Spanish savings institutions and the role of *cuotas participativas* in times of crisis

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Abstract Financial institutions have a very important intermediation role with respect to savings and the financing of firms and households. To perform this function, financial institutions need financial resources. In Spain there are different kinds of financial institution: banks, savings institutions and credit cooperatives; in terms of intermediation, it is the savings institutions that have the most important role. This paper analyses the role of financial institutions in general as well as their need for additional financial resources during a period of crisis. In this context, the paper studies a new way for savings institutions to obtain financial resources: *cuotas participativas*.

Keywords: *finance, savings institutions, issues,* cuotas participativas

INTRODUCTION

Financial institutions have a very important intermediation role with respect to savings and the financing of firms and households. Within Spain, this intermediation function is fulfilled by a greater number of savings institutions than banks or credit cooperatives.

The period of financial crisis that started in August 2007 has now spread to the real economy and its impact can be seen in the pricing of mortgages and loans and the more stringent conditions that must be met before banks will consider making such loans.

In this situation it is important to understand how economies respond to the monetary policy of the European Central Bank. By offering loans, banks can contribute to the development of the real economy, but without liquidity they cannot finance new investment projects.

This paper analyses the role of different financial institutions in Spain. The following section studies the importance of savings institutions in particular. The third section evaluates the current financial crisis and its implications for savings institutions. The final section analyses new financial instruments for savings institutions to obtain financial resources.

THE ROLE OF SAVINGS BANKS IN THE SPANISH FINANCIAL SYSTEM

Savings institutions are the main collectors of funds from domestic economies and providers of finance to the non-financial corporate and household sectors. This situation contrasts with the USA, where capital market-based finance is more important[1] (see Table 1). Structured instruments are more advanced in the USA than in the Eurozone. In the Eurozone, products are related to commercial activities.

Table 1: Selected indicators of financial structure in the Eurozone and the USA (as a percentage of GDP)

End 2007	Eurozone	USA
Total bank financial assets	249	144
Bank credit to non-banks	137	62
Of which loans to the non-financial corporate sector	50	17
Debt securities issued by non-financial corporations	8	26
Stock market capitalisation	75	112
Securitisation	6	18

Sources: ECB, Eurostat, Dealogic, Thomson Financial Datastream and the Federal Reserve Board of Governors.
Notes: Total bank financial assets refers to the aggregated MFI sector for the euro area and to the sum of commercial banks, savings institutions, credit unions, money market mutual funds, and security brokers and dealers for the USA. Securitisation figures are based on euro/dollar-denominated asset-backed securities, mortgage-backed securities and agency-related securities.

Within the Spanish financial system, one can distinguish three different kinds of institution: banks, savings institutions and credit cooperatives. Each of these has a different legal nature: banks are public limited companies; savings institutions are institutions with no profit motive, the original function of which was to provide loans to people in need; and credit cooperatives were born from the credit section of farming cooperatives.

Traditional activities facilitate flows of financial assets from savers to those with investment and consumption needs. In this sense, deposits and loans to firms and households are the most important activities.

Since the 1990s, however, the activity of savings institutions has changed. They have many branches in Spain and now offer a variety of financial services. Supply of new financial products has had an impact on financial operations, making it possible to obtain resources in new way.

In terms of volume, credits and deposits have developed in different ways. Deposits at savings institutions and credit cooperatives have increased on a year-by-year basis. By way of example, Figure 1 shows a mean 200 per cent increase in deposits between 2003 and 2007, with savings institutions having the greatest volume of deposits (€39.493m in 2007 — see Table 2). The growth in credit was considerably more stable during this period (Table 2 and Figure 1).

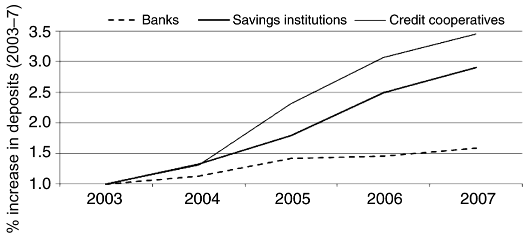

Figure 1: Percentage increase in deposits

THE EFFECT OF CURRENT CRISIS AMONG BANKS

In general terms, analysts trace the source of the present crisis to 2007, placing particular blame on the granting of subprime mortgages in the USA.

In the run-up to 2007, European economies had been growing, much like the US economy. This was a period of low interest rates, making it easier for people to buy homes. However, the increased demand for housing led to increased prices, meaning that people needed more money to buy property and were obliged to take out increasingly larger mortgages.

To help fuel the supply of mortgages in the USA, another financial product was created: the subprime mortgage — a product to give those who are less financially secure the opportunity to borrow money at a slightly higher interest rate. Kiff and Mills[2] describe subprime mortgages as residential loans that do not conform to the criteria for 'prime' mortgages — they are made to more 'risky' borrowers and hence the expectation of full repayment is lower. The risk assessment uses objective criteria such as loan-to-value ratios and the borrower's credit score and record.

