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Abstract

Like the rest of the world, Spain has suffered frequent financial crises and undergone several changes in its regulatory framework. There have been crises that have been followed by reforms of the financial structure, and also troubled financial times with no modification of the regulatory and supervisory regime. In various instances, regulatory changes have predated financial crises, but in others banking crises have occurred without reference to changes in the regulatory regime. Regulation and supervision has been usually absent in the XIXth century, while in the XXth century policy makers have been more active and diligent. Moreover, all major financial crises have been followed by intense financial restructuring, although as elsewhere banking restructuring and interventions not always have been successful (in fact, the cases of failures and mixed results overcome the successful cases). The paper provides a short history of the major financial crises in Spain from 1856 to the present, and also reviews the main financial reforms and the distinctive regulatory regimes that have been in place in this last 150 years time span.

Keywords: Spanish banking, Financial crisis, Financial regulations, Banking reforms.

JEL Classification: N2, N4, GO1, G18.

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FINANCIAL CRISES AND FINANCIAL REFORMS IN SPAIN: WHAT HAVE WE LEARNED?

Pablo Martín-Aceña^{}, Angeles Pons[†] and Concepcion Betrán[‡]*

Like the rest of the world, Spain has suffered frequent financial crises and undergone several changes in its regulatory framework. There have been crises that have been followed by reforms of the financial structure, and also troubled financial times with no modification of the regulatory and supervisory regime. In various instances, regulatory changes have predated financial crises, but in others banking crises have occurred without reference to changes in the regulatory regime. Regulation and supervision has been usually absent in the XIXth century, while in the XXth century policy makers have been more active and diligent. Moreover, all major financial crises have been followed by intense financial restructuring, although as elsewhere banking restructuring and interventions not always have been successful (in fact, the cases of failures and mixed results overcome the successful cases). The paper provides a short history of the major financial crises in Spain from 1856 to the present, and also reviews the main financial reforms and the distinctive regulatory regimes that have been in place in this last 150 years time span.

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1. Introduction

The current international financial crisis has again raised the specter of a long and profound economic depression. Bank failures, the need for massive liquidity assistance by central banks and the intervention of governments bailing out or partially nationalizing major credit institutions have also unveiled the fragility of the financial structures in many countries. Supervisory authorities have been caught off-guard. Although we have built a highly sophisticated financial monitoring system, the truth is that it has been of no use to prevent our present economic turmoil. The regulatory framework in place has revealed its deficiencies and if we have learnt anything from the crisis it is that financial regulation and supervision need to be tightened and their scope

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broadened. Hence, bank regulators and supervisors have an important and increasingly difficult job. They must ensure the integrity of the payments mechanism, they have to protect the interests of depositors and they have to promote the efficiency in the banking sector. At present they must carry out these tasks against a complicated and unstable financial environment with a background of highly variable asset markets, an unprecedented increase in the number and variety of financial instruments and against the complexities created by the growing internationalization of banking and financial markets. Can history help policy makers design a better regulatory system? Can the past provide guidelines to enhance the effectiveness of prudential regulations?

Mishkin (2001) has explained why to have good banking regulations it is essential to maintain financial stability. Moreover, he has convincingly argued that to ensure the safety and soundness of the banking industry prudential supervision is needed. An instrument such as lender of last resort may serve to contain bank panics, and explicit deposit insurance provides limited protection for depositors. Both are, however, ex post mechanisms to reduce the income losses generated by financial crashes. On the contrary, prudential supervision is, like preventive medicine, an ex ante policy instrument better suited to avoid financial catastrophes.

Mishkin has listed nine basic forms of prudential supervision of banks: a) restrictions on asset holdings and activities; b) separation of the banking and other financial service industries; c) restrictions on competition; d) capital requirements; e) risk-based deposit insurance premia; f) disclosure requirements; g) bank chartering; h) bank examination, and i) a supervisory versus regulatory approach. He argues that getting prudential supervision right is extremely important for the health of the economy. Hence policies that enhance the effectiveness of these nine basic forms of prudential supervision will contribute to preserve the safety and soundness of the financial system.

But can we really prevent financial crises? Can we design a potent regulatory framework capable to assure the stability of the financial system against all kind of economic events?

There is no full agreement in the literature that regulation and supervision assure financial stability. The repetition of financial crises and the multi-causality of their origins suggest that it has been impossible until now to devise a regulatory framework capable to prevent banking crises. Because as Díaz-Alejandro (1985: 2) put it: “there is no humanly possible way of devising a fail-proof system of finding out the true intentions of borrowers”. Benston (1991: 227) has argued that regulation introduced after crisis “has overwhelmingly tended to make the banking system and individual banks less stable”. According to his views, regulations in fact have played an important role, at least in the United States, for making banking significantly less stable by constraining banks from diversifying efficiently. Calomiris and Gorton (1991) suggest that because banking and capital markets are in continuous transformation by technological change, it is extremely complicated to design effective public policy. Since each crisis has taken place in a different historical environment, regulations put in place after a particular crisis has been of no use to prevent the following episode of distress. Barth et al (2001) have shown, for a sample of sixty countries, that there are substantial variations among the national regulatory framework. They too show that some forms of prudential regulation, such as restrictions on mixing banking and

commerce or restrictions on security activities of commercial banks are associated with greater financial instability. They argue that, contrary to what is usually sustained, the likelihood of a banking crisis is also greater, on average, the tighter the restrictions placed on bank ownership of non-financial firms.

Perhaps there is no such thing as an optimal regulatory regime, and perhaps crises after all are simply impossible to prevent, because it is not possible to develop a framework to cover all possible events.

What do we know about banking supervision in Spain? Has the Spanish financial system been adequately regulated? Have financial reforms and regulations contributed to banking stability? What, if any, have been the policy instruments used by the Spanish authorities to combat financial instability? What government agencies have been responsible for banking supervision? Have financial reforms been introduced as a response to financial crises? Have financial crises been followed by financial reforms? What has been the role of the Bank of Spain?

The Spanish experience of the last two centuries illustrates at least five points. First, banking crises have not been uncommon and usually they have produced damaging effects in terms of financial wealth destruction, and also in terms of lower economic growth rates. Although more research is needed, banking crises may have contributed to the retardation of the Spanish economy. Second, the Bank of Spain has not performed its duties as lender of last resort until very recently. Third, financial crises not always were followed by changes in the regulatory framework. Fourth, a full and effective prudential regulation regime, as defined by the nine basic forms listed by Mishkin, has been introduced in the XXth century. Prudential regulation is an issue of our present days. Fifth, the long XIXth century and the XXth century offer a contrasting picture. Banking regulation was absent during the nineteenth century, dominated by the "laissez-faire, laissez passer" ideology. Not until after the First World War Spanish authorities introduced legislation to regulate the financial system. Much stricter new legislation was adopted in 1939 after the civil war, reversing entirely the relatively liberal framework of the previous periods. Market discipline was substituted by State intervention. Deregulation began in 1962 and accelerated after 1974. Modern prudential supervision rules were introduced after the devastating 1976-85 banking crisis.

Table A in the Appendix includes the main banking reforms in Spain adopted in the last 150 years. Table B also in the Appendix lists the banking regulatory agencies for four relevant periods. Finally, table C summarizes the features of the supervisory regimes for banks and saving banks between 1856 and 1975.

2. 150 years of economic and financial crises

A significant number of scholars have examined the behavior of different macroeconomics variables in the years (or months) before and after a financial crisis to investigate the possible links between the economic and the financial environments. In general, it has been proven that banking crisis tend to erupt when the economy deteriorates as a consequence of the accumulation of imbalances, and particularly when

growth is low and inflation is high. Gorton (1988: 221) has forcefully sustained that banking crashes far from being “mysterious events” are in fact systemic events associated to business cycles. Kaminsky and Reinhart (1999) have examined the behavior of a number of macroeconomic variables in an ample sample of countries showing that financial crises occur as the economy enters a recession, following a prolonged boom in economic activity fuelled by credit, capital inflows, and accompanied by an overvalued currency. Demigürc-Kunt and Detragiache (1998) have found that low GDP growth, excessively high real interest rates, high inflation, adverse terms of trade shocks, the size of the fiscal deficit and the rate of depreciation of the exchange significantly increase the likelihood of systemic financial problems. The relationship between macroeconomic fluctuations, financial fragility (excessive competition, asset price increases and high non-financial sector indebtedness) and banking crises has been demonstrated by the influential works of Minsky (1977) and Kindleberger (1978). And more recently Reinhart and Rogoff (2008) have argued that periods of financial distress have been associated with macroeconomic circumstances, such as economic downturns, declines in income, and depressed assets markets, that typically follow waves of domestic and international credit expansion.

In this first section we try to identify the major Spanish economic and financial crises over the approximately 150 years time span covered by our paper. The purpose of the exercise is to find out if banking panics and failures have coincided with boom and busts in economic activity.

To identify major economic crisis we examine two key macroeconomic time series, GDP and industrial production[§]. An economic crisis is associated to a sharp and exceptionally large decline in economic activity, and according to this definition both indicators should capture every major downturn. To look for banking crises we have collected data for stock prices as well as for other typical financial variables.

A cursory inspection of figure 1 (and the complementary figure 2) reveals that the Spanish economy had suffered at least nine severe contractions (defined as a fall in GDP growth rate equal or above 5 per cent). The first declined began in 1864 and ended in 1868, with an overall real GDP drop of 10.6 per cent. Industrial output sank too, although its decline was less pronounced (-4.5 per cent). The contraction was caused by the collapse of a railway boom, a succession of bad harvests and mounting fiscal difficulties. Financial fragility and the repercussions of the Overend and Gurney Company failure in London also contributed to the duration and depth of the crisis.

The mid years of the 1870s, 1880s and 1890s all recorded recessions that exceeded the 5 per cent mark. Particularly intense was the fall in GDP in 1874 (- 8.7 per cent), when the Spanish economy was hit by the international crisis that swept Europe after the Franco-Prussian war. In that same year manufacturing production declined sharply by 11.1 per cent. Again the near-bankruptcy of the Treasury aggravated the downturn. In 1885 through 1887 the rate of growth of GDP was negative, with a total accumulated loss of 6.3 per cent. Since no major international crisis is recorded, the Spanish downturn must be attributed to domestic factors. The last XIXth century economic contraction was linked to the 1890 turmoil generated by the Argentine suspension of payments and the Baring Brothers failure that affected almost all European markets as well as the American economy. Initially the crisis was relatively

[§] All data come from Prados de la Escosura (2003).

mild, GDP did not fall and industrial output exhibited a positive growth rate. The depression came a few years after: in 1893 income declined by 3.6 per cent and again in 1894 and 1895, when it fell by an astonishing 8.3 per cent. The interruption of foreign investment, a succession of bad harvests, a marked decline in industrial output, and the beginning of the Cuban war of independence all factors together contributed to the downturn of the cycle.

The following crisis episode in 1930-31 coincided with the world depression. The Spanish contraction includes the same economic and financial factors that caused the international depression and hence it does not need to be explained here. However, it is evident from our data that the crisis was milder in Spain than in other European nations. Industrial output certainly fell as much as a 10.5 per cent in 1931, but overall GDP only dropped by 3.4 per cent in 1930 and 2.6 per cent in 1931. Relative isolation from world markets and the depreciation of the exchange rate account for the softer impact of the Great Depression on the Spanish economy.

The seventh and more destructive economic decline of the XXth century took place during the two initial years of the Civil War. GDP fell as much as by 25 per cent between July 1936 and December 1937. All the components of GDP contributed to the intense recession: private consumption and investment dropped over 50 per cent and the fall in exports and imports was abysmal. Only public consumption and investment increased, partially compensating the negative trend of the other macroeconomic variables. Recovery did not begin until the war was over.

Figure 1 also identifies 1945 as another critical year with GDP growth rate dropping by 7 per cent. Politically isolated and doomed by the adoption of an extreme autarkic and interventionist strategy, the Spanish economy fell into a deep contraction. The crisis was triggered by two successive droughts that caused a sharp decline in agrarian output and led to widespread hunger.

The last and long lasting economic crisis began after the Franco death in 1975, and did not finish until the early 1980s. Its occurrence was the result of a combination of economic and political factors. In the first place the beginning of the international recession. The 1973 oil price shock and the break-up of the Bretton Woods system cut abruptly the fairly stable economic environment that had existed in Western Europe since the end of the Second World War. The second round of price rises in raw materials and energy in 1979 intensified the recession and forced Western governments to adopt policy measures to fight the crisis back. In Spain, to assure a smooth transition to democracy, politics took priority over economics, and politicians postponed any adjustment to face up the deterioration of the economy. Inflation increased to record levels above 25 per cent, employment rose up to more than 20 per cent of total active population and GDP growth slowed down. Industry was particularly hit, more so than the rest of the economy, exhibiting negative growth rates in 1981 and 1982. Recovery was not on solid bases until the middle of the decade.

Having identified nine major economic crises between 1850 and 2000, we shift the focus now to the financial sphere. How many financial crises can be detected in Spain's financial history? Have financial crises coincided with macroeconomic contractions? Have banking difficulties and failures predated or followed macroeconomic fluctuations?

