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Banking union and the future of alternative banks: revival, stagnation or decline?

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ABSTRACT
Banking union challenges the institutional mechanisms that alternative banks use to retain their status, goals, identity and carry out their operations. Yet the impact of banking union on them varies considerably and systematically: those alternative banks that held most closely to the traditional model fared best in the recent financial crises and have been impacted the least by banking union. In contrast, those banks that strayed from the traditional model and sought rapid expansion into new geographic or financial product markets fared much worse under the adverse conditions of recent years and, consequently, ended up under the full weight of banking union provisions. But even where alternative banks hewed to their traditional model and remain a significant part of national financial systems, we find that the crises and subsequent strengthening of the EU's financial role have reduced the scope for national control over all banks, not just those directly supervised by the ECB.

KEYWORDS Banking union; alternative banking; savings banks; Germany; Spain

Alternative banks – primarily savings and cooperative banks – have long been important components of national financial systems in many member states. Across Europe they are recognised as key institutions for small and medium-sized enterprise (SME) finance, as well as the key institutions for providing mortgage and other credit to low- and medium-income households (LMIHs) that other banks undersupply. In the wake of Europe's financial crisis and its response in the form of banking union, alternative banks increasingly fall under stricter banking regulation designed primarily for commercial banks and the supervision of the European Central Bank (ECB). But the ECB's philosophy and methodology of ensuring that banks are properly capitalised and committed to standardised prudential practices and insurance schemes poses challenges to the traditional business model of alternative banks. They find it difficult to raise outside capital under stress due to their non-profit status, difficult to dispose of assets due to the overwhelming importance to their business model of lending to local businesses, government and households, and costly to establish modern systems of deposit insurance and bank resolution

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that apply to commercial banks. These EU-imposed adjustment costs come on top of the general economic challenges faced by many European alternative banks as a result of the EU's secular economic stagnation and decline. They also come on top of restrictions on state aid to banks by the European Commission that began to take effect in 2015.

Yet the impact of the financial crises and banking union varies widely across alternative banks. At one end of the spectrum we find German Sparkassen which came through the recent financial crises unscathed and managed to evade much of the direct impact of banking union. Spanish cajas, on the other end, were devastated by the crisis and ended up under the full impact of banking union. What explains the divergent impact of banking union on alternative banks? In this paper we advance the thesis that choices by states and banks prior to the crisis determined the impact of banking union on alternative banking. Specifically, the divergent fates of alternative banks can be traced, among other factors, to strategies adopted to cope with the end of state financial guarantees and European financial market integration. Those that retained their traditional business model remained small, financially stable and capable of asserting their interests to national and European politicians after the crisis. Those that liberalised and grew through leverage, investment speculation (whether in financial securities or real estate in a bubble environment) and deposit-hunting far from home found themselves insolvent or deeply troubled by 2010, which led to a further wave of mergers that generated banks of systemically important size. This vulnerability – their need for liquidity – led them and their political patrons to accept ECB oversight, rule application, mergers and, in rare cases, even closure. The degree of visible institutional change and mission shift varied in these cases, with differing results. German Sparkassen retained their original mission and institutions, even strengthening them, and remained strong; Spanish cajas liberalised their mission and institutions and could not withstand the crisis; while some German Landesbanken retained the institutions of alternative banking but not the mission (Cassell 2016). Those that did so most greatly were the ones shut down, while all were more fully liberalised afterward.

To shed light on this claim, we examine in this paper two divergent cases – Germany and Spain. We selected these two cases on three grounds. First, they are large euro zone states with large alternative banking systems possessing great political importance and commensurate political influence. These are therefore two countries where, in the abstract, alternative banks would have substantial political power to resist banking union (or elements thereof). Second, prior to the crises both countries preserved a large number of independently competing alternative banks in these sectors. This provides scope for comparing banks within each country. This also stands in contrast to other states such as Italy, where most large savings banks merged with commercial banks, or France, where the state brought cooperatives and savings banks into hierarchically managed banking groups. Finally, these two cases embody the full range of banking union's impact on alternative banks.

In Germany, we see evidence that Sparkassen (public sector savings banks) held true to the traditional model, while the regional savings (giro) Landesbanken were liberalised. As a result of the crises, a number of insolvent Landesbanken were closed or merged with others and eventually placed under the supervision of the ECB. In contrast, Sparkassen won exemption from all elements of banking union, based on their own track record, their own institutions of supervision and insurance, and the unwavering support of German politicians.

In contrast to Sparkassen, but like the Landesbanken, prior to the crises Spanish savings banks – cajas – were extensively liberalised and expanded outside their traditional territories, becoming increasingly aggressive in mortgage, business and local government lending. The collapse of Spain's real estate bubble in 2008 led the state to consolidate the cajas into a handful of much larger banks that are more commercial than alternative banking in character. As a result, the cajas ended in full coverage under banking union with direct ECB supervision.