The subprime mortgage was introduced during a period of global economic growth and hence was not initially perceived to pose any threat to the financial system. During periods of crisis, however, there is a tendency for discussions regarding the financial fragility of capitalism to come to the fore. This Keynesian idea is used by some economists to explain how the financial world is the source of crisis and how this crisis can spread to the real economy. Galindo[3] indicates different stages in the cycle according to Minsky:[4] displacement, boom, euphoria, profit collection and panic. When the economy is growing, positive expectations engender a climate of speculative euphoria; under these circumstances, loan volume increases. Credit increases, along with the period of time over which payments are made. Consequently, if loan repayment falters, a crisis starts. Cassidy[5] also uses this idea to explain actual crisis.

So, what factors explain growth and euphoria? One possible answer is lower interest rates. In this context, the low

Table 2: Evolution of deposits and credits in the Spanish financial system (€m)

	2003	2004	2005	2006	2007
Deposits	20,092	22,797	28,450	29,175	31,866
Credits	19,871	20,696	23,136	23,696	23,825
Savings institutions					
Deposits	13,590	18,000	24,425	33,851	39,493
Credits	12,052	12,611	13,485	13,738	14,323
Credit cooperatives					
Deposits	901	1,182	2,083	2,764	3,112
Credits	549	552	545	547	607

cost of borrowing started a speculative boom in the property sector. The public demanded more mortgages and the banks supplied them — even to people with a high risk level. But, as noted previously, banks did not at first see this risk as a problem; indeed, through the use of new high-risk instruments, many banks increased their profits. However, when conditions in the mortgage markets change, problems start. Throughout 2007, data on residential investment in the USA showed a change in situation; however, in August 2007 the mortgage market worsened, and the slowdown and executions increased quickly in the high-risk subprime sector.[6]

Why does outstanding debt affect the whole financial system? In the preceding period of growth, the supply of subprime mortgages increased significantly. The problem arose when financial institutions needed more resources in order to provide more loans and began to securitise their existing debt obligations. Securitisation has major advantages for banks as they can free capital and liquidity as the loans are removed from their balance sheets. However, if a bank knows that its loans are not going to appear on its balance sheets, it may not apply the same strict risk assessment as it would conduct otherwise (ie there is a problem of moral hazard).

When a non-securitised loan is not repaid, the lender is the only party to suffer. However, once the debt has been distributed among multiple institutions, the market does not know how many institutions have problems and so tension increases. This was how a problem in the US housing market spread to the financial and monetary system — thanks to securitisation, financial institutions were diversifying subprime mortgage risk at an institutional and international level. Due to globalised markets, the high proportion of structured finance instruments and asset-backed securities in the balance sheets of financial institutions obscures the volume and distribution of loss. Confidence drops when it is difficult to assign a value to a real situation, and this translates to declining economic prospects. The result is increased tension in interbank money markets and decreased liquidity due to the lack of confidence in other institutions' solvency. Such changes in prospects affect firms in the real economy.

After the crisis started, it became more difficult to place issues of corporate fixed income instruments, risky prime acquired a more prominent profile, and property assets were less valuable on the balance sheets of financial institutions. On the other hand, the conditions for obtaining finance have become more expensive and restrictive, making it more difficult for institutions to access the loan market. Thus, one of the more important consequences of the crisis is the impact on loan activity. To this end, the major central banks (including the European Central Bank, as well as the US, UK, Swiss and Canadian central banks) have provided liquidity to the market to reduce monetary tensions and to generate confidence among investors. One of the more important aims for central banks is to create stability within the financial system. In addition, banks are being stricter about offering loans and have reduced the volume of structured instruments they are issuing.

RECENT DEVELOPMENTS IN SAVINGS INSTITUTIONS

At the end of the last century and the beginning of the 21st century, financial institutions in the USA and Europe had very different sources of finance. In Europe, particularly Spain, regulations and supervision by central banks and security exchange commissions require financial institutions to show their income streams on their balance sheets. Banks must also set aside funds or assets to cover risky loans. Banks in the USA also have regulatory bodies, although they are less strict than in Europe. The more relaxed regulation in the USA meant that when institutions created new assets to diversify the risk of their more risky loans, problems spread to the financial system. As such assets were less commonly used in Europe, its exposure to the crisis was reduced.

Whereas securitisation activities in the US financial system have been important for a number of years, in the Eurozone they have developed more recently — despite the strong growth observed in recent years, the level of securitisation activity in the Eurozone remains below that in the USA and UK.[1]

In the present crisis, however, financial institutions are finding it increasingly difficult to attract deposits. This is a major problem as banks need resources in order to provide loans; without resources they cannot play their intermediation role. This problem is more acute among savings institutions as their legal status prevents them from issuing shares to realise funds.

Since the passing of Act 26/1988 and Royal Decree 664/1990, savings institutions in Spain have been allowed to issue a form of asset known as *cuotas participativas* (CPs). This asset type was created to put savings institutions on a more equal footing with banks in terms of obtaining equity reserves. In other words, the asset gives savings institutions the opportunity to maintain their legal status while still benefiting from an alternative source of finance.

As with shares, CPs are traded on the stock market; however, CP owners have no voting rights and may not participate in the management of the institution in question. This is because savings institutions are not public corporations; rather, they are owned by civil institutions.