Economists and economic historians have found six major financial episodes, all of them characterized by runs on banks, bank failures and government (or central bank) intervention. The first in 1866 have been studied thoroughly by Sánchez Albornoz (1963, 1967) and Tortella (1973). Research by Tedde de Lorca (1974) too has identified a sequence of troublesome banking episodes during the second part of the XIXth century. The interwar years, with two crises in the twenties and another in the thirties, have been examined in detail by Martín-Aceña (2001). And the last financial crisis, at least for the time being, that began in 1977 and ended in 1985, has been studied by a long list of scholars, and more in particular by Cuervo (1988).^{**}

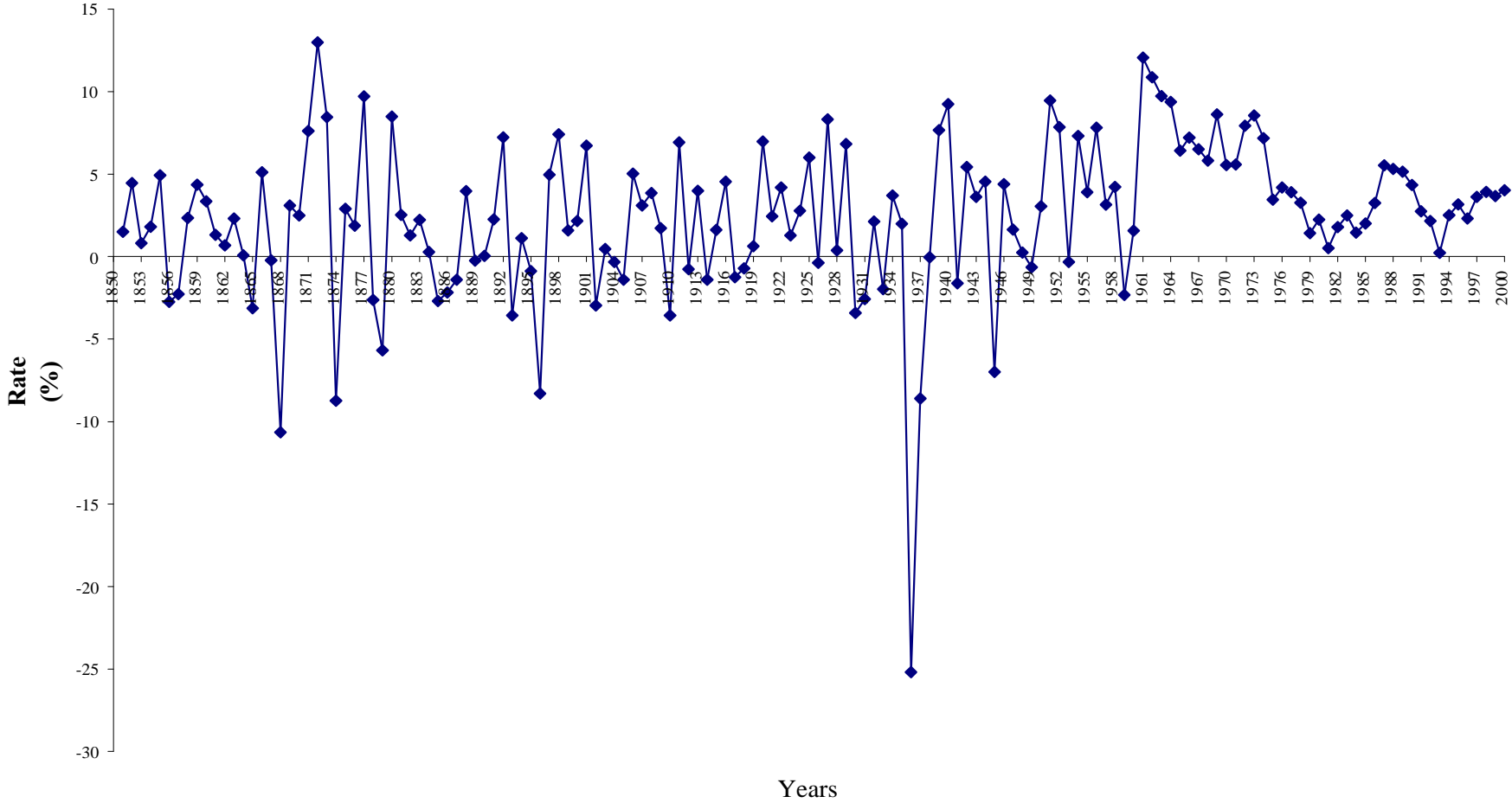
According to this chronology, table 1 shows that all financial crises, except one, coincided with economic crises. The Spanish historical experience seems to be consistent with the literature and the empirical evidence mentioned above. In general declines in real income and industrial production have caused banking crises, although the reverse may be also be true, and it is something that has to be studied yet. However, it is also evident from table 1 that the frequency of economic contractions is higher than the episodes of banking turmoil. Another conclusion is that years or periods classified as economic and financial crises correspond chiefly with international downturns. It seems that, despite her relative economic and political isolation, Spain has been systematically influenced by the international economic and financial environment.

Table 1. Economic crises and financial crises

Economic crises	Financial crises
1864-1868	1866
1873-1874	---
1878-1879	---
1882-1884	1882
1895-1896	1890
---	1920-22
---	---
1930-1932	1931
1936-1937	---
1945	---
1975-82	1977-85

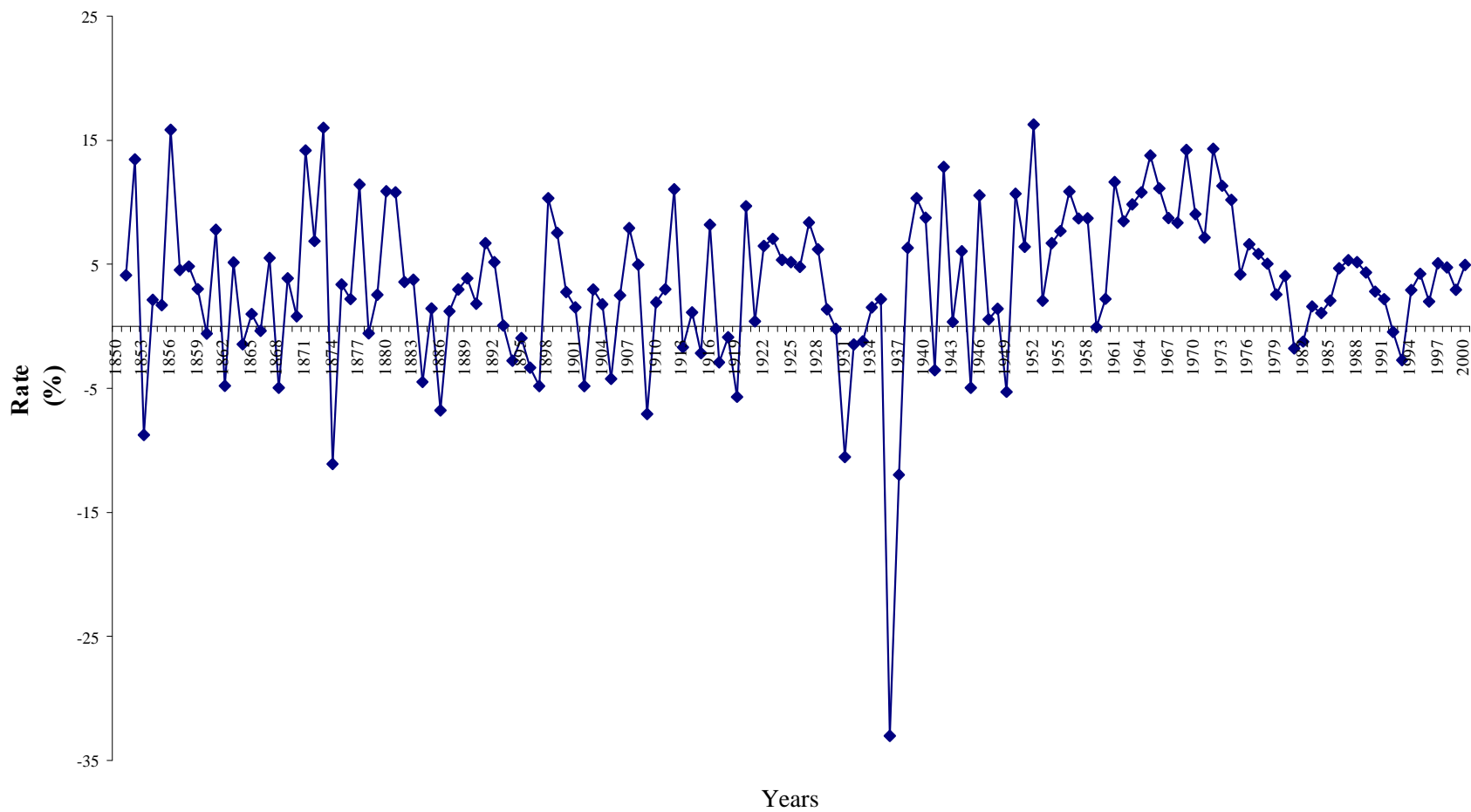
^{**} The financial data to identify banking crises is presented and examined in each of the following sections of the paper.

Figure 1: Rate of Growth of Real GDP (%)



Source: Prados de la Escosura (2003): El Progreso Económico de España (1850-2000). Madrid. Fundación BBVA.

Figure 2: Rate of Growth of Industrial Output (%)



Source: Prados de la Escosura (2003): El Progreso Económico de España (1850-2000). Madrid. Fundación BBVA.

3. The unregulated banking era, 1856-1920

The modern history of Spanish banking begins in 1856. In this year the Parliament approved two important acts that favored the creation of joint-stock banks: the Bank of Issue Law and the Credit Company Law. These two acts established a relatively open and liberal financial framework that with minor changes remained in place over the next six decades. Regulation was loose, supervision practically absent, and whatever could happen to the banking system or whatever correction it needed was left to market discipline^{††}.

The Bank of Issue Law regulated the establishment and operations of the banks of issue. Incorporation required government authorization, although it was easily obtained by a mere Royal decree.^{‡‡} Plurality of issue was permitted, but limited to only one bank per town. Capital had to be paid up entirely at the time of constitution. The maximum volume of currency banks could issue was set equal to three times the amount of paid-up capital. The law imposed a metallic cash ratio of 30 per cent against banknotes in circulation, and a reserve to capital ratio of 10 per cent. Banks were also compelled to publish their balance sheets monthly in the Official government journal adjusted to a model fixed by the Ministry of Finance. To overview and to make sure that the operations of the banks were conducted according to their self-written statutes, the government appointed a Royal Commissioner in each institution. One of his main tasks was to assure that the banks maintained "sufficient cash and liquid assets to cover all liabilities, including banknotes, current accounts and time deposits". On the other hand, banks could engage in all sort financial operations with hardly any restriction. Their primary business, however, was deposit-taking, discounting of bills exchange and commercial short-term loans. The only prohibitions were to be overdrawn, to use their own assets as collateral to making loans, and to deal in public securities.

The Credit Company Law was much less restricted. According to the liberal ideology of the time banks were supposed to operate just as any other non-financial firm. Like in the case of the banks of issue, incorporation required the previous approval of the government. The charter could be obtained too by a simple government decree, so that no parliamentary act was needed. Banking transactions were not subject to any sort of restrictions. The act imposed a minimum capital requirement of 10 per cent, but no cash or liquidity ratios. Although for most of the nineteenth century credit companies and commercial banks were single-officed, no permission was needed to open branches in any region of the country. Banks and credit societies could undertake all kinds of commercial operations, discounting of bills, extending short and long term loans and investing in equities and in private and public securities. They could also promote, invest and own all types of industrial companies. They could accept both current account and time deposits. Although credit companies were obliged to send their balance sheets and income and losses accounts to the Ministry of Finance, there were no uniform accounting and disclosure standard norms. No supervisory agency was created, but the government could at any time order the examination of the accounting books of the companies and verify the state of their metallic holdings.

^{††} For Spanish banking in the XIXth century, see Tortella (1970), Tedde (1974) and Martín-Aceña (1987).

^{‡‡} The Bank of Issue Law renamed the semi-official Banco San Fernando as Banco de España (Bank of Spain).

The following ten years after the approval of these two acts were characterized by a remarkable financial expansion, portrayed in figure 3. Some sixty new banks opened, most of them in Madrid and Barcelona, although there were important banks that were established in other commercial and industrial cities. Of these sixty corporations, about twenty were banks of issue and the rest credit companies. This was certainly a remarkable growth, since in 1855 there were no more than five joint-stock banks. The largest credit companies were founded by French capitalists and entrepreneurs. Banks of issue and credit societies rapidly increased their commercial activities mobilizing large amounts of capital. The main dedication of the credit companies (which in fact operated as investment banks) was the financing of railway companies.

The number of savings banks also increased. A Royal order of 1835 established the bases for the foundation of these "peculiar" institutions. The initiative came from the Ministry of Interior and was aimed to combat usury and to spread the virtues of thrift among the popular classes. Savings banks were organized as mutually held institutions and they were supposed to fulfil a social role collecting and safeguarding "ordinary" people's money, and not involve themselves in risky lending. The first institution was set in 1839 (Caja Madrid, today still in existence). In the following years thrifts institutions were established in different provinces throughout the country and by 1855 there were at least 15, while ten years later the number had risen to 22. The savings banks' structure was rather decentralized with a few large urban units and multitude of small ones scattered all over the country. Although their foundation required the approval of the government, their organization, operations and financial objectives were basically subject to its own statutes. Their main operation was to collect deposits to be invested in loans granted usually by their affiliated "Monti di Pieta". They also extended long-term loans against real state collateral and with personal guarantees. They had no obligation to disclose information or to publish their financial statements. Neither were they under any regulatory or supervisory government body. In 1853 the Ministry of Interior made an attempt to regulate and control the thrifts. The government thought it necessary to regulate in detail their operations, in particular the composition of their portfolio. It also deemed necessary to put the savings banks under the supervision of the provincial and local authorities. Accordingly, new legislation was passed. However, the attempt failed because of the strong opposition raised by the founders and directors of the institutions. The consequence was that the Act approved in 1853 was never enforced and thrifts remained self-regulated until 1880, when a general Law of Saving Banks was approved. §§

The financial expansion that took place during the 1850s and 1860s was associated to a parallel economic boom. A batch of reforms that affected agriculture, mining, the transport sector, as well as the monetary and the commercial regime provided new opportunities for profit. The construction of the railway system was the protagonist of the economic expansion. In less than a decade the main lines were completed and opened to traffic. As indicated above, the promoters of the railway companies were the banks and credit societies founded after the banking laws approved in 1856. Banks not only bought stocks and bonds, but also granted loans and advances to the railway companies. Moreover, banks distributed stocks both in the domestic market and in foreign financial markets, particularly in Paris. However, as it happened elsewhere, the expectations raised by the construction of the railways were excessively

§§ For the early history of savings banks, Titos Martinez (1999)

optimistic. Construction and financial costs were higher than expected and the demand of inland transport was not enough to cover expenses. Income from traffic hardly reached to pay for loan interests, and most firms run into heavy losses. The railways were less profitable than the promoters had promised and the holders of stocks and obligations had expected.

Beginning in 1864 the stocks of the main railway companies plummeted in the Paris Bourse. Mining equity prices and government debt prices also fell. The collapse of the Bank of Spain's shares in the Madrid Stock Exchange was even more dramatic (figure 4, for the overall behavior of the Madrid Stock Exchange). With large portfolios of railways shares, bonds and government debt, the balance sheet of banks deteriorated sharply and many of them suffered substantial losses. By the end of the year a major financial crisis was looming.