Thus the transformation of alternative banking in the context of establishing banking union can best be understood as a case of crisis-induced liberalisation in which the prudential standards and institutions of banking union compound existing pressure on some alternative banks to raise outside equity capital in the absence of state financial support. The business models of the banks and the regulatory environments that make alternative banking possible are being replaced with the same rules and supervision as mainstream banks - i.e. alternative banks have become much more 'commercialised'. In this context, they can no longer perform their traditional functions to the same degree. But the liberalisation imposed through banking union only took hold where states and banks already had liberalised alternative banking. In those cases banks faced a trifecta of restrictions: a general economic deterioration that hurt the bottom line; the falling away of state aid or solvency guarantees, with attendant rise in costs; and the application of more stringent rules on capital and liquidity requirements, plus higher deposit and resolution insurance contributions as large entities supervised directly by the ECB. Taken together, we find the ability of governments (national, regional and local) to promote and protect alternative banking has narrowed substantially.

What makes alternative banks different?

Two key differences between alternative and commercial banks are the business model – service to local SMEs, households and public agencies on the basis of public or club goods – and the institutional setting in which they are embedded – mutual insurance funds, traditionally but no longer with the explicit promise of public assistance in time of crisis, plus stakeholder governance with local governments featuring prominently.

Alternative banks are *not-for-profit* banks established with the intent of providing financial services in greater quantity and on better terms than their private commercial banks do. They provide credit for home ownership, and business and local public sector investments (ranging from infrastructure to innovation and training programmes) that are not profitable enough or too risky to secure funding from commercial banks, where finance on equity (share) markets is not an option, or where bond markets are underdeveloped, too expensive or are too short-termist, thereby exposing borrowers to excessively volatile repayment conditions. Alternative banking provides a way for these borrowers to secure adequate funding in ways compatible with medium and long-range planning (i.e. patient capital). Thus alternative banking developed historically out of a need to compensate for market failures of profit-maximising commercial banks and financial markets more generally (Goyer 2006). The profit motive, embedded in both bank statutes and governing laws, is relatively modest and reflected in the business strategy of extending credit to those on the margins of the broader credit market. The alternative model is further facilitated by a *territoriality principle* in which individual banks are geographically confined in order to limit competition between – and promote mutual support among – banks in the same sector.

This specialisation on supplying local, undersupplied clientele with long-term finance contributes to both grassroots economic development and the relationship banking that underpins distinctly different varieties of capitalism than are found in liberal market economies (Goyer 2006). Furthermore, the modus operandi of alternative banks and the legal frameworks that support them promote long-lasting relationships between them and local stakeholders (businesses, households and government), contributing further to coordination and planning between banks, local clientele and local government that is capable of resilience, even where liberalisation of banking and financial markets throughout the rest of the economy takes place. This resilience is not guaranteed: it depends not only on the political will to maintain their constitutive institutions, but on the overall strength of family and small business capitalism that they promote and rely upon.

Alternative banks may be private, public or semi-public in nature, reflecting whether the state protects and promotes their place in the market directly (as state banks or banks with significant state links) or indirectly (as private cooperative banks whose legal status insulates them from regulatory and financial demands applying to commercial institutions). Private banks include cooperative banks, mutual societies and credit unions (Butzbach and Mettenheim 2013).

Alternative banks therefore encompass two types of economic activity that are very similar at the point of credit creation, but vary significantly in terms of the structures that sustain the viability of the banks over time. Public and semi-public banks relied traditionally on support from local governments for assistance in securing low-cost, long-term funding (through implicit or explicit government guarantees of bank liabilities), and continue to do so implicitly for providing emergency liquidity in times of crisis or extended economic downturn.[1] Their public status and mission also shield them from profit maximisation pressures. It stands to reason, therefore, that anything that interferes with these public sector links would jeopardise the viability of such banks. Private cooperative banks, in contrast, maintain their own sectoral systems of liquidity sharing and deposit insurance that are separate from the institutions of the larger, national financial system applicable to other banks. Their reasoning is that they constitute a low-cost, low-risk form of finance that would not be able to function if forced to pay higher amounts of capital into schemes designed to protect depositors and creditors of mainstream banks with riskier business practices (Ayadi and Lastra 2010; Bruni 2009). While they do not directly rely on guarantees from local government, they certainly require the acquiescence of national supervisory authorities in maintaining their own systems and institutions at a lower cost. They also require regulations that inhibit de-mutualisation – i.e. the conversion of cooperatives into commercial banks. In Germany, Austria, Netherlands and Spain (before the recent crisis), mutual insurance of alternative banks outside the systems for commercial banks persists to insulate them from the costs and pressures of reforming these systems nationally and beyond. As member-owned institutions, cooperative banks return their profits to their members in the form of better conditions and services.

The logic, rationale and instruments of banking union

Banking union was originally conceived with three main components: supervision (ensuring capital adequacy), resolution (closing insolvent banks in an orderly fashion) and deposit insurance (preventing depositor panic) (Goyal *et al.* 2013). All three components together provide a mutually reinforcing set of institutions and financial resources to prevent individual bank collapses and to prevent one bank failure from unleashing a wave of collapses (Howarth and Quaglia 2013b). While early Commission plans envisaged robust European institutions and rules applicable to all banks, banking union in its final form distinguishes between 128 systemically important banks representing 85 per cent of bank assets in the EU, subjecting them to higher standards and more intense scrutiny by the ECB, and the other 6,000-plus smaller banks. Some alternative banks, particularly large ones that had been previously liberalised, proved to be large enough to warrant direct ECB supervision and tougher standards. Although the ECB retains ultimate supervision rights to all banks, and is developing a single rulebook to rule them all indirectly, national supervisors remain in charge of daily supervision and retain some discretion.

