

## Addressing a significant 'hidden' factor behind Spain's failed banks

*To celebrate 10 years of the Department of Management, we explore how our research is making a difference. In the first of 10 articles, we analyse how Professor Luis Garicano influenced the Spanish government to overhaul the way bank executives are appointed.*



### What was the problem?

In the wake of the 2008/09 global financial crisis, the Spanish real estate market collapsed, putting in jeopardy the country's network of savings and loan banks known as Cajas.

The collapse exposed a huge volume of overlending by these banks to projects and loans with little likelihood of repayment. Since 2009 many weak or failing Cajas had to be taken over by other banks or rescued and nationalised by the state.

### What did we do?

Luis Garicano, LSE Professor of Economics and Strategy, and Vicente Cuñat, Associate Professor of Finance, investigated the educational qualifications, business experience and other key personal characteristics of every top executive in almost 50 Cajas. They also collected data on the Cajas' lending decisions and the subsequent performance of those loans.

They found that the chairmen of Cajas who had been the recipients of political patronage, had low education, or had no previous banking experience had a negative impact on the institution's performance during the crisis.

For example Cajas led by chairmen without a university degree:

- extended 7% fewer loans to individuals and 5-7% more loans to real estate developers than other Cajas;
- had over 1% more non-performing loans;
- had 0.2% lower return on assets – the ratio of profits earned to capital used – in 2006.

Since these Cajas were more likely to lend to real estate borrowers in the boom, this poor result suggested that they were badly managed rather than taking larger risks.

Working with two US academics, Garicano identified what he called a "political credit cycle" where bubble conditions sharp rises in asset prices made it harder to ensure that a bank was well-governed. The researchers found that the banks that recruited poorly qualified executives and gave them weak incentives tended to suffer longer post-bubble shocks.

### What happened?

In the wake of the Cajas crisis, the Spanish government introduced a broad reform of governance practices in 2010 and 2013 to reinforce the professionalism and competence of Cajas managers. This included specific requirements in terms of experience and education.



During the reform process Garicano and Cuñat presented their research to Banco de España, the central bank. Their research generated debates in political and academic circles about its implications for the regulation of financial institutions and influenced the drafting of the new rules.

In a separate development, Spain was forced to seek funding from the so-called “troika” of the European Commission, European Central Bank and International Monetary Fund because of the insolvency of Bankia, a non-Caja banking conglomerate. In 2012, as part of that process, the

International Monetary Fund published a technical report that specifically cited Garicano and Cuñat’s finding that Cajas whose chairmen were political appointees or lacked proper banking experience had significantly worse performance.

The IMF report motivated the way that the restructuring of the Caja sector was designed. The LSE research influenced the Fund’s recommendation that the rescue package agreed by the European Commission, European Central Bank and IMF should include specific measures to strengthen the governance structure of the Cajas.

The research also had a large media impact. Earlier in 2012 Garicano had written a blog for the [VoxEU.org](http://VoxEU.org) website that set out recommendations for reforming the governance of financial institutions, which attracted more than 6,000 views. El País, Spain’s highest circulation daily newspaper, devoted its front page to the LSE research. Both Garicano and Cuñat wrote several opinion pieces in the Spanish press, including several articles in El País.

#### Note:

- *This article was initially published as an [Impact Case Study](#) and re-published on our blog with the author’s permission.*



**Luis Garicano** is a Professor in Managerial and Economics Strategy. He has been the Director of Research in the Department and has worked as an economist for the Commission of the European Union and has been involved in efforts to promote structural reforms in the Spanish economy. In particular he has co-authored proposals to reform the labour markets, housing markets, and the pension and health systems. He recently wrote a best-selling book on these reforms “El Dilema de España”, (Destino 2014).



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