Eventually, the financial crisis erupted in May 1866. In Madrid one of the major French credit societies, the Compañía General de Crédito, declared suspension of payments. The market was shaken and the following weeks panic broke loose with a chain of bankruptcies. The panic was particularly violent in Barcelona. Two big financial firms suspended payments, the Catalana General de Crédito and the Crédito Mobiliario Barcelonés. Moreover, a significant number of industrial and commercial firms unable to repay its loans and obtain fresh accommodation discontinued their operation and went bankrupt, the Stock Market closed and all banks, except the Banco de Barcelona, closed their doors temporarily. Riots threatened Barcelona and in order to avoid disorders, the military authorities declared the "corso forzoso" of banknotes in circulation and of short-term obligations of banks and credit companies. From Madrid and Barcelona the crisis spread to the rest of the peninsula. Valladolid, Seville, Cádiz, and other commercial center saw their banking structures shattered. The scramble for liquidity -conversion of banknotes into metallic cash - that took place in 1866 can be observed in figure 5, that shows too how the lack of confidence on the banking system persisted over the following years.***

The 1866 crisis was deep and damaging. Financial and non-financial companies went into liquidation and the stock market crashed in Madrid and Barcelona. The number of joint stock banks fell and many private bankers and merchant houses disappeared (figure 3). Of the 37 financial institutions funded after 1856, only 22 survived the crisis. Of the 82 officially registered bankers and private finance houses in 1866, there were 43 in operation by 1870.††† Only savings banks, with no risky assets, remained untouched by the financial turmoil.

The crisis had long lasting consequences. The blow was so severe that it took more than a quarter of a century for the banking crisis to recover. As many other cases have proven, even when the panic abates, incompetent management is removed and insolvent firms are liquidated, much work usually remains before depositors' confidence returns and the crisis can be said to be resolved. Moreover, since the banking collapse contributed to the downturn, partly because of the disruption of financial contracts, including the flow of credit as well as the payment system, economic recovery required some kind of financial restructuring. Moreover, economic growth is

*** Sánchez-Albornoz (1963 and 1967) and Tortella (1973), for the crises in Madrid and Barcelona..

††† Tedde (1974), p. 255

unlikely to resume on a secure basis until unproductive assets disappear from the banks' portfolio and new management or new financial institutions enter into the industry.

Despite the fact that the crisis wiped out half of the banking system, the financial authorities did not react to the financial crisis during or after the bankruptcies. No measures were taken and the adjustment was left entirely to market discipline. There was no particular system in place to handle the bank failures other than bankruptcy procedures or privately organized liquidations. The laissez-faire policy was maintained, and both the Treasury and the Bank of Spain let the crisis run its own course. The Treasury overwhelmed by its fiscal difficulties contributed to deepen the crisis and to prolong the ensuing recession for two more years. Moreover, no lender of last resort was available at the time since the Bank of Spain too had its own problems and refused to provide the necessary liquidity. The Bank of Spain not only allowed the failure of many provincial banks of issue but neither did it take any measure to assist credit companies with difficulties. Most likely the Bank's inaction in 1866 was the result of a deliberate policy to eliminate potential note-issuing competitors. This episode thus supports the contention that the absence of lender of last resort allows a panic to produce a crisis with deleterious consequences for the banking system at large.

What is more surprising, however, is the fact that instead of introducing legislation to prevent future similar crises, the Ministry of Finance maintained its liberal stance. The crisis did not incite the introduction of amendments in the 1856 laws. Well on the contrary, the authorities took further liberalization measures. In 1869 a new Joint Stock Company Law lifted all restrictions on the creation of banks of issue, discount banks, agricultural banks and credit companies. The law permitted new banks to incorporate freely without the need to obtain a special charter from the government. Entry in the sector was thus entirely free and unrestricted, with the exception that only one note-issuing bank could be opened in each town. Moreover, no regulatory or supervisory measures were adopted.

The role of the Royal commissioner appointed by the government to sit on the board of the banks was to assure that they complied with their own statutes. He had veto power, although he rarely exercised it.^{†††} Royal commissioners were politicians that expected to return again to a post in the government, or relevant members of the business class with close ties with the owners and managers of the banks. Although loyal to the Ministry of Finance, to which they faithfully reported contraventions of the statutes, commissioners tried to avoid disputes with their fellow members of the board and the resolution of conflicts usually implied the resignation of the commissioner.

On the other hand, we know next to nothing about the role of the members of a Credit Company Inspection Agency established in 1865, except that they collected the financial statements of a significant number of banks. These statements were published later in the Official government journal. However, more research in this field is needed to find out the actual working of the agency: which were the examination procedures used by the inspectors and the results of their inspections.

For the last part of the XIXth century and the first two decades of the XXth century Kindleberger (1978) lists five major international financial crises (1873, 1882, 1890, 1893 and 1907), while Schwartz (1986) registers only four (1873, 1890, 1907 and

^{†††} This was at least the case in the Banco Santander (Martin-Aceña, 2007)

1914). Neal and Weidenmier (2003) have also examined four: 1873, 1890, 1893 and 1907, and Goodhart and Delargy (1998) list seven stock exchange panics: in 1873, 1880-82, 1887, 1890, 1895, 1907 and 1914.

Spain's economic history and the available empirical evidence shows that the crises record is shorter. Sardá (1949) and Tedde (1974) have identified only two, 1881-82, and 1890. Nonetheless, this more stable financial environment cannot be taken as a sign of banking strength. Slow GDP growth, as the recent data compiled by Prados de la Escosura (2003) suggests, and relative economic isolation from the world economic cycles, consequence of high tariff barriers and the non participation of Spain in the gold standard may explain best the shorter number of episodes of financial distress.

The 1881-82 crisis has been associated to the so-called "febre d'or" (gold fever) that erupted first in Barcelona and later in Madrid. The troubles unfolded in parallel with the international crisis that, according to Kindleberger, was centered in Paris and associated to a construction boom in Southeastern Europe. The "febre d'or" was a market bubble that affected all stocks in the Barcelona Bourse. Equity and bond prices of financial and non-financial companies rose and new firms were established with the purpose of obtaining rapid short-term returns speculating in the stock exchange. The boom was short-lived but the ensuing bust was deep and lasted for various years. The speculative bubble had also its counterpart in the Madrid Bourse (figure 4). When it ended it caused the failure of a considerable number of undercapitalized and badly managed banks that had been founded in the previous decade (figure 6). Although other cities were not affected by the crisis as much as Madrid or Barcelona, the fact is that the economic consequences of the "febre d'or" were dire. The financial system, not yet recovered from the 1866 collapse and from the disappearance of the provincial banks of issue in 1874 (see below), was severely hit. In addition to the bankruptcies, many of the banks that survived were unable to make a strong recovery and resume their lending activities and ordinary operations until the beginning of the next decade. Moreover, the international crisis left some other important scars. The financial difficulties in Paris interrupted the flows of capital into the Spanish economy and generated an acute current account crisis. Gold flowed out and the Bank of Spain, facing large reserve losses, was forced to suspend temporarily gold convertibility. However, since convertibility was never resumed, Spain remained off the gold standard and detached from the international monetary system throughout all the period (Martín-Aceña 1994).

The crash of 1890 was associated to the international crisis produced by the payment suspension of the Argentine Republic and its repercussions in the Baring Brother finance house, and in the London financial market. Tedde and Anes (1974) have argued that the immediate consequences of the Baring crisis produced a retrenchment of foreign capital and a fall in the Spanish stock prices in the Paris Bourse. They also fell in the Madrid Stock Exchange (figure 4). Particularly hit were again the shares of the railway, mining and financial companies. To the sharp downturn in asset prices, banks reacted by rising their liquidity and cash ratios, by cutting loans and reducing investments. The volume of credit granted by the Madrid and Catalan financial institutions declined substantially for two years in a row and although it leveled off thereafter it never regained its pre-crisis high until the end of the decade. There were not as many failures as in the previous crash, although banks with impaired assets were liquidated. Those with substantial losses but sufficient capital survived. However, the

overall financial structure was damaged and it did not recover until the turn of the century.

Like in the aftermath of 1866, these two crises did not provoke any official reaction. The Ministry of Finance entangled with its own fiscal difficulties did not have any manoeuvring capacity to contain the crisis, even in the unlikely event it would have had any desire to do it. No changes were introduced to alter the financial framework or to introduce regulatory measures to prevent future troubles. And again no lender of last resort assistance was available, despite the fact that the Bank of Spain had been granted the monopoly of issue in 1874, becoming since then the only supplier of liquidity. The decree by which the Bank of Spain received from the government the privilege of banknote issue for the entire country was not the result of any banking crisis but rather an economic compensation for a large loan the Bank made to a bankrupt Treasury. The monopoly brought about an important restructuring of the financial system. Fifteen banks of issues had to liquidate or merge with the Bank of Spain. Most of them opted for this latter alternative, while the rest (three) chose to continue as commercial institutions, including Santander and BBVA, two of the financial giants of the present Spanish financial system.

The reform of the Commercial Code undertaken in 1885 did not produce either any fundamental change in the financial framework. Consistent with the "laissez faire, laissez passer" philosophy of the times, the liberalization of the system proceeded one more step. In line with the law of 1868 the Code maintained free entry to the industry and it did not impose any limitation on banks' operations and activities. The sole obligation for banks was to publish the balance sheets and the income and losses account in the official government journal and in the official provincial journal. Finally in one of its articles, the Code of Commerce included an enigmatic phrase reminding the business community that the "freedom to issue banknotes continued in suspension".^{§§§}

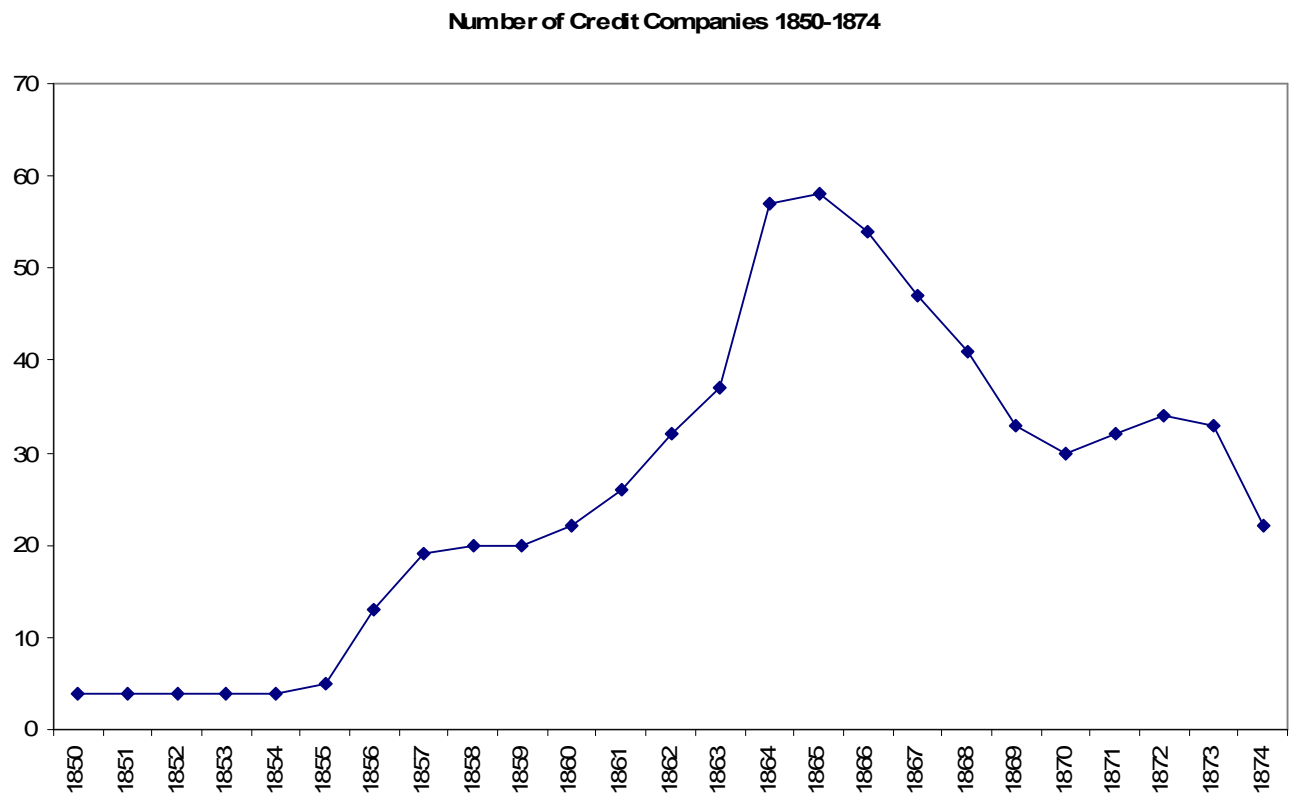
Although thrift institutions weathered the two crises better than the banks, without casualties among its membership, the Ministry of Interior introduced legislation intended to regulate the creation and the scope of saving banks. According to the Saving Banks Law enacted in 1880, the foundation of thrifts remained open to individuals and institutions but their statutes had to be approved by the government. Savings banks de-linked their lending activities from the "Monti di Pieta", and were allowed to operate independently. Thirdly, thrifts were defined as "charitable institutions" and put under the protection of the government. Since no other changes were introduced, savings banks remained unregulated and under the loose supervision of the Ministry of Interior.

To conclude, less than strict regulation is one of the features of the Spanish financial system during this long sixty-five years period. Neither the laws of 1856 nor the institutional reforms introduced thereafter in 1869, 1874 or 1885, imposed strict restrictions on banks' operations or limited their scope or their scale. Saving banks also operated quite unrestrictedly during most part of the XIXth century, subject only to their own statutes. Strong competition among commercial banks, and between banks and saving banks was another central feature of the financial. Fragility was the third salient characteristic of the financial sector. The number of financial institutions varied greatly throughout and, as we have seen, banking failures were not uncommon.

^{§§§} Faus (2001: 63).