The principal concern of bank supervision is to ensure that the money banks have lent and the other assets they have purchased continue to provide the income that is required to keep the bank in business. It also considers whether the market value of those assets is sufficient to raise enough cash in time of need and whether the banks are vulnerable to disruptions in market funding. Supervisors therefore review balance sheets to determine asset quality, look for non-performing assets (that have already gone wrong) and non-performing exposures (that could go wrong). They also engage in stress testing, which runs bank balance sheets through an algorithm designed to simulate economic adversity. Supervisors then instruct banks to shed certain assets as non-performing or excessively risky, or demand that the banks raise additional equity capital to insure against the cost of those assets turning bad (Donnelly 2014, 2016).[2] This can be obtained by selling shares on the open market, bringing in other equity investors, or retaining profits. These options are problematic for alternative banks that are owned by their stakeholders and not operated for profit. The first two moves would transform alternative banks into regular commercial banks if private investors secured a majority shareholding stake.

In the context of negotiating the Single Supervisory Mechanism (SSM), alternative banks were concerned that the ECB would set single liquidity, capital and asset standards for all EU banks regardless of riskiness. There were two parts to this concern: scope and a single rulebook. Given that the ECB might want to be particularly stringent with banks in order to establish its reputation as a strong regulator, alternative banks feared that it would perform a highly critical analysis of non-performing loans and exposures, consequently requiring them to raise additional capital if they were subjected to ECB supervision (Howarth and Quaglia 2013a). The single rulebook is an ECB instrument to set rules for national regulators supervising other banks. If the rulebook treats alternative and commercial banks equally, then alternative banks, with their traditionally modest risk profile, would have to raise additional capital to the same degree as their commercial counterparts.

The ECB answered the scope question itself in a way that exempted alternative banks from direct supervision, unless they counted as systemically important. This decision thwarted an attempt by the German government at the December 2012 Council meeting to limit coverage to the EU's 25 largest banks, reflecting opposition to banking union by its Sparkassen and cooperative banks (DSGV 2010). The ECB algorithm of systemic importance, which the Council accepted in March 2013, empowered it to supervise banks with €30 billion of assets, assets amounting to 20 per cent of national GDP, or belonging to the top two banks in a country. This led to 128 banks being placed under ECB supervision, including all of the German Landesbanken and one Sparkasse, but spared all other alternative banks there and most institutions in Austria. In Spain, France and other southern European countries, relatively larger savings banks fell more frequently under direct ECB oversight.

Alternative bank concerns about ECB stringency proved correct. In the comprehensive assessment that followed, the ECB indeed demanded that a significant number of banks increase capital, failing 25 in the first round based on balance sheets from the end of 2013, and 15 by November 2014. No banks failed in Spain due to advanced restructuring, aid and commercialisation beforehand, while Italian alternative banks made up half of the list where no such measures were taken (Quaglia 2014). Supervision therefore imposes costs on alternative banks, places restrictions on the size and nature of their balance sheets and increases pressure on alternative banks to look to outside investors that could dilute or eliminate their alternative nature. This matters in the future application of the single rulebook.

The principal concern of bank resolution is intervening at the moment a bank becomes insolvent and may involve a variety of countermeasures, including separating good assets from bad, transferring assets from one bank to another, carrying out shotgun weddings in which a healthy bank is forced to take over a sick bank (or the remaining viable parts), and imposing haircuts on creditors that reduce a bank's debts (Claessens *et al.* 2010). However, original Commission plans for a EU resolution authority similar to the Federal Deposit Insurance Corporation in the US were replaced by the coordination of national resolution systems, run by national authorities under national terms for most banks. Protection for alternative banks is potentially provided here. However, an additional layer was established in which a Single Resolution Board comprised of the ECB and other appointees advises the Commission on initiating the resolution of any bank that the ECB directly supervises, subject to a veto of the member states in the Council. So, any alternative banks large enough to be supervised by the ECB are subject to radical intervention in time of insolvency, and a possible merger with a commercial, for-profit bank would be legally problematic.

In addition, resolution systems require an ex ante insurance fund into which banks pay premiums that can be used to offset the impact of closure of other banks and reduce pressure on governments to inject cash. Deposit insurance schemes are expected to chip in alongside the dedicated resolution fund. Initial Commission plans for a common resolution fund were eventually granted by the member states, but at a very low level of funding, with cross-border transfers possible only after a period of 12 years, later reduced to eight, with the guarantee that they would not be used for problems associated with the euro zone crisis (Buch and Weigert 2012; Howarth and Quaglia 2014), and with protection for alternative resolution systems, primarily benefiting alternative banks. Plans for a European deposit insurance, on which the viability of resolution also depends, went nowhere in the face of the objection of countries, led by Germany, that feared a transfer of their own resources to the euro zone's weak periphery. Whether national contributions pose a problem for alternative banks depends on whether the formula for calculating contributions to the resolution fund provides lower rates for them. Protection for alternative banks in Germany on resolution insurance shields most from the higher costs of EU plans.

