

66

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PERSPECTIVES



THE AFTERMATHS OF CRISES SAVINGS AND SAVINGS BANKS: ELEMENTS OF STABILITY IN TIMES OF CRISES?



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SAVINGS AND SAVINGS BANKS:
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Photo on cover: People queuing outside the premises of the Caisses d'Epargne in Paris, at the announcement of World War I. Source: Fédération Nationale des Caisses d'Epargne (France)

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TABLE OF CONTENTS

Foreword	7
Introduction	9
<i>Laure de Llamby</i>	
The role of financial crises in history: Banking and debt crises since the 19th century	11
<i>Johannes Bähr</i>	
The impact of crises on savings banks institutions in the United Kingdom	29
<i>Richard Roberts</i>	
The impact of crises on the savings banks institutions in Germany	47
<i>Paul Thomes</i>	
The crisis and the French savings banks	63
<i>Vincent Tournié</i>	
The impact of crises on the Savings Banks Institutions in Italy	75
<i>Giovanni Manghetti</i>	
The savings bank crisis in Spain: when and how?	85
<i>Pablo Martín-Aceña</i>	
Banks and Crises: Sweden during 150 years	99
<i>Mats Andersson</i> <i>Enrique Rodriguez</i>	

FOREWORD



Dear reader,

It seems as if the crisis affects the full range of our professional activities. We should of course not forget the heavy toll crises take on well-being and quality of life, but we should also consider them as opportunities to improve things.

Regulators and supervisors are working alongside representatives of the industry to repair the damages caused by the worldwide financial crisis. They have done so after each of the various crises that are analyzed on the following pages. Does that mean that history is just the story of people making the same mistakes over and over? I don't think so. The financial sector has become safer and stronger after every crisis, even if it is still not perfect.

The papers in this publication have been written at the occasion of a workshop organized by ESBG, the European Savings and Retail Banking Group in May 2013. The main lobbying objective of our organization is to convince policymakers, regulators, supervisors and all other industry participants that a diversified sector, with a strong retail banking segment ultimately leads to a more stable sector.

I hope that this publication gives you food for thought and wish you happy reading.

Chris De Noose
Managing Director
ESBG

INTRODUCTION



Laure de Llamby

France's savings banks, or Caisses d'Epargne, became cooperative banks in 1999. Their particular change of status has no equivalent in Europe. As cooperative banks, the Caisses have been able to maintain their individuality while being governed by ordinary law. The change has also allowed them to join the "family" of cooperatives, whose values they share, while promoting their special identity forged over nearly 200 years of history.

The merit of this specific model is apparent during these troubled economic times: its values resonate perfectly with the concerns of the French people in these times of crisis.

The Caisses are banks with a local presence; they promote regional development and support businesses in their community. Their strong sales activity enables them to meet the demands of all types of customers – individual, business or institutional – and offer solutions tailored to specific local needs.

The Caisses' longstanding commitment to society is as strong as ever. These savings banks have evolved to better meet today's urgent needs. They now contribute more than EUR 20 million to support philanthropic causes and local projects and are the number one provider of social microcredit. Their motto, "*l'Humain sera toujours une valeur sûre*" ("People will always be a sound investment"), reflects the commitments they make to members and customers. An effective, efficient bank supporting regional economic development and social solidarity: this is the kind of bank the Caisses aim to be, and these are the two pillars from which they will address today's challenges.

The French people have demonstrated that they support our approach. In 2012, they elected Caisse d'Epargne as their "favourite bank" and the bank "most useful to society".

Throughout their history, European savings banks have endured numerous challenges in the financial, economic, political, and social realms, from which they have frequently emerged stronger. In times of crises, they have revealed their resilience and value. In times of difficulty, they have shown their ability to adapt and innovate. In times of trouble, they have built and strengthened the trust of their customers. This trust is an honour and a responsibility for the savings banks in our various countries.

This workshop provides an opportunity to highlight the various ways in which savings banks, according to their country of origin, have weathered major national and international shocks and emerged even stronger. Do they differ from so-called traditional banks in their approach to and management of these crises, the adjustments they made, and the solutions they found? In other words, can we define a crisis-proof savings bank model? And if so, can this tried-and-tested model offer one or more solutions to the current recession? May the following presentations shed light on these issues, and may the lessons from our past lead us to a promising future.

THE ROLE OF FINANCIAL CRISES IN HISTORY: BANKING AND DEBT CRISES SINCE THE 19TH CENTURY

Johannes Bähr

At a 2008 hearing before the American Congress, former Chairman of the US Federal Reserve, Alan Greenspan, called the unfolding financial crisis “a once-in-a-century credit tsunami”, meaning that the crisis hit people like a natural disaster.¹ It is well known that a tsunami is almost totally unforeseeable, comes with very little warning and is completely unpredictable. And indeed crises of this nature cannot be accounted for in economic models. Warnings were given only by a few experts, which led to much criticism later and references to a “failure of academic economics”.² But economic history was of great interest to economists; while they could not have predicted tsunamis, they should at least have provided insight into empirical experience.

The best known publication on the history of financial crises was produced in 2009 by two prominent US economists, Carmen M. Reinhart and Kenneth S. Rogoff. In their book *This Time Is Different*, a compendium of the financial crises of the last eight centuries, they list around 320 debt crises and more than 200 banking crises arranged by country.³ Reinhart and Rogoff have now come in for criticism due to errors in their data, but their figures provide impressive evidence that economic and financial crises are not at all unusual and have occurred throughout history. For economic historians this is nothing new, it is actually pretty obvious.

- 1 Scott Lanman/Steve Matthews, Greenspan Concedes to ‘Flaw’ in His Market Ideology. URL: <http://www.bloomberg.com/apps/news>, 23.10.2008.
- 2 David C. Colander et al., The financial crisis and the systematic failure of academic economics, Kiel working paper No. 1489, Kiel 2009; Geoffrey M. Hodgson, The great crash of 2008 and the reform of economics, in: Cambridge Journal of Economics 2009, 33, pp. 1205-1221.
- 3 Carmen M. Reinhart/Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton 2009.

For them crises are a “normal part of the economic process” and essential because they correct the defective trends which occur with every structural change.⁴ Indeed, there are many indications that crises are the indicators and not the causes of defective trends; in a similar way to fever, which indicates an infection and helps eradicate it.

Another reason for the success of Reinhart and Rogoff’s book was the evidence they provided to back up the widely held view that for centuries financial crises have followed more or less the same pattern.

According to the authors, however well financial systems are regulated they cannot withstand the pressure created by greed and the irrational exuberance that leads to speculative bubbles.⁵ However, this approach does not take into account the fact that the causes and nature of financial crises over the last few centuries have changed radically time and again. Financial crises should be regarded as an integral part of economic development, and it is precisely for this reason that they change in line with that development. New causes, actors and mechanisms all emerge over time. For historians there is little point in counting up all the crises of the last two hundred years. It is much more useful to try and identify specific underlying patterns and the way they change. We can only learn lessons from the past if we take these changes into account. If we hide them, we end up simply playing unhistorical and unrealistic number games. To illustrate the point, let us take Reinhart and Rogoff’s finding that Spain has experienced thirteen cases of national bankruptcy, more than any other European state. Yet if we take a closer look at the data, it is clear that these debt crises are in no way related to the present. Out of the occasions on which the Spanish government’s coffers ran empty, not one occurred in the 20th century, while six date back to the 16th and 17th centuries and the rest to the 19th century. The picture in France, where the last debt crisis arose in 1788 under Louis XVI, is very similar.⁶

The aim of this article is to demonstrate how the patterns that characterise Europe’s financial crises in the 19th and 20th centuries can be categorised from a historical perspective. We shall then examine the extent to which financial crises recur; to what extent they differ from each other and how much we have learnt from them.

4 Werner Plumpe, *Wirtschaftskrisen*, Munich 2010, p. 8, p. 116.

5 Reinhart/Rogoff, *This Time*, pp. 291f.

6 *Ibid.*, pp. 87, 91, 96.

Our main focus will be on the two most important types of financial crisis, i.e. banking crises and debt crises. Given the large number of past crises from which to choose, we shall of necessity focus on a number of selected cases.

The evolution of national debt and the speculative crises of the 19th century

Although debt crises have been a regular occurrence since the late Middle Ages, frequently taking the form of spectacular bankruptcies of entire states, it was not until the 19th century that we had the first banking crises on a scale that threatened the entire banking system rather than merely the collapse of a single bank. Indeed, the first banking systems as such only became established during the course of the 18th century as the trading of goods and precious metals stimulated the formation of an increasing number of private banks.

Before 1800 all the bank collapses we know of were cases of straight-forward insolvency that did not produce a chain reaction. Most were linked to state bankruptcies caused by spending on costly wars. The term “state bankruptcy” means that a state is no longer able to meet its obligations to its creditors. Unlike companies, states are not forced out of existence by bankruptcy. Nevertheless, it does oblige them to take remedial action, and this generally helps to restore a degree of health to the national finances.

The earliest example on record is the bankruptcy of England under King Edward III in 1345. The English crown was unable to pay the debts it had incurred during the Hundred Years’ War against France. For a long time, it was thought that this was the trigger for the collapse of Edward III’s two biggest creditor banks, Bardi and Peruzzi in Florence.⁷ Two hundred years later the Spanish King Philip II led his country into no fewer than three bankruptcies. One of his biggest creditors, the Welser Bank in Augsburg, collapsed as a result in 1557. Eventually, as government bonds became a common form of borrowing, the risk of default following the bankruptcy of a state was borne by a large number of investors rather than individual banks. Risk premiums were already factored into the price.

7 More recent research does not confirm such a link and instead sees the reasons for the collapse of both banks as a change in the flow of trade and internal problems of the Republic of Florence. Edwin S. Hunt, A New Look at the Dealings of the Bardi and Peruzzi with Edward III, in: The Journal of Economic History, Vol. L No. 1 (March 1999), pp. 149-162.

Consequently, Europe's banking systems proved amazingly robust when faced with a whole series of debt crises and state bankruptcies during the Napoleonic Wars. Indeed, many banks – Rothschild being perhaps the best-known example – profited handsomely from debts run up by the countries engaged in those wars. Austria alone stopped servicing its debts on no fewer than four occasions between 1802 and 1816. The period between 1797 and 1812 was marked by an “explosion” of debt, not only on account of military spending but also due to inefficient financial systems. In most countries, the state's finances were not yet separate from the private assets of the monarch and the ruling dynasty.⁸ State bankruptcies were often concealed. In 1806, for example, Prussia became insolvent as a result of the Napoleonic occupation, and was only able to avoid a second bankruptcy after the Congress of Vienna with the help of two loans from Rothschild.

A new pattern emerged after the Napoleonic Wars. In Northern and Western Europe, levels of national debt and the number of state bankruptcies fell considerably. Overall, the 19th century was marked by a reduction of the debt burden in these countries as a direct result of financial reforms, the absence of protracted wars and economic growth generated by industrialisation.

This trend is well documented in British statistics, which are particularly revealing as they date all the way back to the 17th century and have not been influenced by changes in currency or territory. In 1820, public debt in Great Britain stood at around 200% of the country's gross domestic product, whereas by 1855 the proportion had fallen to around 100%. In Europe, cases of insolvency were now almost exclusively limited to Spain, Portugal and Greece, where they occurred with great frequency. Looking at the period between 1825 and 1900, Reinhart and Rogoff list a total of sixteen foreign debt crises and debt restructuring measures in these three countries alone. Only four such crises of this nature occurred in the rest of Europe as a whole, including Russia and Turkey.⁹

By this stage, those countries with the strongest economies (Britain, France and soon afterwards the United States and Germany) had relatively well-developed banking systems.

8 Hans-Peter Ullmann, *Staat und Schulden. Öffentliche Finanzen in Deutschland seit dem 18. Jahrhundert*, Göttingen 2009, p. 54.

9 Reinhart/Rogoff, *This Time*, pp. 155ff.

There were no further cases of national insolvency, although banking crises – triggered by speculative bubbles that formed on the stock markets – occurred at regular intervals. Whereas speculation had previously been driven by independent share traders known as stock jobbers, it was now fomented by the banks – not only the new joint-stock banks but also the older private banks, whose earlier business activities in the 18th century had been much more conservative. Crises of this new type were triggered by speculative investments in new areas of business created by industrialisation and the growth in world trade. Individual bank collapses could easily reduce the supply of credit and consequently jeopardise the banking system as a whole. In many countries, however, newly established central banks provided a crucial foundation that helped to protect the financial system in such crises. Following the model of the Bank of England, they acted as the lender of last resort (LLR) by providing liquidity to hard-pressed banks.

An early example of this is the British bank crisis of December 1825. Speculation with Latin American bonds had created a bubble, loans were cheap and many new stock companies were formed. When this bubble burst, 66 UK banks crashed. The fact that the situation wasn't even worse was thanks to the Bank of England, which issued bank notes worth a total of 5 million pounds. Jeremiah Harman, a former governor of the Bank of England, made the following observation on the role of the central bank in this crisis: "Seeing the dreadful state in which the public were, we rendered every assistance in our power".¹⁰ Over the next few decades, it became generally accepted that one of the functions of the central banks emerging in nearly all the industrialised countries of Europe was to act as a lender of last resort.

They were effectively a new instrument that made it possible not to prevent but at least to mitigate the impact of banking crises.

As capital began to flow more widely across borders and communications were improved by the advent of new technology, crises were able to migrate easily from one country to another. The first global economic and financial crisis occurred in 1857 as a result of "railroad fever", a period of intense speculation in the shares of rail companies.

¹⁰ Quoted in: Walter Bagehot, *Lombard Street. A description of the money market*, London 1873, II.41.