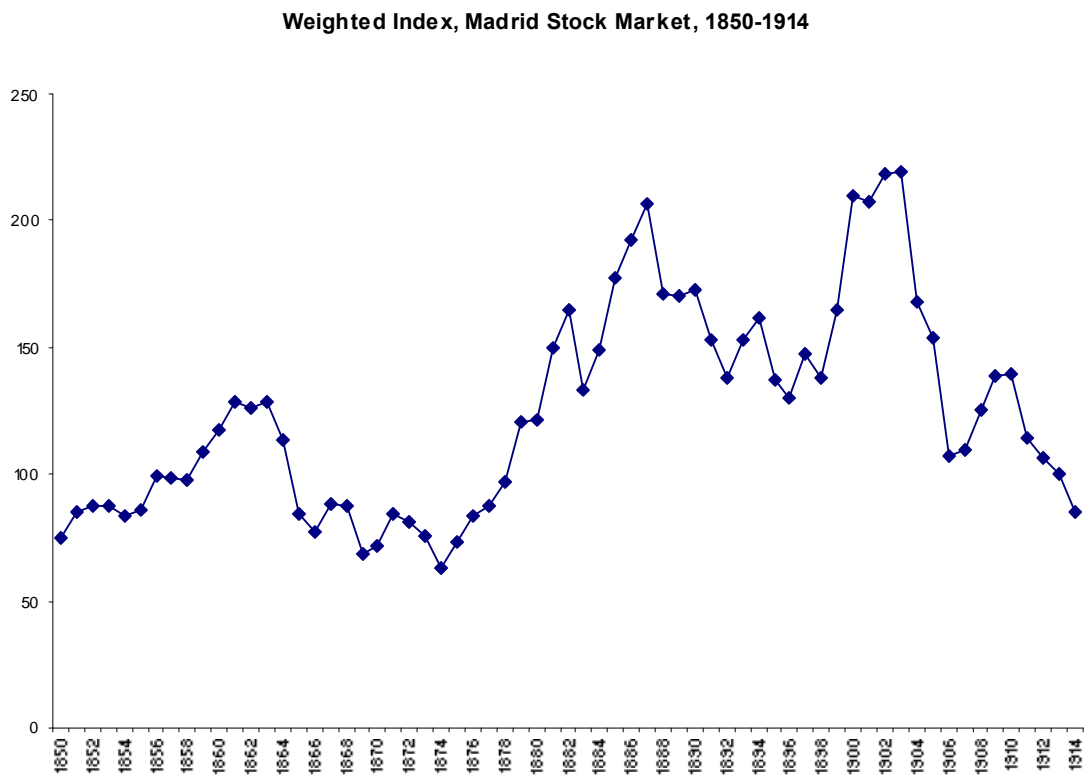
Although more empirical research is required to establish the link between banking crises and the cyclical evolution of the overall economy, the financial fragility that characterized this long period provides a good rationale for the need of regulation and supervision. But as we have seen regulations were kept to a minimum and prudential supervision was circumscribed. Bankers, financiers and the business community at large enjoyed free entry to the industry, and only the issuance of banknotes was limited to one bank per town until 1874, when the Bank of Spain was entrusted with the monopoly of issue. Disclosure requirements were lax and not always respected. Bank examination was conducted by an special body of inspectors created in 1865, although their role was confined to collect financial information. Moreover, there was no agency in charge of banking supervision. Table C in the Appendix shows the main characteristics of the regulatory regime of the period 1856-1920.

FIGURE 3



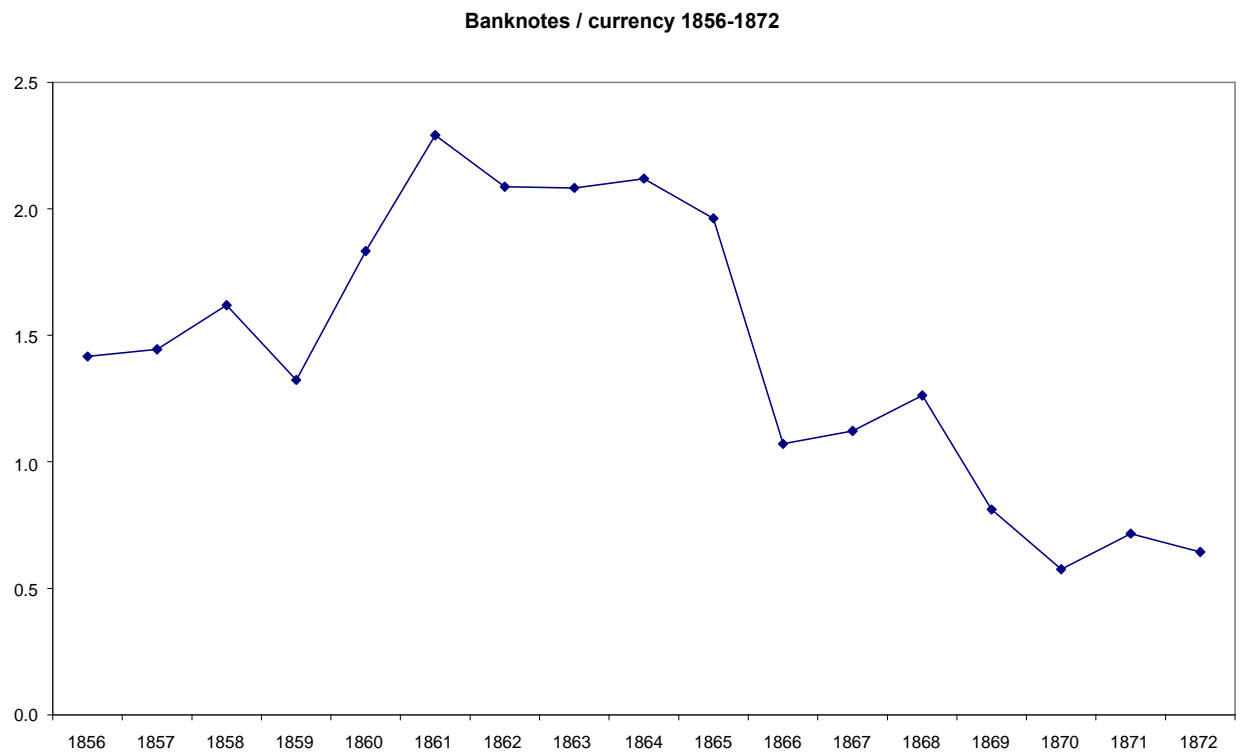
Source: Tortella, Los orígenes del capitalismo en España. Banca, Industria y Ferrocarriles en el siglo XIX. Ed. Tecnos.

Figure 4



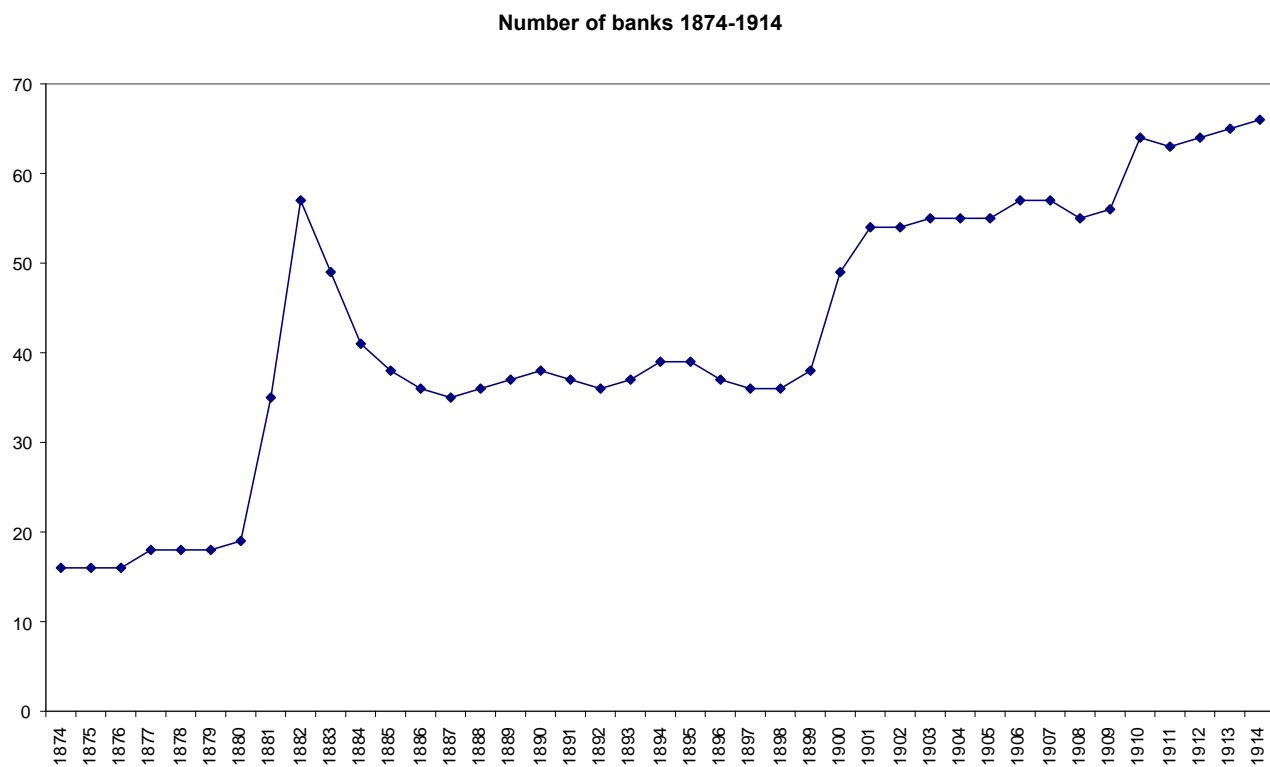
Source: Estadísticas Históricas de España (2005).

Figure 5



Source: Estadísticas Históricas de España (2005).

FIGURE 6



Source: Tortella G. and P. Tedde de Lorca (1974): “Censo y balances normalizados de los bancos privados españoles 1874-1914”, in La banca Española en la restauración. Servicio de Estudios del Banco de España.

4. Banking crises and financial self-regulation in the interwar period, 1921-1936

Financial crises were a prominent feature of the interwar period. Bernanke and James (1991) offer a quite complete chronology of the most salient banking crises from 1921 to 1936. There were over 50 banking crises, with output losses of about 10.5 per cent of GDP. The chronology shows that crises affected all continents. Hardly any European country was safe from bank runs, widespread bankruptcies or at least rumours about the imminent failure of major banks, or suspension of payments. In many instances, bank crises accompanied currency crises, so that the interwar period suffered from what is known as "twin crises".

In the 1920s Spain experienced two periods of financial turmoil, one immediately after the First World War, and the other in 1924-25, when a major bank was near bankruptcy and had to be rescued, and others failed and were liquidated. The crises were caused by unsound lending practices during the war and by excessive speculation in the exchange market thereafter. After a period of relative tranquility, in 1931 the European financial crisis and the collapse of the Monarchy led again to severe banking difficulties, which caused the collapse of various institutions. In both instances the crises were associated with an unstable macroeconomic and political environment.

The outbreak of the war opened a short but intense period of uncertainty. The decline in the market price of domestic commodities, and the collapse in stock and bond prices, threatened to undermine the basis of the entire Spanish financial system. The lack of confidence led to a run on bank deposits, which was directed particularly against the major commercial institutions. They were consequently induced to turn to the bank of issue with extraordinary rediscount requests. But as Spain remained neutral, confidence returned, and the economy experienced a general expansion led by a strong export boom that lasted for the rest of the war period. The expansion was felt both in the consumer and capital goods industries, and the resulting demand for bank accommodation fostered a considerable expansion of banking activities.^{††††} The number of joint-stock banks increased. Banking operations also expanded, visible in the balance sheets of all banks, particularly that of the "big seven".^{††††} In current pesetas, paid-up capital increased threefold and deposits multiplied by five.

During the war, the Spanish financial system made a decisive move towards mixed banking, so that by 1919 the involvement of Spanish banks in industry was much higher than ever before. Roldán and García Delgado (1973) have noted that during the war years the participation of banks in the promotion of industrial firms became a common practice. The mixed banks not only engaged in ordinary commercial operations, but also made long-term industrial investments. Financial institutions stayed ready to extend all types of loans to industrial companies and to acquire industrial securities in larger quantities than previously. Industrial credit was secured by shares, bonds, bills, and even real estate or with business mortgages. Besides, they actively

**** The Spanish financial history during the interwar period is, to a certain extent, similar to that of the Nordic countries (Denmark, Norway and Sweden). All three had severe banking crises in the 1920s, while they were left relatively unscathed by the financial crises of the 1930s. The crisis descriptions in this section are taken from Martín-Aceña (1995)

†††† Roldán and García Delgado (1973), and Sudriá (1990).

†††† The group of the "big seven" was formed by Hispanoamericano, Español de Crédito, Central, Bilbao, Santander, Urquijo and Popular.

participated in the formation of joint-stock companies by underwriting and purchasing securities, and bank directors sat on the boards of companies with which the banks maintained close financial relations. Commercial banks also contributed to finance the public deficits by taking a substantial portion of the debt issued during the war. As the new titles could be used as collateral to obtain automatic credit from the Bank of Spain, banks became extremely liquid, which in turn allowed them to further increase their lending activities.

But the rapid process of growth predicated on mixed banking bore with it significant costs. The involvement of commercial banks in industrial promotion made them vulnerable to fluctuations in the earning potential and in the equity value of the manufacturing firms with which they maintained relations, as if they owned the firms outright. Since banks also made commercial loans against industrial securities deposited as collateral, their loan portfolios also became extremely exposed to variations in stock prices. Furthermore, there were many instances in which commercial loans were used to finance fixed investment; in good times, manufacturing firms would repay such credits by issuing new stocks or bonds on the securities markets; in bad times, however, the banks' commercial portfolios tended to become illiquid. Therefore, the degree of exposure of the mixed banks to a decline in industrial activity ensured that a recession in manufacturing would ripple rapidly through the banking system and the economy as a whole. In short, the bank-lending boom led to increase fragility and systemic risks.

As well-informed contemporary observers anticipated, the war expansion was followed by a crisis that affected the real and the financial sectors alike. The previous industrial boom developed without reference to post-war markets, and much of the new capacity built during and just after the war became idle. Thus the causes of the crisis which followed afterwards unfolded during the war, with high inflation, overlending, and lending on bad collateral. The biggest risks in banks' loans emerged in credits with shares and merchandise as collateral, since it had often been given against a background of highly inflated prices and favorable valuation of the securities.

The banking crisis was especially intense in Catalonia, although other institutions in different places of the country also had difficulties. The first problems appeared in the summer of 1920, when the Banco de Barcelona, one of the oldest and most prominent Spanish credit institutions, announced important losses. The depositors, fearing that the institution could not meet its demand obligations and short-term liabilities, began to withdraw their money. Eventually the bank suspended payments in November of 1920. According to different descriptions, the problems of the bank originated from extensive and continuous speculative operations in the foreign exchange market, and from incautious lending policies; it was known that the bank lent on bad collateral and on overpriced merchandise. The crisis generated panic in Barcelona, and all banks suffered withdrawals of funds; the Catalan politicians pressed the officials in Madrid to convince them of the dangerous financial situation. The Minister of Finance summoned the governor of the Bank of Spain and told him that the central institutions should be ready to provide all the financial assistance that the Catalan bank might ask. However, the Bank of Spain was not forthcoming, and argued that all credit institutions with liquidity problems, including the Banco de Barcelona, were essentially insolvent and should not be rescued. Under pressure, the bank yielded and opened a limited line of credit, which obviously was not enough since in the end the Catalan institution had to close its doors. The effects of the failure of the Banco de Barcelona in Madrid and

Bilbao, the other two Spanish financial centers, remained within certain limits. There were runs on the deposits in various institutions, but on the whole they resisted without much difficulty. Banks with good paper, or with government securities, discounted easily in the Bank of Spain and obtained all the cash they needed. In fact, by the beginning of 1921 the crisis was apparently over. However, as we shall see later, the difficulties were far from over. A few years later they would reappear and several other banks faced serious problems.