Banking union therefore places considerable pressure on alternative banks depending on how large they are, particularly in supervision. Resolution is a potential threat, but a hypothetical one. Where alternative banks are consolidated, as in Spain, France or to a limited degree in Austria, ECB supervision is now a fact of life and the impact depends on the ECB's assessment of how risky their activities are. Elsewhere, national regulators have more room for discretion, despite the single rulebook. National strategies that consolidated alternative banks into national champions (France) or large domestic banks (Italy) therefore enabled more banking union impact than ones that ensured consistently that alternative banks remain small institutions.

Germany

Germany shows two trajectories determined by divergent strategies for dealing with the phasing out of public guarantees for alternative banks. Landesbanken chose to liberalise their business strategy further, while Sparkassen chose to strengthen their traditional alternative mission and the institutions making that possible. German Sparkassen are public savings banks established under state law with capital provided in part by local governments, which in turn elect key bank managers and assume a legal responsibility to support the bank financially if it becomes illiquid or insolvent. The mission of the Sparkassen is first and foremost to promote local economic development by extending credit to local companies on a not-for-profit basis within an exclusive local territory set out in state law and the specific bank's statutes of incorporation (Deeg 1999). This fundament was significantly altered in 2005, when the German government reached an agreement with the European Commission to end by 2015 the practice of explicit local and state government guarantees for the debts of insolvent Sparkassen and Landesbanken (Seikel 2014). This was a victory for private banks in Germany and other countries that had objected to what they saw as an unfair subsidy to Sparkassen, allowing them to borrow money and lend money at lower interest rates, thanks to indestructible creditworthiness.

Although government guarantees for Sparkasse and Landesbank debts had not been called on since the 1970s, phasing them out focused attention on the mechanism used to ensure their solvency in the absence of such guarantees (Busch 2004). Landesbanken and Sparkassen took different routes in response to the 2005 agreement. Landesbanken liberalised (i.e. increased their engagement in non-traditional financial activities) so that they could increase their capital buffers in the absence of state aid, with terrible consequences later. In contrast, the Sparkassen fortified their traditional mutual reinsurance and liability approach, now constituted by four tiers of alternative bank insurance funds: Each Sparkasse incorporated within a German state (Land) pays for its own insurance fund, as well as a mutual insurance fund covering all Sparkassen within that Land that covers shortfalls in individual insurance funds. If the mutual insurance fund is insufficient, Sparkassen can then call on assistance from the insurance funds for their Landesbank and those insuring the state-backed savings and building societies (Landesbausparkassen), which are linked to Sparkassen as special-purpose vehicles for issuing mortgages.

Sparkassen therefore possess a great deal of financial insurance. It imposes constraints on behaviour, which, in turn, underpin their low-risk business model. Each insurance fund supervises the banks it insures, ensuring that they stick to ordinary banking and remain sufficiently risk-averse to make insolvency unlikely. Risk assessments result in higher insurance premiums, as riskiness increases until the emergency brake is pulled on local bank management and restrictions imposed. This role is conducted by a Monitoring Committee – for the individual Sparkassen, for the mutual insurance fund covering all Sparkassen in a Land, and for the two funds covering Landesbanken and Landesbausparkassen. Finally, a Transparency Committee reviews whether these monitoring committees are all practising due diligence. This system of checks and balances is designed to ensure high stability at low cost.

This insurance system also differs from other national systems in that it insures major creditors directly instead of depositors. Many of those creditors are other regional banks and local companies that form part of the local economic ecology and provide an essential source of patient capital on which the Sparkassen and their business model rely. By insuring creditors first and foremost, the bank insurance system institutionally supports the network of banking relationships that define how Sparkassen do their business. This network would be undone by a system that channels money quickly to depositors but leaves creditors uncertain about keeping their money where it is and subjects them to the likelihood of haircuts on their claims. The bank insurance system is therefore vital to the maintenance of the German variety of coordinated capitalism and patient capital relations on which the Sparkasse sector relies.

German Sparkassen and politicians won recognition for the viability of this model without state guarantees before the onset of the financial crisis. Post-crisis European plans for supervision, resolution and deposit insurance, however, were deemed incompatible. In this context, Sparkassen were naturally concerned about regulatory innovations that might increase costs even further, particularly regarding contributions to resolution and deposit guarantee funds. They were adamant that the system of banking and insurance discussed above was so mutually independent that replacing it was unthinkable – and that new requirements could only be layered on top of existing schemes. The Sparkasse lobby argued that the additional costs would reduce bank liquidity and impact negatively on credit creation and regional development (DSGV 2010). It might also exacerbate any existing capital deficits with negative impacts on financial stability (Deutscher Bundestag 2010).