One of the main drivers of this speculation was rapid expansion of the joint-stock banks that had been set up to finance the construction of new railway lines. When the railroad boom faltered after the Crimean War, the bubble burst. The collapse of Ohio Life Insurance and Trust Company in New York unleashed a panic that also affected individual savings banks.¹¹ Commercial bills of exchange lost their value, and as a result the crisis spread to Europe and South America. In London, the Bank of England intervened, while the big trading houses in Hamburg received assistance from a city government support fund. In a lead article for the *New York Daily Tribune*, Karl Marx wrote: "This kind of communism, where the mutuality is all on the one side, seems rather attractive to the European capitalists."¹² The US economy, more than any other, took some time to recover fully from this crisis, yet contrary to Marx's predictions it did not prove to be the beginning of the end of capitalism. Confidence in the banks returned quickly, and Europe experienced another boom – followed soon after by its next major financial crisis.

Run on the Seaman's Savings Bank during the Panic of 1857.



Source: *Harper's Weekly*

11 Charles P. Kindleberger/Robert Z. Aliber, *Manias, Panics and Crashes. A History of Financial Crises*, 6th ed., New York 2011, p. 164.

12 *New York Daily Tribune*, No. 5202, 22. Dec. 1857.

Strong economic growth in Central Europe during the early 1870s led to an outpouring of optimism and feverish speculation in shares and property. In Germany this mood was stoked even further by the foundation of the Reich and by French reparations. Money was cheap, and the market had been deregulated by the removal of concession requirements for joint-stock companies. Between 1870 and 1873, new joint-stock companies sprang up like mushrooms – nearly a thousand in total including many joint-stock banks with a dubious funding base. The speculative bubble burst in 1873 – first in Vienna, then in New York. The stock exchanges in both these financial centres had to cease trading. In October 1873 the crisis reached Berlin, where many of the newly founded joint-stock companies disappeared in the wake of the crash. This was followed by a sustained period of falling prices and shaky economic growth. Recent research has linked the extent and duration of this Great Deflation with the rise of the gold standard as the first international currency system.¹³ In 1873, as a direct response to the crisis, Germany amended its joint-stock legislation and once again introduced a series of stricter regulations. From this point onwards, joint-stock companies were obliged to disclose their year-end accounts.

National debt and political interests had very little impact on the classic speculative crises of the 19th century. Equally, governments were not directly involved in measures to tackle these crises. This was the task of the central banks, which consulted each other and took action to provide the market with liquidity. It was not until after the 1873 crisis that legislative bodies in several countries introduced stricter regulation. Although Europe continued to experience banking crises at almost regular intervals, their impact was mitigated by central bank intervention. The collapse of Union Générale in France at the beginning of 1882 following a stock market crash led to the country's first serious banking crisis but failed to provoke a wider financial crisis at international level.¹⁴ Eight years later Baring Brothers, one of the most famous British banks, was pronounced bankrupt, yet the Bank of England managed to prevent the international financial system from crashing with the help of a standstill agreement signed by a consortium of London's joint-stock banks and further assistance from the central banks in Paris and St. Petersburg.¹⁵

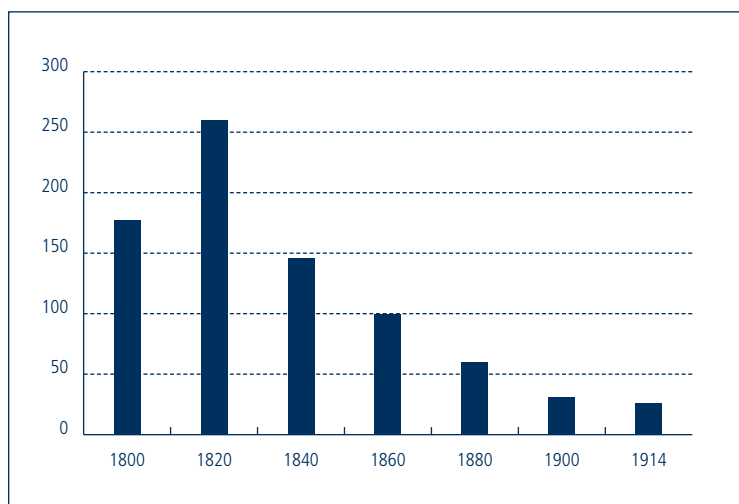
13 Plumpe, *Wirtschaftskrisen*, pp. 65ff.

14 Eugene White, *The Crash of 1882 and the Bailout of the Paris Bourse*, in: *Cliometrica, Journal of Historical Economics and Econometric History*, Association Française de Cliométrie, Vol. 1(2) July 2007, pp. 115-144; Kindleberger/Aliber, *Manias*, pp. 78-81.

15 Eichengreen, *Globalizing Capital*, pp. 33f.; Kris James Mitchener/Marc D. Weidenmier, *The Baring Crisis and the Great Latin American Meltdown of the 1890s*, in: *Journal of Economic History* Vol. 68, June 2008, pp. 462-500.

Central banks now had to adjust to the gold standard, which spread out from Britain to encompass all the major industrialised countries and established itself as a new international monetary system. The act of linking national currencies to gold limited the scope of these countries to increase their money supply.¹⁶ A “credit tsunami” was practically impossible, and both prices and currencies remained stable. Once again, this can be illustrated particularly well with the help of statistical data from the UK, where the ratio of public debt to GDP fell to a historic low up to the beginning of the First World War. Of course, this level of stability was only made possible by the absence of wars between the European powers in the period between 1880 and 1914.

United Kingdom Public Net Debt in percent GDP 1800-1914¹⁷



By contrast, on the periphery of the gold standard in the Mediterranean region and Latin America, state bankruptcies remained a common event in countries plagued by economic and political instability and by military conflicts. In Spain, a series of civil wars, revolutions and coups between 1820 and 1882 led to recurring deficits and insolvency. In 1875 the Ottoman Empire stopped paying its creditors.

¹⁶ See Barry Eichengreen, *Globalizing Capital. A History of the International Monetary System*, 2nd ed., Princeton 2008.

¹⁷ Source: <http://www.ukpublicspending.co.uk>.

In 1893, the Greek Prime Minister Charilaos Trikoup declared his country bankrupt when it was no longer able to service its foreign debts after a sharp fall in agricultural prices. Three years earlier, a major decline in commodity prices had plunged Argentina into bankruptcy. The London bank Baring Brothers, which had invested heavily in Argentinian bonds, met the same fate.¹⁸

The worst banking crisis in the decades preceding the First World War began in the United States, which at the time had no central bank. The Knickerbocker Trust Company, one of the biggest trust companies in New York, collapsed in the autumn of 1907. This triggered a run on the banks. Within a very short time, deposits were withdrawn all over the country. The banks ran short of funds and many collapsed. It is only thanks to the intervention of J.P. Morgan, the richest banker in the country at the time, that the situation did not deteriorate much further.¹⁹ In response to this crisis, US legislators introduced stricter regulation. Following the recommendations of a commission set up by the Congress, the country established its own central bank in 1913, the Federal Reserve System.

Inflation, depression and the gold standard: the crises of the 1920s and 1930s

The First World War and its aftermath brought about a fundamental change in Europe's economic situation and consequently in the nature of future crises. The major European states had accumulated large debts and lost ground to the United States in terms of economic power. World trade was hampered by new tariff and non-tariff barriers, while currency problems created new risks. Faced with these problems, governments increased their spending, with the result that levels of national debt that had already increased during the war rose further still. In Britain, the ratio of national debt to GDP almost reached the level of 1820, while in Germany the sheer amount of debt caused inflation on an unparalleled scale – a development that the government initially regarded as opportune as it helped the Reich to pay its creditors.

18 Rogoff/Reinhart, *Time Is*, pp. 91ff.; Francisco Comin, *Default, Rescheduling and Inflation. Debt Crisis in Spain during the 19th and 20th Centuries*, Universidad Carlos III de Madrid, Working Papers in Economic History, June 2012; K. J. Mitchener/Weidenmier, *Baring Crisis*; MichaelisPsalidopoulos/KorinnaSchönhärl, *Die griechische Staatsverschuldung in der zweiten Hälfte des 19. Jahrhunderts*, in: Thorsten Beigel/Georg Eckert (Eds.), *Vom Wohl und Wehe der Staatsverschuldung*, Münster 2013, pp. 149-164.

19 Paul Krugman, *The Return of Depression Economics and the Crisis of 2008*, New York 2009, pp. 155ff.

The hyperinflation of 1923 finally allowed Germany to pay off that part of its debt not denominated in foreign currencies. It was one of the most radical examples of debt reduction in recent history, although in Germany it also destroyed a great deal of capital and subsequently created a growing pile of foreign debt.²⁰

Even the United States saw its national debt rise after the First World War, but, unlike Europe, it was also experiencing an economic boom that generated a speculative bubble on the real estate and share markets. When this bubble burst in the stock market crash of October 1929, known on Wall Street as the legendary Black Friday, the US economy plunged into a depression that broadened into the world's then biggest-ever economic crisis.²¹

Two years earlier, in 1927, Japan was hit by the Shōwa financial crisis, the worst banking crisis in its history. For years, the central bank had been pumping cash into the market, partly in response to the Kanto earthquake. Then the glut of credit ceased, many of the country's banks collapsed and hundreds disappeared permanently from the market.²²

In the early 1930s, banks in many countries came under pressure as a result of the global economic crisis. There were major banking crises in Austria (May 1931), Germany (July 1931) and the United States (early 1933). All these were triggered by the collapse of banks that had entered into riskier credit deals than others: Creditanstalt in Austria, Darmstädter und Nationalbank in Germany and the Guardian Trust Company of Detroit in the US. Banking panic struck Berlin and New York. Customers, afraid the collapse might spread to other banks, stormed the counters. Unlike the banking crises of the 19th century, however, these customers were no longer solely business people. Thanks to the growing popularity of savings accounts, they now represented a broader spectrum of the public, with the result that savings banks were also hit by runs.

In Germany and the United States, the crises escalated because the central banks failed to take appropriate action in good time. Instead, their priority was to protect the gold standard, which had been reintroduced in the 1920s.

20 See Gerald D. Feldman, *The Great Disorder. Politics, Economics and Society in the German Inflation, 1914-1924*, New York 1993.

21 John Kenneth Galbraith, *The Great Crash*, 8th ed., Boston/New York 2009.

22 Chusichichi Tsuzuki, *The Pursuit of Power in Modern Japan, 1825-1995*, New York 2000, pp. 225f.

This system had been under pressure for a long time on account of the global economic crisis and had prevented central banks from supplying the banks with additional liquidity. Consequently, only massive intervention by the German government was able to save the country's banking system from collapse. After the failure of Darmstädter und Nationalbank in July 1931, Germany closed all its banks temporarily and opted for a large-scale bailout. Some of the most important commercial banks, including Dresdner Bank and Commerzbank, were nationalised.

There was also support for the savings banks and their "giro centres" (especially the recently collapsed Rheinische Landesbank) and for numerous cooperative banks, but not for the private banks.²³ In the United States, the banking crises of the Great Depression reached a climax in February 1933.

As soon as he was elected in early March of that year, President Franklin D. Roosevelt declared a National Bank Holiday and drove through a comprehensive reform of banking legislation.

People in front of the Savings Bank of Berlin. July 1931.



Source: DSGV (German Savings Banks Association)

23 Harold James, The Causes of the German Banking Crisis of 1931, in: The Economic History Review Vol. 37, No. 1, Feb. 1984, S. 68-87; Johannes Bähr/Bernd Rudolph: Finanzkrisen 1931-2008, Munich 2011.

While it is true that the banking crises of this period were also caused by the behaviour of certain banks, they escalated because they occurred in a problematic environment: not as a result of national indebtedness but on account of an exchange system that made it difficult for central banks to implement support measures. The gold standard, which many saw as a blessing prior to 1914, was now regarded as a curse.²⁴ The situation was aggravated by growing nationalism and particularly by the antagonism between Germany and France, which contributed to the banking crisis of 1931. By contrast with the speculative crises of the 19th century, systemic deficiencies were unresolved even after the crises were over. Unemployment in the United States remained high, and the recovery of the banking system in Germany was very slow.

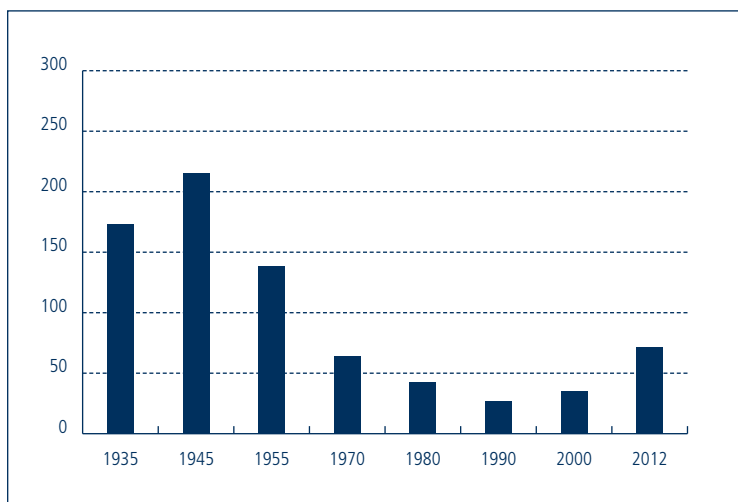
It was not until the period between 1935 and 1937, during the Third Reich, that the nationalised banks could be reprivatised. In both countries, the banking crises prompted a reform of banking legislation in the shape of regulations that were greater in scope than those implemented in the wake of the 1873 crisis. In Germany, this included the introduction of a banking industry supervisor. In the United States, the 1933 Glass-Steagall Act brought about the separation of investment banking and commercial banks.

