

**Spain: Financial Sector Assessment Program—Technical Note—
Regulation, Supervision, and Governance of the Spanish *Cajas***

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SPAIN

**TECHNICAL NOTE ON REGULATION,
SUPERVISION, AND GOVERNANCE OF THE
SPANISH *CAJAS***

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REGULATION, SUPERVISION, AND GOVERNANCE OF THE SPANISH *CAJAS*¹

I. INTRODUCTION

1. Spain's financial markets have been deregulated since 1977, spurred by political change and closer ties with the European Communities. As part of this process, Spain's *cajas de ahorros* (savings banks) were gradually reformed so that they could compete in the newly liberalized market. In particular, they were allowed to engage in universal banking activities previously reserved to (commercial) banking institutions, and, since 1988, to expand into all regions of Spain and abroad. The *cajas* have been very successful in taking advantage of deregulation by expanding significantly in the lending and deposit-taking markets, where they have now a market share close to or above that of banks.

2. In parallel with deregulation, the governance structure of the *cajas* was reformed. Since 1977, their governing bodies were opened to a broader representation—including depositors, founders, employees, and other cultural, charitable, and academic organizations—with a view to reducing what had been substantial political influence, and thus allowing them to compete more effectively with banks.

3. Despite the broader representation in *cajas*' governing bodies and the liberalization measures aimed at leveling the playing field of *cajas* and banks, the governance structure of *cajas* is more extensively regulated—by the State and by the Autonomous Communities—than that of banks. Furthermore, the governance framework of *cajas* has been frequently revised in the period 1977-2005. Legislative reforms—in 1985 and 2002—and rulings of the Constitutional Tribunal introduced changes in the governance structure of *cajas*. Reforms introduced in 1985, and rulings of the Constitutional Tribunal in 1988 increased public sector representation, whereas the legislation enacted in 2002 reduced it. Despite these institutional changes, the fundamental character of the *cajas* as credit institutions that are also private organizations with foundational origins and social objectives has remained intact.² Moreover, an issue that has frequently arisen in Spain's public debate is whether and to what extent various levels of government and political parties have influenced business decisions made by *cajas*.

4. Against this background, a fundamental policy question affecting the Spanish *cajas* is whether the existing governance structure is conducive to sound risk management by ensuring that these institutions' business decisions are free of political interference and that proper internal controls are in place. A supplementary question is whether deregulation has sufficiently leveled the playing field between commercial and savings banks to support competition. This latter question brings to the front the dual character of the regulation and supervision of credit institutions in Spain: commercial banks are regulated and supervised by the central government, whereas savings banks are regulated and supervised both by the

¹ Prepared by Mario Catalán and Marina Moretti.

² For more details about the legal and institutional nature of *cajas*, see Section III.A.

central government and by Autonomous Communities. Although the powers of Autonomous Communities over savings banks are restricted to aspects of internal organization and conduct of business, the division of oversight responsibilities over savings banks raises issues such as the need for coordination, in particular to avoid the possibility of conflicts.

5. This note discusses these issues and is structured as follows. Section II provides background on the financial liberalization and deregulation process that started in 1977, with special reference to the *cajas*. Section III provides an overview of the *cajas*' governance structure. Section IV analyzes the regulation and supervision of *cajas*, with particular reference to the division of responsibilities between the central government (State) and the Autonomous Communities. Section V discusses the main challenges going forward in terms of ensuring the *cajas*' operational autonomy and further leveling the playing field between savings and commercial banks. Section VI summarizes the main findings and provides recommendations.

II. DEREGULATION

6. The deregulation of Spanish financial markets since 1977 had a profound effect on the *cajas*.

7. The evolution of *cajas* has taken place in three stages. In the first stage, starting in 1835, the role of *cajas* was the promotion of savings. Most *cajas* were created in the first half of the nineteenth century by local councils, associations, and religious orders, or evolved from the existing pawnshops (*montes de piedad*). Their original function was to collect savings from the local communities, provide small loans backed by pawns—goods held in pledge as security for the loan—and channel their “profits” (*excedentes*) back to these communities through social and cultural projects.

8. In the second stage, starting in 1926, the *cajas*' business shifts toward granting credit to the public sector and other sectors favored by the government. Until the 1970s, the *cajas* were subject to extensive government regulation including directed credit (the so-called *coeficientes de inversión obligatoria*),³ a prohibition to engage in business with companies, and the right of the finance minister to veto high level appointments to the *cajas*.

9. In the third stage, starting in 1977, the role of *cajas* shifts toward the promotion of credit to households and small and medium enterprises, and also—in the last decade—toward industrial shareholdings, while their regional specificity declines. As part of the deregulation process, the *cajas* were allowed to carry out universal banking activities starting in 1977, and directed credits were gradually eliminated (although not fully abolished until 1992). Further deregulation in 1988 allowed the *cajas* to expand their operations outside their home regions, allowing them to compete on a national (and potentially international) scale. Legal barriers

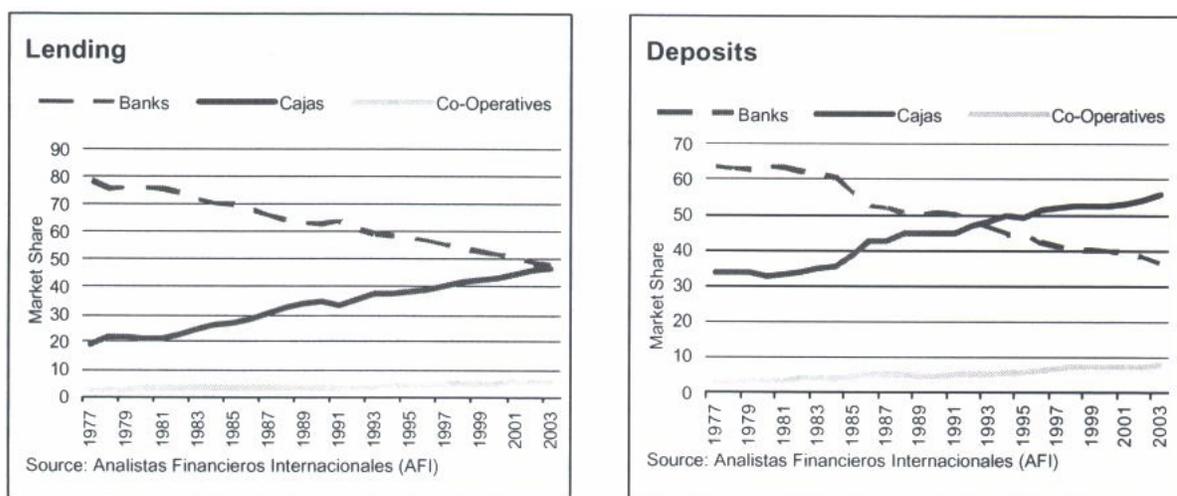
³ The *coeficientes de inversión obligatoria* required financial institutions (both banks and *cajas*) to invest 50 percent of their deposits in government paper, and another 30 percent in lending for set purposes (largely housing in the case of *cajas*).

preventing mergers and strategic alliances among *cajas* were eased in 2002, allowing *cajas* from different regions to merge.⁴

10. The outcomes of this liberalization were rapid expansion and consolidation. The *cajas* have consistently gained market share over the past 30 years, in a few cases accelerated by the acquisition of banks. *Cajas*' share in total banking system assets grew from 22 percent in 1976 to 33 percent in 2004; their share in lending from 18 to 45 percent; and their share in deposits from 33 to 52 percent—in the latter case surpassing banks by a significant margin (Figure 1). Most *cajas* now have branches outside their home regions and some of them have established truly national networks—in particular the *Caja de Ahorros y Pensiones de Barcelona (La Caixa)* and the *Caja de Ahorros y Monte de Piedad de Madrid (Caja Madrid)*.

11. The liberalization and the intensification of competition in the Spanish banking system spurred a process of consolidation that affected both commercial and savings banks. In the case of *cajas*, a significant number of mergers took place over the past 30 years, bringing their total number from 84 in 1976 to 46 in 2004. While no *caja* has ever defaulted on its obligations, in a few cases mergers resulted from the need to resolve a problem *caja*. The latest case occurred in 2001, when the *Caja de Ahorros de Valencia, Castellón y Alicante (Bancaja)*, the third largest Spanish *caja* by assets, absorbed the *Caja de Ahorros y Préstamos de Carlet*, a small savings bank based in Valencia that had encountered financial difficulties.⁵

Figure 1. Banking System: Evolution of Market Shares, 1976-2003



⁴ Previously, only mergers between *cajas* from the same region were regulated.

⁵ FitchRatings, 2004, *The Spanish Cajas: A Consolidated Force in Spanish Banking*, Special Report, April.