The collapse of the Banco de Barcelona and the passive stance of the Bank of Spain raised serious concerns in the Treasury as to the adequacy of the legal financial framework. Banks' directors and owners too had expressed since 1910 concerns about the "lack of regulation" of the banking industry. They complained over the unfair competition of the savings banks protected under the umbrella of the Ministry of Labor, and raised voices against the intrusion of unprofessional "second-rated financiers" that could open freely small banks and finance houses without minimum capital bases and guarantees. To defend their interests they promoted the creation of various regional banking associations that eventually merged in 1918 to form a federation under the name of Central Spanish Bank Committee (Comité Central de la banca española). Two years later, the crisis and fears that individual bankruptcies could spread to the whole financial structure prompted the Federation to ask for the adoption of some kind of regulatory regime. Thus, the banking crisis opened an opportunity to introduce significant changes in the financial framework for the first time since 1856.

When Francesc Cambó, a successful Catalan financier, took charge of the Ministry of Finance he immediately prepared an act to regulate and reorganize the banking system. He wanted also to transform the Bank of Spain into a real central bank, forcing its Board to assume its responsibility as lender of last resort. The project, with the name of Banking Inspection Law (Ley de Inspección Bancaria), was sent to the banks and to the Bank of Spain for discussion. The former proposed several amendments to the original project, some of which were accepted by the Treasury, while the latter opposed the entire project because, as they said, it curtailed its autonomy as private financial institution. Once the project had been agreed with the banks, it was sent to Parliament where it went through a long and lively debate. In his parliamentary speech Cambó expressed his conviction that, due to their "special nature", banks and credit companies should be subject to some form of control. The Finance minister told members of Parliament that "the banking industry (...) by its nature cannot be an absolute free industry". Coordination and regulation were needed to avoid excessive competition and individualism, and to defend both the public interest and the stability of the financial structure. Cambó explained that banks' failures hinged not only on shareholder and depositors but also could spill over onto the rest of the economy with devastating effects. Lack of restraint and imprudent behavior such as excessive risk-taking by individual banks could endanger the functioning of the whole financial structure and undermine the soundness of the banking system. Hence, a prudential regulation policy was needed to ensure the well functioning and stability of the banking system. Finally, in the last part of his speech in defense of the law, the minister of Finance praised the policies that had been undertaken in other European countries, and in particular he expressed his admiration for the American Federal Reserve Act of 1913.

Cambó was a politician and a capable businessman and most likely he was unaware that his arguments were consistent with all the theoretical and empirical

literature that justify the need for supervision and prudential regulation. The asymmetric information problem was implicit in his argument. We also find in his arguments another well-known fact: that in times of turmoil and bank runs the public cannot distinguish between solvent and insolvent institutions. He was not a theoretician, but had learnt from experience the deleterious effects that bank failures can cause on the economy. Experience rather than theory had convinced him of the need to adopt measures to monitor and supervise bank activities. Although the final text of the law did not introduce a complete and sophisticated prudential supervision framework as we think of it today, it was nevertheless a significant step in the right direction.

The Banking Regulation Law (Ley de Ordenación Bancaria) was eventually enacted in December 1921. Inspired by the Federal Reserve Act, it created the legal regime that was to regulate Spanish banking in the next two decades.^{§§§§} The new legislation pursued two main objectives. First the restructuring and the regulation of the sector. The authorities wanted to establish certain controls on banking operations and a close supervision on the banks' activities. The liberal chartering regime of the previous era persisted, but the new act defined what a institution named bank ought to be, and what rules and conditions a financial company ought to comply with. The act divided the country into three geographical banking zones, and separated the credit institutions into three categories: registered banks, non-registered banks, and foreign banks.

One of the most important provisions of the 1921 law was the establishment of a new institution: the Supreme Banking Council (SBC).^{*****} The Council was entrusted with broad regulatory and supervisory powers. It could set minimum capital requirements, and set limits on pricing, fixing maximum rates for current accounts and deposits. The Council could also establish the proportionality between different items of the banks' balance sheets such as the ratio between total earning assets and short-term liabilities, and the ratio of total deposits to paid-up capital plus reserves ratio.^{††††}

The law compelled banks to submit monthly statements of their balance sheets to the SBC and to publish their income statements. Moreover, the SBC was the agency in charge of the collection of all banking statistics. The Council too was responsible for designing the model of the balance sheet and of the income and losses account that had to be submitted by all financial institutions. The new model was ready by the end of 1922 and applied for the first time in 1923. This was a step forward in order to increase banks' transparency and accountability, because until then the financial statements had been rather opaque and published without regularity. The SBC was also empowered to investigate bank operations and accounts and to impose disciplinary sanctions. As a consulting agency, it could advise the government in financial matters.

The president of the SBC was a Royal Commissioner appointed by the government while the rest of the SBC's members were named by the banks, the Bank of Spain and the Chambers of Commerce. An official or public Banking Record Office within the SBC was opened. Registration was free until 1927, but registration was required to gain access to the special discount window in the Bank of Spain open to

^{§§§§} The law has been examined, among others, by Tortella (1970) and Pons (1999).

^{*****} Since the model for the Spanish banking law was the American banking framework, we may presume that the Supreme Banking Council was inspired in the Office of the Comptroller of the Currency.

^{††††} However, no restrictions on asset holdings and asset composition were imposed, so that banks could diversify their portfolio as they wished.

registered banks. The registration permitted officials to request information on the new banks in order to examine if they fulfilled the minimum requirements to start business; it also allowed the SBC to obtain information on the existing institutions.

A second goal of the 1921 Banking Law was to transform the Bank of Spain into a true central bank and to increase the control of the State over the institution. The authorities believed that the post-war crisis could have been avoided had the bank behaved as a real lender of last resort. They also believed that in the past, the bank had only performed one of the functions predicated of a central institution, that of the Government's banker, but had neglected the other two (lender of last resort and monetary authority). In consequence, the law regulated the relationship between the Government and the bank. It limited the amount of advances that the Treasury could obtain from the bank and fixed the quantity of banknotes in circulation; any change over and above the established limit required government authorization. In order to strengthen the links between the banking community and the Bank of Spain, the law forced the latter to give preferential treatment to the credit institutions; in particular, it established that financial institutions could discount paper at a preferential rate. Finally, the act did not forbid the Bank of Spain to operate with the non-banking private sector, but it set a ceiling to the outstanding amount of private securities in the portfolio of the Bank.

Although we do not have a history of the SBC, Faus (2001) has been able to consult the minutes of the executive board from its first meeting to the Civil war. The SBC began business soon after it was established. In 1922 it had already set minimum capital requirements according to the size of the bank and according to its geographical area of operations (national, regional or local). In 1923 the official model for statement accounts had been designed and sent to the banks. It also had fixed the maximum rate limits for current accounts and time deposits, and the ratios between the different balance sheet items were also in place. In 1925 a Banking Inspection Service was created to control and supervise the compliance of banks to the rules imposed on them. The Service had to annually publish the list of banks and bankers and to make sure that all banks were sending their statements accounts according to the model approved by the SBC. The Service was entrusted as well with supervisory tasks: the examination of financial statements; it could also conduct inspections to assure that banks did not set rates different from those set by the SBC. But actually we do not know how the Banking Inspection Service operated, and how effective it was in conducting its supervisory duties. More research is needed to find out the procedures employed by the inspectors and the sanctions, if any, imposed, on the banks that violated the rules.

Almost without time for the full implementation of the 1921 law, a new banking crisis exploded (figure 7). As argued above, the financial institutions entered the 1920s with many unsettled problems. A certain number of banks were incapable of liquidating bad loans and getting rid of devalued stocks. For a limited period banks could carry large losses by running down reserves built during earlier years. But as the recession deepened and the price of shares did not rise, industrial recovery was delayed and the financial situation deteriorated. Eventually, the difficulties re-emerged after the summer of 1924. The new crisis appeared as a continuous run on bank deposits, which lasted nearly a year until September 1925, as the deposit to currency ration in figure 8 shows. In the meantime, during these fifteen months the level of deposits decreased by 17 per cent; the run was particularly acute in the last part of 1924, and although it was

over by the end of 1925, confidence in the credit institutions was not immediately restored. All in all, during 1924-6 half a dozen salient banks failed and were forced to liquidate. Particularly serious were the situation of the Crédito de la Unión Minera and the Banco Central, one of the biggest and most influential institutions, whose problems threatened to shatter the whole financial structure.⁺⁺⁺⁺

The second part of the 1920s was of relative tranquillity for the banking system. Although there were 20 liquidations and 25 new creations, there was not any major bankruptcy or bank panic. Deposits grew at a moderate pace, universal banking consolidated, big banks opened branches throughout the country, foreign banks expanded and opened new offices and the government promoted the establishment of official or semi-public banks designed to meet the credit demand of special sector. The number of the saving banks also experienced a remarkable increase. At least 50 new institutions were established between 1920 and 1929.

The easy and calm times of the late 1920s came to end in 1929. The Great Depression was, with some exceptions, less severe in Spain than elsewhere in Europe and the financial system left only minor scars with only a major institution, the Banco de Cataluña, and two of its affiliates, going bankrupt. The crisis erupted in April 1931.^{§§§§} The demise of the Monarchy, the proclamation of the Second Republic, and the formation of a coalition government with various socialist ministers brought anxiety and fear to the business community and to the public in general. To make things worse, the new minister of Finance, the moderate socialist Indalecio Prieto, threatened financiers and industrialists that he would block all bank accounts if capital flights were detected. Besides, the news of the failure of the Creditanstalt and the difficulties of the central European institutions also contributed to darkening the atmosphere. The run on banks was intense between April and June. The removal of funds continued during the summer and by the end of September, when the crisis can be said to have been over, the total volume of deposits had declined by 1,300 million pesetas, or 20 per cent of the total outstanding in March 1931 (figure 8 shows the fall in the deposit to currency ratio). Banks did not fail because they were able to obtain all the cash they needed to convert deposits into currency. Two reasons may help to understand what made this possible. For the first time the Bank of Spain was ready actually to behave as a lender of last resort; secondly, banks had plenty of liquid assets. When the run started, the government made a swift and surprising move to deter the crisis. Indalecio Prieto summoned the governor and the deputy governor of the central bank and all members of the Supreme Banking Council and pressed them to reach a compromise. All agreed that banks were basically solvent but could run into serious difficulties for lack of liquidity. In consequence the Bank of Spain and the Treasury agreed on a combined action to facilitate all the cash banks might need. The government authorized an increase in the limit of banknotes in circulation, and the directors of the bank agreed to lend freely; this meant that they would discount bills on demand and would accept unhesitatingly eligible paper as collateral for credit. Since the crisis coincided with a flight from the peseta, the government also authorized a rise in interest rates to stop the outflow of capital. As though Prieto and the governor had not likely read Walter Bagehot, they adopted a "lend freely but at a high interest rate" policy, as the British writer had recommended when facing a simultaneous domestic and foreign financial crisis. The other reason that contributed to prevention of a banking collapse was the fact that

⁺⁺⁺⁺ The crises of these two banks are described in Martín-Aceña (1995).

^{§§§§} Martín-Aceña (1983) and Tortella and Palafox (1984).

Spanish banks were loaded with gilt-edged securities; they simply pledged their unused portion of government paper to obtain cash, and in this way public securities acted as an automatic built-in stabilizer. Hence, a rapid and surprising intervention of the central bank, plus the ability of banks to monetize their holdings of government paper, explains why financial institutions did not collapse in 1931.

Although the Republican minister had the full collaboration of the Bank of Spain in order to resolve the financial crisis, the Bank refused to side with the Treasury to defend the exchange rate of the peseta. The minister, no matter his inappropriate and untimely purpose to stabilize the peseta and to adopt the gold standard as late as the spring of 1931, believed that the Bank ought to have assisted the policy of the Treasury. The Bank refused to use its gold reserves to contain the depreciation of the currency because it considered that the defense of the exchange rate was not among its responsibilities. The minister, however, was convinced that the Board of the Bank preferred to safeguard the property of the shareholders (the gold reserves) rather than to co-operate with the center-left Republican government and he firmly believed that the non-compliance of the Bank was politically motivated.

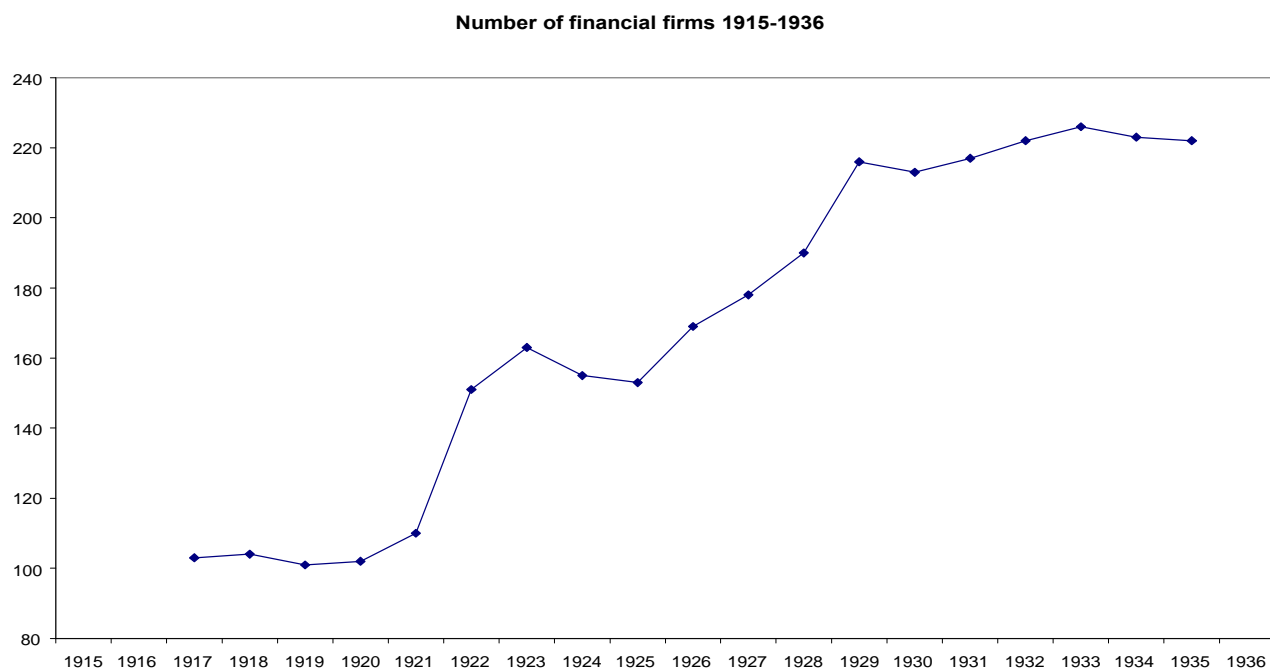
As a consequence, the Ministry of Finance decided to reform the Banking Regulatory Law of 1921. The reform did not affect the banking system and there were no changes in the supervisory framework. The modifications introduced in the law referred exclusively to the role and responsibilities of the Bank of Spain. In essence, what the reform aimed at was to increase the control of the Bank by the government. As a result, the composition of the Board was altered to include three more members named by the Ministry of Finance in representation of the so-called "general national interests". The other significant change was the obligation imposed on the Bank to put its gold reserves at the disposal of the Ministry in case of an official intervention in the foreign exchange market.

