DEREGULATION AND COMPETITION IN SPANISH BANKING*

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1. Introduction

The Spanish financial system has undergone a strong liberalization process in the last fifteen years, which has accelerated recently, starting from a situation of tight regulation and protection from competition. The deregulation process has been reinforced by the projected integration of European financial markets and has accompanied major developments in financial markets and banking.

Deregulation has many effects; in this short note we concentrate mainly on competition in banking. After reviewing the evolution of regulation (section 2) and the present state of the financial system (section 3) we analyze the effects of liberalization on competition (section 4) and conclude with some comments on other effects and open questions.

2. Banking: From regulation to competition

Spanish banking has been traditionally and until recently a closed system, heavily regulated, protected from foreign competition, conservative in terms of innovations, and controlled by the large banks, who also own big portions of industry. The Spanish financial system and private agents being quite unsophisticated, banks would get their main input, deposits, at a very low (deposit rate) cost and were required to finance public expenditure by investing in low-yield government securities (among other investment requirements). In exchange, large banks were allowed to coordinate their market actions by agreement among themselves in a context of complete regulation of interest rates.

The banking system was subjected to a strong shock from 1978 to 1985.

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Many banks failed and had to be rescued. It is worth noting that the crisis is not a consequence of the deregulation process that started in the mid seventies. The roots of the banking crisis must be found in the severe industrial crisis the country suffered after the oil price increases in the seventies, the close links between banks and industrial firms (risks concentration), bad management and fraud and the lack of monitoring of banks in trouble by the central bank. A deposit guarantee fund (the 'Fondo de Garantía de Depósitos') was instituted only in response to the crisis, being consolidated in 1980.

The banking crisis temporarily reversed a trend towards lower concentration and slowed down the deregulation process started in the mid seventies (as the authorities became worried about the solvency of the system). After the crisis, concentration went down again until two of the largest banks (Bilbao and Vizcaya) decided to merge.

The Spanish banking system has been heavily regulated in terms of interest rates, entry, branching, and investment and reserve requirements. Furthermore these regulations have put different constraints on different institutions, such as banks and savings banks, for example. Liberalization advanced significantly in the seventies and has accelerated recently as banking has tended towards the model of a free-market business.

We now present an overview of the liberalization process and its connections with European financial integration.

**Limits on entry.** As regards national banks, limits on entry were relaxed in 1974. Foreign banks have been allowed only restricted entry since 1978 (so as to minimize their participation in the retail market). Regulators not only set general conditions for entry (for national or foreign banks), but maintain a large degree of discretion. This discretionary power was already forbidden by early regulations of the EC ('First Coordination Directive', December 1977), and even more clearly so by the proposed Second Coordination Directive, January 1988. After 1992, Spanish authorities will have to authorize any bank as long as the candidate satisfies the established conditions, and their discretionary power will be abolished.

**Limits on branching.** The limits on branching have been liberalized (subject to capital adequacy) for national banks since 1974 and for savings banks since 1975 within its (geographical) region of operation and outside it since 1989.

1 Between 1978 and 1983, 51 banks (representing 46% of the total in 1977) involving 20% of total 1983 non-equity liabilities were affected. The peak of the crisis was in 1982 (12 banks failed) and 1983 (21 banks, basically the Rumasa group - 20 banks). Five more banks were affected in the period 1983-1985.

2 The Second Coordination Directive laid down the basic principle that any bank authorized by its home member state will be able to provide a wide set of banking services in any country of the EC - the so-called 'single banking license' provision. This directive permits host countries to enforce their own rules on liquidity, business conduct and investor protection rules.
**Investment requirements.** These were established to finance public projects. Since 1987 they concern almost exclusively public debt holding. The government will phase them out gradually by 1993.

**Interest rates.** Liberalization of interest rates started in 1969, received a big impulse in 1974–1977 (for maturities of more than one year) and was completed in 1987.

**Dividend distribution.** The distribution was liberalized in 1981 for private banks.

**Segmentation of institutions.** The attempt to distinguish 'industrial' from commercial banks was unsuccessful. Savings banks used to be subjected to more severe restrictions than private banks. But regulation now tends to treat them equally. At present both types of institutions can basically do the same operations although the ownership structure of savings banks is different.