The long years of post-war stability and the return of crises

As a result of the Second World War, national debt soared to record levels in Britain, the US and above all Germany, which had been heading inexorably towards bankruptcy during the last few years of the war. By contrast with the situation after the First World War, when inflation had eaten away at the country's debts, it was a "haircut" (the other radical method of debt relief) that allowed the country to deal with most of its post-war debt mountain. For German creditors, the outcome was nearly as bad as having their loans eroded by high inflation. Meanwhile, the value of savings deposits fell by 94% in the 1948 currency reform. By contrast, thanks to the relative stability of its currency, Britain again managed to reduce its own pile of wartime debt without recourse to such draconian measures.

24 Barry Eichengreen, *Golden Fetters. The Gold Standard and the Great Depression, 1919-1939*, New York/Oxford 1992; Ben Bernanke/Harold James, *The Gold Standard, Deflation, and Financial Crisis in the Great Depression. An International Comparison*, in: R. Glenn Hubbard (ed.), *Financial Markets and Financial Crises*, Chicago 1991, pp. 33-68.

United Kingdom Public Net Debt in percent GDP 1935-2012²⁵



In the decades that followed, it seemed that the economies of the world's leading industrial nations could no longer be destabilised by serious banking and debt crises. Now we know better, of course, and the role of the post-war boom in economic history will need to be reassessed in the light of the financial and economic crisis of 2008-2009. If we assume that crises are an integral part of economic development, the astonishing thing is not so much that we have now witnessed major new crises but that the leading economic powers remained free of such crises for so long. This was certainly helped by strong economic growth in the first few decades after the war, as well as the price and currency stability established by Bretton Woods. Between 1950 and 1970, European and US debt as a proportion of gross domestic product fell by a greater margin than at any period in the 20th century. In 1970, Britain's debt stood at just 64% compared to 138% in 1955.

25 Source: <http://www.ukpublicspending.co.uk>.

The Bretton Woods system collapsed in 1973, and the high levels of growth enjoyed in the post-war period came to an end in the same year with the onset of the first oil price crisis, which drove unemployment back up and was responsible for a sharp increase in levels of national debt. Even under these conditions, the world's financial systems proved remarkably stable for a long time. Individual bank collapses, such as the insolvency of Cologne's Herstatt Bank in 1974, remained isolated events with no risk of contagion. The same was true of the US savings banks crisis in the 1980s. The Swedish banking crisis of 1990-1992, which was preceded by a property market crisis, shook the banking system but had no impact outside the country. In the United States, Western Europe and Japan – the world's major economic centres – confidence in the banking system was unbroken. This is particularly remarkable given the debt crises of the 1980s in Latin America and a raft of state bankruptcies (e.g. Mexico in 1984). In this context, it would be hard to dispute the effectiveness of the protective measures set up in response to the crises of the 1930s. Sweeping legislative reforms had imposed new regulations covering the banking industry, share trading and taxation, while new powers had been established for the central banks and the International Monetary Fund, which had been set up in 1944 under the Bretton Woods Agreement.

So why was this long period of relative stability followed by the major crisis of 2008-2009? Opinions on this matter diverge considerably. There are those who take the view of Reinhart and Rogoff that financial crises simply cannot be prevented, however sophisticated our regulations and control systems.²⁶

By contrast, the Financial Crisis Inquiry Commission established by the US Congress concluded that the Lehman Brothers collapse could have been avoided and that the government, the financial supervisor and the banks all bore an equal share of the blame.²⁷ There are many who see the deregulation of financial markets in the 1980s and 1990s as the origin of the crisis, although others frequently point the finger instead at regulation, e.g. of the US mortgage market.

²⁶ Reinhart/Rogoff, *This Time*, pp. 291f.

²⁷ Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, January 2011.

There is a good deal of evidence to suggest that a new kind of crisis has emerged. This “twin crisis”, to use the term adopted by many economists, differs from both the classic speculative crises of the 19th century and those of the inter-war period. A twin crisis is characterised by the link between a banking crisis and a currency (balance-of-payments) crisis. It occurs when a banking crisis provokes a currency crisis, thus creating a vicious circle. This pattern was first observed in the financial crises that struck East Asia and Latin America in the 1990s. In an article published in 1999, Graciela Kaminsky and Carmen Reinhart described it as follows: “We find that problems in the banking sector typically precede a currency crisis – the currency crisis deepens the banking crisis, activating a vicious spiral”.²⁸ The present euro crisis appears to provide striking confirmation of this pattern.

High-risk transactions in the banking industry undoubtedly contributed to the latest crisis, and there can be no disputing the fact that speculation – driven by a huge increase in the volume of money in circulation and by the sheer complexity of bank products – long since entered a completely different dimension from that of earlier periods. Yet these factors alone cannot trigger a twin crisis; others need to be in place. Kaminsky and Reinhart also noted that twin crises were generally preceded by a lengthy boom with a credit glut and an overvalued currency, alongside measures to deregulate the financial markets (financial liberalisation) that in turn led to riskier lending practices because they gave the banks easier access to sources of funding.²⁹ A similar conclusion was reached ten years later by Reinhart and Rogoff.³⁰ The real estate bubble that formed in the US from 2001 onwards was indeed caused by historically low interest rates. The once-in-a-century credit tsunami to which Alan Greenspan referred was in part a direct consequence of his own policies.

There is of course nothing new about loose monetary policy and bank deregulation enticing banks to engage in risky transactions that lead to a financial crisis. Throughout history this has been the rule rather than the exception, as the crashes of 1825, 1857, 1873 and 1929 demonstrate. Nevertheless, there were differences in the most recent crisis.

28 Graciela L. Kaminsky/Carmen M. Reinhart, *The Twin Crises. The Causes of Banking and Balance-of-Payment Problems*, in: *The American Economic Review*, Vol. 89, No. 3 (June 1999), p. 473.

29 Ibid.

30 Reinhart/Rogoff, *This Time*, p. 271.

The insolvency of Lehman Brothers on 15 September 2008 did not trigger a banking panic or a run to withdraw deposits. What really threatened to topple the world's financial systems was that the banks no longer trusted each other and were no longer prepared to lend to each other. As a result, the crisis rapidly expanded from the US investment banks and mortgage lenders to every other type of bank including those which had remained solvent. At the same time, adding another new element to the crisis, high levels of national debt in many countries created additional risks. A combination of loose monetary policy and the post-2011 credit glut had proven irresistible not only to the banks but also to governments. Furthermore, many European countries saw the introduction of the euro as an opportunity to refinance their debt on more favourable terms, and this had a similar impact. In the 1990s, gross debt had actually fallen in several European states, especially in Sweden but also in the UK, Italy and Spain.³¹ It was not until after 2005 that debt levels began to rise steeply as part of a more generalised trend. US debt had already set a new record high in 2003 but then continued to grow at a rapid pace. While the banks were encouraging speculation with cheap money, many governments were piling up ever greater levels of debt. With modern states apparently perceiving a need for almost unlimited funds, this took on even greater importance than it had in the past. As predicted by the twin crisis model, when the credit bubble burst the result was first of all a banking crisis and then a debt and currency crisis. The fact that subsequent bailout packages drove national debt levels higher still simply took things one step further but was not the trigger for the ensuing vicious circle.

Lessons from history

High-risk speculation and financial mismanagement have existed ever since the first banks were established and will no doubt remain with us. When the economy is performing well, such cases remain isolated and do not threaten confidence in the banking system as a whole. Yet when we enter a boom phase, the heady mix of speculation, euphoric expectations and credit glut can easily produce a bubble.

31 Christiane Nickel/Philipp Rother/Lilli Zimmermann, Major Public Debt Reductions. Lessons from the Past, Lessons for the Future, European Central Bank/Eurosystem, Working Paper Series No 1241, September 2010, p. 9.

At such times many of those involved, including bankers and investors alike, submit to pure greed. This irrational manifestation of business activity is referred to by the economists George A. Akerlof and Robert J. Shiller as “animal spirits”.³² In their interpretation, it is in the nature of financial market actors to perceive the chance of profit more strongly than the corresponding risks and indeed to screen out those risks when the potential for profit reaches a certain level.

At the same time, however, our historical perspective demonstrates that for this very reason history does not repeat itself at all; that the nature of financial crises changes in line with economic development, and that we can also learn valuable lessons from previous crises. Financial crises are not shaped by some automatic mechanism but by the prevailing economic and legal framework and the responses of central banks and political leaders. Crucially, it is the economic and political environment that determines whether a banking crisis merely serves to correct certain undesirable developments over a relatively brief period – as was the case with the classic speculative crises of the 19th century, which took place within a robust framework – or whether it is accompanied by and exacerbates a major economic crisis, as in the early 1930s. We have experienced lengthy periods during which there have been no large-scale financial crises. Equally, countries do manage to overcome and free themselves permanently of debt crises. So far, we have fared well in our attempts to consolidate the lessons of the last crisis in regulation. This will not prevent the next one from occurring but should allow us to keep it at bay for a bit longer and mitigate its impact.

The link we can now see between the 2008 banking crisis and the debt and euro crisis is not a good sign. In this form, it represents a new constellation of developments within Europe. While the ECB has – for now – managed to restore the confidence in the markets, high levels of unemployment across much of Europe will force central banks to maintain a loose monetary policy, and this will tempt many banks to engage once again in riskier business practices. Nevertheless, there are also more hopeful signs: international cooperation is relatively smooth, even when it comes to support for the banking systems; the euro zone is the only major region experiencing a currency crisis; and we are seeing growth in the world's biggest national economies. From this perspective, today's situation is different from that of 1931.

32 George A. Akerlof/Robert J. Shiller, *Animal Spirits. How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*, Princeton 2009.

By contrast with the aftermath of previous crises in 1873, 1907 and 1931-1933, there is some cause for concern that the lessons drawn from the latest crisis have not as yet given rise to substantive changes in the regulation of financial markets.

We can be certain that this will not be the last crisis and that the scope of the next one and the speed with which we approach it will depend on the extent to which we implement the lessons learnt from our latest experience.

About the Author



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THE IMPACT OF FINANCIAL CRISIS ON SAVINGS BANK INSTITUTIONS IN THE UNITED KINGDOM

Richard Roberts

This essay examines the impact of financial crises on savings bank institutions in the United Kingdom from the early nineteenth century to the early twenty-first century.¹ It focuses principally on the trustee savings banks and their ancillary penny savings banks, as well as the Post Office Savings Bank. Attention is also given to building societies, savings institutions that specialised in the provision of residential mortgages for wage-earners, and to various commercial banks that targeted deposits from small savers.

The first fully-fledged British trustee savings bank was established in Rothwell, Dumfriesshire, Scotland, in 1810 with the aim of encouraging and assisting thrift and self-reliance among the working class.² It was immediately followed by a host of imitators; by the end of 1818 there were no fewer than 465 trustee savings banks in the British Isles. Expansion continued but at more moderate pace, the peak being 645 in 1861. They were run as mutual institutions owned by their depositors with a board of trustees, who mostly comprised local dignitaries motivated by philanthropic ideals as well as the hope of keeping down the local poor relief tax bill.

The establishment of the Post Office Savings Bank in 1861 significantly extended popular access to savings accounts with facilities soon available at 1,700 Post Office branches.³

1 I am grateful to Duncan Ross, Mark Billings and Charles Munn for providing me with copies of relevant papers written by them.

2 H. Oliver Horne, *A History of Savings Banks* (London: Oxford University Press, 1947) p.80.

3 Duncan Campbell-Smith, *Masters of the Post: The Authorized History of the Royal Mail* (London: Penguin, 2011) p.175; pp.92-106; Martin Daunton, *Royal Mail: The Post Office Since 1840* (London: Athlone, 1885) pp.92-106.

The government envisaged the 'gradual extinction' of the trustee savings banks and competition from the Post Office Savings Bank contributed to a steady contraction of their number; in 1913 there were 202.⁴ Nonetheless, far from dying out the deposits trustee savings banks' grew more or less continuously, the combined amount rising from £1.7 million in 1818 to £71 million in 1913. Post Office Savings Bank deposits grew even more rapidly and overtook those of the trustee savings banks from 1887; in 1913 Post Office Savings Bank Deposits were £187 million, more than double those of the trustee savings banks. The trustee savings banks also faced competition for deposits by small savers from friendly societies, building societies, industrial life assurance companies, and, from the late nineteenth century, some commercial banks. The survival and continued expansion of the trustee savings banks is explained by a number of factors – the social idealism of many leading figures, their important community role, their development of penny savings banks as feeder institutions, the security of depositors' savings, and in many years their payment of a higher rate of interest than other savings institutions.

The financial arrangements of the trustee savings banks of England, Wales and Ireland (Scotland as well from 1835) were set by legislation in 1817. Savings bank deposits, net of working funds for day-to-day operations, were paid into a separate account at the Bank of England called the 'Fund for the Banks for Saving' and the trustees were guaranteed full repayment on demand. This safeguarded depositors' funds against fraud, investment loss and credit risk – the trustee savings banks' only borrower was the state. The savings banks' funds were administered by the Commissioners for the Reduction of the National Debt, who had responsibility for the management of government funds. To encourage deposits and expand this handy source of loans for the state, parliament in 1817 set the rate of interest paid by the National Debt Commissioners at 4.56 per cent per annum, which was a substantial premium over the current 3.75 per cent yield on Consols, the British government bond that served as a global benchmark of a default-risk free security. Since the Commissioners usually principally invested the funds they administered in Consols, in many years, the payments by the Commissioners to the savings banks exceeded the income generated by the investment of their deposits requiring a subsidy from taxpayers. This was controversial, but supporters of the savings bank movement and its work in promoting thrift successfully resisted moves to end the subsidy.