The first savings institution to issue CPs was Caja de Ahorros del Mediterráneo, which placed €50m of CPs on the stock market. This was the first time in the history of the Spanish stock market that a savings institution had used the market to finance its development projects. Since then, Spanish savings institutions have come to consider the stock market an efficient mechanism for finance and valuation.

This new trend is informed by changes in the business of these financial institutions. From the mid-1990s, Spanish savings institutions changed their business strategy to one of obtaining funds through the issuance of assets in the financial markets. There are two main reasons for this change: first, the good position of these institutions within the mortgage market; secondly, the major increase in economic and industrial activity over the last decade, which has been accompanied by an increased demand for housing. The new business structure of savings institutions requires an increasing volume of equity reserves.

Due to these changes and the need to promote efficiency in the Spanish financial system, savings institutions need new assets to maintain a system with a large increase in total equity reserves and high solvency. For savings institutions, the first role of CPs is to obtain external capital, but they can be considered total equity reserves.

This type of asset has some requirements. Decisions on CP issues are voted on in the general assembly of savings institutions, although they may be delegated to the board of directors. The volume of CPs circulating is limited and cannot be more than 50 per cent of the savings institution's total equity. CPs cannot be issued below nominal value and can be issued with risk prime.

Certain restrictions about the percentage of investment in CPs are established by law. First, the issuing institution is forbidden from buying its own CPs (although, in exceptional circumstances, it may buy up to 5 per cent of the total issue). Secondly, no one may own more than 5 per cent of the total issue.

CP owners may receive a dividend when profit is distributed, but this will be in line with the volume of CPs represented in the total equity of the savings institution (the total equity reserves is made up of total equity plus reserves plus CPs).

Since the first CP issuance by Caja de Ahorros del Mediterráneo, savings institutions have increasingly participated in the Spanish stock markets, with a number of key goals met over the last 20 years.

For example, CP issuance has brought one of the most important sectors of Spain's economy and financial system to the stock market. In terms of traditional bank business — attracting deposits and providing loans — savings institutions account for more than half of these activities in Spain. Moreover, the issuance of corporate fixed income instruments on the market by savings institutions is half of all issuance in the Spanish financial system.

In addition, the issuance of CPs has created a new source of total equity reserves for institutions that were previously constrained in this regard. When share issuance is not possible, the only way to obtain total equity reserves is through self-financing, a condition that limits the potential growth of these financial institutions. Although the present environment does not lend itself to growth similar to that of a few years ago, savings institutions have to improve their internationalisation. Continued growth is necessary to generate total equity reserves greater than retained earnings. Generating basic total equity reserves makes it possible to guarantee and expand resources dedicated to charitable work.

Nonetheless, CP issuance produces major qualitative changes. Savings institutions are now subject to the markets, which affect their credibility because markets will weigh the quality of bank management. This should have a positive impact on performance.

CP issuance by savings institutions demonstrates that they can manage resources with the same efficiency as other financial institutions while maintaining their differences. Savings institutions are close to customers because they have a local base, they finance projects related to the economic and social development of these areas, and distribute profits through charitable work. Other financial institutions, by contrast, are motivated solely by profits or the generation of dividends.

These financial instruments demonstrate the positive performance of savings institutions and help the market to value these assets using the same criteria it would apply to other products. This enhances the internal and external credibility of savings institutions. Their assets and growth are included in any assessment of their activity. Savings institutions already have mechanisms for evaluating their activities by credit ratings or bond issues which allow the market to assess their capacity to meet obligations. CP issuance involves quantitative and qualitative growth in the soundness of savings institutions.

Furthermore, CP issuance is important in relation to value creation. It is sometimes said that savings institutions should not be subject to market pressure like other share-issuing companies. CP issuance obviates this question because the rise in the price of these assets is incorporated by other indicators and ultimately aims to improve management.

CONCLUSIONS

The present financial situation has changed the way business is done. Within the financial sector, the drop in confidence has meant that many types of financial asset have fallen out of favour; for example, there is less activity in interbank money markets. The rules have changed and it has become necessary to rebuild trust in financial operations. To this end, more regulation is necessary.

The development of financial markets is directly related to regulation — less regulation means more development. However, when regulation is minimal or even absent, crisis situations become more frequent or more severe — one only has to consider how the present situation stems from low regulation in the US financial market.

Among financial institutions there is at present no sense of 'business as usual'. Of particular note is the difficulty they are having with respect to attracting deposits. This problem is very important because small savers do not trust the system and only invest if there is a high yield, making it more difficult for financial institutions to play their intermediation role. In the case of savings institutions, they have an additional problem because their legal status prevents them from issuing shares to realise capital.

New ways to finance are needed, but these new assets must meet two conditions: they must guarantee investor trust while not increasing risk.

CP issuance meets such criteria. The issue of CPs has added value to companies while rewarding investors with a percentage of the profits. Of course, these assets let savings institutions increase total equity reserves and maintain their solvency. In this sense, savings institutions and CPs should be adopted in other economies where banks alone are not enough to promote development.

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