**Reserve requirements.** These were introduced in 1970. As of this writing, Spanish private and savings banks are required to keep 19% of a subset of their liabilities as deposits in the Bank of Spain. A share of these deposits receives a rate of return below market levels. This requirement plays an important role in financing public deficit and will not be affected by EC regulations, as other measures related to monetary policy. However, since the return on banks' reserves is much lower than the market return and the reserves requirements of other European countries are much lower, maintaining these numbers in the near future could jeopardize the competitive position of Spanish banks. The government plans to lower the reserve coefficient to about 5 or 6% by 1992, essentially suppressing the part which is remunerated.

**Capital requirements.** Since May 1985, Spain regulates the solvency of financial intermediaries in accordance with the Basle Agreement. However, the ratio of equity to assets is above the 4% recommended level. At 5% (1987), it is one of the highest in the world. This is a product of the financial crisis. One potential problem of the discussed EC harmonization of solvency requirements for Spanish banks is the limitation that it will impose on the extent of industrial holdings in relation to bank equity.

The evolution of competition in banking has principally featured the described loosening of the heavy regulatory environment and the disintermediation process. Banks have found themselves competing in the medium/long term maturity market with government (Treasury issues to finance public debt) and firms (commercial paper issues) but they have acted as underwriters for most of the issues, thus keeping a certain control of the process. Savings banks have been less affected. In fact, the underlying factor in the decreasing trend in concentration, except for the recent mergers, has been the growth of smaller institutions, most of all that of the savings banks.

The outcome of the deregulation process is a banking system which looks,
relative to other industrialized countries, oversized, sound (as regards solvency), less open in terms of foreign trade, overpriced and not very cost efficient. Profitability and concentration levels do not look particularly different from the international norm. Despite the protectionist and regulatory Spanish tradition, it should be noted also that the penetration of foreign banks in Spain does not differ from European standards.\(^3\)

3. The financial system\(^4\)

The present Spanish financial system looks unbalanced. On one hand, the relative weight of the banking industry is very important, although declining. More than 60\% of private financial wealth is held in cash plus deposits, well above other European countries. On the other other hand, there exist sophisticated organized markets for public debt (short and medium term) and an interbank market, in clear contrast with the underdeveloped, although rapidly growing, long term capital market (stocks and bonds). Organized option and future markets are nonexistent, although there are immediate projects to develop them, and there is already a thin over-the-counter market in both instruments.

Thus, developed money markets coexist with thin, long term bond (public and private) and mortgage markets and with incipient private pension funds. The stock market has taken off since 1983 and now shares the basic characteristics of other stock markets in the continental European countries like France and Italy: for example, a low market capitalization and liquidity (as compared with the U.S., U.K. or Japan). In any case, the Spanish market is still characterized as narrow and illiquid (few large firms are listed, banks and public utilities dominate the market, there are no domestic mutual funds); transaction costs are high; there is a lack of transparency; and insider trading and price manipulation are the rule rather than the exception. Nevertheless the reform under way is supposed to take care of all these problems.

The reason for the asymmetrical developments in the financial system is that market reforms in the deregulation process have been implemented primarily when needed to finance the public deficit. Basically, orthodox financing of the public deficit only starts in 1984. During the seventies the financial sector was clearly underdeveloped as compared with industry.

4. Effects on competition and strategies

The deregulation process has brought major changes to competition in

\(^3\)Excluding Luxembourg and the U.K., the simple average market share of foreign banks in EC countries is 11.7\% just above the 11\% of Spain.

\(^4\)For an excellent overview of the Spanish financial system see Mañas (1989). See also the book by Trujillo et al. (1988).
banking: in general terms, increased competition in a segmented market context, a certain management shake up and a strategic repositioning of financial institutions. An important fact has been the end of the 'status quo' or the traditional 'gentlemen's agreement' between major banks in the wake of the attempted takeover of Banesto by Banco de Bilbao.

4.1. Competition and market power

When interest rates were regulated competition could only take place through quality and convenience to clients. When free branching was allowed, from 1974 on, branch proliferation and free services resulted (in two years the number of branches doubled). The question is how much price competition will take place once interest rates are liberalized. International comparisons seem consistent with a relatively high degree of market power in the Spanish banking sector (for example, the Price Waterhouse report for the EC or comparisons of Tobin's $q$ ratio). This view is reinforced by the fact that Spanish banks have been getting returns much higher than other firms in the industrial sector. Nevertheless, the evidence is mixed. While there is some evidence of tacit collusion among major financial institutions with respect to interest bearing checking (money market) accounts, some studies find no evidence of market power in the submarket for term deposits. The latter may be because of competition between term deposits and public debt.