III. GOVERNANCE

A. Ownership and Mandate

12. In Spain, current legal interpretation is that *cajas* are credit institutions that act and are organized as private enterprises but have foundational origins and fulfill social functions. Their ownership structure is such that those exercising control—the public sector, depositors, employees, and others that are represented in the governing bodies—are not legal owners. The *cajas* do not have any share capital and equity consists mainly of reserves generated through retained earnings. Their social involvement and public sector representation created ambiguity as to whether they belong to the private or the public sector, but the Constitutional Tribunal clarified their nature.⁶

13. *Cajas* are required to allocate at least half of their profits to reserves, and they channel the remainder back into the community toward projects that fall under their social mandate (*obra social*).⁷ *Cajas* seek to maximize their profits—and thus, their allocation to the *obra social*—through their day-to-day business operations and compete fiercely with banks and other credit institutions for the provision of financial intermediation services. A key feature of *cajas* is that they pursue, both through their activities and the allocation of their profits, the following main objectives:⁸

- universal provision of financial services (promote savings among low- and middle-income classes);
- economic efficiency (guarantee safety and profitability);
- promotion of competition and avoidance of monopolistic practices (avoid usury);
- contribution to welfare and redistribution (provide benefits for the poor); and
- promotion of regional and community development.

14. The share of profits allocated to the *obra social*—averaging close to 30 percent per year—has decreased somewhat over the past decade, albeit the absolute level of profits has increased. The decline in the share of *obra social* is accounted for by increased taxation—

⁶ In a 1988 ruling, the Tribunal noted that they are credit institutions with a social character that do not distribute profits to private parties (*entidades sin fin de lucro* or non-profit institutions), which does not correspond to the traditional concept of enterprise. See Constitutional Tribunal, ruling 49/1988 of March 22, 1988.

⁷ This requirement, initially set by national legislation (Real Decree-August 27, 1977), has to be respected by all the Autonomous Communities.

⁸ Historical missions are in parentheses.

cajas were (almost) tax-exempt before 1985—and higher capitalization requirements imposed on credit institutions. The *obra social* share has also been increasingly allocated to the provision of public goods—particularly cultural, environmental, and research—which may suggest that its more direct re-distributional role has been declining.

15. The *obra social* has typically been focused on low-income groups, the elderly, and less populated areas. A recent study shows that the *obra social* benefits 96 percent of the Spanish population, with the disadvantaged groups receiving most of the benefits.⁹ Spanish citizens, on average, make use of services or public goods provided by savings banks about three times per year. The study concludes that the extensive provision of social and cultural services by the private sector—strictly, by savings banks—in Spain cannot be found in any other country. Finally, it suggests that the private provision of public goods through the *obra social* complements well the government’s provision of such goods. Specifically, savings banks play a leading role in identifying specific needs of disadvantaged groups, and once these needs have been identified, the public sector plays its own role. In this context, the savings banks have also helped to improve the overall provision of public goods. Moreover, as Spain’s per capita income has increased, *obras sociales* have been adjusting the menu of those goods.

B. Governing Bodies

16. The early reforms in the *cajas*’ governance, launched in parallel with liberalization in 1977, aimed at standardizing their internal structure so as to avoid the moral hazard of self-perpetuating boards of directors (and their capture by executive managers) as well as to reduce the state’s influence in the running of these institutions. In particular, management responsibility was transferred to *cajas*’ founders (including, in some cases, the local governments and/or Autonomous Communities),¹⁰ depositors, employees, and other groups (local academic, cultural, and charitable organizations). National standards of internal organization were introduced by legislation (Figure 2); these standards can be modified by the Autonomous Communities with a view to adapting the general rules to the conditions in their respective region.¹¹

- *General assembly.* The general assembly—similar to the shareholders’ meeting of a public limited company—is the main governing body of a *caja*, responsible for providing its strategic orientation and selecting management. The LORCA (Law 31/1985 of August 2, 1985) set the number of members, which can vary between 60

⁹ See PricewaterhouseCoopers, 2005, *Valoración del impacto de la obra social*. The study was sponsored by the confederation of Spanish savings banks (CECA).

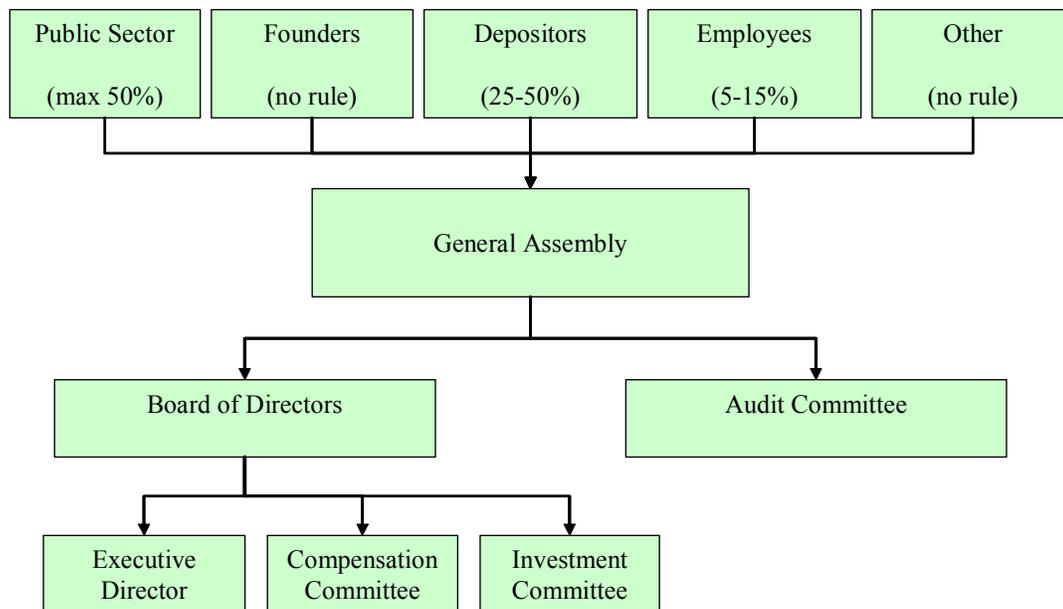
¹⁰ The 1978 Constitution granted Spain’s regions a certain degree of autonomy, embodied in a new level of public administration, the *Comunidades Autónomas* (Autonomous Communities).

¹¹ Deviations from the national norm are permissible with respect to the number of assembly members and each group’s share; the inclusion of representatives from other groups; and rules for selecting assembly members.

and 160 depending on the size of the *caja*.¹² The *Ley Financiera* (Law 44/2002 of November 22, 2002) capped the number of public sector representatives—State, Autonomous Communities, public law agencies and Municipalities—at 50 percent of members of the general assembly.¹³ A 2003 amendment to the LORCA also altered public sector representation in the assembly by requiring that all the Municipalities in which the *caja* has branches be represented.

- *Board of directors.* Board members are selected by the assembly usually from its ranks and reflect its representation.¹⁴ Besides management, the board is responsible for the *cajas*' social mandate. The board's chairman is also president of the assembly and of the *caja*.
- *Internal audit function.* Members of the audit committee are also selected by the assembly from its ranks and reflect its representation.

Figure 2. *Cajas*' Governing Bodies



¹² The LORCA (*Ley sobre Órganos Rectores de las Cajas de Ahorros*) also reinforced the influence of the public sector in *cajas*' decision-making.

¹³ This reform was partly in response to the need to clarify whether *cajas* are public or private undertakings under EU law. EU directives define public undertakings as “any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it” (Directive 80/723-EEC of June 25, 1980).

¹⁴ Board members are usually selected among assembly members. However, up to two board members may be selected each from the ranks of depositors and public sector, without being members of the assembly.

- *Management.* Most board functions are delegated to the executive director level (executive committee and director general). The executive director(s) are appointed by the board based on professional criteria and confirmed by the assembly. They are expected to serve terms of between four and six years (depending on each *caja*'s by-laws) and although re-election is allowed, they cannot serve for longer than 12 years.
- *Other.* The 2003 Law on Transparency and Governance (Law 26/2003 of July 17, 2003) added new governing bodies to the *cajas*—specifically, a *compensation committee* that provides information on the compensation and incentives policies of board members and senior managers; and an *investment committee* responsible for proposing investment strategy and monitoring compatibility between the *caja*'s investment portfolio and its social mandate.¹⁵

IV. REGULATION AND SUPERVISION

17. Unlike banks, the *cajas* are regulated and supervised by the central government—through the ministry of the economy and the central bank—as well as by the Autonomous Communities (ACs).¹⁶ The division of regulatory and supervisory powers between the central government and the ACs is determined by the Constitution, the ACs' own Statutes (*Estatutos de Autonomía*)—which differ across ACs—and the rulings of the Constitutional Tribunal.

18. Spain's Constitution contains no explicit references to savings banks—albeit it does refer explicitly to “credit and banking” in its Articles 148 and 149. This fact, combined with the special legal nature of *cajas*—credit institutions and not-for-profit private foundations—generated some conflicts regarding the division of regulatory and supervisory responsibilities between the State (central government) and the ACs, which the Constitutional Tribunal had to settle.

19. The guiding Constitutional principle regarding the division of powers is that the State has rights and responsibilities to set “the bases that shall order credit, banking and insurance activities in Spain”—*las bases para la ordenación del crédito, banca y seguros* (Article 149 of the Constitution). These rights and responsibilities apply to savings banks, as they are legally considered credit institutions.

