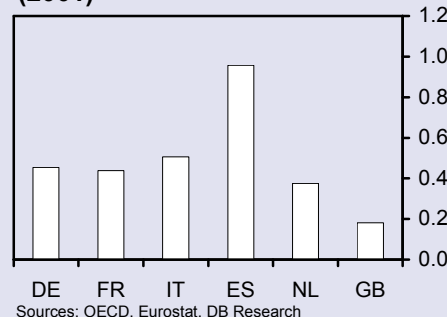
Source: Economistas, 09/2003, Nr. 98

**Cajas: market share vs share of branches (1988 to 2003)**



Sources: Banco de España, DB Research

**Branches per 1,000 inhabitants (2001)**



Sources: OECD, Eurostat, DB Research

<sup>36</sup> Owing to the data situation, the calculation was based on the *cajas'* market share in lending of the deposit-taking institutions (banks, *cajas* and *cooperativas*).

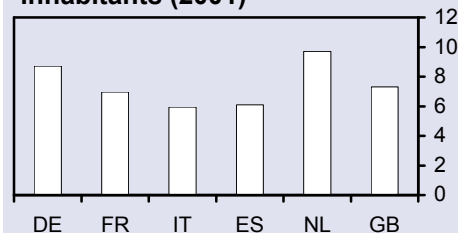
<sup>37</sup> OECD Banking Profitability; the data refer to 2001.

Compared with their European peers, the Spanish credit institutions have registered a relatively steady, positive development in their return on equity; only the British institutions have performed considerably better. In recent years the Spanish banks have expanded abroad, especially into Latin America, whereas the savings banks have grown at home. The banks are now also devoting greater attention to the domestic market, as the growth of Spain's economy probably implies further growth potential for the Spanish financial market. Spain's big banks, with their market capitalisation and earning power, are well equipped for any consolidation of the financial sector in Europe. The *cajas* hold stakes in several medium-sized Spanish banks. This should be to their advantage in the event of further consolidation in the Spanish market. After expanding at home so far, savings banks are now thinking of making the leap abroad. La Caixa already engages in retail business in France through La Caixa Bank.<sup>38</sup> Caja Madrid is considering moving into Mexico and Chile. Internationally, too, the *cajas'* legal form protects them against being taken over by rivals.

**c) The customer's view**

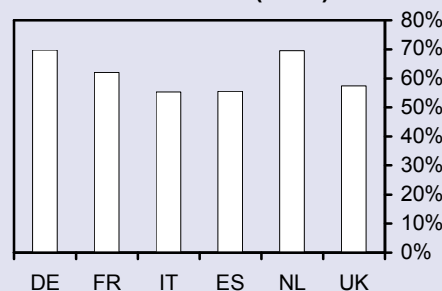
The enlargement of the branch networks in Spain was partly a logical consequence of the branch concept. The staff at the branches concentrate on customer advisory services, mainly selling complex, high value-added bank products. This personal advice helps to strengthen customer loyalty in the face of the growing competition both among the credit institutions and from other financial intermediaries such as investment companies or insurers. The branches are technologically well equipped and, despite being relatively small, they offer a wide range of products. Other distribution channels are also used, especially for standardised services. Automated teller machines (ATMs) have become very important in Spain, accounting for roughly 25% of all transactions. ATMs outnumber the branches (39,830) in Spain by more than 40%. Customers can also use telephone and online banking.