4 Dauntton, *Royal Mail*, p.100.

The Treasury also favoured the status quo, appreciating the financial flexibility provided by the savings banks' funds. For instance, at the start of the Crimean War in 1853 the government borrowed from the savings banks' account while awaiting parliamentary authorisation of funds for the army and navy.⁵ One of the motives for the establishment of the Post Office Savings Bank was to boost the savings bank funds available to the Commissioners, thus making the state less dependent on the financial markets for borrowing.⁶

The rate paid by the National Debt Commissioners to the trustee savings banks was modified a number of times over the years, but until 1888 they received a premium over that paid by the Commissioners to the Post Office Savings Bank which allowed them to remain competitive. Sometimes, depending on market conditions, the rate paid by the trustee savings banks was even competitive to that from commercial banks. For depositors in trustee savings banks, these arrangements ensured that their funds were both safe and paid a modest but attractive return. Furthermore, deposits were available to individual depositors on demand from till cash; in cases of heavy general demand funds were promptly remitted by the National Debt Commissioners.

Friendly societies were another significant dimension of United Kingdom savings institutions in the nineteenth century, providing insurance and other benefits for members. Legislation in 1834 allowed them to bank with the trustee savings banks thereby acting as feeder institutions. So did the 'penny savings banks' that were established in large numbers from the late 1840s to broaden the availability of savings facilities for the smallest of savers.⁷ Open typically once or twice a week in the evening in a parish schoolroom, these ancillaries gathered very small sums from 'the very humblest of the working class' that were channelled to a trustee savings bank.⁸ The recognition and regulation of building societies, a further savings institution, began with legislation in 1836.⁹

5 Horne, *A History of Savings Banks*, p.150.

6 Jeremy Wormell, *The Management of the National Debt of the United Kingdom, 1900-1932* (London: Routledge, 2000) pp.13-14.

7 Horne, *A History of Savings Banks*, pp.182-198; Duncan M. Ross, 'Penny Banks in Glasgow, 1850-1914,' *Financial History Review*, vol.9 (2002) pp.21-39.

8 Samuel Smiles, *Thrift* (London: Murray, 1882).

9 E. J. Cleary, *The Building Society Movement* (London: Elek, 1965) p.28.

One of the reasons for government support for the placement of funds with them by small savers was because of the cost to the Exchequer of the savings bank arrangements; a critic in 1838 protested that over the previous twenty years the subsidy had cumulatively cost the state £1.5 million.¹⁰ By 1870, 3,500 building societies had been registered under the act but most were small ‘terminating’ societies that were wound up after members had achieved their housing objectives. The assets or deposits of the various savings institutions in 1913, providing a sense of their relative magnitudes, were:

Table 1: United Kingdom savings institutions funds, 1913

	£ million
Post Office Savings Bank	187
Trustee savings banks	71
Building societies	66
Friendly societies	53

Source: E. J. Cleary, The Building Society Movement (London: Elek, 1965) p.275.

‘Stations down the line’

Britain experienced a series of systemic mercantile-cum-banking financial crises during the nineteenth and early twentieth centuries with certain years, observed banking historian Richard Sayers, as ‘familiar as the stations down the line’: ‘major smashes’ in 1825, 1837, 1847, 1857, 1866 and 1878; with 1890, ‘a shudder rather than a crash.’¹¹ ‘As time went on the repercussion of general economic disturbance upon the banks were less devastating,’ noted Sayers, ‘for the banks the significance of 1890 and 1907, for example, is not so much that they were years of crisis as that they ushered in years of depression.’ There were two principal reasons for the mitigation of the severity of banking crises in Britain towards the end of the century. First, the emergence through amalgamations of a much more concentrated commercial banking system dominated by big banks with national or extensive regional branch networks and usually a London head office.¹²

10 Horne, A History of Savings Banks, p.101.
 11 R. S. Sayers, Lloyds Bank in the History of English Banking (London: Oxford University Press, 1957) p.206.
 12 See Forrest Capie and Ghila Rodrik-Bali, ‘Concentration in British Banking 1870 - 1920’, Business History, vol.24 (1982) pp.280-92.

Second, the Bank of England's pioneering development of a central bank's lender of last resort function, as exemplified by the successful management of the Barings crisis of 1890.¹³

Charles Kindleberger's 'Anatomy of a Typical Crisis' in his *Manias, Panics and Crashes* presents a schematised series of stages of a financial crisis derived from historical episodes (and also based partly on the work of Hyman Minsky): a 'displacement' event or innovation that changes profit opportunities; an expansion of bank credit; speculation and 'euphoria'; speculative 'mania'; 'Minsky moment' – onset of financial distress and disillusion ; scramble for liquidity, 'panic', 'stampede'; and 'revulsion' featuring a public backlash against bankers.¹⁴ Britain's nineteenth century commercial crises conform reasonably well with this schematic model (as they should since it is substantially derived from their experiences) each seeing a larger or smaller number of failures of merchant firms and commercial banks, with 1825, 1866 and 1878 especially devastating. However, none of these major systemic crises appears to have caused the failure of a savings bank.

Banks fail either because of problems on the asset side or the liability side – or both. The nineteenth century systemic crises featured some commercial bank failures because of bad debts or depreciated assets. But there were no savings bank failures during the crises due to asset side problems because of the arrangements with the National Debt Commissioners. In a crisis banks mostly fail because of a problem on the liabilities side, meaning a run on deposits and insufficient liquid assets to meet demands for withdrawals on the part of depositors. Runs are triggered by fears about solvency and the repayment of deposits. As already mentioned, solvency was not an issue for the trustee savings banks nor for the Post Office Savings Bank (essentially a government department). Thus, unlike the commercial banks, there was no reason for a run on a trustee savings bank because of a financial crisis. Nevertheless, savings bank deposits often fell during or after the systemic commercial crises.

13 See Forrest Capie, 'The Emergence of the Bank of England as a Mature Central Bank', in Forrest H. Capie and Geoffrey E. Wood (eds), *The Lender of Last Resort* (London: Routledge, 2007).

14 Charles P. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises* (London: Palgrave, 1978) pp.14-24.

Duncan Ross of Glasgow University has conducted a forensic analysis of deposits at the Savings Bank of Glasgow, a leading British trustee savings bank, in the crises of 1847 and 1857.¹⁵ He looked at the closure of accounts by depositors during and after these crises. He found that there were higher levels of withdrawals by closure than usual on both occasions suggesting that savings banks were affected by the banking crises. There are two possible reasons for depositors to make such withdrawals: either a contagion panic effect from the commercial banking crisis; or a hardship effect from the resulting downturn in the national or regional economy. For 1857, he found that there was a short sharp spate of account closures, with money withdrawn up 182 per cent on the previous year, and concluded that there was clear evidence of a significant, but temporary, contagion effect. The economic downturn in 1857-58 was short-lived and deposits at the Savings Bank of Glasgow soon recovered. In 1847, by contrast, the financial crisis was followed by a deep and lasting recession. Deposits at the Savings Bank of Glasgow declined for several years as people drew on their savings to help them through hard times: it was not until 1850 that deposits returned to the level ahead of the crisis. On neither occasion did deposit withdrawals pose a threat to the Savings Bank of Glasgow.

British systemic financial crises, 1825 to 1890

The financial crisis of 1825 saw widespread commercial bank failures, with the closure of 73 of the 770 banks in England and Wales and three of 36 Scottish banks – but not of savings banks.¹⁶ Figures for the combined deposits of the savings banks of England and Wales were published from 1817. Between 1825 and 1826 they fell from £13.25 million to £13.13 million reflecting increased unemployment and decreased earnings. ‘Savings were bound to suffer,’ observed savings bank historian Oliver Horne, ‘and a decline of less than 1 per cent in accumulated small savings was not serious and was indeed less than might have been expected as a result of such an acute depression.’¹⁷

15 Duncan M. Ross, ‘Savings Bank Depositors in a Crisis: Glasgow 1847 and 1857,’ *Financial History Review* (forthcoming).

16 Larry Neal, ‘The Financial Crisis of 1825 and the Restructuring of the British Financial System,’ *Federal Bank of St Louis Review*, (May/June 1998) p.65.

17 Horne, *A History of Savings Banks*, p.117.

The next crisis in 1837 had no impact on the advance of savings banks' deposits. But the deep depression that followed the crisis of 1847 resulted in a significant retrenchment in overall savings bank deposits (echoing Glasgow), that fell from £31.7 million in 1846 to £28.1 million in 1848 (11 per cent); it was not until 1852 that the pre-crisis level was surpassed.¹⁸ The 1857 crisis that followed the end of the Crimean War brought down three significant regional banks: the Western Bank of Glasgow; the Borough Bank of Liverpool; and the Northumberland and Durham Bank and ruined many other businesses. The ensuing recession was sharp but short; nationally savings banks' combined deposits continued to rise despite the downturn.

The devastating failure in 1866 of Overend Gurney & Co., the leading and systemically important City of London money market bank with liabilities of £9.8 million, the largest bank failure to date, brought down some 200 banks, finance houses and mercantile enterprises.¹⁹ Casualties included the Birmingham Banking Co., the senior bank in the West Midlands with deposits of £1.8 million, the biggest provincial bank failure.²⁰ At the time the trustee savings banks were facing competition from the new and rapidly expanding Post Office Savings Bank as a result of which their combined deposits declined year by year from £41.5 million in 1861 to £36.3 million in 1866. This existing down-trend complicates assessment of the impact of the Overend Gurney crisis on the trustee savings banks. However, in 1867, the year following the crisis, the combined deposits reversed its decline and grew to £36.5, suggesting that the Overend Gurney crisis largely by-passed the trustee savings banks. 'The crisis was essentially one of big finance and the savings banks were little affected,' commented Horne. 'The small depositors did not doubt that their savings were secure.'²¹

The banking crisis of 1878 began in October with the collapse of the City of Glasgow Bank, the city's leading commercial bank with £12.4 million of liabilities.²² The collapse ruined its shareholders, beggared depositors and creditors, and caused a major recession in the west of Scotland economy.²³

18 Horne, *A History of Savings Banks*, p.386.

19 Ashraf A. Mahate, 'Contagion Effects of Three Late Nineteenth Century British Bank Failures,' *Business and Economic History*, vol.23 no.1 (1994) p.103.

20 A. R. Holmes & Edwin Green, *Midland: 150 years of Business Banking* (London: Batsford: 1986) p.46.

21 Horne, *A History of Savings Banks*, p.220.

22 Holmes & Green, *Midland: 150 years of Business Banking*, p.60.

23 Michael Collins, 'The banking crisis of 1878,' *Economic History Review*, vol.xlii, no.4 (1989) p.504.

The City of Glasgow Bank failure shook commercial banks all over the country with another major failure, the Bristol-based West of England and South Wales District Bank (liabilities £3.4 million), and numerous temporary payments suspensions elsewhere.²⁴ The Savings Bank of Glasgow, by then Britain's largest and most successful trustee savings bank with deposits of £3 million, weathered the storm without a run though deposits were depleted as families hit by the recession drew on their savings to tide them through the down-turn.²⁵ The City of Glasgow failure triggered a temporary suspension of payments by the Caledonian Bank of Inverness that, in turn, prompted a run on the savings bank at Inverness that banked with it. Confidence among the savings bank's depositors was restored by the personal appearance of the trustees who reassured them by brandishing the receipt for their funds from the National Debt Commissioners.²⁶ Frightened depositors at the Airdrie Savings Bank, another Scottish trustee savings bank, also rushed to withdraw deposits, though by January 1879 funds were returning.²⁷ There was also a run on the Queen's Building Society of Manchester (fourth largest in the country) that was believed to have balances with the City of Glasgow Bank and lost 5 per cent of deposits before confidence was restored thanks to a letter from the Bishop of Manchester.²⁸ Nevertheless, overall there was relatively little contagion from the problems of the commercial banks to the trustee savings banks and no failures or closures for this reason.

Fraud and embezzlement crises

A common factor in the failure of Overend Gurney and the City of Glasgow Bank was fraud and the mis-allocation of deposits to speculative investments that resulted in large losses; in both cases directors went to jail. Fraud is an asset side event – depositors and shareholders suddenly discover that they do not have the assets they thought they had because staff have lost or embezzled them – J. K. Galbraith labelled the discrepancy 'the bezzle.'²⁹

24 Holmes & Green, *Midland: 150 years of Business Banking*, pp.60-1; Sayers, *Lloyds Bank in the History of English Banking*, pp.208, 211-12.

25 Horne, *A History of Savings Banks*, p.221; Michael Moss, *An Invaluable Treasure: A History of the TSB* (London: Wei-denfeld & Nicolson, 1994) p.91.

26 Horne, *A History of Savings Banks*, p.220.

27 Charles W. Munn, *Airdrie Savings Bank: A History* (Airdrie: Airdrie Savings Bank, 2010) pp.29-30.

28 Cleary, *The Building Society Movement*, p.127.

29 John Kenneth Galbraith, *The Great Crash 1929* (London: Allen Lane, 1954) pp.152-153.

Numerous trustee savings banks experienced embezzlement which was the principal cause of crisis at individual institutions. However, the timing of these episodes bears no perceptible relation to the boom and bust of the major systemic commercial bank crises. The trustee savings bank episodes typically involved embezzlement of funds by management that was facilitated by poor governance on the part of well-intentioned but amateur trustees. Thus depositors' funds disappeared through local frauds before they reached the safe custody of the National Debt Commissioners. The years 1848 and 1849 saw major scandals of this nature at trustee savings banks in Dublin, Tralee and Killarney in Ireland, and Rochdale, Lancashire, that inflicted substantial losses on depositors; additionally the years 1844 to 1857 saw 21 further cases of fraud at small savings banks, though mostly without loss to depositors.³⁰ Many trustee savings bank embezzlements went on for years with financial crises coming and going before they came to light for other reasons.