¹⁵ The distribution of seats in the two commissions must be in line with the board's (and therefore the assembly's) voting structure.

¹⁶ An exception are the three savings banks linked to the Catholic Church—*CajaSur* (Andalucía), *Cajacírculo* (Castilla y León), and *Caja Inmaculada* (Aragón)—which are supervised by the central government instead of the Autonomous Community (see Table 1 below). A five-year conflict in Spanish tribunals over the division of oversight responsibilities and the control of *CajaSur*—involving the savings bank, the central government, the Junta de Andalucía and the representatives of the Church in the *caja*—has been resolved recently. The agreement between the Church and the Junta de Andalucía restored the oversight powers of the Autonomous Community in exchange for a rebalancing of representation powers within the savings bank. See, for instance, *CincoDías*, October 17, 2005, “La rápida reconversión de CajaSur.”

20. The “bases” shall define a minimum common ground to ensure the unity of the system. The spirit of the Constitution is that preserving the unity of the system requires all financial institutions in Spain—regardless of their regional origins in the case of *cajas*—to be subject to the same “bases.”

21. This constitutional principle gives rise to the following practical questions: what is the exact definition of the “bases”?; what is the meaning of “bases” regarding regulatory and supervisory practices?. Over the years, rulings of the Constitutional Tribunal (CT) have clarified the meaning and extent of the “bases.”

- First, the CT has confirmed that not only the State, but also the ACs have regulatory and supervisory powers over *cajas*. The CT’s ruling 48/1988—*Sentencia del Tribunal Constitucional* (STC) 48/1988—granted regulatory and supervisory powers over saving banks to ACs on the grounds of the *cajas*’ regional specificity and importance.¹⁷ The State and the ACs have regulatory, supervisory and sanctioning powers within their corresponding areas of responsibilities.
- Second, a direct implication of granting powers to ACs is that “the bases” cannot aim at complete uniformity, that is, they cannot be so detailed that they prevent ACs from exercising any regulatory and supervisory rights.
- Third, the “bases” must be stable to the greatest possible extent. The State has, however, the right to modify the “bases”, and if it does so, the ACs must adapt their own norms accordingly. It is desirable that the State defines the “bases” through laws, but it can also define them through lower-level legal instruments such as circulars and simple executive actions—associated with *competencias ejecutivas*.
- Fourth, regulations and executive actions aimed at safeguarding the solvency of credit institutions are considered “basic” by the Constitutional Tribunal. These include: the definition of own funds, capital adequacy requirements, requirements on consolidation of accounting balances and results, limits on credit risk concentration and industrial participations, regulations on exchange and market risk exposure, informational and transparency requirements.¹⁸

¹⁷ Notice that currently banks are not characterized by such regional specificity and importance. Even though the traditional territorial limits of *cajas* were eliminated in the 1980s, and thus, their regional specificity declined, it remains significant. The CT also ruled on territorial issues and divisions of responsibilities among ACs; the following case can be cited as an example: a clause in Law 31/1985 stated that the central government would hold full oversight responsibilities over saving banks that raise more than 50 percent of their deposits outside their region of origin. The CT ruled that such clause was unconstitutional. Also, the CT rulings allowed for the possibility that the State could enact “basic” legislation to frame the relations among ACs regarding their relative powers, with the aim of safeguarding the general interest and encouraging solidarity among ACs. This legislation has not materialized yet.

¹⁸ The corresponding rulings of the Constitutional Tribunal are the following: STC 96/1996, 135/1992, 37/1997, 235/1999.

- Fifth, the responsibilities that fall within the orbit of ACs powers generally have to do with safeguarding social objectives, transparency and consumer protection.

22. Tables 1 and 2 show the current division of regulatory and supervisory powers between the State and the ACs classified according to (a) powers affecting the internal structure and organization of saving banks, and (b) powers affecting the activities of savings banks.

23. Although the objective of defining the “bases” is to preserve the unity of the Spanish financial system, the actual definitions of such “bases” that result from rulings of the Constitutional Tribunal may appear, in some particular cases, not fully consistent with that objective. Of particular concern in this regard are the ACs powers to grant large investment and credit authorizations and to veto merger and acquisition proposals made by savings banks even if supported by the Bank of Spain.

24. The first of these powers (over investment and credit authorizations) can affect solvency. Although ACs are not currently imposing investment and credit authorization requirements—and it is commonly understood that they will not do so—the fact that the legislation explicitly allows them to do so creates ambiguities.

25. The second power (over mergers) can impede further consolidation of the financial system as it may prevent economically optimal mergers. The fact that mergers and acquisitions among *cajas* are subject to approval by the regional authority (of both ACs in case of mergers or acquisitions across community borders) puts a hurdle to the efficiency of mergers and may open the door for political interference. So far, all but one of the mergers involving *cajas* have been between institutions from the same region.¹⁹

¹⁹ The only merger between *cajas* from different regions was between *Caja Madrid* and *Caja de Ceuta*.

Table 1. Division of Oversight Responsibilities: *Cajas* Structure and Organization

	Central Government (Basic)	Autonomous Community (Not Basic)
Savings banks' governing bodies	The State creates, and defines the nature of, the <i>cajas</i> ' governing bodies. It regulates the general composition and representation, and essential roles of the governing bodies (general assembly, the board of directors and the audit committee).	ACs can include additional groups to be represented in the government bodies of <i>cajas</i> , as long as the general model set out by the State is not altered significantly.
Composition of savings banks' governing bodies	The State defines the specific groups to be represented in the <i>cajas</i> ' governing bodies, as well as their minimum and maximum representation shares. However, the CT has ruled that the State's definitions of the groups and their representation shares serve as a reference, but are not strictly binding for ACs (STC 48 and 49/1988). Thus, it granted most responsibilities in this regard to the ACs. It is the State's right, though, to require the same proportional representations in the general assembly, in the board of directors, and in the audit committee.	ACs define the exact representation shares of different groups, taking the basic framework as a reference. In response to CT decisions (STC 48 and 49/1988), many ACs included their own legislatures among the represented groups, thus increasing the participation of the public sector significantly. Law 44/2002 aimed at eliminating the public sector's dominance of many <i>cajas</i> .
Savings banks founded by the Catholic Church	The CT ruled that the special regime that applies to savings banks founded by the Catholic Church has a "basic" character—based on a 1979 international agreement with the Vatican. Catholic savings banks are not subject to the representation shares imposed by ACs on other savings banks, albeit they must give some representation to all the relevant groups. Catholic savings banks are supervised by the AC where they operate (Law 5/2005; previously, they could opt to be supervised by the Ministry of the Economy).	ACs have no power over Catholic savings banks—unless such banks voluntarily choose to be overseen by the AC. Andalucía's attempts to subject such savings banks to its general Law on <i>cajas</i> were rejected by the CT. Recently, a voluntary agreement between the Church and the Junta de Andalucía granted powers over <i>CajaSur</i> to Andalucía.
Election systems	The State can only require that ACs design election procedures that guarantee the representative character of the governing bodies of <i>cajas</i> .	The design of election systems is responsibility of the ACs.
Eligibility, incompatibilities and removal of members	Related to the State's right to safeguard the representativeness of governing bodies' members, the State can also determine eligibility and incompatibility conditions for the selection and removal of such members.	ACs can only add eligibility and incompatibility conditions to those defined by the State.
Duration	The State is empowered to limit the duration of the mandates of governing bodies' members. Currently, the State's legislation sets limits of 4-6 years, to be exactly determined by the savings banks' statutes. Thus, the basic legislation leaves no scope for ACs' intervention.	Despite the State's legislation—which delegates to <i>cajas</i> ' own statutes the choice of mandates' durations—the new laws on <i>cajas</i> of some ACs determine these periods directly, in apparent contradiction of the basic law.
Reelection	The CT ruled against the basic nature of the one-period reelection limit (STC 49/1988), which had previously been set at the State level. It follows that the State cannot prevent ACs from allowing successive reelections of governing bodies' members.	ACs have the right to determine the number of successive reelections of members of <i>cajas</i> ' governing bodies.
Creation of savings banks	The State can only exercise powers in this regard through the report of the Bank of Spain, which has a basic, though formally non-binding—character.	ACs have the right to authorize the creation of a savings bank, subject to a (non-binding) positive report from the Bank of Spain.
Mergers of savings banks	The State can only exercise powers in this regard through the non-binding report of the Bank of Spain, which has a basic character (STC 48/1988).	Mergers must be authorized by the corresponding ACs, subject to a non-binding positive report from the Bank of Spain.
Dissolution and liquidation of savings banks	The State can intervene and liquidate savings banks that do not comply with the "basic" regulations and legislation. These powers apply, in particular, to solvency regulations, which are clearly "basic."	ACs have the power to authorize the liquidation and dissolution of <i>cajas</i> when violations of norms occur within their orbits of responsibility.
Savings banks operating in several regions		Regarding its structure and organization, a savings bank that operates in more than one region is subject to the regulations of the AC of origin—where it is headquartered.