Sparkassen also feared that they could be exposed via European resolution and deposit insurance to liability for bank failures originating in the private commercial sector, which involved higher-risk investment activities, as had been the case for Landesbanken, but without any opportunity for Sparkassen influence. Sparkasse and national government strategy focused instead on securing continued recognition of functional equivalence to deposit and resolution insurance. Until the financial crisis put banking union on the European agenda, the German government entered into agreements with Brussels in 1998 and 2009 to set minimum standards for deposit insurance, but exempted banks which had their own alternative systems. In the context of negotiating on resolution and deposit insurance, the German government continued these demands to ensure that the combination of resolution and deposit insurance particular to Germany would remain untouched, that the additional contributions of German banks to a common European resolution fund would be limited to the largest banks under ECB supervision (thereby exempting German alternative banks), that national contributions would be locked into national compartments and unavailable for use in other countries for eight years, and that the Single Resolution Mechanism would keep national resolution systems largely intact for all banks, including those subject to ECB supervision (Aumer 2010; Deutscher Bundesrat 2010). This strategy proved successful.

The financial crisis of 2008 exposed one of the key weaknesses of this mutual liability insurance scheme. Whereas the Sparkassen came through the crisis in good order due to their adherence to the traditional alternative model, several Landesbanken incurred massive investment losses. In response to the loss of state guarantees and market pressures, most Landesbanken pursued risky investment strategies in the early 2000s, causing several insolvencies for which the Sparkassen became liable. Before the 2005 agreement between the Commission and the German government, Land governments might be called on to help out their respective Landesbanken. This would not only ensure the ultimate viability of the Landesbanken in time of crisis, but shield Sparkassen, which are also investors in the Landesbanken and part of the mutual liability scheme, from taking a fatal financial hit should the Landesbank fail.

With the end of such state guarantees, however, the failure of a Landesbank could, and in the case of WestLB in 2012 did, generate an enormous financial liability for the Sparkassen of the Land of North Rhine Westphalia, which were liable for 50 per cent of the bank's balance sheet shortfalls. This mortal threat was averted by the winding up of WestLB through a package deal approved by the Commission of capital injections by the Land government, the establishment of a bad bank to wind down WestLB's balance sheet, and the transfer of regular Sparkassen business to the neighbouring Landesbank for Hessen and Thüringen (Helaba). Sparkassen in the east of the country had to be saved by similar moves: Sachsen LB was transferred to Landesbank Baden Württenberg, and Landesbank Berlin cut down in size. Without this exposure via Landesbanken, the Sparkasse system gained needed credibility.

However, Sparkassen continued to value Landesbanken. The resolution of WestLB and the near destruction of SachsenLB made the Sparkassen more intent on ensuring that their system of mutual insurance functioned properly at the lowest level possible – of individual Sparkassen and the inter-bank insurance fund - and no further. Given the large potential impact of the WestLB case, the Sparkassen might also have calculated that Landesbanken were more of a liability than an asset, and would be best cast off – in the sense of being cut down to size with more aggressive European bank supervision, and participation in European bank resolution and deposit guarantee systems. But the Sparkassen did not do this. Rather, they continued to value Landesbanken in principle as a valuable and important part of the alternative banking system, even if that value was becoming increasingly unreliable or tenuous (DSVG 2010).

There are two rationales that shed light on this tenacity in the face of adversity. First, European supervision that required Landesbanken to reduce the size of their balance sheets would have required them to reduce their business with Sparkassen, which had to secure loans and make deposits somewhere. Second, given the emphasis of German Sparkassen on retaining the legal status of public banks and the legal and practical relationships between Sparkassen, Landesbanken and government, it can be inferred that they had confidence that they would be better off having the strongest say possible in the future behaviour of the Landesbanken, rather than exiting the relationship. Keeping these relationships intact would be incompatible with requirements to raise large amounts of capital from outside investors, as other banks under ECB supervision faced. This speaks to the relative primacy of institutionalised relationships over cost. Nevertheless, the burden of some Landesbanken was sufficient for federal politicians to relinquish supervision to the ECB.

Spain

The story of the Spanish savings banks, cajas, contrasts sharply with that of German Sparkassen, but mimics that of the Landesbanken. Like the Landesbanken, most cajas in Spain moved away from their historic mission while their regulatory framework, especially the governance institutions, remained largely unchanged. The growing mismatch between the changing mission and traditional governance greatly facilitated excessive risk assumption (compare Cassell 2016). Prior to the financial crises Spanish politicians, regulators and regional actors (governments and other social groups involved in caja governance) pushed the cajas toward a growth model based on territorial and market expansion. While cajas retained their traditional governance structure and ties to local and regional actors, their business models were increasingly commercial and aggressive (as was their treatment by regulators). From the perspective of national politicians and regulators, the long-term strategy was to modernise and consolidate savings banks in order to make them stronger competitors to commercial banks (Maixe′-Altes 2010). This strategy appeared enormously successful until the property-related bubble burst in late 2007. With the additional weight of the global financial and European sovereign debt crises, the Spanish savings bank sector collapsed. Through a series of capital injections and reform measures, the cajas were consolidated into 11 large regional banks that are more commercial than alternative in character. In contrast to Germany, the desperate need of the Spanish government for a European bailout ultimately led to Spain's full embrace of banking union and nine of 11 remaining cajas falling under direct ECB supervision. As a result, the future of alternative banking in Spain as true alternative banking is in doubt.