**Bank employees per 1,000 inhabitants (2001)**



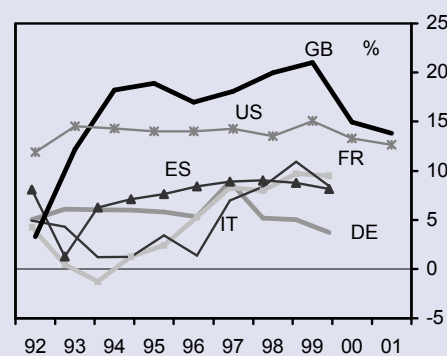
Sources: OECD, Eurostat, DB Research

**Cost-income ratios (2001)**



Sources: OECD, DB Research

**Returns on equity**

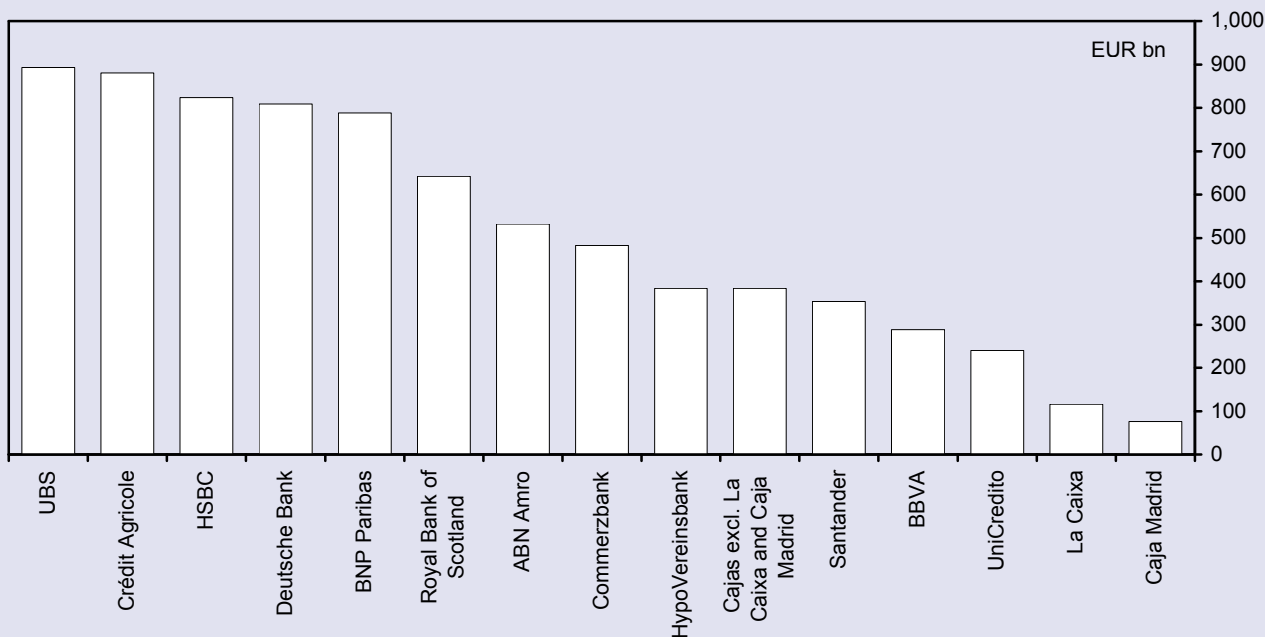


Sources: OECD, DB Research

<sup>38</sup> In 1988 CGBI was acquired from Paribas and under the name La Caixa Bank it now has assets totalling EUR 2.1 bn and reported a profit of EUR 0.875 m in 2003. The branch network has so far been enlarged from 16 to 50 branches and is to be further extended



### Balance sheet totals of European credit institutions (2003)



Sources: The Banker, Bankscope

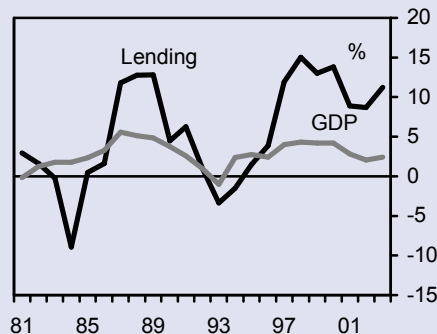
Lending rates have improved greatly for customers since price controls were lifted – though the decrease has admittedly also to be seen in the context of Spain’s entry into the EU and EMU. A comparison of the banks and savings banks shows that since around 1990 the cajas have been able to offer achieve better conditions than the banks in important categories of lending and deposits.<sup>39</sup> The new methodology of Banco de España still shows the cajas to have stronger pricing power in the market segments in which they are especially strong: household savings deposits, building financing and corporate loans of more than EUR 1 m.<sup>40</sup> This seems to indicate strong customer loyalty, which could be explained by the savings banks’ greater number of branches and their strong presence in rural areas as well as the cities.

The growth of the Spanish economy over the past two decades has been accompanied by a rise in lending by credit institutions. Lending to domestic residents expanded much more strongly than GDP. Lending growth lagged GDP growth only in the 1980s and from 1991 to 1993 when the credit institutions reacted to the current economic difficulties by curtailing lending.

### Conclusion

The financial-sector reforms introduced since 1977 as part of the market-oriented transformation of the whole economy have increased competition and led to a larger and cheaper range of bank services for customers. This reflects not only the success of the cajas after they were put on an equal operational footing with the other credit institutions, but also the competition within the savings

### Real growth of lending to residents and of GDP



Sources: Banco de España, DB Research

### Deregulation strengthened Spain’s financial sector

<sup>39</sup> Banco de España, Interest-rate statistics up to 2003. Categories: mortgage loans, loans for 1-3 years, short and long-term personal loans.

<sup>40</sup> Banco de España, Interest-rate statistics from 2003.

bank sector following the abolition of the regional principle. The *cajas*, however, are still protected against competition to some extent by their legal form. Since they cannot be taken over, the market cannot determine the fate of a savings bank on the basis of its business success. In addition, the *cajas* – unlike the banks – can strengthen their equity by ploughing back a large proportion of their profits. The banks are under more pressure to distribute profits as dividends. The efforts to depoliticise the *cajas* have not succeeded. The fact that considerable political influence can be exercised through representation in the management bodies or through the powers held by the autonomous governments runs counter to market principles. The *cajas* are, for example, free to merge with institutions beyond regional borders, but in practice this freedom is restricted for political motives.

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### ***Cajas* not subject to market discipline**

### **Political influence on *cajas* remains strong**

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