Table 2. Division of Oversight Responsibilities: *Cajas* Activities

	Central Government (Basic)	Autonomous Community (Not Basic)
Distribution of profits	The Bank of Spain is entitled to prevent the distribution of profits when the own funds of the savings bank are below 80 percent of the minimum own-funds requirement. Also, the Bank of Spain can authorize an allocation of less than 50 percent of a <i>caja</i> 's profits to reserves if the <i>caja</i> 's own funds exceed by more than 33 percent the minimum requirement. The Ministry of the Economy can authorize—upon request from the Bank of Spain—a reduction in the allocation of profits to reserves to avoid the interruption of <i>obras sociales</i> . The Ministry of the Economy is also empowered to authorize the distribution of profits and the <i>obra social</i> of savings banks founded by the Catholic Church.	In all other circumstances, ACs are empowered—and indeed have complete discretion in some cases—to authorize the distribution and use of profits.
Discipline and sanctioning	The State is empowered to apply its discipline mechanisms and sanctioning powers when savings banks violate “basic” norms. This applies, in particular, to norms related to solvency and stability, monetary and financial policy. The violations and sanctions defined in the Law of Discipline and Intervention of Credit Institutions apply with equal force to banks and <i>cajas</i> . The European Central Bank is empowered to impose sanctions when a savings bank violates the reserve requirements.	The ACs can discipline and sanction savings banks that violate norms in areas of responsibility attributed to ACs.
Supervision	The Bank of Spain and the ACs are empowered to supervise and inspect savings banks. The ACs must share with the Bank of Spain the information obtained through their supervisory activities. Also, the Bank of Spain and ACs can cooperate in supervision through formal agreements.	The ACs have supervision powers along with the Bank of Spain.
Savings banks operating in several regions	The CT has acknowledged that conflicts could arise among ACs that jointly regulate and supervise savings banks operating in their regions. Therefore, it empowers the State to enact basic legislation to resolve such conflicts and regulate the relations among ACs in these regards.	Regarding its activities, a savings bank operating in more than one region is subject to the regulations of all the ACs in which it operates—territorial criterion. This applies, for instance, to the allocation of the savings bank's <i>obra social</i> across regions.

26. Table 3 illustrates the regulatory and supervisory powers of some large ACs (Madrid, Valencia, País Vasco and Cataluña) over *cajas*, summarizing the norms set out in their respective savings banks laws on licensing, regulation, supervision and transparency, and sanctioning. It shows that ACs have a significant role in safeguarding transparency and consumer protection, and in authorizing the allocation of profits. In addition, they hold veto powers over merger proposals, and powers to impose authorization requirements for equity investments (Madrid, País Vasco, Cataluña) and lending (País Vasco, Cataluña). Also, the lack of independence of ACs' supervisors from the ACs' executive governments—and possibly from the supervised *cajas*—appears as a weakness in the current institutional framework. Finally, the constraints imposed on the compensation of members of governing bodies may limit the capacity of *cajas* to use compensation as an incentive device.

27. The ACs' powers to prevent mergers of *cajas* across Spain's regions raises concerns about the scope for further consolidation since consolidation has already drastically shrunk the number of *cajas* headquartered in any industrial AC (Table 4). Thus, they raise the question whether those powers will constrain the ability of the *cajas* to adapt to the long-term challenges posed by the ongoing integration of European banking.

Table 3. Regulatory and Supervisory Powers of Autonomous Communities over Cajas

	Licensing	Regulation	Supervision and Reporting	Corrective Action and Exit
<p>Madrid</p> <p>Authorization. The <i>Consejería</i>—an office in charge of Economic and Financial Policy within the Autonomous Community of Madrid—is entitled to grant licenses for the opening of new savings banks, based on previous analysis and positive reports from the Bank of Spain. Once the authorization is granted and the savings bank’s statutes are approved, the establishment certificate of the entity is granted. The requirements to obtain a license include: minimum capital, limits on the scope of activities (restricted to those typical of a credit institution), appropriate accounting and internal organization and control procedures, probity and honorability of members of the governing bodies. A license can be denied if the Community’s supervisory responsibilities cannot be effectively exercised due to business or personal relations of savings bank’s members with other physical or legal persons.</p> <p>Withdrawal. The license of the savings bank can be revoked for one of the following reasons: if activities are interrupted for more than six months, if false information was provided to obtain the authorization, if the</p>	<p>Mergers. They must be authorized by the Government of Madrid. Requirements include: none of the merged entities must be in a liquidation process; the merger must preserve the rights and guarantees of physical and legal persons; the merger must guarantee the continuation of the <i>obra social</i> of the merged entities and labor stability to the maximum extent possible; the merger must be approved by the General Assemblies and by the Boards of Directors of the merged entities. The new entity must be registered in the Bank of Spain and in the Community of Madrid.</p> <p>Mergers between cajas originated in different Autonomous Communities—one of them in Madrid. They must be jointly approved by the governments of both communities, who must also determine the representation shares of the public sectors of both communities.</p> <p>Equity investments (participaciones). Equity investments that result in a savings bank assuming control of a company, and that represents more than 5 percent of the savings bank’s capital, must be authorized by the <i>Consejería</i>. Investments that represent more than 2 percent of the consolidated assets of the savings bank’s business group must also be approved, even if the bank does not assume a controlling</p>	<p>Supervision. It is delegated to the <i>Consejería</i>, which is empowered to impose sanctions when law infringements are detected—the law defines different types of violations, according to their severity.</p> <p>Reporting. When granted a license, a savings bank is registered in the registry of savings banks—<i>Registro de Cajas de Ahorro de la Comunidad de Madrid</i>. <i>Cajas</i> must report to the <i>Consejería</i> changes in the status of members of the Board of Directors and the Audit Committee, and the replacement of General Directors. These changes are then registered in the registry of members of governing bodies of the savings banks—<i>Registro de Altos Cargos de las Cajas de Ahorro con Domicilio en la Comunidad de Madrid</i>. <i>Cajas</i> must also inform the <i>Consejería</i> the openings, transfers and closures of branches.</p>	<p>Without prejudice to the Bank of Spain’s and the State’s powers, the Community of Madrid exercises disciplining and sanctioning powers. <i>Cajas</i>—as entities—and the members of their governing bodies are subject to “order and discipline” norms dictated by the Community of Madrid. Failure to comply with such norms render the <i>caja</i> or the individuals liable for infringements of administrative laws—without prejudice to penal violations that may also occur—that are sanctioned according to this law and basic State legislation.</p> <p>Violations of norms are classified according to their severity as very severe, severe and minor. Members of governing bodies are accountable for violations except if they voted against the illegal norm or decision, or if they were not present in the meeting where such decisions were made.</p> <p>Very severe violations. Sanctioning procedures must be proposed and initiated by the <i>Consejería</i>, but the final decision corresponds to the Government of Madrid. This category of violations includes: creation of the <i>caja</i>, merger arrangements, acquisition of another entity, change of statutes, distribution of profits, and opening of branches through irregular procedures, including the use of false information and fraud. It also includes: the recurrent involvement of the <i>caja</i> in activities that are forbidden, or that are not typical or appropriate of credit institutions; failure of the duty to provide truthful information to clients; resistance to the supervisory activities of the <i>Consejería</i>. These violations must cause significant damage to the entity or its clients.</p> <p>Sanctions to the entity include one or more of the following: fines of up to the maximum of 1 percent of capital or 300,000 euros, withdrawal of the license, and publication of the violation and penalties imposed.</p> <p>Sanctions to the individuals include one or more of the following: fines of up to 150,000 euros, loss of membership in the governing body of the <i>caja</i> for a</p>	