To conclude, the reform of 1921 was a reaction to the banking instability of the previous two years that had threatened the public's confidence in banks and, in consequence, in bank deposits, the payments system and the economy. The authorities believed that it was necessary to regulate the banking industry because it was a special industry that could not be left solely to the action of free market forces. The reform of 1921 is thus consistent with the argument made by some scholars that suggest that regulation is forged in response to crisis (Calomiris and Gorton 1991; Mitchener 2006).

A feature of the new legal framework was that the regulatory responsibilities were transferred to the banks through the Supreme Banking Council. Hence, from the unregulated system of the XIXth century, Spanish banking entered an era of financial self-regulation. No regulation was substituted by self-regulation. Although the Supreme Banking Council introduced some "prudential regulation" rules, such as minimum capital, bank registration, and some asset to liability ratios, the regulatory regime remained rather lax. There were only modest changes in the practice of bank supervision. Some improvements with respect to the previous period were the obligation of banks to send their financial statements to the Supreme Banking Council. The design of a common balance sheets for all banks increased transparency. Bank examination, though still limited, experienced a minor advance. The reform of 1931 responded to a different motivation. This time the aim of the Treasury was to increase its control over the Bank of Spain. The purpose was to reduce the autonomy of the Bank

and to assure its collaboration with the monetary policy of the government. As in the previous section, Table C in the Appendix summarizes the characteristics of the supervisory regime of the interwar period.

FIGURE 7



Note: the number of financial institutions includes banks and saving banks.

Source: BBVA (2003): La Banca en España en el período de entreguerras, 1920-1935. Un modelo de modernización y crecimiento. BBVA-Archivo Histórico

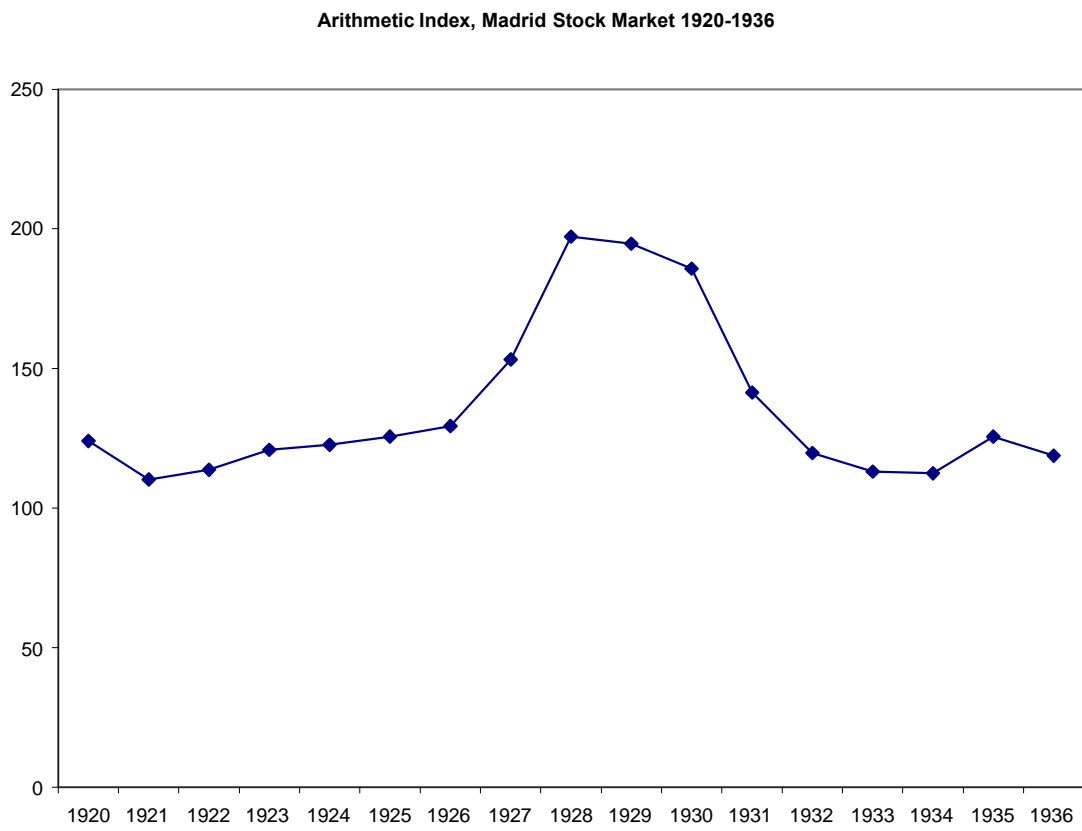
FIGURE 8

Deposit / Currency ratio 1920-1936



Source: Estadísticas Históricas de España (2005)

FIGURE 9



Source: Estadísticas Históricas de España (2005)

5. Interventionism and regulation between 1939-75

One of the noteworthy features of the international financial environment after World War II and until the demise of the Bretton Woods system was the absence of banking crises. An explanation given for this is that banking regulations were so restrictive and capital flows were so low for most part of the period that there were no causes to provoke banking crises. But with the collapse of the Bretton Woods system, financial crises returned with intensity to the world scenario. In many countries the crises had their origin in a previous cycle characterized by excessive real state investment, rapid credit expansion and exceptional increases in asset prices. A permissive factor was the domestic financial liberalization that began in the late 1970s and was completed by the late 1980s. When the booms ended, the busts led to bankruptcies and widespread financial instability. Having dismantled the shelter provided by the postwar structural controls and not having set in place yet the new instruments of prudential, ex ante supervision to control the riskiness of portfolios, the authorities were taken aback and forced to design a new architecture of financial regulation.

Spain was not an exception to this general trend. After the Civil War and up to the 1970s there were relatively few banking failures. As Pons (2002) has argued, banks and saving banks in difficulty were systematically rescued by the Bank of Spain, that now acted as a forced "lender of last resort" and subject to the close surveillance of the Ministry of Finance. Mergers and acquisitions of banks in trouble by sound banks, with the fiscal support and under the auspices of the supervisory authorities, was the other alternative used to avoid bankruptcies. As figure 10 shows, despite the absence of financial crises, the number of banks increased in the second part of the 1940s and then fell steadily until 1962. The decline was the result of a strong consolidation movement whereas big national banks bought small local and provincial banks. The upsurge after 1962 is explained by a change in the regulatory framework that promoted the establishment of investment banks (see below). Thereafter, a wave of financial consolidation led to a new reduction in the number of institutions.

As it has been mentioned above, the "financial stability" (absence of banking crises) of the Bretton Woods era is attributed to the repressed regulatory framework introduced after the Second World War. In Spain it was the civil war that brought about the end of the period of financial self-regulation (Spain did not join the IMF until 1958). The autarkic and interventionist orientation of the early years of the Franco regime prompted the imposition of structural controls and a shift in bank supervision away from market discipline towards government discretion. Financial stability and government-oriented resource allocation rather than competition became the priority of the authorities. *****

The new regulatory regime was forged by an array of acts approved between 1939 and 1942. The aim of the legislation was to restore and to restructure the broken postwar financial system, and to introduce measures to subject banks and savings banks to strict control. An important decree of 1939 because of its long lasting effects imposed a so-called banking "statu quo" which prohibited the establishment of new financial institutions without prior government scrutiny and approval.

***** This section is based on Martín-Aceña and Pons (1994), Faus (2001), Pons (2002).

In 1946 when the old 1921 Banking Law expired, it was replaced by a new and more restrictive legislation. Policy makers and regulators were convinced that financial institutions should be subject to strict controls and reoriented to supply whatever funds the “national economy” would require. As elsewhere in Europe, the financial market was suppressed and banks became the agents of government industrial policy. The myth of economic planning coupled with the idea that banking was a special sector, where the principles of market freedom had somehow to bow to "superior" interests of controlling the economy, explain why legislation empowered authorities (central bank and/or Ministry of Finance) to impose structural controls.

The Banking Regulatory Law of 1946 gave the Ministry of Finance ample discretionary powers to grant or to deny bank charters. Entry was at the discretion of the Ministry of Finance that used its authority rather arbitrarily. The era of easy entry came to an end. A new Banking Record Office was established. Only existing banks were allowed to register and to continue in the industry. Newcomers had to demonstrate the need for banking services in a specific geographic area. The banks' capital structure, its potential earnings, its management and the convenience and needs of the community were elements the new regulators considered before approving the establishment of a new bank. Furthermore, a favorable report of the Supreme Banking Council, also under the control of the government, was needed. Branching expansion depended on the financial density of each region, the existence of unattended financial demand or well proven insufficient financial services. The concession of branches was linked to the volume of capital and reserves of each bank. The larger the bank the higher the likelihood it had to obtain authorization to open a new branch. As a result, financial concentration increased.

The Ministry set maximum and minimum interest rates on deposits and on loans. It also set in preferential rates for the so-called “priority industrial sectors”. All banking operations were subject to controls. Portfolio restrictions included that only discounting and short-term commercial loans, with 90 days maturity, was authorized. Long-term credit was severely restricted until 1960. Quantitative credit ceilings were imposed according to the industrial policy of the government. The Ministry of Finance also fixed the minimum capital requirements and the proportionality between assets and liabilities, but no legal cash or liquidity ratios, or capital to asset ratio were established. Variations in nominal or paid-up capital, reserve provisions, dividend distribution and exchanges and acquisitions of shares among financial institutions were all subject to ministerial approval. Disclosure rules too were set in and banks had to permit on-site inspections at the authorities' discretion.

The architecture of financial regulation was simplified. The main supervisory agency for banks was the Ministry of Finance and the Ministry of Labor for savings banks, until 1957 when the former was made also responsible for thrift institutions. The General Directorate of Banks and Stock Exchange, a technical department of the Ministry of Finance, was in fact the entity in charge of all supervisory tasks. This Directorate was responsible for the Banking Record Office. Other assignments included the inspection of banks, so that they fully comply with the official regulatory norms and the credit policy dictated by the government. In 1957 the Directorate was reformed and renamed General Directorate of Banks, Stock Exchange and Investment assuming also responsibilities over insurance companies and savings banks. Hence, Spain opted for a

unique supervisory agency, as it was the case of many other European countries, e.g. Italy.

The Supreme Banking Council established in 1921 remained in place, although with reduced supervisory duties and limited autonomy. Its main function was to act as a consulting agency for the Ministry of Finance; other functions were to receive the application for the establishment of new banks and for the opening of new branches and the collection of bank statistics. Although the Supreme Banking Council lacked any supervisory power, it housed a Supervisory Board (Junta de Vigilancia) with the task of enforcing the official policy and banks' compliance with all official regulations.

The Bank of Spain, that maintained its private status, was put under the control of the Ministry of Finance and lost all its remaining autonomy. It was not nationalized but it became an institution entirely dependent on the Ministry of Finance. Furthermore, it was stripped of many of its functions. Monetary policy was transferred entirely to the Ministry of Finance, and the exchange policy to a special institution, the Spanish Exchange Control Institute, depending on the Ministry of Industry and Commerce.

In 1962 the regulatory framework created after the civil war was partially altered. Changes in the European financial environment and the exhaustion of the domestic expansionary cycle that began in 1951 convinced the government that the autarkic and interventionist strategy ought to be dismantled. The Spanish economy grew fast during most of the 1950s, but at the same time it had accumulated a series of fiscal and monetary imbalances that threatened to abruptly halt the past economic improvements, and even to reverse what had been achieved in terms of income per capita. Protectionism and interventionism also had led to gross industrial inefficiencies and misallocation of resources. In 1959 a Stabilization plan, modeled after a similar French plan, was adopted to correct the inflationary process and the mounting disequilibrium in the balance of payments. The plan was followed by a series of reforms aimed to dismantle the autarkic framework, reduce the role of the State and enhance the role of the market.

In the financial sphere, the 1946 Banking Law was replaced by a new Banking and Credit Regulatory Law. The Bank of Spain was nationalized and old and new monetary instruments were put in place. Monetary policy, however, remained in the hands of the Ministry of Finance. The law established cash and liquidity ratios, a new public-debt ratio, by which banks were required to hold a certain proportion of government securities in their portfolio. Reserve requirements were also introduced for both banks and savings banks. Another relevant change was the separation between commercial and industrial banks. The latter were allowed to make long-term investments and hold all types of firm's securities (bond and equity). On the contrary, commercial banks should specialize in short-term credit and bill discounting of commercial paper with less than 18 months maturity. The changes introduced by the 1962 law intended to enhance the role of the market forces in achieving bank efficiency. Competition was a new goal, and it was no longer seen with suspicious eyes.

The liberalizing winds of the 1962 law took time to materialize. Entry barriers persisted for banks and savings bank. Branching limitations also remained in place. Interest rate ceiling on deposits and loans rested too under strict government control. Since financial institutions were supposed to play an active role promoting

industrialization, a so-called “investment coefficient” was introduced, by which banks and savings banks were compelled to maintain a certain proportion of their portfolio in government bonds or in pre-determined industrial securities. In addition, “preferential” interest rates were adopted to favor the development of industrial sectors considered of “national interest”.