The second half of the 1980s was a crucial reform phase for the savings banks. It was during this period that they were de-territorialised via the lifting of all branching restrictions, universalised and placed under the same regulatory and supervisory regime with commercial banks. In 1988 all banks were placed under the supervision of the Bank of Spain, which now had full responsibility for prudential regulation, supervision, bank intervention and resolution, as well as setting bank accounting standards (Martín-Aceña *et al.* 2010). Thus Spanish cajas lacked the expansive mutual insurance and liability schemes of their German counterparts and were dependent on implicit state guarantees. The remaining major difference between commercial and savings banks in Spain was in their ownership and corporate governance – savings banks remained non-profit public institutions.

As a result of reforms and a booming economy, the evolution of the savings bank sector was dramatic. Like commercial banking, there was extensive consolidation, with their number dropping from 77 in 1989 to 47 by 2000 (Maixe′-Altes 2010). With new-found market and branching freedoms, many savings banks expanded aggressively – from 1992 to 2004 the number of savings bank branches grew some 300 per cent and their lending by 500 per cent, while total commercial bank branches declined and their lending growth was 300 per cent. As a group, cajas' deposit market share grew from 32 per cent in 1977 to just over 50 per cent by 1994 (Cardenas 2013: 10–11).

During the 1990s Spain became one of the most competitive retail banking markets in Europe. It was in this context that the property bubble developed between 1998 and 2007, in which the cajas played a major role. On the demand side, weak borrowing limits for households and foreign purchases fuelled expansion. On the supply side, intense competition and 'profit' pressures led many cajas to become increasingly aggressive and riskier in their mortgage lending, lend freely to property developers, engage in property development themselves, and buckle under political pressure to finance showcase infrastructure projects (Cardenas 2013).[3] By one estimate the total real estate exposure of the savings banks increased nearly tenfold from 2000 to 2008 (Cardenas 2013: 14–16). Many cajas compounded the risk of heavy exposure to property by increasingly borrowing funds in wholesale markets, rather than following the traditional alternative banking model of relying on deposits.[4]

In sum, savings bank reforms strengthened this sector in market terms and made the domestic Spanish banking market almost impenetrable by foreign banks. However, they also let many savings banks stray from several traditional alternative banking principles – emphasising expansion over prudence (some even took over cooperative and commercial banks), and letting intra-group competition suppress cooperation (see also Butzbach 2008).

During the first two years after the 2007 onset of the property crisis the Spanish banking sector was holding up surprisingly well. But the global liquidity crisis in late 2009 quickly overwhelmed the savings banks on both sides of the balance sheet, and a full-blown crisis quickly emerged. This prompted the central government to establish a state-owned Fund for Orderly Bank Restructuring (FROB) with €9 billion for bank recapitalisations. The FROB began a multi-year process of restructuring and resolving (overwhelmingly savings) banks (Cardenas 2013: 22). This restructuring process picked up in 2010 after a new law (Royal Decree 11/2010) established a formula for Institutional Protection Schemes (IPS) in which several banks were linked within an overarching organisation to provide mutual liquidity and solvency support. The IPS was a complicated construction but one that reflected the political resistance of regional governments (Autonomous Communities) to cross-regional consolidation of savings banks (IMF 2012: 13). The 2010 law also included regulations to increase the professional character of savings bank management, reduce political influence over the banks, increase the ability of the banks to raise external equity capital, ease mergers among savings banks and institute new prudential regulations (Financial Stability Board, 27 January 2011). A significant element of this law was the introduction of a new corporate formula whereby savings banks could (or could be compelled to) transfer their financial activities to a new commercial bank in which the savings bank(s) would retain ownership.

In February 2011 the government, following new international and European agreements, instituted new capital adequacy requirements.[5] These stringent requirements ushered in a second phase of savings bank restructuring, most notably a shift from IPS arrangements to actual merger of savings banks – a condition for receiving additional FROB funds.[6] Despite these measures, bank balance sheets continued to deteriorate, prompting the government in October 2011 to merge the previously independent Deposit Guarantee Funds operated by each of the three banking sectors (commercial, savings and cooperative) into a single fund jointly governed by the Bank of Spain (through appointees) and the three associations. Along with dramatically increased fees, this effectively forced the commercial banks to support the solvency of the deeply troubled cajas (Ross-Thomas and Penty 2011).

July 2012 was the historic turning point in the Spanish crisis. Battling mounting debts and unable to raise adequate capital on the markets to finance its bank rescues, the Spanish government sought a bailout from the European Stability Mechanism. The quid pro quo for the bailout (up to €100 billion was made available) was a memorandum of understanding in which the Spanish government committed to a range of measures that effectively started a process of banking union. The immediate step was to conduct stress tests by an independent auditor to determine the capital needs of all the banks; a requirement for burden sharing by holders of hybrid instruments in banks exhibiting capital shortfalls; application of a higher tier 1 capital asset ratio of 9 per cent; the segregation of damaged assets from banks requiring public capital injections into a new 'bad bank'; and further strengthening of transparency requirements and corporate governance of the savings banks.[7]

Shortly after agreement on the principles of banking union at the late October European summit (see Epstein and Rhodes 2014 for more details), the Spanish government passed two more laws (Law 9/2012 and Royal Decree 1559/2012) that adopted much of the EU's prescriptions for definition of bank crisis scenarios, restructuring and resolution instruments. The laws granted new powers to the FROB to manage restructuring and resolution of credit institutions, and created a 'bad bank' (*Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria*) to take on impaired assets from state-aided banks (Cardenas 2013; IMF 2012).