One result of the deregulation process has been the merger of two large banks (Bilbao and Vizcaya) in 1988. If we were to believe that the Herfindahl (national) concentration index $H$ provides an appropriate measure of market power (consistently with modelling competition à la Cournot), the 1988 changes in $H$ could have induced changes in industry average mark-ups, both in the deposits and the loans markets, or more than 13%, when considering competition among groups of banks only, or for more than 7%, when considering competition among groups of banks and savings banks. The Bilbao-Vizcaya merger, had it not been accompanied by other deconcentration movements which occurred simultaneously in 1988, could have resulted in a more noticeable increase in aggregate mark-ups. This increase would have ranged from 17% to 22%, depending on whether we were to look at groups of banks only (22.5% for deposits and 22.3% for loans), or both at groups of banks and savings banks (17.65% for deposits and 20.30% for loans). Nevertheless, apart from the usual criticisms about reading performance results from concentration indexes, in some submarkets of the loans

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5See Ballarin, Gual and Ricart (1988).
6Since 1987 interest rates on all accounts are free but the introduction of checking accounts yielding market rates is very sluggish and restricted to secondary trademarks.
and deposits markets the correct index to use is of a local or international nature and not national.

4.2. Strategies

Another major consequence of the deregulation process is the strategic repositioning of financial institutions. The big banks have been losing market share both in terms of deposits and loans because of the disintermediation process since the end of the banking crisis in 1983–1984. The crisis itself had led to an increase in their market share because of the consolidation process.

The erosion of the position of the big banks, including those affected by the 1978–1983 crisis, Hispano and later Banesto, has been met by different responses, mergers attempts being the most prominent. Banks like Santander and Hispano have made or are trying to make agreements with foreign banks in other European countries. It is important to observe the active role played by the government in the merger process. Government seems to have intervened in the belief that a large size is needed to compete in the European market and to avoid take-overs of national banks by foreigners.

The merger projects admit two readings. On one hand, they can be seen as an attempt to realize necessary economies of scale and scope and to shake up inefficient management in order to face the competition of an integrated market. However, the mergers seem to have been made without a careful study of the empirically feasible economies. In any case, recent econometric studies [Delgado (1989)] do not show signs of economies of scale at the firm level and find evidence of economies of scope only for certain classes of banks.

On the other hand, the mergers can be seen as a defensive response of large banks, used to a regulated environment in which they could easily coordinate their actions, when faced with the prospect of fierce competition by would-be more efficient and sophisticated institutions. In this view, the intention would be to maintain high barriers to entry wherever possible and to preempt the entry of foreign institutions. In this sense the extensive branching network and the ATM systems, together with consumer inertia and the goodwill of established institutions, may indeed prove to be formidable barriers to entry in the retail business. One open issue is whether big banks will be able to stick to tacit agreements to keep profitability high,

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8 The attempt of Banesto and Central failed recently in the mist of a struggle for control.
9 The government is clearly worried about this possibility. Deutsche Bank’s unsuccessful attempt, at first and due to the intervention of the Bank of Spain, to control the Banco Comercial Transatlántico provides an example.
10 For further assessment of the social and private costs and benefits of mergers in banking see Vives (1988).
for example by introducing interest-bearing checking accounts only marginally, and to coordinate their actions in order to make entry of foreign institutions difficult, for instance, by not allowing foreigners easy access to the main ATM systems.

Big banks in Spain, as in most other countries, are caught in a situation where they must compete on all fronts (retail, wholesale, international, new financial operations) without seemingly having the competitive edge in any one of them. Maybe some of the 1988 spin-offs or sales of middle-sized banks of the groups Banesto, Hispano and Santander are a reflection of this state of affairs.