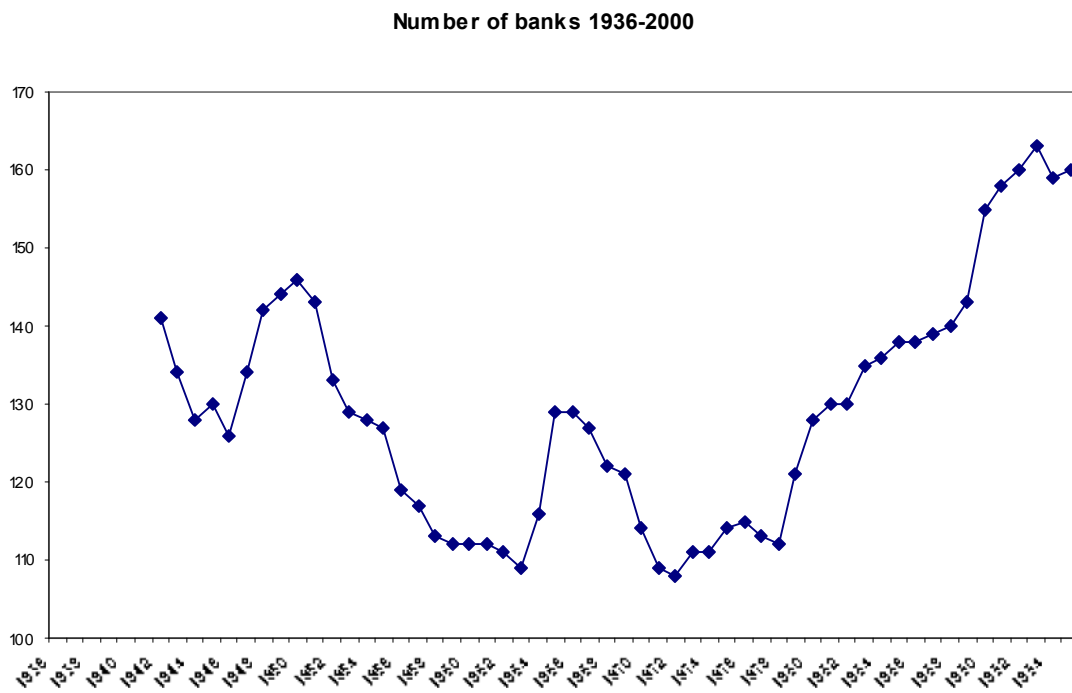
The supervisory architecture established in 1946 experienced only minor modifications. The Ministry of Finance maintained its fully comprehensive powers over the financial system. Credit policy and banks’ supervision stayed in the hands of agencies within the structure of the Ministry. The Bank of Spain lacking autonomy continued to implement monetary policy as a mere instrument of the government. A significant improvement, insofar as transparency and disclosure, was the creation of a Risk Information Center within the organization of the Bank. Its role was to receive and centralize in one department all banks’ data concerning risk concentration. The Center provided the Bank with an excellent instrument to monitor the risk level of the financial system. Moreover, two new agencies were created. The Institute of Credit and Savings Banks (Instituto de Crédito de las Cajas de Ahorros) to regulate and supervise the savings banks, and the Institute of Medium and Long Term Credit, established to coordinate and control the so-called official credit entities.

Cautious deregulation began in 1969. Interest rates restrictions on long-term (two years or more) loans were lifted. Barriers to entry were loosened and branching restrictions were partially removed. These more relaxed chartering and branching policies enhanced competition. After 1974, deregulation speeded up. Discrimination between banks and savings banks were eliminated. Banking operations were liberalized and the obstacles to competition among financial institutions were progressively suppressed. By 1976, when a new crisis was looming, the Spanish financial system had been renovated and partially deregulated. Nevertheless, the old structural controls had not been substituted by prudential non-discretionary rules, or to put it less radically, the shift from structural to prudential control as a means to achieve financial stability has been incomplete. Moreover, by the mid-1970s the Spanish financial system was still non-competitive internationally and poorly diversified. Highly regulated for a long period and sheltered from foreign competition (foreign banks were not allowed to enter the country until 1978), Spanish banks accumulated notable inefficiencies. Individual institutions were small, compared to Western European standards, with weak deposit bases and loans portfolios, and limited economies of scope.

In summary, the Spanish financial regulatory regime built after the civil war, not at all very different from that adopted in other European nations, offers a remarkable contrast with that of the previous two periods. Competition was sacrificed for stability. The government, showing an unmistakable distrust for bankers and no faith in the market, replaced the role of the market in the allocation and distribution of resources. After 1962 deregulation made some inroads. Competition was enhanced in various forms and some financial activities liberalized. At first, the stability of the system was not compromised because still many of the old regulations remained in place. Moreover, the profitability of the banks maintained the levels reached in previous decades. What it is true, however, is that after 1962 the variability of deposits, loans and profits, measured by the coefficient of variation, was higher in 1962-74 than in 1940-62. Hence, as Pons (2002) has suggested, the changes in regulation after the 1962 Banking Law impinged somehow on the stability of the financial system. Some individual banks

and savings banks experienced difficulties, but were handled swiftly and discretely by the Bank of Spain. Takeovers and mergers were permitted to avert any possible bank failures. As seen in figure 10 the number of banks declined but it was not the result of bankruptcies or traumatic liquidations. Again table C in the Appendix summarizes the most salient elements of the regulatory regime of this period.

FIGURE 10



Source: Consejo Superior Bancario. Boletines.

6. Banking crisis and financial reforms, 1975-2000

The late 1970s and early 1980s saw the largest failures of the Spanish financial system since the crash of 1866. Twenty-four institutions were rescued, four were liquidated, four merged, and twenty small and medium-sized banks were nationalized. These 52 banks out of 110, representing 20 per cent of banking system deposits, were experiencing solvency problems. Because of its depth and the number of institutions affected this crisis has been included in the group of the so-called recent “Big Five Crises”, identified by Caprio et al (2005) and Reinhart and Rogoff (2008). This financial episode came unexpectedly, as usually was the case with other crisis and its resolution was complicated and costly in terms of the public resources employed to avoid the collapse of the financial system. Savings banks also went through difficult times, although in this case consolidation was the solution adopted to prevent major bankruptcies. In many instances insolvent small and medium-size saving banks were absorbed by larger and better managed institutions. In other cases, merging was the procedure used to solve the problems. All in all, between 1977 and 1985 more than a dozen savings banks closed.

The resolution of the banking crisis imposed a high fiscal toll on the economy. The total gross fiscal costs of the rescue operation were approximately 5 per cent of GDP. It has been estimated that the sum was equivalent to the fiscal cost of the industrial restructuring that took place at the same time. Although during the period the evolution of the budget deficit was conditioned by different elements, the deficit multiplied by a factor of 50. From a being a mere 0.5 per cent of GDP in 1975 it rose to more than 6 per cent in 1984 and 1985. Credit to the private sector fell sharply from an annual growth rate of 25 per cent at the beginning of the crisis to a 1.4 per cent low in 1984. Shareholders and creditors of the banks placed under public administration incurred in heavy losses, but depositors did not suffer any reduction of their balances.

Behind the causes of the banking crisis there was a combination of exogenous and endogenous factors (Gil 1986; Cuervo 1988; Ontiveros and Valero 1988; Faus 2001). The banking crisis coincided with a deep economic recession. In the mid-1970s the stable macroeconomic environment of the previous decade came to an end. Energy, raw material and labor cost rose. The balance of payments current account deteriorated. Inflation escalated and nominal interest rates increased. Unemployment rose to record levels up to 25 per cent at the peak of the crisis. The industrial sector was severely hit. Low demand combined with increasing costs reduced the profitability of firms. Technical obsolescence, lack of competitiveness and dependability on external finance put industrial companies in a complicated situation. Firms in sectors such as mining, iron and steel, shipbuilding, and machinery experienced heavy losses and many had to close its doors. Consumer good industries also went through difficult times. Banks caught with large industrial portfolios saw their balance sheets deteriorated. The volume of non-performing assets rose. Banks’ profits were reduced and in some cases losses were recorded although they were not publicly unveiled. Equity prices fell sharply, and so did housing and commercial real state prices after several years of a pronounced upward trend supported by high borrowing levels (figure 11). Around 1980 non-financial sector indebtedness had reached a historical record with a leverage ratio around a 100 per cent. The decline in assets and stock prices affected the portfolio of the banks and reduced its market net worth (Torrero 1990).

Deregulation and competitive pressures were other causes of the banking crisis. The number of banks increased slightly after the partial liberalization of the 1962 law, reversing the steady decline of the previous period. Moreover, there was a rapid expansion in the number of branches at existing commercial banks following the liberalization of the authorization to establish branches. Competition from foreign-owned banks after 1978, credit companies, insurance companies, and in particular finance companies led to intensified pressures. Bank managers were not used to operating in a competitive environment and increased their focus on gaining market share. Many banks expanded into geographical and business areas in which they had little prior knowledge. Industrial banks established after 1962 lacked expertise and qualified professionals. There were cases of illegal banking practices, unwarranted risk concentration and imprudent management, as it had happened a century ago in 1866.

As the banking crisis erupted almost unexpectedly, the Ministry of Finance and the Bank of Spain were caught unprepared. Deregulation had not been accompanied with the establishment of an efficient system of banking supervision. The authorities had neither the legal instruments, nor the institutional mechanisms to face the turmoil caused by the massive banks' insolvencies. The inspection department of the Bank lacked the human capacity to carry out adequate banking examination. Disclosure requirements for financial holdings were not in place and hence it was difficult to gauge the solvency of the financial firms within the holding. Auditing of banks was not at the time a widespread custom and many firms resisted the inspection by outsiders. Procedure rules to impose sanctions to managers were non-existent or outdated. Procedures to remove the administrators of banks in troubles were legally complicated. In sum, despite the fact that a "regulatory regime" certainly existed, the financial authorities lacked an adequate system of information and supervision. To avoid a possible catastrophe the Bank had to implement emergency measures to prevent bank runs and a contagion effect from unsound to essentially solvent institutions. Containment included lender of last resort assistance to banks with temporary liquidity problems and the intervention of basically failed banks.

At first the crisis affected only a limited number of small institutions. Rescue operations began in 1977 with Banco de Navarra and it was followed by a series of interventions that continued until 1983. To provide limited guarantee to depositors and to have a quick and adequate mechanism to intervene banks a Deposit Guarantee Fund was established in November 1977. During the two initial years of the crisis the Fund intervened 29 institutions. Only one institution was liquidated, while the rest were restructured and reorganized, and later sold to other banks. In 1978 a new and more potent institutions was created: the Banking Corporation (Corporación Bancaria), a society with a social capital of 500 millions pesetas, that received contributions from the Bank of Spain and from 95 banking firms. The objective of this corporation was similar to the Fund. To intervene the institutions in troubles, remove and substitute the administrators, reorganize the banks, and in due time, to return them to the private sector. The main role in the restructuring process was played by the Bank of Spain.

In one special case, the bail-out of Banco de Urquijo, a major industrial bank, the intervention was conducted directly by the Bank of Spain. And the Ministry of Finance too intervened directly in another special case: the nationalization of the Rumasa holding, formed by 600 commercial and industrial firms and 17 banks that were essentially used to finance the operation of the group. With a level of risk

concentration, that exceeded the legal limits, over 70 per cent of the credit granted by the banks went to firms of the group, and widespread fears of a ruinous collapse, the Ministry of Finance decide to nationalize the entire holding in 1983.

The resolution of the banking crisis was followed by an intense period of financial restructuring. Commercial banks reduced their industrial portfolios, whose share in the balance sheets declined from 33 per cent of total assets in 1975 to 13 per cent by 1986 (Martín, Carbó and Sáez 1995). The holding of public securities, on the contrary, increased. Financial concentration was also an outcome of the crisis. Mergers were the result of both public policy recommendations, and of purely economic reasons. Consolidation accelerated at the end of the 1980s and the beginning of the 1990s. In 1989 Banco Bilbao merged with Banco de Vizcaya to form BBV, which later in 2000 became BBVA after the purchase of the public banking group Argentaria. The other major merger was Banco Central and Banco Hispano Americano, in 1991, to form BCH, which later in 2000 consolidated with Banco Santander. Now BBVA and Santander are two giants in the Spanish domestic market as well as in the world financial system.

According to Mishkin (1991: 57), "although desirable, deregulation and liberalization can be disastrous if not managed properly. If the proper bank regulatory and supervisory structure is not in place before liberalization, risk-taking behavior will not be adequately constrained. Bad loans are likely outcome, with potential calamitous consequences for bank balance sheets at some point in the future. Financial deregulation and liberalization also often lead to a lending boom, both because of increased opportunities for banking lending and because of a financial deepening that brings more funds into the banking system, opening up new lending opportunities that may result in loan portfolios of very poor quality". This argument is perfectly applicable to the Spanish experience.

The authorities (Ministry of Finance and Bank of Spain) realized that the previous framework was flawed in many respects. The regulations in place at the time of the banking crisis were inadequate and insufficient. The financial statements provided by banks did not permit to evaluate the real risks of the institutions. Accounting procedures were obsolete. Moreover, the inspection capacity of the Bank of Spain was limited, and the sanctions that could be imposed on banks' administrators for wrong doings of dubious efficacy.

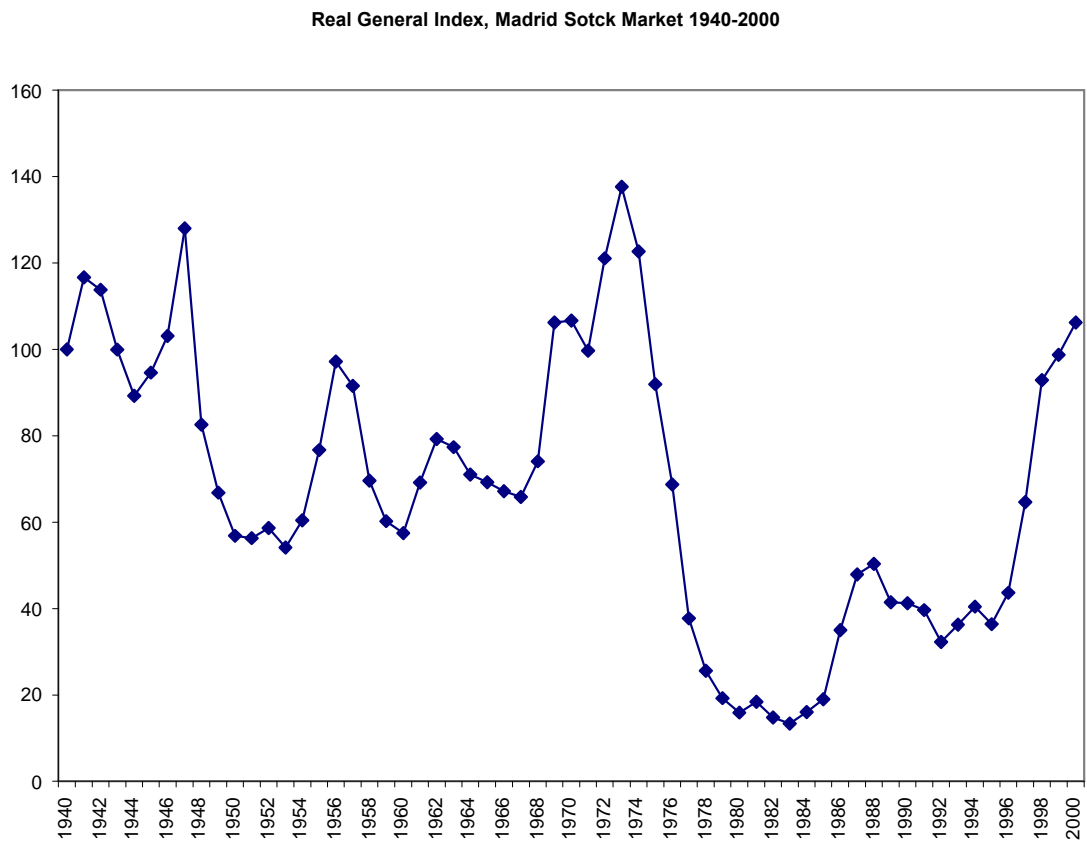
The crisis taught important policy lessons, and the regulators moved swiftly to forge a strong banking supervisory regime. First they realized that bank regulatory and supervisory agencies needed adequate resources to do their job effectively. Without enough human and material means a bank supervisory agency is unable to monitor banks well enough to keep them from engaging in inappropriately risky activities, or to see that they have the appropriate management expertise and controls to manage risks and sufficient capital to keep in check the moral hazard incentives to take on excessive risk. Second, they realized as well that proper accounting standards and disclosure requirements are crucial to a healthy banking system. Third, bank supervisors need to take prompt action to stop undesirable bank activities and, even, close down institutions that do not have sufficient net worth, making sure that stockholders and managers of these insolvent institutions are appropriately punished. Fourth, because of prompt corrective action is so important, the bank supervisory agency requires sufficient

independence from the political process so that it is not encouraged to sweep problems under the rug by engaging in regulatory forbearance. One way to do this is to give the bank supervisory role to a politically independent central bank.