The final and perhaps most significant savings bank sector reform came at the end of 2013 (Law 26/2013, The Law of Savings Banks and Banking Foundations). The law stipulates that any savings bank with more than €10 billion in consolidated assets, or which exceeds 35 per cent market share in its Autonomous Community, must transfer banking assets to a commercial banking unit and retain its ownership stake via a banking foundation. The law has further provisions to limit political influence over the banks, most importantly by banning executives of political parties, trade unions and professional associations, elected officials, senior government officials and anyone having held such a position in the previous two years from being a member of the governing bodies of the savings bank. The law also importantly reinstates a territoriality principle by limiting these banks to conducting retail banking to one autonomous region or a maximum of 10 adjacent regions (pdf: 8–10).

By mid-2014 the consolidation, restructuring and resolution of the savings bank sector was largely completed. From 45 cajas prior to the crisis, only 11 remain – nine of which now operate as commercial banks with savings bank foundations as owners. These nine 'cajas' fall under the first pillar of the SSM (European Commission 2014).[8] These savings bank foundations are subject to further requirements if their collective holding in their commercial bank exceeds 30 per cent of capital, and even more if it exceeds 50 per cent; in this case the foundations have to build an extra capital reserve fund. In short, the new regime encourages foundation-controlled commercial banks to bring in outside investors.

Ultimately, the Spanish state – with European assistance – rescued the savings bank sector and preserved a strong domestically focused bank industry, albeit at a heavy cost to alternative banking. The re-territorialisation around retail banking provides some impetus for refocusing on the historic mission of alternative banks.[9] Savings banks also remain institutionally rooted to local and regional governments and groups, but the professionalisation of their management and the new incentives to bring in private capital pushes them away from alternative banking. Moreover, the remaining savings banks are no longer local but large regional banks, more 'distant' from their firm customers and perhaps less likely to lend or develop the relational banking that is a hallmark of alternative banking.

Conclusion

Does banking union threaten alternative banking? To answer this question we analysed alternative banking prior to and after the introduction of banking union in two countries, Spain and Germany, with radically different trajectories and outcomes. A simple look at savings banks in the two cases might lead one to conclude that banking union itself poses no inevitable threat to alternative banks, given that Spanish savings banks fell under the full impact of banking union while their German counterparts did not. One might explain this divergent outcome with reference to national institutional differences. But this cannot explain why German Landesbanken got into so much trouble and came under the full weight of banking union while the Sparkassen did not. In this paper we argued that this divergence in outcomes is to a large degree a function of the strategic choices made by state actors and the banks themselves long before the 2008 crisis. German Landesbanken and most Spanish cajas followed growth strategies that entailed increasing amounts of risk in their balance sheets, moving them away from alternative banking practices and ideals. The German Sparkassen hewed to the traditional mission, prospered, and were thus able to avoid much of the direct impact of banking union.

In this article we highlighted one of the most important factors shaping these strategic choices, namely the European Commission's crusade against financial links between local government and alternative banks in the early 2000s. Occurring in the context of advancing European financial market integration – i.e. rising (or threatened) competition from foreign banks – the end of automatic government guarantees to alternative banks forced them to make crucial strategic choices. In Spain, the cajas intensified their reach for growth and took on increasing amounts of risk, including increased borrowing from (and exposure to) global financial markets. In Germany, two paths were taken to compensate for the lack of state guarantees to alternative banks.

Landesbanken, which provided wholesale services to both regional government and local Sparkassen, and had no garden-variety alternative bank activity on which to fall back, were allowed to liberalise further and invested in a wide range of risky financial instruments like their commercial counterparts. Sparkassen on the other hand, redoubled their commitment to their alternative model by strengthening a system of mutual insurance and supervision that could act prudentially (avoiding exuberant, excessive lending), thereby minimising the likelihood that insurance funds would be called on. Their traditional approach and mutual schemes largely shielded them from the tribulations of international financial markets and thus they had little incentive to support a European banking union (compare Howarth and Quaglia 2016). Politicians and regulators, meanwhile, upheld conservative prudential standards (particularly lending standards) and separate pillars of bank regulation at home, while successfully fending off European Commission demands to end special treatment for German savings banks.

The riskier growth models adopted by the Landesbanken and cajas made them highly vulnerable to the bursting of asset bubbles (in the US and Spain, respectively) and the global liquidity squeeze in 2008. The damage from the financial crisis per se was further exacerbated by the subsequent general economic decline and sovereign debt crises in Europe. In this weakened state, the European Commission's efforts between 2012 and 2014 to establish a banking union had their greatest impact on those alternative banks that had strayed furthest from traditional banking, suffered deep losses in the crisis, and thus lacked the political muscle and financial resources to resist.