Savings banks seem to have a better competitive position in retail in terms of quality of service, which translates into a higher accumulated stock of goodwill, but they do so at the price of higher operating costs. As indicated before, savings banks are able to compete on an equal footing with private banks since 1989, when they were finally allowed to expand outside their own region.\(^1\) This possibility of expansion will probably induce a process of mergers and takeovers among savings banks which will increase concentration in the sector. This process in fact has already started in several regions.\(^2\) As a further consequence, a higher degree of competition will follow in the mass retail market and the few 'underbanked' spots that remain in Spanish cities will be occupied.

Middle-sized banks do well specializing in some market segments or on a regional basis: they may center on the higher income segment of the retail market or on the servicing of small and medium-sized firms and merchant bank operations. In fact some middle-sized banks seem to follow a dual strategy: universal banking in their own region and specialized banking in the rest of the country.

Foreign banks have an edge in the wholesale business, international operations in particular, and also seem to do well in the higher income segment by offering, for example, high interest checking accounts. Thus, Barclays is expanding aggressively in well-to-do neighborhoods in Spanish cities. Foreign banks are innovative in the Spanish context, but they try to accommodate to the established business practices of national banks.

4.3. Segmentation

The Spanish banking seems to be evolving into a segmented market with

\(^1\)Nevertheless the government will retain the possibility of introducing restrictions till 1992 and new out-of-region branches will not be allowed to do business in insurance.

\(^2\)The projected merger of La Caixa and Caixa de Barcelona, two of the largest savings institutions, is a notable example.
very different degrees of competitiveness in individual segments. While higher income retail and servicing large firms are developing into highly competitive submarkets, due to the disintermediation process and the increased competition of new entrants, others, like mass retail or servicing small firms, do not seem to follow this pattern.

In summary, the competition in wholesale banking competition will tend to be mainly between the big banks and the foreign banks, with some specialized smaller banks and some of the large savings banks acting as side players. This part of the market is the one that will be the most affected by the integration of financial markets, the further development of the stock market and the advance of the disintermediation process. Competition will be fierce, big banks wielding their industrial portfolio as a major asset and foreign banks enjoying a better technological position. The upper end of the customer retail market may see the development of similar levels of competition, especially since communications technology may decrease the value of an extensive branching network and facilitate the entry of foreign banks and new players such as large commercial firms, mortgage societies and small investment companies. In the case of the mass retail market, the degree of competition will depend on the aggressiveness of the large savings banks and their willingness to behave noncooperatively rather than play by the tacit rules established by the big banks.

5. Other effects and open questions

Deregulation, coupled with the integration of the European market, is having and will have many other consequences in the financial system. Let us mention a few of them.

(i) An increased volatility of interest rates (obvious if we think of the transition from a system of regulated to market set rates) with effects on the stability of the financial system (bank failures) and the conduct of macroeconomic policy. Let us recall nevertheless that in Spain deregulation did not provoke the severe banking crisis of the early 1980s.

(ii) An increased transparency to the system along with the development of capital markets, the regulation of insider trading and the establishment of stronger information requirements.

(iii) A considerable impact on the public budget because of the reduction of seigniorage through the lowering of reserve requirements, via 'competitive' harmonization in the EC, and the reduction of inflation in order to converge towards the lower EC levels. Seigniorage is quite important in Spain as a source of government revenue. A reserve ratio is equivalent to a proportional tax on deposit income plus a contractionary open market

13 See Melitz and Bordes (1989).
A lower reserve ratio means a lower increase in the monetary base (the tax base of the inflation tax) to maintain the same rate of growth of a broader monetary aggregate. It has been estimated by Mañas (1989) that the harmonization of reserves requirements could cost the Spanish Treasury more than 1% of GDP.

Some open questions emerge:

(a) Will the increase in competition brought by deregulation affect the stability of the financial system?

(b) Will Spain manage to develop a financial center of any magnitude, say for stock and securities in Madrid and, perhaps, for options and futures in Barcelona? Or will Spanish financial centers be of second order with most of the financial weight concentrated in the big European centers?

(c) Will the European banking market be a system of national oligopolies with limited cross participation or will it become more integrated? More specifically, will barriers to entry persist in the sectors of retail and small firm services and will these barriers prevent foreign institutions from getting an important foothold in the national markets?

(d) Will Spain follow the German or the British model with respect to the relationships of industry and banks? How will the answer be affected by the EC harmonization Directives regarding solvency requirements?

14 See Romer (1985) and also Repullo (1989).

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