It is not surprising therefore that while the crisis unfolded the regulatory authorities introduced legislation in order to reinforce the supervisory capacity of the Bank of Spain. In 1980 the Law of Governing Bodies of the Bank of Spain (Ley de Organos Rectores del Banco de España) transferred all responsibilities for bank supervision, discipline and sanctions to the central bank, that at the same time was given ample political autonomy. In a short time thereafter, the Bank, by means of ministerial orders or by mere communications (circulares) introduced new rules regulating accounting practices and disclosures norms with regard to the income and losses account. The distribution of benefits, the classification of risk according to the nature of the each asset, the provision against future insolvency, and norms to value balance sheets were subject of special attention. In 1988 the Credit Company Intervention and Discipline Law unified the control of all financial firms under the Bank of Spain. The law regulated the causes for bank intervention, made a graduation of the possible infringements, established the standard procedures for banking examination, and listed the sanction to banks and managers according to the severity of the fault. The following step came with the Autonomy of the Bank of Spain Law, in order to comply with EU legislation. Finally in 2000 the Bank of Spain introduced the so-called forward-looking provisioning, also referred to as the dynamic or statistical reserve, a mechanism of pre-provisioning for loan losses over the course of the cycle. The idea behind this new solvency provision, together with the "old" existing provisions, is to try to capture expected losses. From the very moment that a loan is granted, and therefore any impairment on this specific loan appears, there is a positive default probability (no matter how low it might be) following a statistical distribution with an expected loss. The expected loan is known in a statistical sense but not yet identified in a specific loan operation or borrower. As the risk appears at the beginning of the operation, so does the statistical operation requirement. With this system, provisions run in parallel to revenues and are, therefore, distributed through the cycle, allowing for a better mapping between income and costs in the profit and loss account. Its merit, according to the Spanish authorities, is that it introduces incentives for better risk management, while at the same time attenuating the cyclicity of the financial sector and, thereby, swings in the real economy. †††††

††††† Poveda (2000); Caruana (2003)

FIGURE 11



Source: Estadísticas Históricas de España (2005)

7. Conclusion

Episodes of financial fragility appear to be an inherent feature of market-oriented financial systems, and both macroeconomic and microeconomic factors have figured in banking crises, as observed by Caprio and Klingebiel (1996). Avoiding crises through regulation and supervision, and preserving at the same time the fundamentals of a market-oriented system have therefore been put high in the agenda of governments in many countries and in international standard-setting bodies.

The history of international crises and the history of financial regulation illustrate at least two points. First, regulation and supervision of individual financial institutions contribute to a safer and sound financial system by reducing the probability of financial distress of individual institutions. In particular, regulation and supervision protect the financial system against idiosyncratic risks, i.e. risks that affect a few banks depending on their exposures, but that may affect the financial system as a whole through interlinkages between financial institutions. As Caprio and Klingebiel (1996: 79-101) have suggested, banking systems can be made most robust in their responses "to bad luck and bad policies" through a regulatory framework that rewards prudent and diversified risk taking by bankers. Second, despite the improvements made in the regulatory frameworks and supervisory procedures, financial crises do reemerge time after time. So far regulation and supervision have been proven ineffective in avoiding or preventing financial crises. We still have to design a regulatory framework that enables the banking system to be a more resilient absorber of shocks. In his recent paper on the history of financial supervision, Goodhart (2007: 64) has put it clearly: what historical record demonstrates, and as every central banker and practitioner comes to understand, is that regulation and supervision are primarily reactive. In Goodhart's words, when something goes wrong in the financial system, some people lose money and then almost by definition the existing system of supervision and regulation is held to be at fault. The Press takes up the cry, "heads must roll". Since the politicians do not want it to be their own heads that they become parted from, they feel the need to be seen to be taking actions to make sure that that particular disaster never happens again.

Like the rest of the world, Spain has suffered frequent financial crises and changes in the regulatory framework. In various instances, regulatory changes have predated financial crisis, but, in others, banking crises have occurred without reference to changes in the regulatory regime. There have been crises that have been followed by reforms of the financial structure, and also troubled financial times with no modification of the regulatory and supervisory regime. Economic policy action has been usually absent in the XIXth century, while in the XXth century regulators have been more diligent. Moreover, in all cases, major financial crisis have produced intense financial restructuring, although as elsewhere banking restructuring and interventions not always have been successful.

The XIXth century legislation reflected the liberal ideology of the times. Banks were considered as any other commercial or industrial firms. The lack of regulation was the most prominent feature of the period. For credit companies, entry into the sector was easy and there were no restrictions on asset holdings or financial operations. There were no well-defined solvency or liquidity ratios. Banks of issue had some limitations. Entry was easy but only one per town was permitted. They had also restrictions insofar as their portfolio composition. Moreover, after 1874 the privilege to issue banknotes for

the entire country was granted to the Bank of Spain. Supervision was practically absent and, presumably, banking examination was nonexistent. Disclosure requirements were minimum. There was not either any depositor insurance device in place. Market discipline rather than public surveillance prevailed for more than half a century. The Royal commissioner was the only, if somehow blurred, supervisory authority. Crises episodes and bankruptcies were not uncommon. Whether the existence of a regulatory or supervisory regime may have prevented the occurrence of financial turmoil it is something difficult to say and certainly more research is needed before a definite answer is given.

The postwar banking crisis brought to the fore the need to regulate the financial sector. The 1921 Banking Regulatory Law was to some extent a watershed because it broke a long period of nearly “free banking”. Supervision was entrusted to the Supreme Banking Council, a new agency which was controlled by the banks themselves. We have characterized this period as one of self-regulation because the regulatory and supervisory tasks were put in the hands of the banks. Supervision was focused on the reinforcement of market discipline. The attempt to transform the Bank of Spain into a real central bank was another salient feature of the 1921 law. Until then, the Bank had privileged its private interest over its duties as bank of issue. The regulatory regime born in 1921 was of no use to prevent a new crisis in the mid-1920s or the liquidity scramble of 1931 that ended with various bankruptcies. However, in this last occasion the Bank of Spain employed its capacity as lender of last resort to avoid the collapse of the financial system.

The Civil War marked an abrupt shift in the regulatory regime. Legislation introduced in 1939-42 and later in 1946 imposed strict barriers to entry and restricted branching. Competition was superseded by government discretion. The lack of faith in the market led to arbitrary administrative allocation of resources. Banks were put at the service of political economy goals as defined by the financial authorities. Protected from competition within the industry and from outside, the banking industry enjoyed a long period of relative stability. Although the number of banks varied over time, there were no major failures. Forbearance for trouble institutions was permitted. Liquidity problems were resolved by the Bank of Spain on individual cases, and banks insolvencies were dealt with by merging operations.

The regulatory regime was altered in 1962 as part of a general shift from an inward-looking to an outward-looking growth strategy. The 1962 Regulatory Law softened the interventionism of the previous period and introduced a division between commercial and industrial or investment banks. A cautious process of liberalization began in 1969 and deregulation accelerated after 1974. Restriction on asset holdings were lifted as well as ceilings on maximum interest rates on deposits. However, deregulation was not accompanied by a change in the supervisory regime. During the favorable economic environment of the 1960s, the financial industry expanded considerably. When the world economic cycle changed in the mid-1970s, Spain was severely hit by the crisis, suffered a long and protracted period of financial turmoil. The banking crisis that began in 1977 affected half of the banking structure and lingered out until 1985. The supervisory authorities had to implement emergency measures to contain a generalized collapse. New instruments were created, such as the Deposit Guarantee Fund and a public joint-stock company, the Banking Corporation, to bail out

banks in trouble. In the 1980s and 1990s the supervisory regime was reinforced and Spain introduced measures to comply with EU directives and the Basel accords.

APPENDIX A
MAIN BANKING REFORMS IN SPAIN

Year	Legislation
1835	Royal Order of the Ministry of Interior promoting the establishments of savings banks
1853	Royal Decree regulating savings banks: not enforced
1856	Bank of Issue Law Credit Companies Law
1869	Joint Stock Company Law
1874	Decree granting the monopoly of issuance of banknotes to the Bank of Spain
1880	Law of Savings Banks. Statutes approved by the Ministry of Interior. Saving banks were put under the protection of the government. Defined as “charitable” institutions
1885	Reform of the old 1835 Code of Commerce. Removal of chartering requirements. Free establishment of all types of joint stock companies. Financial companies subject to similar rules than commercial and industrial firms.
1891	Royal Decree extending the monopoly of issuance of banknotes to the Bank of Spain
1921	Banking Regulation Law. First act regulating the banking industry. Establishment of the first regulatory body: the Supreme Banking Council
1926	Royal Decree establishing a Regulatory and Inspection Office for the saving banks
1928	Royal Decree creating the Spanish Confederation of Saving Banks (a supervisory body similar to the Supreme Banking Council)
1931	Partial reform of the Banking Regulation Law. It affected exclusively the functioning of the Bank of Spain
1933	Decree approving the General Statute of Saving Banks. Definition of saving banks as thrift and charitable institution. Regulating the portfolio composition of saving banks
1939	Order of the Ministry of Finance declaring a financial “statu quo”
1946	Banking Regulation Law. A complete reform of the previous Banking Regulation Law of 1921
1947	Decree regulating the composition and appointment of members of the Board of saving banks
1957	Decree by which the saving banks are put under the supervision of the Ministry of Finance
1962	General Banking Law. Complete reform of the 1947 law. Nationalization of the Bank of Spain. Division between commercial banks and investment banks.
1964	Decree defining saving banks as financial institutions. Restructuring the boards of the directors of the saving banks. Regulating the composition of the saving banks portfolio. Creation of the Credit Institute of the Saving Banks, with supervisory responsibilities.
1971	Official Credit Law, to reform the regime of the public financial institutions
1974	Orders of the Ministry of Finance liberalizing different banking prices, operations, and the

	opening of branches.
1977	Decree-law of Saving Banks, reorganizing the functions and operations of the savings banks
1980	Law regulating the functioning and responsibilities of the Bank of Spain
1994	Law of Autonomy of the Bank of Spain Law of Reform of the Financial System, to comply with EU legislation
1996	Royal decree regulating the establishment and activities of the financial system
2002	Reform Law of the Financial System

APPENDIX B
SPANISH BANKING REGULATORY AGENCIES

PERIOD	BANKS	SAVING BANKS
1856-1920	Ministry of Finance	Ministry of Interior
1921-1936	Ministry of Finance Supreme Banking Council Bank of Spain	Home Ministry: 1921-1926 Labor Ministry: since 1926
1936-1962	Ministry of Finance	Labor Ministry: until 1957 Ministry of Finance: since 1957
1962 to the present	Ministry of Finance Bank of Spain	Ministry of Finance Bank of Spain

APPENDIX C
SPANISH BANK SUPERVISORY REGIMES

BANKS

Prudential regulations	First Period: 1856-1920	Second Period: 1921-1936	Third Period: 1939-1975
1. Entry	Only one bank of issue per town (1874: monopoly of issue granted to the Bank of Spain. Incorporation needed government authorization. Obtained easily with minimum requirements	Subject to government authorization and a favorable report of the Supreme Banking Council. Compulsory registration in the Official Register of the SBC	Restriction on entry. Entry subject to strict norms and regulations
2. Capital requirements	Fixed minimum	Fixed minimum	Regulated. Fixed by the Ministry of Finance
3. Limits on economies of scale	No limits	No limits	Strong branching limits. Strict controls on mergers and consolidation
4. Limits on economies of scope and diversification	Banks of issue: some restrictions Credit companies: no limits	No limits	Restriction on portfolio composition
5. Limits on pricing	No limits	Maximum rates on deposits	Strict regulation by the Ministry of Finance. All rates
6. Liability insurance	No liability insurance	No liability insurance	No liability insurance
7. Disclosure	Publication of financial statements in the Government Official Journal	Information disclosure to the Supreme Banking Council	Information disclosure to the Ministry of Finance
8. Examination	At the discretion of the government.	Supreme Banking Council. Rarely conducted	At the discretion of the government. Examination by the General Inspectorate Committee.
9. Supervision and enforcement	Royal commissioner. Limited to the compliance with the statutes	Limited to the observance of the rules establishes by the Supreme Banking Council.	Strict enforcement of rules. Repeal of the bank charter in case of violation of the law.

SAVING BANKS

Prudential regulations	First Period: 1856-1920	Second Period: 1921-1936	Third Period: 1939-1975
1. Entry	Free Entry. Minimal discretion. The statutes required the approval of the Ministry of Interior	Unvaried	Similar to banks

2. Capital requirements			
3. Limits on economies of scale	One saving bank per town	Unvaried	Strict branching limitations
4. Limits on economies of scope and diversification	Restriction on assets	Unvaried	Restrictions on assets
5. Limits on pricing	Unregulated.	Unregulated.	Strict government regulation
6. Liability insurance	No liability insurance	No liability insurance	No liability insurance
7. Disclosure	Unregulated	Unregulated	Disclosure to the Ministry of Labor and later to the Ministry of Finance
8. Examination	Unregulated	Unregulated	Similar to banks. Examination performed by special agencies established to regulate savings banks
9. Supervision and enforcement	Unregulated	Unregulated After the approval of the General Statute of Savings Banks, supervision was conducted by Ministry of Labor	Similar to banks. Supervision conducted by the special agencies established to regulate savings banks

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