Another notorious savings bank scandal erupted at Bilston, West Midlands, in 1862; it excited widespread interest because the embezzler was the local priest. Coming hard on the heels of the launch of the Post Office Saving Bank there were predictions of the collapse of the trustee savings bank movement but they proved exaggerated. A further spate of sensational savings banks frauds in Cardiff in 1886, and Sevenoaks, Kent, and Macclesfield, Lancashire, in 1888, led to a crisis of confidence on the part of depositors and trustees and contributed to a slump in the number of trustee savings banks from 400 in 1887 to 267 in 1893, most of which were perfectly solvent, in favour of Post Office provision for small savers; combined deposits fell from £47.2 million to £42.2 million.³¹ The Cardiff 'bombshell' prompted the creation of a Trustee Savings Bank Association in 1887 that created an Inspection Committee to monitor and improve the management of member banks with one third being inspected every year.³² The crisis of confidence among trustee savings banks in the late 1880s and early 1890s coincided with the Barings crisis of 1890, which saw the failure of a leading City investment bank and its rescue by a consortium of banks organised by the Bank of England. But this was very much a City matter and it did not contribute to the difficulties of the trustee saving banks or impact on the Post Office Savings Bank or the building societies.

30 Horne, *A History of Savings Banks*, pp.123-128

31 Horne, *A History of Savings Banks*, p.262.

32 Horne, *A History of Savings Banks*, pp239-241; Moss, *An Invaluable Treasure: A History of the TSB*, p.104.

Growing competition for the custom of small savers from building societies and commercial banks, in addition to the Post Office Savings Bank, was a source of pressure on the trustee savings banks in the final decades of the nineteenth century and early twentieth century. Some of these rivals were also beset by frauds, with depositors much more exposed to loss than savers with trustee savings banks. The spectacular collapse in 1892 of the Liberator Building Society and the London and General Bank, vehicles of swindler Jabez Balfour, left thousands penniless.³³ The Liberator, with liabilities of £3.3 million, was Britain's biggest building society and twice the size of its nearest rival. Its downfall was mainly due to losses from speculative real estate development that were covered-up by executives. Its failure was a great shock to public confidence in building societies and there were runs and several further failures, all of which made the state-protected savings banks and the Post Office Savings Bank attractive as safe havens for small savers. But increasingly, noted the *Economist* in 1908, the Post Office Savings Bank was suffering from 'the birth and growth of gigantic credit institutions like the Birkbeck Bank, which make a direct and much advertised appeal to the small capitalist, open up fresh avenues for thrift, and tend to draw away from the Post Office the class for which it is intended.'³⁴ One of them, the Charing Cross Bank, with 44 branches and £9 million of deposits, failed in 1910, again because of losses from speculation by management in Canadian railway shares.³⁵ So too Farrow's Bank, with 73 branches and £4 million of deposits, which shut its doors in December 1920 having lost £1 million through trading.³⁶ In both cases directors went to jail for publishing false accounts. For decades Farrow's Bank was the last significant British bank failure involving retail depositors – until Northern Rock in 2007.

Financial crises of 1911 and 1914

The banking crisis of 1911 is largely unrecognised in the literature on financial crises. The cause of the weakness that affected a significant number of banks was the decline in the price of fixed-income securities (bonds) from the 1890s due to macro-economic monetary factors.

33 See David McKie, *Jabez: The Rise and Fall of a Victorian Scoundrel* (London: Atlantic Books, 2004).

34 'Savings Banks,' *Economist*, 3 October 1908.

35 'The Charing Cross Bank. Payment Suspended,' *The Times*, 19 October 1910; 'The Small capitalist and the State,' *Econ-omist*, 19 November 1910.

36 'Farrow's Bank. Payment Suspended,' *The Times*, 21 December 1920; 'Farrow's Bank Arrests. Chairman in Custody,' *The Times*, 22 December 1920.

From the mid-nineteenth century Consols were regarded as the most suitable earning asset for a bank's surplus assets and liquidity reserve, as George Rae expounded in his influential text *The Country Banker* published in 1885.³⁷ After cash, they were a bank's most important line of defence in a run. 'Consols are the very best security that a Bank can hold,' a leading London bank advised a provincial bank in 1860, 'and that they have seen three Panics, when for a time all other securities were absolutely un-negotiable, even Exchequer Bills – but – they never knew a time when money could not be borrowed on Consols.'³⁷ The conversion of the coupon on Consols from 3 per cent to 2.5 per cent (effected in two stages) reduced their yield to investors. In response, the Trust Investment Act 1889 widened the list of trustee-grade securities beyond British government obligations to higher-yield, but still high-calibre, investments such as colonial government and municipal bonds or high-class railway debentures.³⁹ The expansion of eligible trustee securities from £1 billion to £1.8 billion was believed to be a key factor in the decline in the yield on fixed-income securities from the mid-1890s.⁴⁰ This resulted in financial deficits at the Post Office Savings Bank from 1896 to 1911 that had to be covered by annual votes by parliament.⁴¹ In 1902, two small commercial banks, Bucks and Oxon Union Banking Co. Ltd and Cornish Banking Co., were so debilitated by the writing down of the value of their fixed-income investments that they had to be rescued by absorption by major joint-stock banks.⁴²

The pressure on banks with a relatively high proportion of fixed-income investment assets mounted to a crisis in 1911. The first casualty was the Birkbeck Permanent Building Society, which traded as Birkbeck Bank, with 113,000 depositors and a £12 million balance sheet. Founded in 1851, the *Economist* observed that it 'fulfilled a useful purpose by providing banking facilities to small depositors, for whom the joint-stock banks do not as a rule cater.'⁴³

37 Charles Goodhart, *The Business of Banking, 1891-1914* (London: Weidenfeld & Nicolson, 1972) pp.127-132; George Rae, *The Country Banker. His Clients, Cares and Work* (London: Murray, 1885) Letter 29.

38 Holmes & Green, *Midland: 150 years of Business Banking*, p.49.

39 Wormell, *The Management of the National Debt of the United Kingdom, 1900-1932*, p.44.

40 'Consols and the Bankers,' *Economist*, 10 February 1912.

41 Daunton, *Royal Mail*, pp.102-103.

42 Wormell, *The Management of the National Debt of the United Kingdom, 1900-1932*, p.42.

43 'The Birkbeck Suspension,' *Economist*, 10 June 1911.

An unusual feature of the bank's business was the payment of 2 per cent interest on current accounts above £100, 'and there is no doubt that this inducement led many well-to-do persons to deposit substantial sums.' The London-based savings institution survived a 'severe' run in 1892 triggered by the collapse of the Liberator Building Society. Again in November 1910 it suffered a further run with the 'small working-class capitalist for whom the Birkbeck is mainly intended frightened by the Charing Cross failure.'⁴⁴ It survived that emergency with liquidity support from the Bank of England. But withdrawals necessitated the sale of a large volume of fixed-income investments at a substantial loss and in June 1911 it suspended payments having become insolvent. Absorbed by London, County and Westminster Bank, depositors eventually received reimbursement of 50 pence in the pound.

Yorkshire Penny Bank, an important regional savings bank with 615,000 small saver depositors and £18 million in deposits was also troubled. Founded in Halifax in 1859, Yorkshire Penny Bank's dynamic leadership developed it into an important community institution with branches across the county. In 1871 it registered as a company rather than a trustee savings bank, which allowed it greater freedom both to gather deposits and to invest in assets rather than handing the funds over to the National Debt Commissioners, which helped to fuel expansion. Yet primarily its purpose remained paternalism rather than profit-making; it estimated that two-thirds of customers were unprofitable but serviced them for social reasons.⁴⁵ As with a mutual organisation, depositors were shareholders which made it impossible to raise capital except through retained earnings. Yorkshire Penny Bank had accumulated reserves from profits, but these became insufficient with the growth in the volume of deposits and as the value of its portfolio of fixed-income assets depreciated; by 1911 its reserves of £468,000 were just 2.6 per cent of deposits making it vulnerable to a run. Yorkshire Penny Bank's weakness came to the attention of Sir Edward Holden, chairman and managing director of London, City and Midland Bank, Britain's biggest bank and third largest in the world.⁴⁶

44 T. E. Gregory, *The Westminster Bank Through a Century* (London: Westminster Bank, 1936) vol.II. pp.6-7; "'Run" on the Birkbeck Bank,' *The Times*, 12 November 1910.

45 Mitchell J. Larson, Karen Ward and John F. Wilson, 'Banking from Leeds, not London: regional strategy and structure at the Yorkshire Bank, 1859-1952,' *Accounting, Business & Financial History*, vol.20, no.2 (2010) p.127.

46 Holmes & Green, *Midland: 150 years of Business Banking*, pp.144-146.

Following Birkbeck Bank collapse, he was concerned that a run on Yorkshire Penny Bank could lead to its failure devastating depositors and destabilising the banking system. After consulting the Governor of the Bank of England, Holden organised a secret rescue consortium, comprising Midland and four other leading commercial banks, that formed a new company to take over the business with capital of £2 million as well as depreciation cover for Yorkshire Penny Bank's investments of £900,000; the rescue was announced in August 1911.⁴⁷

The third crisis institution of 1911 was National Penny Bank. This was founded in London in 1875 in imitation of Yorkshire Penny Bank's business model with a small saver client base. While fundamentally saving banks, National Penny Bank and Yorkshire Penny Bank 'drifted away' from the savings banks movement and developed more along the lines of a commercial bank – they omitted 'Savings' in their titles – but the absence of shareholders and the acceptance of small sums made them anomalous hybrids relative to the mainstream commercial banks.⁴⁸ Though smaller than its prototype, by 1911 National Penny Bank had 14 branches, 145,000 small saver depositors and £3 million of deposits. It too was weakened by the depreciation of the value of its fixed-income investments and experienced a run in November 1911 during which £1 million was withdrawn – a 33 per cent depletion. The eminent, well-connected directors appealed to the Bank of England which provided liquidity support and the run was halted. But there was no rescue consortium buy-out leaving it potentially vulnerable to another run.

A new run on National Penny Bank began in the week beginning 27 July 1914 as London's financial markets broke down in the financial crisis that erupted in the approach to the First World War and culminated in the closure of the London Stock Exchange on Friday 31 July.⁴⁹ The following day, National Penny Bank did not open its doors. Notices posted outside the branches stated that: 'owing to the severe financial situation and the enormous depreciation and temporary unsaleability of Stock Exchange securities, together with the difficulty of obtaining gold coin, the directors have been compelled to close the branches of the institution.'⁵⁰

47 David Kynaston, *The City of London: Golden Years 1890-1914* vol.II. (London: Chatto, 1995) pp.533-534; Gregory, *The Westminster Bank Through a Century*, vol.II. pp.5-6.

48 Horne, *A History of Savings Banks*, p.189.

49 See Richard Roberts, *Saving the City: The Great Financial Crisis of 1914* (Oxford: Oxford University Press, 2013).

50 'Financial Crisis: National Penny Bank Suspends Payment,' *The Times*, 2 August 1914.

Yorkshire Penny Bank branches also suffered runs because of the similarity of the name although there was no commercial connection between the institutions and its ownership by the consortium of big banks effectively guaranteed its depositors against loss. National Penny Bank chairman the Earl Bessborough, a prominent businessman and philanthropist, appealed to the Chancellor for the Post Office Savings Bank to take over its assets and liabilities, that is rescued by taxpayers.⁵¹ But Treasury officials with much else on their plates were unable to make a quick decision and the directors decided upon voluntary liquidation; depositors eventually recovered 87 pence in the pound.⁵²

National Penny Bank was a casualty of the 1914 financial crisis, but emergency measures taken by the authorities, notably a four-day bank holiday the following week, a general moratorium and the issuance of a new state currency, ensured that there were no more suspensions among the commercial banks, trustee savings banks or other savings institutions. Savings bank depositors were specifically exempted from the potential restrictions on withdrawals from banks made possible by the moratorium (though these were almost entirely not used). By an administrative oversight, the Post Office Savings Bank was left open during the four-day bank holiday providing its customers with access to their savings while all other banks were closed (including the trustee savings banks). But there was no abnormal withdrawal of funds and Treasury officials considered that the oversight might have boosted public confidence. Upon the reopening of the banks on Friday 7 August 1914 at the end of the emergency four-day bank holiday, with Britain now at war, there were substantial withdrawals from trustee savings banks, notably at Aberdeen, Glasgow, Hull and Liverpool, but the 'pressure' soon subsided and by the middle of the month normal conditions prevailed.⁵³ In addition to National Penny Bank, the crisis of 1914 resulted in the closure of two small commercial banks, but there were no casualties among the trustee savings banks.

51 British Library. MS 88888/2/9. Diary of Sir Basil Blackett, Friday 7 August 1914, Monday 10 August 1914; 'Obituary: Lord Bessborough,' *The Times*, 3 December, 1920.

52 'The National Penny Bank,' *The Times*, 5 April 1917.

53 Horne, *A History of Savings Banks*, pp.303-304.

TSB – rise and fall, and resurrection

The relationship between the savings institutions of the United Kingdom and financial crisis in the century after the outbreak of the First World War falls into two parts: from the First World War to the start of the 1970s; and then from the 1970s to the early twenty-first century. From 1914 to 1971, broadly the era of British corporatism, there was a stable cartelised system of financial institutions, each with an allotted function, as directed by the state. The savings banks had an established role and continued to fulfil it, growing modestly.⁵⁴ The building societies expanded rapidly in the inter-war years, which saw a house building boom and a large increase in owner occupation; their assets overtook those of the trustee savings banks in the 1920s and those of the Post Office Savings Bank in the 1930s. The building societies' vigorous expansion resumed in the 1950s; in 1963 their assets of £4.3 billion exceeded the savings banks' combined funds of £3.4 billion.⁵⁵ Britain was free of systemic banking crises in these decades, though not of financial crises that took the form of currency devaluations in 1931, 1949 and 1967, plus innumerable sterling crises in the 1950s and 1960s and fiscal crises notably in 1931. These crises may well have affected UK savings institutions and their depositors, but generally and not directly.