	<p>capital is insufficient, if the entity is excluded from the Deposit Guarantee Fund.</p> <p>The <i>Consejero</i> must propose the withdrawal of the license, which must be finally authorized by the Government of the Autonomous Community of Madrid. If the license of a savings bank is revoked, the entity must be dissolved and liquidated.</p> <p>Change of Statutes. Significant reforms of the statutes and internal rules of the savings bank must be authorized by the <i>Consejería</i>.</p> <p>Liquidation process. It is subject to the control of the <i>Consejería</i>, without prejudice to basic legislation on these matters.</p>	<p>interest in the company.</p> <p>Use of profits and <i>obra social</i>. The <i>Consejería</i> is responsible for approving the use of profits and plans of <i>obra social</i> of savings banks.</p> <p>Disclosure of relevant information on clients. The savings bank must not disclose financial information or transactions of clients, except those requested by the supervisory authorities.</p> <p>Remuneration of Members of Governing Bodies. Members of the governing bodies cannot receive remuneration, except compensations for expenditures related to their attendance to meetings of the governing bodies.</p> <p>Independence duty. The members of the governing bodies must act independently of the entities or groups that appointed them, and those groups cannot instruct them on how to exercise their functions.</p>	<p>maximum period of 5 years, inability to hold managerial positions in any other credit or financial entity for up to 10 years.</p> <p>Severe. Sanctioning power is fully exercised by the <i>Consejería</i>. This category includes: the involvement of the <i>caja</i> in inappropriate activities, as long as such involvement is only sporadic; failure to provide information requested by the <i>Consejería</i> or minor failures to provide truthful information to clients (in cases that are not especially relevant); failure of internal controls or accounting and organization procedures, as long as they cannot be considered very severe in terms of the damage caused to the entity or its clients.</p> <p>Sanctions to the entity include one or more of the following: fines of up to the maximum of 1/2 percent of capital or 150,000 euros, and publication of the violation and penalties imposed—official rebuke or <i>amonestación pública</i>.</p> <p>Sanctions to individuals include one or more of the following: private rebuke or <i>amonestación privada</i>, official rebuke or <i>amonestación pública</i>, fines of up to 90,000 euros, inability to hold management positions in any other credit or financial entity for up to 1 year.</p> <p>Minor. Sanctioning power is fully exercised by the <i>Consejería</i>. It includes, among others: repeated failure to attend meetings of the governing bodies.</p> <p>Sanctions to the entity include: fines of up to 60,000 euros, and private rebuke or <i>amonestación privada</i>.</p> <p>Sanctions to the individual include: private rebuke and fine for up to 15,000 euros.</p> <p>All sanctions—except private rebukes—will be registered in the registry of savings banks and in the registry of members of the governing bodies of the savings banks. In all cases, sanctions will be chosen taking into account the nature and severity of the infringement, the resulting losses and damages, the size of the savings bank, the own initiative of the party involved to correct the misbehavior, the degree of responsibility of different persons, previous conduct of the individual or entity, and the stakeholder’s group that the individual represents within the savings bank.</p>
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<p>Valencia</p>	<p>The Ministry of Economy and Finance of the <i>Generalitat Valenciana</i>—<i>Conseller de Economia, Hacienda y Administración Pública</i>—can authorize the creation of a new savings bank, subject to the basic norms of the State. The authorization process is conducted through the <i>Instituto Valenciano de Finanzas (IVF)</i>—an office within the <i>Conseller</i>—that must also authorize the own statutes and rules of the <i>caja</i>—the IVF is also empowered to authorize changes in the <i>caja</i>'s statutes after its creation.</p>	<p>Mergers and sales of assets and liabilities. They must be approved by the <i>Conseller</i>. Mergers between two <i>cajas</i> from different communities must be jointly authorized by the <i>Consellers</i> of the two communities.</p> <p>Appointment and removal of members of governing bodies. The <i>Generalitat</i> holds 25 percent of seats in the general assembly. The <i>consejeros generales</i> are appointed by Valencia's legislative body. The IVF is empowered to remove the Director General through a disciplinary action of its own initiative or upon request from the Bank of Spain.</p> <p>Marketing activities. <i>Cajas</i> must request IVF approval to undertake marketing activities with economic and financial contents, due to IVF's consumer protection responsibility.</p> <p>Obra social. The IVF approves plans for the <i>obra social</i>. It establishes guidelines and priorities for use of the <i>obra social</i>; <i>cajas</i> can choose within these guidelines.</p>	<p>Supervision. It is delegated to the IVF. The IVF is entitled to sign cooperation agreements with the Bank of Spain. The IVF is empowered to impose sanctions when law infringements are detected—the law defines different types of violations, according to their severity.</p> <p>Reporting. When granted a license, a <i>caja</i> is registered in the registry of savings banks—<i>Registro de Cajas de la Comunidad Valenciana</i>. <i>Cajas</i> must report to the IVF changes in the status of members of the Board of Directors and Audit Committee. They must also inform the IVF the issuance of securities, as well as openings, transfers and closures of branches located in Valencia and in other communities.</p>	<p>Without prejudice to the Bank of Spain's powers, when a <i>caja</i>'s solvency or liquidity are at risk, the entity can be intervened, or its management substituted, by the <i>Conseller</i>.</p> <p>The <i>Conseller</i> is also empowered to revoke the license of a <i>caja</i> if conditions explicitly stated in the law are satisfied. The <i>Conseller</i> must take over the operations of the <i>caja</i> if liquidation has been approved.</p>
<p>País Vasco</p>	<p>Authorization. The <i>Departamento de Hacienda y Finanzas</i>—a Department in charge of Economic and Financial Policy within the Autonomous Community of Euskadi—is empowered to grant licenses for the opening of new savings banks, and to approve their statutes.</p> <p>Withdrawal or Intervention of the Entity. Intervention of the entity—control of its governing bodies—can be decreed by the</p>	<p>Mergers and acquisitions. They must be authorized by the <i>Departamento de Hacienda y Finanzas</i> upon receiving a joint request from the savings banks involved, which must provide an economic evaluation of the proposed merger. Requirements include: none of the merged entities must be in a liquidation process; the merger must preserve the rights of stakeholders and creditors. Similar procedures apply for acquisitions.</p> <p>Investment and Lending Restrictions. The <i>Departamento de</i></p>	<p>Supervision. It is delegated to the <i>Departamento de Hacienda y Finanzas</i>. The <i>Departamento</i> is empowered to impose sanctions when law infringements are detected—the law defines different types of violations, according to their severity—and to intervene in the liquidation processes of savings banks.</p> <p>Reporting. When granted a license, a savings bank is registered in the registry of savings banks—<i>Registro de</i></p>	<p>The <i>Departamento de Hacienda y Finanzas</i> has disciplining and sanctioning powers. The savings bank and the members of their governing bodies are subject to the norms of "order and discipline". Violations of norms can be very severe, severe, and minor. Members of governing bodies are accountable for violations except if they voted against the illegal norm or decision, or if they were not present in the meeting where such decisions were made.</p> <p>Very severe violations. Sanctioning power is fully exercised by the Government of Euskadi. This category of violations includes: creation of the savings bank, merger arrangements, acquisition of another entity, change of statutes, distribution of profits, and opening of branches in foreign countries, through irregular procedures, including</p>