That crisis moment led both the Spanish and German governments, against their preferences, to reduce the footprint of alternative banking, with increased liberalisation as a result. Cajas were essentially transformed into commercial banks with an ostensible alternative mission that might well clash with the fiduciary responsibilities of their parent bank managers to turn profits. Landesbanken survived as a species, but not all of the individuals did. The consolidation of the sector still leaves open the question of their future viability for two reasons. First, their failed model is discredited but has not really been replaced. Second, like the cajas, Landesbanken now fall under the heightened supervision and standards of the European Central Bank and the comprehensive demands applicable to systemically important banks in the EU.

Banking union is therefore a threat – although not a homogenous one – to alternative banking. It entails crisis-induced liberalisation by forcing banks to raise outside capital, contribute extra funds to resolution and deposit insurance, and by threatening the breakup of insolvent alternative banks – but it did not start the liberalisation process. Rather, liberalisation of alternative banks went through two prior phases: before the crisis in response to rising competition and the European Commission crusade against state support for banks; and immediately after the crisis in the absence of state-provided lender of last resort facilities. Commission policies therefore forced governments and banks that had liberalised in the mid-2000s to choose between further liberalisation or widespread financial collapse. The affected banks were already large and will be forced into further liberalisation under banking union. For German Sparkassen, however, banking union will not be a threat to their model in the foreseeable future.

The outlook for alternative banking therefore appears quite varied across Europe (Butzbach and von Mettenheim 2014). The stakeholders of alternative banks that previously liberalised (municipalities, SMEs and households underserved by commercial banks) should expect to acquire credit at higher cost and with greater difficulty than before. Credit will depend more on commercial banks, and perhaps foreign banks that place a lower priority on local lending (Epstein 2008). It has been shown that, as bank competition lessens, or the distance between banker and borrower grows, the availability of finance tends to diminish and the cost tends to rise (Ryan *et al*. 2014).

Countries like Germany and Austria, where most of these banks remain small, should see far less immediate impact. Where alternative banks still exist in liberalised countries, room should exist to rebuild and partially insulate the sector by emulating the German Sparkasse approach (Butzbach and Mettenheim 2013). However, there are limits to such a strategy. Looking at the remaining small savings banks in other countries one sees that all rely on larger partners that provide wholesale financial services for them. Thus, even where small alternatives remain under national supervision, the ECB always supervises the larger entity to which they are connected. Landesbanken are one example, but others such as the Erste Group and Erste Bank in Austria, the Rabobank Group in the Netherlands and the Banque Postale, which organises the alternative Caisses d'épargne in France, fall directly under banking union even as many of their alternative bank entities deal with national supervisors (Howarth and Quaglia 2016). Beyond the issue of banking supervision, banking union's future impact lies critically in the extent of the ECB's Single Rulebook application to the smaller alternatives. In sum, while there is still an economic need and political and social support for alternative banking in Europe, taken altogether, banking union narrows the scope for member states to protect and promote alternative banks.

Notes

1. State aid to banks is prohibited in normal times but permitted during crisis (see Donnelly 2011).
2. The financial crisis of 2007, and the euro zone crisis from 2010 onward is characterised by both features: interest rates skyrocketed for banks, some more than others in Europe in 2010, and lending stopped altogether across Europe in autumn 2008.
3. Even though a 2002 reform limited the combined voting rights of public authorities to 50 per cent in savings banks' governing bodies, banks with high

public ownership often had senior managers appointed by governments with direct ties to political parties, often with little banking sector experience. One study found that banks whose chairman was appointed by a political party performed significantly worse (Cardenas 2013: 11).

4. Accordingly, the funding gap for the sector rose from just over 10 per cent in 1980 to 36 per cent in 2010 (IMF 2012).
5. These included new capital requirements of 8 per cent of risk-weighted assets (RWA), rising to 10 per cent for banks or banking groups with funding gaps in excess of 20 per cent or which did not have third-party investors holding at least 20 per cent of their capital.
6. Four banking groups or IPS of savings banks – Catalunya bank, Unnim, Nova CaixaGalicia, Banco de Valencia – required a total of €5.7 billion in capital injections from the FROB, which transformed them into commercial banks and effectively nationalised them.
7. Following the stress test in September, eight banks or groups required additional injections of public capital: the lion's share (over 90 per cent) of public capital injection in 2012 went to the four banks/groups that had already been nationalised (Spain FROB facts').
8. Seven savings banks were nationalised in the course of the restructuring process and two – Bankia and Banco Mare Nostrum – remained in majority government (FROB) control at the end of 2014. Six banks were ousted from the savings bank sector by the FROB, which sold them to Banco Bilbao Vizcaya Argentaria, Spain's second largest commercial bank.
9. While cooperative banks remain a much smaller part of the Spanish banking system, since the onset of the crisis they have undertaken restructuring as well, reducing their number from 26 to 19 banks plus a newly created bank to serve as their central bank. The 20 banks are grouped under the Institutional Protection Scheme legislation and are treated as a consolidated group subject to the SSM and count among the directly supervised banks (http://www.thespanisheconomy.com/financialsector).

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