Competition in banking was revived in 1971 with the introduction of Competition and Credit Control, a radical new liberalisation measure. One outcome was a credit boom that stoked a real estate bubble that led to the Secondary Banking Crisis of 1973-75. But that crisis mainly affected specialist commercial property lenders that funded themselves in the wholesale financial market; it did not impinge on savings bank institutions. However the new policy also resulted in greater competition by commercial banks for the customers of the savings banks. Competitive and political pressures culminated in the unification of all the individual British trustee savings banks into the Trustee Savings Bank (TSB) in 1976. Provided with the same powers as other banks, it became a mutually-owned commercial bank with a mostly small saver client base and regional strengths in the Midlands, North and Scotland. In 1981 TSB acquired United Dominions Trust, a leading UK consumer lending businesses that was a casualty of the Secondary Banking Crisis, which significantly extended the scope of its activities in a complementary direction.⁵⁶

54 See Moss, *An Invaluable Treasure: A History of the TSB*.

55 Cleary, *The Building Society Movement*, p.275.

56 Margaret Reid, *The Secondary Banking Crisis 1973-75* (London: Macmillan, 1982) p.160.

Privatised by the Thatcher administration in 1986 as part of the government's privatisation programme, TSB became a regular commercial bank with shareholders. The following year it acquired the troubled British investment bank Hill Samuel. This turned TSB into a sort of universal bank, which posed significant management challenges. Hill Samuel went on a lending spree and by 1992 was making a large loss with huge bad debts. TSB merged with Lloyds Bank in 1995 constituting Britain's third biggest bank – the 'new powerhouse' LloydsTSB.⁵⁷

The commercial banks became increasingly active in the provision of residential mortgages after Competition and Credit Control, invading the building societies' traditional preserve.⁵⁸ Changes to British banking law in the 1980s allowed building societies to compete by offering a full range of banking services, the principal remaining difference being the mutual ownership of the building societies. The Building Societies Act 1986 permitted building societies to 'demutualise' and adopt limited company form turning them into regular commercial banks. Between 1989 and 2000, ten of the larger building societies converted, six floating on the stock market as a commercial bank and four being acquired by a major bank to boost its mortgage business. The former building societies turned banks found it hard to compete with the bigger established banks; by 2008 all of those that floated had either been bought by another bank or nationalised.

The banking crisis of 2007-08 was arguably the most severe crisis in the history of British banking. It resulted in the nationalisation of two former building societies, Northern Rock and Bradford & Bingley, and the rescue of two leading banks, Lloyds Banking Group and RBS, by the state through massive injection of taxpayer funds. Northern Rock that developed an 'originate and sell' business model that allowed it to grow very rapidly. Its mortgage loans were packaged and securitised and sold to investors, which allowed it to make more loans. The problem with the model was on the liabilities side. Northern Rock outgrew its retail deposits and became increasingly reliant on funding in the wholesale short-term money market. When the money market froze in August 2007 it could no longer fund itself. Nor could it raise funds from securitisation because demand for securitised assets had evaporated.

57 'Banking on Size,' Financial Times, 12 October 1995.

58 See David Lascelles, *Other People's Money: The Revolution in High Street Banking* (London: James & James, 2005).

Northern Rock turned to the Bank of England for emergency assistance. News of the talks was leaked and panic-stricken depositors formed queues outside branches. The Chancellor was forced to guarantee all deposits and Northern Rock was eventually nationalised. Bradford & Bingley was also heavily reliant on wholesale funding and in addition had mounting problems with its loan book; it was nationalised in summer 2008.⁵⁹

HBOS, formed in 2001 by the merger of Halifax, a former building society and Britain's biggest mortgage lender, and Bank of Scotland, grew rapidly in the five years before its demise in 2008. Its massive expansion of commercial property lending was largely funded by borrowing in the wholesale money market. It was hit hard by the conjunction of crashing property prices and the breakdown of money market liquidity. In addition it had invested in high-yield structured products related to US sub-prime mortgages. When this became known, the share price collapsed and it became unviable as an independent bank; in September 2008 it was acquired by LloydsTSB, a prudent bank that had hitherto been unscathed by the banking crisis. The combined entity was renamed Lloyds Banking Group and 198 years since the establishment of the Rothwell Trustee Savings Bank the name TSB disappeared from British banking. But instead of keeping HBOS afloat, the merger sank Lloyds Banking Group and the combined entity had to be saved by the government which became a 43 per cent shareholder.

As a result of the government rescue of Lloyds Banking Group, the bank was required to divest 632 branches to comply with European Union state aid regulations. It was decided that these branches should form a separate business trading under the brand TSB that would be launched in September 2013. And thus Britain's trustee savings banks rose again, at least in name, resurrected by the United Kingdom's most recent financial crisis and heralded by the newspaper headline – 'TSB Is Back.'⁶⁰

59 House of Commons Treasury Committee, Banking Crisis: dealing with the failure of the UK banks (May 2009) pp.14-18.

60 'TSB is back as Lloyds Rebrands,' Sunday Times, 30 June 2013.

About the Author



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THE IMPACT OF CRISES ON THE SAVINGS BANKS INSTITUTIONS IN GERMANY

Paul Thomes

Introduction: objectives, definitions, concepts

In this paper, we use an exemplary but systematic approach to address the impact of crises on savings banks in Germany. We compare selected situations in the 200 years of savings bank history and combine them in an analytical abstract – including some suggestions for handling the future. We would like to begin with some definitions.

- The German business model has been characterised from its beginning to the present day by three main characteristics: local/regional, communal and not for profit.¹
- “Crisis” literally means just a turn for the worse within a process; in general, though, its connotation is negative. There are different types of crises, including systemic, structural and cyclical crises. In relation to this segmentation, you can define local, national, continental and global crises as well as politico-social and economic ones. A further systematic distinction would be internal versus external – each with different effects on financial industries and the economy.²

1 There are only a few exemptions concerning the features “local/regional” and “communal”. For further details, see below. For a comparative perspective, see Wissenschaftsförderung, 1990, 2000, 2010; WSBI-ESBG 2007, 2011.

2 For a definition, see Spiethoff, 1955; for a very systematic examination concerning savings banks up to 1931, see Sommer, 1934, passim.

- Lastly, German savings banks – as in other countries – are the product of a structural crisis. The savings bank movement began in the second half of the 18th century. At that time in Western Europe, the shift from an agrarian to an industrial economy had begun. This shift was combined with a demographical and societal crisis, and on the continent it was accompanied by the severe political crisis of the “*Ancien Régime*”, culminating in the French Revolution; in other words, a series of external shocks occurred.³

Within this framework, savings banks were designed by the old authorities as innovative top-down instruments that could conserve the political system and the ancient order and effectuate socio-economic and technical change processes. The innovative features of the new financial players – we could also call them institutional change agents – were the acceptance of relatively small savings bearing interest and the provision of small-scale credit at transparent and reasonable rates. A core motive behind the idea was the creation of saving incentives. Savings would help to bridge individual financial crises at times when social security depended on family networks, which had started to dissolve. Further motives for encouraging savings were to improve general liquidity by integrating low-income households into the formal financial services sector and to fight usury.

We learn two things: the concept of a savings bank simultaneously contained innovative and conservative elements. The link between savings banks and crises is not a one-way connection but is a reciprocal relationship. Savings banks have a double function and must be seen as the outcome of a systemic crisis as well as an instrument to manage it.

Analysis: savings banks and crises

The first practical crisis for the early German savings banks was Napoleon's occupation of the German states, which lasted approximately 25 years.⁴

3 For the German case, see Wehler, vol. 1 and 2; in general, see Mura, 1996, 2000.

4 For a discussion on the first savings banks, see Ashauer, 1991; Wysocki, 1980.

Although we know few details, despite heavy turbulence, not only did the concept survive Napoleon, but most of the institutions survived it, too. In fact, in 1815, when the Vienna Congress created new old rules in Europe after the French defeat, we find more savings banks in the German states than existed in 1790. In the years to come, the transformation process from innovation to diffusion accelerated, and the number of banks grew quickly. This development was fostered by legal regulations, such as the famous Prussian charter of 1838, which gave the savings bank movement a solid basis and transformed the savings banks into financial institutions. We interpret these changes as being a result of the banks' resilience during the critical years before and after 1815. Obviously, savings banks were seen as adequate instruments that could manage the manifold transformation processes that were gaining speed with the accelerating industrialisation of the economy. Two landmarks were the establishment of the Zollverein, which created a common economic market for the German national states, and the first German railway in 1835.⁵

A significant amount of the evidence that we have is for the critical years 1846-1849, known as the last old style European economic crisis, caused by massive crop failures and food shortages mixed with a severe political crisis, all occurring just as industry was about to take off – another systemic shock mixing with structural elements.⁶ There were, of course, effects on the savings banks beginning in 1846. We performed significant research on the largest German savings bank at that time, which was situated at Aachen, the most western Prussian city.⁷

The findings from this research provide interesting details. In 1846 especially, small savings deposits diminished. The bank's annual report blamed a heavy increase in food prices and proudly stated that the low-income households who had saved were able to brave the crisis using their "own means" and the bank had no problems disbursing these savings. The bank's proven reliability built up credit in the young institution.

5 In general, see Trende, 1957; Born, 1976; Deutsche Bankengeschichte, vol. 2; Knebel Doeberitz, 1907; Malchus, 1838; Wandel, 1998; Wehler vol. 2.

6 For the take-off process, see Wehler, vol. 2; for the general background, see Abel, 1972; Ehmer, 2004; Klein, 1973.

7 Thomes, 2010; Thomes/Bonin, 2013. Hoffmann, 1963.

In 1848, in the face of another political revolution, the situation became more critical. Within only two months, the bank's clients withdrew almost 50% of all savings deposits; again, the savings bank mastered the run through efficient liquidity management and some luck. Within the same year, the withdrawn money was almost completely returned when the situation stabilised. Therefore, we see no trace of this event in the balance sheets.

This event demonstrated beyond doubt that the existence of savings banks alleviated the effects of the crisis.⁸ The effects of the crisis on the savings banks were positive, too: they had succeeded in building up more credit. Other countries even more systematically built up their savings banks in the wake of the crisis, especially in their rural regions; and credit cooperatives, as an alternative approach to include low-income households in the formal financial services sector, also began to spread.⁹

However, confidence regarding trust or credit is an ephemeral phenomenon. In the subsequent political crises of 1866-67 and 1870-71, the pattern of panicked withdrawing followed by re-depositing once the situation is settled reappears and is more or less consistent.¹⁰ One point of interest is that 1866 was the only year between 1860 and 1914 in which withdrawals exceeded deposits in Prussia, while interest credits kept the balance positive. Failures were the exception and, if necessary, state provincial banks or regional or local authorities helped to overcome liquidity deficits. This help was important because in 1866-67, the savings banks reported difficulties in selling or borrowing against government bonds, assets which the majority of them had bought to guarantee liquidity in emergency situations and needed to cover withdrawals.¹¹

The German "*Gründerkrise*" of 1873-1875, following the economic boom in the wake of the foundation of the German Empire in 1871, affected the vast majority of German savings banks only slightly, as the boom had done before. Savings banks had not financed enterprises to a large degree, and when they did, the loans were secured by hypothecation.¹²

8 See f.i., Pohl, 2001, 84 ff.

9 For the history of cooperatives, see Bormann et al., 2013, Faust, 1977; Kluge, 1991.

10 In fact, bonds as an instrument to secure liquidity in times of crises did work, though only limitedly, as the years 1866-67 showed; Thomes, 1985.

11 Thomes, 1985; in general, see Hahn, 1920, 182, 244 ff.; Trende, 1957, 299 ff., 389 f., 490 f.

12 Thomes, 1985; see, too, Bracht, 2013.

We see the same result concerning Rosenberg's so-called Great Depression, a period of approximately two decades, starting around 1875.¹³ These findings are not particularly surprising. The crisis affected mostly joint stock companies and commercial banks intensively engaged in the investment business. The "Great Depression", after all, was a period of moderate growth, while since the 1880s, quite innovative social security acts widened the consuming and savings capabilities of middle- and low-income households enduringly.¹⁴

A further important point must be made: because investment opportunities decreased during those more difficult years, investment risks rose and interest rates diminished; savings banks attracted bigger savings, including the deposits of wealthy households that had been previously invested elsewhere. In other words: through risk aversion and relatively stable rates of interest paid by savings banks, no later than in the second half of the 1870s, and maybe even earlier, did savings banks obtain "safe haven" status. In fact, they have conserved this status to date, as the last crisis proved in an impressive manner.

As early as 1933, Albrecht Sommer systematically analysed these developments. He differentiated between income savings and asset savings. During the depression and parallel to the high jobless rates, income savings tended to decrease because income was needed by the savers. Asset savings, however, accompanied by low-interest rates outside of the savings banks sector, rose, while savings bank interest rates stayed constant. This process is why savings banks cycles were and are partly contrary to economic cycles, even when their rates became more flexible. Savings banks are subject to economic cycles, of course, but in a different way from commercial banks. This mechanism, explained above, stabilised savings banks and, with them, the regional economy. In other words: savings banks have taken over smoothing or buffering functions for the national economy.¹⁵

As a consequence of this function, the growth of savings has slowed since the middle of the 1890s, when big savings disappeared parallel to better economic growth perspectives.