<p>Government of the Community, upon proposal from the <i>Departamento</i>, when the viability and stability of the entity are at risk. The Government of the Autonomous Community is also empowered to withdraw the license.</p> <p>Change of Statutes. Reforms of the statutes and internal rules of savings banks, once they have been authorized by the savings bank's Assembly, must be approved by the <i>Departamento de Hacienda y Finanzas</i>.</p> <p>Liquidation process. Agreements to voluntarily dissolve or liquidate a savings bank must be ratified by the <i>Departamento de Hacienda y Finanzas</i>. Such process is subject to the control of the Administration of the Autonomous Community, through a member appointed by the head of the <i>Departamento de Hacienda y Finanzas</i>.</p>	<p><i>Hacienda y Finanzas</i> is empowered to classify or select the assets in which savings banks can invest. The government of Euskadi can force savings banks to request authorization from Euskadi to invest in real estate, shares or monetary assets, or to extend large loans or increase single name credit concentrations—including business groups. The authorizations are granted by the <i>Departamento de Hacienda y Finanzas</i>.</p> <p>Use of profits and obra social. The <i>Departamento de Hacienda y Finanzas</i> is responsible for approving the use of profits and plans of <i>obra social</i> of savings banks.</p> <p>Disclosure of relevant information on clients. The savings bank must not disclose financial information or transactions of clients, except those requested by the supervisory authorities or information exchanges between entities of the same consolidated group.</p> <p>Remuneration of Members of Governing Bodies. Members of the governing bodies cannot receive remuneration, except compensations for expenditures related to their attendance of meetings of the governing bodies.</p>	<p><i>Cajas de Ahorro de Euskadi</i>, which must include the statutes and internal rules of the bank. The public registry must also record all the changes in the statutes and internal rules, the mergers, acquisitions, dissolution and liquidation processes, and the sanctions affecting the savings bank. <i>Cajas</i> must report to the <i>Departamento</i> changes in the status of members of the Board of Directors, Audit Committee, and General Director, which will then be registered in the registry of members of governing bodies of the savings banks—<i>Registro de Altos Cargos de las Cajas de Ahorro de la Comunidad Autónoma del País Vasco</i>.</p>	<p>the use of false information and fraud. It also includes: the recurrent involvement of the <i>caja</i> in activities that are forbidden, or not typical or appropriate of credit institutions; failure of the duty to provide truthful information to clients; resistance to the supervisory activities of the <i>Departamento</i>, the acquisition of significant shares of companies when such actions are forbidden, and deficiencies in accounting and internal control procedures. Violations must cause significant damage to the entity or to its clients in order to be considered “very severe.”</p> <p>Sanctions to the entity include one or more of the following: fines of up to the maximum of 1 percent of capital or 300,000 euros, withdrawal of the license, and publication of the violation and penalties imposed. Sanctions to individuals include one or more of the following: fines of up to 150,000 euros, loss of membership of the <i>caja</i>'s governing body for a maximum of 5 years, inability to hold management positions in any other credit or financial entity for up to 10 years.</p> <p>Severe. Sanctioning power is exercised by the <i>Departamento</i>. This category includes: the involvement of the <i>caja</i> in inappropriate activities, as long as such involvement is only sporadic; failure to provide information requested by the <i>Departamento</i> or minor failures to provide truthful information to clients (in cases that are not especially relevant); failure of internal controls or accounting and organization procedures, as long as they cannot be considered very severe in terms of the damages caused to the entity or to its clients.</p> <p>Sanctions to the entity include one or more of the following: fines of up to the maximum of 1/2 percent of capital or 150,000 euros, and publication of the violation and penalties imposed—official rebuke or <i>amonestación pública</i>.</p> <p>Sanctions to the individuals include one or more of the following: private rebuke or <i>amonestación privada</i>, public rebuke or <i>amonestación pública</i>, fines of up to 90,000 euros, inability to hold management or administration positions in any other credit or financial entity for up to 1 year.</p>
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<p>Minor. Sanctioning power is exercised by the <i>Departamento</i>. This category includes violations of the laws that are not included in the other two categories. Sanctions to the entity include: fines of up to 60,000 euros, and private rebuke or <i>amonestación privada</i>. Sanctions—except private rebukes—are registered in the registries of savings banks and members of the governing bodies of the savings banks.</p>				<p>Cataluña</p>
<p>The <i>Departamento de Economía y Finanzas</i> exercises disciplining and sanctioning powers. Not only the savings bank as an entity, but also the members of their governing bodies are subject to the norms of order and discipline. They incur in disciplinary responsibility if violations of rules occur, including those related to one or more of the following activities: opening of branches, distribution of profits and the <i>obra social</i>, investments, provision of the required accounting information, improper use of the license. Sanctions include private rebuke, public reprimand communicated to other savings banks of Cataluña, fines of up to fifty million pesetas, and withdrawal of the license. All sanctions will be imposed by the <i>Departamento de Economía y Finanzas</i>, with the exception of license withdrawals which can only be imposed by the Government of the <i>Generalitat</i>. The procedural and sanctioning regimes will be further developed in additional, subordinate legislation (<i>reglamentariamente</i>).</p>	<p>Supervision. Supervision is delegated to the <i>Departamento de Economía y Finanzas</i>. The <i>Departamento</i> is empowered to impose sanctions when law infringements are detected, and the Government of the <i>Generalitat</i> is empowered to intervene in the liquidation processes of savings banks. More generally, the Law establishes that savings banks are subject to the public protectorate of the <i>Generalitat</i>, which is exercised through the <i>Departamento</i>, and is guided by three principles: 1) to promote all the legal activities of savings banks, 2) to check that savings banks perform their social roles and attain their social objectives, 3) to guard the savings banks' independence and defend their reputation, prestige, and stability. In addition, it explicitly establishes the objective of savings banks, which is to promote savings, offering adequate returns and investing such savings in assets of general interest. Reporting. When granted a</p>	<p>Mergers and acquisitions. They must be authorized by the government of the <i>Generalitat</i>. Requirements include: none of the merged entities must be in a liquidation process; the merger must preserve the rights of creditors and depositors. The <i>Generalitat</i>'s authorization will be published in newspapers and official bulletins, the statutes will be approved by the <i>Consejero</i>, except for the change of address of the entity's headquarters, which must be authorized by the Government of the <i>Generalitat</i>. Similar procedures apply for acquisitions. Investment and Lending Restrictions. The <i>Departamento de Economía y Finanzas</i> is empowered to classify or select the assets in which savings banks can invest, within the basic order and framework of credit and monetary policy set up by the State. The Government of the <i>Generalitat</i> can force savings banks to request its authorization to invest in real estate, shares or monetary assets, or to extend large loans or increase single name credit concentrations—including business groups. The limits or coefficients imposed by the <i>Generalitat</i> must be based on the total assets or own resources of the regulated entity. The authorizations</p>	<p>Authorization and Withdrawal of Licenses. The <i>Consejería de Economía y Finanzas</i> of the <i>Generalitat</i> of Cataluña—which is in charge of Economic and Financial Policy—is empowered to grant and deny requests of licenses for new savings banks and to approve the statutes once licenses are granted. The <i>Consejero</i> is also empowered to admit new savings banks into the public registry of savings banks (<i>Registro de Cajas de Ahorros de Cataluña</i>), a necessary requirement for the initiation of activities. The licensing process includes a transitory period, which cannot exceed two years, during which special rules apply until the permanent license is granted. The Government of the <i>Generalitat</i> is solely empowered to withdraw the license. Intervention of the Entity. The Government of the <i>Generalitat</i>, upon proposal from the <i>Departamento de Economía y Finanzas</i> or the Bank of Spain, can decree intervention (i.e., control of its governing bodies) when the viability and stability of the entity are at risk. The <i>Consejero</i> can intervene and take</p>	

	<p>control of the savings bank's governing bodies in emergency situations, but such decision must be immediately ratified by the government of the <i>Generalitat</i>. Intervention may also be requested by one or more governing bodies—such as the Audit Committee—of the savings bank.</p> <p>Change of Statutes. Reforms of the statutes and internal rules of savings banks must be approved by the <i>Consejero de Economía y Finanzas</i>.</p> <p>Liquidation process. Voluntary dissolutions and liquidations of savings banks must be authorized by the government of the <i>Generalitat</i>. The process must be controlled by a representative of the <i>Generalitat</i> that is proposed by the <i>Consejero</i>, but that is directly accountable to the government of the <i>Generalitat</i>. The allocation of the proceeds and assets during the liquidation process will be conducted in accordance with Cataluña's legislation on private foundations (<i>Ley de Fundaciones Privadas de Cataluña</i>). These norms will apply without prejudice to the State's regulations of the Deposit Guarantee Fund. In any case, institutions and offices with joint responsibilities will establish cooperation agreements to ensure an appropriate degree of coordination in the exercise of their corresponding powers.</p>	<p>are granted by the <i>Departamento de Economía y Finanzas</i>. The Law explicitly states that the provision of credit to, and investments in, small and medium enterprises, social enterprises, and cultural projects, enjoy preferred status.</p> <p>Use of profits and obra social. The profits of savings banks will be applied to reserves and the <i>obra social</i>, according to official rules. As part of their <i>obra social</i>, savings banks will undertake own as well as joint projects coordinated with other public or private institutions. The <i>Generalitat</i> will provide guidance and general directions on the <i>obra social</i>, indicating priorities while respecting the right of each savings bank to choose among alternative projects. The <i>Departamento</i> is empowered to approve the decisions of the <i>General Assemblies</i> of savings banks in regard to uses of their <i>obra social</i>.</p>	<p>license, a savings bank is registered in the public registry of savings banks—<i>Registro de Cajas de Cataluña</i>—which includes the statutes and internal rules of the bank. The public registry must also record all the changes in the statutes and internal rules, the mergers, acquisitions, dissolution and liquidation processes, and the sanctions affecting the savings bank. In addition, savings banks must report to the <i>Departamento</i> the opening and closure of branches, including those that are located outside of Cataluña.</p> <p><i>Cajas</i> must report to the <i>Departamento</i> appointments and changes—including reelections—in the status of members of the Board of Directors, the Audit Committee, and of the General Director, which will then be registered in the registry of members of savings banks' governing bodies—<i>Registro de Altos Cargos de las Cajas de Ahorro de Cataluña</i>—and reported to the Bank of Spain. Such registration of governing bodies' members ensures the effectiveness, for legal purposes, of the appointments.</p>
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Table 4. Number of *Cajas* per Autonomous Region

	1988	2003	Difference
Andalucía	14	6	-8
Aragón	2	2	0
Asturias	1	1	0
Baleares	2	2	0
Canarias	2	2	0
Cantabria	1	1	0
Castilla y León	11	6	-5
Castilla-La Mancha	4	2	-2
Cataluña	11	10	-1
Extremadura	4	2	-2
Galicia	4	2	-2
Madrid	1	1	0
Murcia	1	1	0
Navarra	2	1	-1
País Vasco	6	3	-3
La Rioja	1	1	0
C. Valenciana	9	3	-6
Ceuta y Melilla	1	0	-1
Total	77	46	-31

Source: *Economistas*, No. 98, September 2003.

V. OTHER ISSUES AND CHALLENGES

28. This section analyzes the issues raised by public representation, and the challenge of immunizing savings banks from political influence. Also, it identifies barriers that limit the *cajas'* capacity to raise capital from outside sources, the limits to the market contestability of *cajas'* performance, and the restrictions on the compensation of members of *cajas'* governing bodies.

A. Public Representation and Political Influence

29. In Spain, as in other countries, the substantial representation of the public sector in savings banks' governing bodies raises concerns about the scope for, and the effects of, political influence.²⁰

²⁰ It has been argued elsewhere that despite the existing checks and balances, the public sector—and thus political parties—remain highly influential in *cajas'* governing bodies. See, for instance, Deutsche Bank Research, 2004, “Spain’s *Cajas*: Deregulated, but not Depoliticized,” *EU Monitor. Financial Market Special*, No. 20, December.

30. Historically, the evolution of the public representation and the political influence in the Spanish savings banks' sector has not been linear. The pre-constitutional period was clearly characterized by significant public intervention and political influence. As noted earlier, the liberalization process started in 1977 reduced public sector participation, giving broader representation to different social groups. The LORCA law and CT rulings (STC 48 and 49/1988), gave greater leeway and discretion to local governments to increase their representation shares—particularly municipalities—and caused a temporary setback in the disengagement of the public sector until the Law 44—*Ley Financiera*—of 2002 was passed.

31. Since the *Ley Financiera*, Spain has made significant progress in reducing the public sector representation in *cajas*, and thus, the scope for political influence.²¹ In particular, the representation ceiling of the public sector was reduced to 50 percent, and the irrevocability of the *consejeros* was institutionalized. These reforms responded to the need of ensuring that *cajas*' loans and investments would not be considered public aid under European Commission (EC)'s regulations.²² In sum, these reforms point to further disengagement of the public sector from savings banks but it is still early to decide whether they will succeed in reducing public sector's influence.

32. The first institutional change—the reduction of the public sector's representation ceiling to 50 percent—may not have fully dissipated perceptions that there may be other channels for political influence.²³

33. The second institutional change—the “irrevocability” of public sector representatives in the governing bodies of *cajas*—has helped in creating an armor against political influence, although the fact that members can be reelected still can affect their independence. Although the effectiveness of this mechanism will be tested over the years through successive electoral cycles, it is a significant step toward reducing political influence while preserving public representation. The evidence on comparative turnover of high officials of commercial banks and *cajas* is mixed. While *cajas* had a somewhat higher turnover of directors and presidents, they had a much lower turnover of general directors (Table 5).²⁴

²¹ A mitigating factor regarding political influence is that public sector representatives are often from different parties, reflecting the political makeup of the government bodies they represent.

²² Under EC norms, the definition of public aid applies to the subsidies, loans and investments granted in lax terms (compared with market conditions). The case for public support of enterprises can be more convincingly made when the public sector representation is greater than 50 percent.

²³ For instance, representatives in the assembly of other interest groups—such as “*impositores*,” depositors and workers—may be linked to political parties.

²⁴ Press coverage suggests that the political parties still argue over high-level appointments at *cajas*. See, for instance, *El Mundo*, March 20, 2004, “El PP acepta el regreso del PSOE en la comisión ejecutiva de Caja Madrid;” *Expansión*, May 20, 2005, “Mas considera ‘muy grave’ el nombramiento de Sierra al frente de Caixa Cataluña.”

Table 5. Executive Turnover in Banks and *Cajas*, 1986–2000
(In percent per year unless otherwise stated)

	Commercial Banks	<i>Cajas</i>
Observations (institution/year)	1246	859
Turnover of directors	18.8	20.7
Permanence of directors (years)	5.3	4.8
Turnover of presidents	13.2	16.4
Permanence of president (years)	7.6	6.1
Turnover of general director	31.2	13.1
Permanence of general director (years)	3.2	7.6

Source: *Presente y futuro de las cajas de ahorros*. Fundación CaixaGalicia, 2003.

B. Barriers to the Raising of Capital and Performance Incentives

Limits to savings banks' capacity to raise capital

34. *Cajas'* legal form, which precludes shares issuance, limits their capacity to tap external sources of capital, and they must rely largely on retained profits. Over the past ten years, the *cajas* channeled over 70 percent of after-tax profits into their revenue reserve every year. Since 1985, however, savings banks can raise capital by issuing subordinated debt (Tier 2 capital) and preferred participations—which are considered part of Tier 1 capital (qualifying preferred participations) or Tier 2 capital (non-qualifying preferred participations).

35. The *cajas'* limitations in raising equity capital have several implications: (i) they may reduce the scope of these institutions to expand if a particular operation (e.g., a purchase of another institution) requires more capital than what the *caja* has; (ii) they seriously limit the capacity to replenish capital if for any reason a *caja* suffers major losses; and (iii) they deprive *cajas* of an instrument (the value of a share) to assess the market's view on an institution's performance on a continuous basis.

36. To help address those limitations, since 1990 *cajas* can also raise funds through equity units (*cuotas participativas*), which are considered part of Tier 1 capital (see Box 1). Nevertheless, *cuotas participativas* are not standard equity instruments, as they grant no voting rights to holders and their issuance is, in general, more heavily regulated than that of corporate stocks.

37. Moreover, while *cuotas participativas* can help to address (i) and (iii) above, they are much less useful to deal with a situation of financial distress, where a large and prompt capital injection is needed. In such cases, the voting rights associated with standard equity are crucial to take decisions such as replacing management or restructuring operations, and thus facilitate capital infusions.

38. By end-2005 no *cuotas participativas* had been issued, partly because *cajas* had ample capital and partly because they had access to alternative, cheaper, sources of capital.²⁵ In particular, preferred participations (*participaciones preferentes*) had been used intensively by some *cajas* during 1999–2001, but their share in regulatory capital was capped to 30 percent in 2003.²⁶

39. Some features of the *cuotas participativas*—besides their lack of voting power—that might entail some uncertainty for potential issuers and investors are the following.

- First, although the *cuota* is a variable-income instrument, the legal framework allows *cajas* to smooth the returns earned by the *cuota*-holders (*cuota-participes*) through a dividend stabilization fund. Such a smoothing mechanism diminishes the variable income nature of the instrument and may have added uncertainties.
- Second, the *cajas*' discretion to allocate profits to the *obra social* could give rise to concerns about dilutions of the *cuota*-holders' shares in the profits of the *caja*. However, such dilution, if it occurs, is of limited practical concern because there are no voting rights attached to the *cuota*-holders' shares.²⁷
- Third, there is a widespread belief in a “first-mover-disadvantage” among potential issuers that could delay the issuance of the *cuotas* to the market. The instrument's specificities imply that the first issuer will incur some transaction costs—associated, for example, with advertising the investors' rights through the CNMV—which later issuers will largely avoid. In addition, initial offerings of *cuotas* may be subject to investors' aversion toward new instruments, but such uncertainties are likely to fade over time as they learn that the instrument is accepted and actively traded.

40. Box 2 describes the successful reform experience of Norway's savings banks that introduced capital instruments that grant voting rights to investors but that are otherwise similar to *cuotas participativas*.

²⁵ The General Assemblies of some *cajas*, such as Caixa Galicia, have authorized the issuance of *cuotas participativas*, but they have not been effectively issued. CECA has issued *cuotas participativas* that were purchased by its members (individual *cajas*). Before the reform in the legal framework of *cuotas participativas*, which started with the *Ley Financiera* of 2002, the *cajas* had been reluctant to issue them because the law was unclear as to the influence investors could exercise through them.

²⁶ Law 19/2003 of July 4, 2003, states that the outstanding amount of *participaciones preferentes* cannot be greater than 30 percent of Tier 1 capital, without prejudice to restrictions that the Bank of Spain may impose on the use of *participaciones preferentes* for regulatory capital purposes. Both preferred participations and subordinated debt are used more intensively by *cajas* than by banks, precisely because of the *cajas*' restrictions to issue shares.

²⁷ Furthermore, Royal Decree 302/2004 allows *cajas* to undertake corrective actions to avoid such dilutions of *cuota*-holders' in profits.

Box 1. Capital Instruments Available to Spanish Savings Banks: *Cuotas Participativas* and *Participaciones Preferentes*

The capital instruments available to savings banks are the *cuotas participativas* (Tier 1), the *participación preferente* (Tier 1 in the case of qualifying preferred participations and Tier 2 in the case of non-qualifying preferred participations), and subordinated debt (Tier 2). The Spanish legal framework requires both *cuotas participativas* and *participación preferente* to be issued as securities that are publicly traded in exchanges, whereas subordinated debt may or may not be publicly traded. Preferred shares and subordinated debt can be issued by all financial institutions, while *cuotas participativas* are specific for *cajas*.

Cuotas Participativas

A *cuota participativa* is an equity-like variable income instrument that grants no voting rights to its holder. The instrument was introduced in the Spanish legislation in 1990 (Decree 664). The *Ley Financiera* of 2002 and the *Decree 302* of 2004 modified the previous legal framework.

Holders of *cuotas participativas* have economic rights such as the participation in profits through variable dividends—the base to compute the minimum allocation of the profits to the *obra social* excludes that part of the profits that corresponds to *cuota*-holders. In case of liquidation of the entity, the holder has the right to receive its share of the liquidation value. In case of premature amortization of the *cuota*, the holder has the right to receive its market value. Although the legislation included a clause that grants investors a preferential subscription right over new *cuotas*, it has been recently ruled out by a decision of the Constitutional Tribunal—in a suit filed by a labor union (*Comisiones Obreras*).

The issuance of *cuotas*, as well as the distribution of annual dividends must be approved by the General Assembly of the *caja*, which can delegate the operational issuance decisions—such as the timing and the exact amounts—to the Board of Directors.

The General Assembly can also approve the creation of a group of *cuota*-holders to which the representation of all *cuota*-holders will be delegated. This group will have the right to participate in the General Assembly with voice but with no voting power.

The legal framework establishes some limits to the amounts issued by a savings bank and to *cuota*-holdings by individuals, as follows: the volume of *cuotas* issued cannot exceed 50 percent of the entity's net worth, and no natural or legal person can acquire more than 5 percent of *cuotas* issued.