13 Deutsche Bundesbank, 1976; Rosenberg, 1967; Wehler, vol. 3.

14 For Bismarck's social security acts, see Wehler, vol. 3.

15 Sommer, 1934, 184-188; Reusch, 1935, 174, formulates "Konträrbewegung zwischen Wirtschaftskrise und Sparkassen-krise".

Concerning the sheer number of savings banks, the first decade of the 20th century even appears to indicate a crisis in terms of a dwindling number of savings banks. This decade saw accelerating urbanisation and subsequent administrative restructuring. Many smaller institutions were integrated into larger savings banks, but the branch network continued growing constantly along with the balance sheets.¹⁶ Nevertheless, 1907 brought another crisis that was also felt by the savings banks; in reality, a precise examination shows that this crisis was not a threat to the banks. The equation mechanism, described above, worked once more.¹⁷

In 1913, saving was a strong institution in Germany. Statistically, every household was the client of a savings bank. Moreover, we see more or less complete financial inclusion throughout all social classes. Because the inclusion of more individuals in the financial system means more stability, savings banks must be considered to have been an important element for smoothing, if not preventing, economic crises since the second half of the 19th century, when industrialisation, with its new cyclic movement, intensified. Of course, economic cycles increasingly affected savings banks, which were becoming part of a well-developed financial system. However, no savings banks closed for business reasons.¹⁸ In the beginning of the 20th century, savings banks acted within well-established networks that included strict and regular controls, and they had regional central banks that would help in a liquidity or other crisis. The primarily public business model of banks promised safety as long as there was no systemic shock and, consequently, the state did not have to take action. So the quite liberal Prussian savings bank law of 1838 remained valid.¹⁹

It is also important to keep in mind that savings banks had developed a broad credit business. They financed industrialisation as well as urbanisation to a great extent and met local and regional needs. Savings banks financed communal infrastructure, such as gas, water, and electricity, traffic systems, and public buildings such as town halls, schools, churches, etc. In terms of economic and business affairs, savings banks helped to manage the industrialisation process by financing small- and medium-sized enterprises that mechanised production.

16 Thomes, 1995; Thomes, 2007.

17 Reusch, 1935; Wissenschaftsförderung, 2010.

18 Thomes, 2008.

19 Hahn, 1920; Hoffmann, 1969; Mura, 1991, 1994, 1995. For a controlled closing down during a heavy political crisis after the First World War, see the chapter on the Savings Bank of the Aachener Verein, Thomes, 2010.

The surpluses achieved – at that time a normal situation – again helped to finance widespread regional not for profit social, cultural and educational activities. Savings banks in 1913 were core economic elements that allowed to even out structural and cyclic fluctuations. At the same time, savings banks had established themselves as a source of stability and as efficient and reliable instruments of change and crisis management.²⁰

The First World War launched a catastrophic “age” for savings banks and savers. After two fatal World Wars, three systemic political crises and a deep global economic crisis, this catastrophic period ended only in 1948 with the second currency reform within 25 years. The great difference in this period compared to the past century was that external political aspects dominated economic ones. What is interesting, and at a first glance difficult to explain using a mere rational approach, is the persisting loyalty of German savers to their savings banks.

During the First World War, a unique and radical change in the credit business took place with consequences for the crisis sensitivity of the savings banks. In 1918, the vast majority of assets consisted of government bonds as a result of a war-motivated nationalistic change in credit policy. When the Kaiserreich lost the war and subsequently dissolved and Germany was required to pay reparations, those assets most likely had no value, a challenging and threatening scenario.

Nevertheless, the new democratic Weimar Republic managed to keep things going astonishingly well using a loose monetary policy. By 1922, however, the consequences for the currency were becoming quite clear and finally hyperinflation, in 1923, devaluated savings and assets more or less completely. The savings banks could not prevent this catastrophe nor could they mitigate it because they were an integral part of the system. However, in terms of their future, it is important to note that the public did not see them as perpetrators but as victims of these incidents. After the currency reform, which erased 12 nuls, savings started growing rapidly again, representing a “*Spannwunder*”. Germans had obviously internalised saving while the hope for a partial revaluation of savings helped to rebuild credit.²¹

20 See, in general, Pohl et al., 2005.

21 For the entire period up to 1931, see Sommer, 1934, 158 ff.; Pohl et al., 2005.

During the Great Depression, starting in 1929, savings banks statistics showed no alarming signs for a long time.²² Up until the famous banking crisis of 1931, the savings banks were once more performing well. In fact, deposits during this period were larger than disbursements. Again, non-typical assets found their way into the banks as they served their safe haven function, while even the experts for a long time continued to believe that this deep recession was just a technical correction.²³

In fact, there were two bank holidays in July 1931 as a consequence of a commercial bank failure – a unique event. Also during this time, savings banks had to withstand a run that generated an avalanche: the Landesbanken and clearing houses (Girozentralen) for the savings banks in this critical situation failed to provide liquidity. This lack of liquidity occurred because the primary debtors of the savings bank system, the communal entities, were insolvent as an effect of the economic crisis, increased social expenses and diminishing tax revenue, while the extensive loans from the US that had flowed into Germany since 1924 slowed down because of the US crisis. In the end, the Reichsbank helped overcome this deep general crisis that Germany faced: between 1929 and 1933, GNP shrank by approximately 50%, a level that is not at all comparable with the current crisis.²⁴

However, because no saver lost any money, the savings banks did not lose the confidence of their clients. Again, savings banks were seen as the victim rather than the culprit and they were the winners of the crisis from another perspective as well. A new general banking law, prepared in the wake of the crisis in 1934, confirmed the status of savings banks as regional public universal banks against the fierce lobbying of the commercial banks, which were suffering heavily from the crisis.

Despite these events, savings banks were not in a position to prevent the first German democracy from failing. In 1933, the Nazi dictatorship took over, another highly dramatic system change. Savings banks saw positive perspectives in light of the stability promised by the new regime, but came out of the frying pan and right into the fire. The Nazi regime ruthlessly exploited savings banks as public institutions in pursuit of its felonious goals right from the beginning and perverted the savings idea to an extent not seen by any regime before or since.

22 James, 1987; Kindleberger, 1973.

23 Pohl et al., 2005, 138-158.

24 Pohl, 1982; Mura, 1991; Fischer, 1997; Bormann et al., 2013.

The forced abstinence from consumption increased savings, while the government used the savings to finance armament and war purposes. We know the results: a global war unprecedented in its effects, unrelenting distress and finally, in 1945, peace. For West Germany, peace meant the chance to return to democracy with the help of the Western allies, and for the savings banks it meant the chance to restart.²⁵

The war left impressive figures in the balance sheets as well as in savings accounts. However, no one knew how much the war had devaluated savings. It took until 1948, after three long years, for another currency reform to eradicate uncertainty. Within those years, characterised by a strong hidden economic sector in addition to the regulated market, savings banks became a playing field for speculation, with high fluctuations in assets driven primarily by rumours and not by economic facts. Under these conditions, there was no real opportunity to stabilise the economic situation. At least the savings banks organised monetary transactions quite efficiently. When the currency reform did take place, the savings banks were an important instrument to realise it. In other words, they were an integral part of the restart.

The involvement of savings banks might be one reason why Germans resumed saving almost immediately. This renaissance was backed by diverse public capital formation programmes under the new concept of a social market economy for the primary clientele of savings banks: wage earners and low-income households. Therefore, savings banks were also part of the *“Wirtschaftswunder”* that brought remarkable economic stability – parallel to a continuous upsurge up until the early 1970s.²⁶ Savings banks backed the growth decisively. To take just two examples, savings banks financed almost all local regional public infrastructural projects; and by triggering cashless wage payments, they led financial inclusion to a new level, with additional stabilising economic effects.²⁷

At that time, the second modern structural crisis was on the horizon, characterised by the decline of the old industries such as textiles, mining and steel, and the upsurge of the high tech and IT industries and the services sector.

25 Pohl et al., 2005; Thomes, 1996.

26 For a general overview, see Abelshauser, 2005; Eichengreen, 2008; Wehler, vol. 5; Pohl et al., 2005, 286-405; Thomes/Belvederesi, 2007.

27 Thomes, 2001, 2002, 2011; Wissenschaftsförderung, 2010.

Since the 1970s, savings banks have again and quite impressively proved their worth as regional management instruments. During this time, savings banks started to finance innovative business and production models hand in hand with regional private-public initiatives including universities. In this context, since the 1980s, they were among the initiators of local technology centres fostered by tax money. This approach was an innovative scheme that inspired and accompanied the economic restructuring. Meanwhile, savings banks have become established as a successful platform to manage change processes. In fact, to this day in Germany, savings banks have been the leaders in financing start-up enterprises – a core factor in an economy's resilience to economic crises.²⁸

Savings banks again showed this twofold quality of crisis resilience during the last global financial crisis starting in 2008, in a completely different dimension. These banks braved the crisis in an outstanding way and formidably defended their image as a source of stability and a safe haven.

The reasons behind the resilience of savings banks are easily found in their sustainable business model. This business model has stayed unaltered through all of the political and economic changes since the end of the 18th century – a literal sustainability. Compared to savings banks in other countries, German savings banks also overcame the heavy liberalisation wave starting in the 1980s as well as recent German and European Community privatisation plans.²⁹ The latter trend came to an end – perhaps temporarily – with the crisis and the strong performance of the savings banks.³⁰

The strength of this business model and its decisive role in the business performance of savings banks foretells the doom of the Landesbanken, the regional central banks, owned by the German federal states and the German savings banks networks. These regional central banks abandoned their original model, which was designed to support the regional economy and the savings banks in their business and money transfers. Instead, these regional central banks began to go global, with disastrous results; most of these banks experienced a complete restructuring or liquidation.

28 Eyll/Eschweiler, 2000; Thomes, 2001, 2010, 2011; Maubach, 2007; Thomes/Maubach, 2008; Thomes, 2002.

29 Deutscher Sparkassen- und Giroverband, 1984; Steiner, 1994; Genossenschaftsverband Bayern, 1996; Butzbach, 2007; Thomes, 2009.

30 For details, see the other papers in this book.

Summary and conclusions

How have savings banks served as elements of stability? Several decisive features of their business model have made German savings banks crisis-resilient and unique. From an organisational perspective, they are full service retail banks regulated by public law. Savings and credit business are of equal importance. Business is regionally restricted, mostly within cities or counties. Networks guarantee liquidity. From the beginning, the mission of savings banks has not been profit maximisation. In this sense, management is more independent in its business policy than f.i. private banks, which must address their owners' call for dividends. According to the idea of common welfare, German savings banks have been serving the public good, instead. Surpluses, after a proper endowment of reserves, have been used to back non-commercial measures – social, educational or cultural.

What have been the reasons behind economic crises? There are two general explanations: For cyclical as well as systemic political crises, speculation in combination with overconfidence has been responsible for these crises. There have been different fields of speculation and different socio-economic, technical and political environments over history, of course, but the mechanisms have been essentially the same. For structural crises, a shift of production conditions, be it continental or global and depending on technical or other changes, triggering a need for change has been responsible.

What were the effects on banks? Concerning systemic crises, the effects depend on how close an institution or a group of institutions is to the system to be replaced and how they fit into the new political scheme. Savings banks have a type of universal identity. Because savings banks have been the banks for the masses and because they are predominantly public, they have fit into every political concept. In this sense, savings banks have always been system relevant. As a consequence, the concept of the savings bank has been kept alive and the clients have been, to a certain extent, compensated for losses to keep the system going.

Concerning structural crises, which take longer to resolve than other types of crises, savings banks have always been part of the restructuring process. In fact, savings banks were established as the product of a structural crisis as agrarian society turned into industrial society, starting in 1850, and they were designed to play an integral role within the change process. Savings banks played a similar role during the second great European structural crisis when industrial society became high tech and service society. It would not be incorrect to refer to savings banks as integral change agents.

Concerning cyclical crises, from the 19th to the 21st century, banks intensively involved in speculation booms have, without any exemption, taken high risks, and many have had to pay for these risks, including with bankruptcy: A. Schaaffhausen'scher Bankverein, the first German joint stock bank, and others in the 1840s, many commercial banks during the "*Gründerkrise*" 1873 to 1875, as well as several cooperative banks and even very large banks during the great slumps of 1929 and 2008. The only exemptions, more or less, were, in fact, savings banks.

How is the current crisis being solved and are there national traditions of government action? In fact, there has been a long tradition of government action in Germany. Most of the early savings banks were founded by the political authorities to fight pauperism, and there have been savings banks laws since 1838. The first German joint stock bank, A. Schaaffhausen'scher Bankverein, owed its foundation, in 1848, to a state act in an emergency when the failure of the forerunner bank was imminent, a case of system relevance.³¹ *Gründerkrise*, however, was mastered without public help in a markedly liberal climate. The 1923 currency reform and the 1931 banking crisis during the great depression, for instance, required massive government help to overcome the general money squeeze; these events led to a strict and all-embracing control of the banking sector, which was released only since the 1970s.³²

The current financial crisis in Germany has been resolved so far by decided and concerted governmental action. On the one hand, there was an early and strong government commitment to guarantee savings.

31 Deutsche Bankengeschichte vol. 2, 1982.

32 Thomes, 2009.

On the other hand, there was massive financial support provided to the financial industries. Savings banks did not need any public help to overcome the crisis; they were affected only marginally, although they had to pay for the problems of the Landesbanken. This operation was successful because of the strong structural alliance.³³

Are there lessons for current policy? Past, present and future never have been directly comparable to each other. Therefore, it is difficult to learn lessons through copy and paste solutions: they would most likely fail. However, there have been similar situations, and in this way, the systematic use of past case studies can, indeed, reveal particular parameters, characteristics or similarities, such as the following findings from the quite unique German savings banks' business model.