Participaciones Preferentes

In Spain, a preferred participation or *participación preferente* is a subordinated debt instrument that grants the holder the right to receive a fixed dividend when the issuer (a *caja*) obtains profits, and no right to dividends when the institution suffers losses. The legal framework for the issuance of *participaciones preferentes* in Spain was approved in 2003.

Before 2003, many savings banks relied heavily on the issuance of *participaciones preferentes* abroad to finance their operations.¹ The savings banks were unable to issue the *participaciones preferentes* in Spain because an appropriate legal framework was lacking—particularly regarding their ability to absorb losses. In particular, the legal nature of savings banks precludes them from issuing securities granting ownership and voting rights in the *cajas*—but private ownership rights could be established over the special vehicles controlled by the *cajas*. The legal framework established in 2003 adapted the *participaciones preferentes* to the Spanish legislation by treating them like bonds, making it possible to issue them in Spain.

¹ They issued the *participaciones preferentes* through special purpose vehicles located in offshore centers with Anglo-Saxon legislation. The instrument granted voting rights to the holders; those rights were limited to the vehicle itself but excluded the *caja*.

Box 2. Savings Banks and Capital Instruments in Norway

Norway's reform of the savings banks system introduced financial instruments, the so-called primary capital certificates (PCCs), which are broadly similar to the "*cuotas participativas*," but provide voting rights to their holders and are tradable. Such instruments have proved to be an effective vehicle to capitalize the savings banks—they accounted for 16.1 percent of savings banks capital (including subordinated debt) in 2000. They have been used mainly by the large savings banks.

Characteristics of primary capital certificates (PCCs):

- *Property and dividend rights.* The certificates confer property rights over the capital and profits of the savings bank. The latter can be distributed as dividends or accumulated in a dividend stabilization fund. In case of liquidation of the savings banks, PCC holders have the right to receive their share of capital and the dividend stabilization fund, after all creditors' claims have been fully repaid.
- *Voting rights.* PCC's voting rights are not proportional to their share of capital, which makes such certificates different from equity. PCC holders choose one quarter of the members of the general assembly, whereas the other interest groups (depositors, employees, and public sector representatives) choose the remaining three quarters. A proposal to increase PCC holders' representation to 40 percent is under analysis.
- *Other.* Savings banks can issue securities convertible into PCCs, which has expanded their financing options. In order to issue PCCs, a qualified majority vote of two thirds of the general assembly is necessary. In addition, the ownership of PCCs is unrestricted, with the only exception that no individual or legal person can hold more than 10 percent of the PCCs of a single savings bank.

41. *Cajas* have not suffered systemic crises. As noted earlier, individual distress cases were resolved through mergers among *cajas*. Assuming that in a distress situation instruments such as *cuotas participativas* would not be very helpful, the remedies available to deal with the situation (besides mergers) would include sale of assets or support from the deposit guarantee fund. Thus, it is even more important for *cajas* than banks to have a solid equity position that provides a cushion in case of losses, and to maintain a risk profile that takes fully into account the difficulties in promptly bringing in substantial amounts of new capital. In practice, *cajas* as a group have higher capitalization.

Limited market assessment and contestability of *cajas*' performance

42. The assessment and contestability of *cajas*' performance by markets are more limited than those of commercial banks in two dimensions. First, lacking owners, *cajas* cannot be purchased by private parties, and standard ownership rights—such as voting—do not apply. Second, *cajas*' do not issue tradable equity instruments which would allow their day-to-day decisions to be fully assessed by capital market participants.

43. In regard to the first dimension of contestability—through takeovers—*cajas* cannot be purchased by private individuals or institutions due to their legal nature, but they can acquire other companies and credit institutions. Nevertheless, *cajas*' assets and branches can

be purchased by individuals, private companies and commercial banks. Mergers and acquisitions among *cajas*, however, are possible so long as the Autonomous Communities give their approval (see Section IV).

44. In regard to the second dimension—the contestability of *cajas*' day-to-day decisions—the fact that *cajas*, unlike many banks, are not listed companies, implies that the market assessment of managers' decisions is more limited. Such assessment would not be continuously reflected in equity price signals in capital markets.²⁸ Although *cajas* issue debt instruments, the value of these instruments reflect the *cajas*' market value only to a limited degree.

45. Transparency is a key element to facilitate good governance of any organization, and is particularly important for the *cajas*. The transparency of *cajas*' decisions is set to improve significantly. Starting in 2005, *cajas* that issue traded instruments must publish an annual Governance Report, which will enhance transparency and market oversight.

46. In addition, a working group led by the CNMV has opened a consultation and study period to propose further improvements to the corporate governance of publicly traded firms and savings banks. A special subgroup is focused on the governance of savings banks to determine which of the general proposals could be applied to savings banks—given their specific legal nature. One of the proposals considered so far is the creation of a Corporate Governance Code that unifies all previous corporate governance recommendations and the current legislation—contained in laws, ministerial orders, circulars and other sets of recommendations such as the Aldama and Olivencia Codes. A first draft has been released for comments, albeit specific recommendations for savings banks will be released later.²⁹

Compensation of members of *cajas*' governing bodies

47. Unlike commercial banks, *cajas* cannot make use of stock options to compensate their *executives*—due to the absence of stock prices for *cajas*—and thus, are deprived of a potentially useful device to induce profit maximization. However, this may also discourage excessive risk-taking, as the use of stock options to compensate executives has led to excessive risk-taking and corporate failures in other countries.³⁰ Savings banks, however, appear to have no difficulties to attract the best professionals, as executives receive compensation appropriate to market conditions.³¹

²⁸ FitchRatings, 2005, *The Framework for Corporate Governance in Major European Banking Systems. Still Evolving, but Good Progress Made*, Special Report, April.

²⁹ The recommendations may also be applicable to the minority of savings banks that do not issue traded securities.

³⁰ This view is advanced, for example, by the IMF's Director of the Research Department Raghuram Rajan, "Has financial development made the world riskier?" mimeo, September 2005.

³¹ As indicated in Table 3, compensation to non-executive members of governing bodies is restricted by law to "*dietas por asistencia y desplazamiento*"—expenditures related to their attendance of *cajas*' meetings.

VI. CONCLUSIONS AND RECOMMENDATIONS

48. The savings banks (*cajas*) have been a major force in extending services and in creating a highly competitive environment in the Spanish financial system. They have close ties with the communities and they support social, cultural, and educational projects. *Cajas* have endeavored to keep close to their customer base and have successfully adapted to the liberalization of the Spanish financial sector. They have a large network of branches and a strong regional identity, and since 1980 have steadily increased their market share of customer deposits and total credit to the private sector—which is concentrated in lending to individuals and to small- and medium-size enterprises—to account for more than one-half of the system in 2005. *Cajas* have built a strong capital base over the years and the system has suffered no systemic crisis.

49. Notwithstanding the overall strengths of the savings banks system, the peculiar structure of savings banks—foundations that do not have owners—requires adequate arrangements that ensure good governance and help them maintain a strong market orientation. In this regard, the following actions would help:

- Ensuring that the 2002 regulations on corporate governance are fully implemented, strengthening them if required in particular as regards outside influence on the savings banks' decisions.
- Promoting new means to raise high-quality capital, such as the issuance of *cuotas participativas* to the market.
- Allowing savings banks to merge freely within and across Autonomous Communities provided the Bank of Spain has ruled favorably on the viability of the merged institution.
- Reducing over time the public sector representation ceiling, currently at 50 percent.

50. Regarding the division of regulatory and supervisory responsibilities over savings banks, the Autonomous Communities' powers do not include solvency or financial stability issues, in line with rulings by the *Tribunal Constitucional* handed down over many years. Looking to the future, eventual changes in the legal regime should clearly preserve the sole and exclusive role of the Bank of Spain in prudential oversight—solvency and financial stability issues—of all financial institutions, including savings banks. In this regard, it is particularly important to avoid any possible inconsistency in the division of responsibilities between the Bank of Spain and the Autonomous Communities. This would help ensure that Spanish financial supervision is consistent with the present trend observed in European and international markets towards avoiding fragmentation and enhancing harmonization.

51. Looking forward to the long term, a weakness of the current model is that its resolution mechanisms are basically restricted to mergers or asset sales. Although mergers among *cajas* could be useful—though not necessarily optimal—to resolve the financial difficulties of smaller *cajas*, they could not be relied on to resolve systemically important *cajas*. The incapacity of *cajas* to raise capital through instruments that grant voting rights

precludes a potentially useful—less costly—vehicle to resolve *cajas* with problems—which could be particularly relevant for large *cajas*. In this regard, the Spanish authorities may wish to consider strengthening the current model by introducing alternative resolution mechanisms. One possibility would be to allow a *caja* to issue capital instruments with attached voting rights if the *caja* is in serious distress or its assembly wishes to do so. More broadly, the supervisor needs to remain particularly vigilant in order to ensure that the risk profile of *cajas* takes fully into account the difficulties of bringing in promptly substantial amounts of new capital.