The relevant features of this model are as follows:

- A not for profit business model. Surpluses have been important, but the core goal of the savings banks' business model has been creating value and sustainability. Surpluses have been used to strengthen reserves and to finance educational, social and cultural projects in their business districts to fortify and stabilise the general framework. Not surprisingly, savings banks usually have the largest market share in their business districts.³⁴
- A regional business scope. This business scope is combined with an intimate knowledge of regional structures, trustful relationships with business partners and earnings consumed or reinvested primarily where they were generated.
- A network structure. This structure offers savings banks enough freedom along with the safety of a mighty alliance. The structure provides important potential for controls, information, cost reduction and lobbying. This structure also allows diversity; the largest German savings bank in Hamburg employed approximately 5,700 people in approximately 250 branches and counts 1.5 million clients in 2011. The smallest institution, in Bad Sachsa, had a balance sheet of €130 million and employed 46 persons in that same year.

33 www.dgsv.de.

34 Deutscher Sparkassen- und Giroverband 1984; Ashauer, 2005.

- The regulation by public law, though it may not be an indispensable parameter. This regulation has made savings banks quite independent of shareholder value aspects and other speculative motives. Instead, their focus is on the real economy.

These parameters have formed a concept defined by regionally responsible retail banks following a holistic inclusive approach. The main reason for the persistence of the business model might be the strong and lasting German federal political structures. These structures have furthered regional independence and hindered the national solutions seen in other European countries.

In the light of crises, history has shown that savings banks have played an active reciprocal role as change agents with significant positive impacts on smoothing these crises. Savings banks have provided this benefit without any constraints as long as there has not been a severe systemic crisis. Moreover, after every slump, crash or disappointment, the savings banks won back trust in a stupendous way and helped the wounded economy to recover. This process might then trigger the following question: are Germans born to save, no matter what happens? This question is difficult to answer. But it is always better to have reserves, especially in times of crises, than to ask banks for credit. These reserves mean smoothing out cyclic fluctuations and crises.

Moreover, we need more than just savings banks to prevent crises or to balance them: they are not a panacea. What we need to meet the challenges of economic, social, political and cultural change – including crises – is diversity and not monotony: mixed financial structures and competing business models. Perhaps we need three pillars, like in Germany: special banks and universal banks as well as regional and global banks, private and public banks, profit and non-profit? Competition matters!

It is important to keep in mind that financial institutions have to serve, not to rule, which is an old adage recently renewed by Pope Francis. German savings banks have, in fact, served most of the time. Therefore, in a globalized world and from an international perspective, the German savings banks' business model appears to deserve more attention than before, especially in a digital global banking context. This business model is worth considering if we earnestly pursue a holistic and socially inclusive approach for the financial industries and beyond.³⁵

³⁵ Friedman, 2007.

About the Author



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THE CRISIS AND THE FRENCH SAVINGS BANKS



Vincent Tournié

The financial crisis buffeting global economies since 2008 has left its mark on French savings banks, or *Caisses d'épargne*. In the late 1990s these *Caisses* embarked on a successful transformation from state-protected financial institutions to today's genuine cooperative banks. By entering the cooperative banking sector and aiming to be a full-services bank, they were able to establish themselves as leaders in the French retail banking market within just a few years. However at the same time they faced strong headwinds from the ongoing financial crisis, and continue to struggle with the problems facing private-sector companies.

We feel that now is a good time to look back at the economic and financial crises that have marked the *Caisses'* two centuries of history. In this paper we will show that crises during what is known as the "traditional period"¹ have had little impact on France's savings banks. This is largely because the banks had set up a system and structure to shield them from major economic downturns. However during this period they remained vulnerable to other types of crises, such as political ones. We will also review the *Caisses'* progress since their transformation, and especially through the global crisis still raging today.

A steadfast system against economic and financial crises

France's *Caisses* are undoubtedly among its most secure banks, since they offer full protection of savers' deposits. They were established as private-sector enterprises to give working classes the kind of welfare protection not available in 19th-century industrial society.

¹ An expression coined by French author Daniel Duet for the period from the *Caisses'* foundation to their first structural reforms in the 1980s.

The French government soon saw that the *Caisses* also went a long way towards improving social cohesion. But policy-makers at the time steered clear of getting the government directly involved in these businesses.

In an article on France's *Caisses* and "providential state," André Gueslin notes the paradox of a society that advances liberal economic policies while allowing for government intervention in its savings banks.² In the 19th century, the use of state funds to secure customers' deposits was justified by the fact that the *Caisses* were considered philanthropic undertakings, like charities. They were deemed private-sector establishments working for the public good, conferring them a unique status.

The key to the *Caisses'* secure system was the deposit guarantee provided by the French government – or governments, since the country went through several different governments in the 19th century, ranging from democratic to despotic. Yet every single government – whether a monarchy, empire, or republic – maintained that guarantee. They all realised that the *Caisses'* deposits were nothing more than the savings of the working class, which made them untouchable.

To make sure its system was infallible, the *Caisses'* founders, especially those of the Paris *Caisse*, decided to invest its funds in the government-backed *Caisse des Dépôts et Consignations* (CDC, a deposits and consignments bank), thereby making customers' deposits even more secure.

This gave the *Caisses* two layers of protection: that of the French government, and that of CDC. By placing their funds with CDC, the *Caisses* could guarantee customers that their savings would be invested in government securities and not in speculative or risky assets. This also ensured that neither the *Caisses'* directors nor managers would be able to carry out trades using customers' deposits. Any possibility of a bad investment was automatically eliminated, protecting savers from the scenario of a *Caisse* going bankrupt.

Backed by the dual government/CDC guarantee, the *Caisses* became risk-free financial institutions. The French system inoculated them from the risk of a financial or banking crisis. But French savers still had to be convinced. There is no point in having the most secure system in the world if nobody believes in it.

2 Gueslin, André. "L'invention des Caisse d'épargne en France, une grande utopie libérale," in *Revue Historique*, 1989, pp 391-409.

The slogan “Placement sûr” means “Secure investment,” and is underscored by the image of the Marianne, which symbolises the security of the French Republic – and of the savings accounts that pay interest “like an outstretched hand.”

This advert is just one example of the Caisses’ marketing strategy emphasising the French government’s deposit guarantee.



So the *Caisses* carried out various initiatives to reassure savers and deliver a trust-inspiring message. They wanted to let depositors know their money would be safe; to give them a sense of “psychological security.”

One of these initiatives involved adopting a reassuring symbol to project the solid, trustworthy image the *Caisses* aspired to. They found such a symbol in France’s elegant *hôtels particuliers*, or “private mansions,” where the *Caisses* decided to set up branch offices. This marked the first pillar of the savings banks’ efforts to establish “psychological security.” According to bank architecture expert Marie-Hélène Chazelle³, these mansions were chosen to underscore the *Caisses*’ social-responsibility focus while anchoring their institutional nature. And because these buildings were in fact monuments, they had an aura of respectability that comforted customers. The mansions also made people on low-incomes, who were often intimidated by traditional banks, feel comfortable visiting a financial institution. In building the *hôtels particuliers*, France’s savings banks initially aimed to create spacious areas better suited to banking activities. However starting in 1880 – and especially after a law passed in 1895 – the primary goal became to demonstrate the *Caisses*’ success and venerability. Most of the mansions were built during France’s *Belle Époque* from the late 1800s to the start of the First World War. The construction programme was halted during the war and picked up again in the 1930s.

The second pillar of the *Caisses*’ efforts to establish “psychological security” was to have honourable, respected managers. Each savings bank chose its managers and directors from the local elite, selecting individuals with virtuous reputations. The idea was to show savers that their local *Caisse* is managed by reputable leaders who would not get their hands dirty with seedy affairs. Thanks to these initiatives, in the 19th century France’s savings banks had a reputation for being solid, trustworthy institutions due to their long history and impeccable track record, free from exorbitant losses and major scandals.

All this helped reassure French savers and appease their fears about what might happen to their nest eggs during a crisis. *Caisse* customers felt secure in the knowledge that their savings were safe and they had made a rock-solid investment.

3 Chazelle, Marie-Hélène. “Les sources sur les hôtels des Caisses d’épargne,” in *Les Sources Historiques des Caisses d’Épargne*, 2007, pp. 91-100.

French savings banks through financial and economic crises: examples from the 1930s and 1970s

The *Caisses'* structure and system were designed to shield them from the devastating effects of a crisis. We now look at how they weathered the crises of the 20th century, focusing on the two main ones affecting France: that of 1929 and that of the 1970s.

Ironically, the *Caisses* entered the 1929 crisis with a record volume of deposits: FRF30 billion. Even after accounting for various devaluations, the *Caisses* have never had so much customer savings on their books. France's private-sector banks, on the other hand, were quickly in trouble. In 1930 they slumped dramatically following the downfall of Adam Bank and the Oustric scandal. Savers immediately grew suspicious of banks, especially small deposit ones. This prompted the French government to look frantically for a way to prevent hoarding – and it found an answer in the *Caisses*. On 31 March 1931 the government passed a law raising the ceiling on regulated savings accounts by 40%, from FRF12,000 to FRF20,000. French people wary of banks but with money to tuck away quickly seized the opportunity. The *Caisses* were happy as they saw their deposits grow. Savers were happy as they found a safe, effective way to boost their savings. And the French government was happy as it found a method for securing its own financing and circulating money that would otherwise have been hoarded.

The ones who were not happy were CDC and the smaller deposit banks. To continue paying out interest on its deposits, CDC had to make long-term investments of money that could be claimed at any time. Small deposit banks, particularly those in dire straits, saw their business cannibalised by the *Caisses*. These two factors were the main reasons the tide started turning against French savings banks in the late 1930s.⁴

The *Caisses* also held up well during the 1970s crisis, despite its calamitous consequences for savings accounts as inflation soared above the interest rate paid on them. During the 1970s France underwent a period of stagflation that didn't end until the government's austerity policies in 1983. However these policies didn't really begin to tackle inflation until 1985-1986.

4 *ibid.*

Nevertheless, in spite of the blow to returns on savings accounts, deposits with the *Caisses* grew at a hefty clip of over 10% per year between 1976 and 1982. The growth rate began to slow in 1983 and fell to 3% in 1985. This drop in growth in the early 1980s appears counterintuitive, since at the same time real (net of inflation) interest rates became more attractive, if not relatively high. The shift away from savings accounts was also reflected in flows out of France's unregulated savings accounts (called *Livret Bs*), which registered net outflows in 1983 and 1984. Savers were turning to other long-term investment options like mutual funds and property.

But why? Why did they invest so heavily in savings accounts when real interest rates were negative, only to turn their backs on such accounts when real interest rates climbed back up? Several reasons have been put forward. One comes from a study by CDC subsidiary SEDES (*Société d'Études pour le Développement Économique et Social*), which shows that during the period in question, 46% of French people used savings accounts to build up a safety net in case of unforeseen circumstances. These savers liked knowing that their money could be available immediately – which wasn't necessarily true for other savings options at the time. So it makes sense that during the 1970s crisis, savers preferred easy access over high returns. Regarding the swing away from savings accounts in the 1980s, two factors played a role: (i) a proliferation of savings products being introduced on the market, coupled with a younger population that was more open to investing in the stock market; and (ii) lower interest rates as inflation shrunk back below the psychological threshold of 10%.

Therefore we can see that France's savings banks stood strong during the two biggest financial crises of the 20th century. This could lead us to believe that the *Caisses* are largely immune to such crises, given their secure system and the trust French savers apparently have in them. But as we will see in the next section, that does not mean the *Caisses* are immune to all crises.

French savings banks and political crises

Although French savings banks withstood financial crises during the "traditional period," they were not invulnerable to all types of crises. The *Caisses* did find themselves victim to political crises – sometimes with drastic consequences.

As mentioned earlier, the *Caisses* could not go bankrupt. While it is tempting to infer that this means they are also shielded from the worst thing that could happen to a bank – a bank run – that conclusion would be wrong. Despite all the precautions taken by the *Caisses'* founders and the French government, the savings banks did experience such calamities; the two worst ones took place in the summer of 1914 and in September 1938.

The summer 1914 bank run, on the eve of World War I, was triggered by fears that bank accounts would be blocked through a safeguard clause (the equivalent for the *Caisses* of a moratorium, where withdrawals would be capped at FRF50 every two weeks). The French government already invoked a safeguard clause during the 1870 war.

French savers were afraid history would repeat itself and didn't want to go off to war leaving their loved ones without access to funds. They descended on their local *Caisses* in droves; some of the early-war bank runs were particularly fierce. Long lines formed in front of the *Caisses*, with people waiting hours to get to a till or their safe deposit boxes.

The first runs took place between 24 and 27 July 1914 – during the first political ultimatums but before war was officially declared. They then intensified and peaked between 28 and 31 July 1914, the date on which the moratorium was eventually passed and the safeguard clause invoked.

The safeguard clause was the main problem for the *Caisses* during World War I. It was invoked on 30 July 1914, the same date as a moratorium was passed for credit and deposit institutions. Dubbed a "necessary evil," the clause was a thorn in the *Caisses'* side throughout the first years of the war. Our research on the clause showed that the French government was having trouble shoring up its finances as it went to war, and to what extent the government's dirigisme was acceptable and, in the end, productive.

The trick was to strike the right balance among utility, trust, and protection of the financial system. Was the safeguard clause the right response? Historians agree that bank runs scaled back sharply after the clause was invoked – but they didn't stop. On Monday, 3 August 1914, customers were still waiting more than two hours to get to their safe deposit boxes, or behind 500 other people to reach a till.

So the clause didn't alter the bank run fundamentals; it just prevented people from making large withdrawals. However the clause did have a major effect on new deposits, which dried up as savers worried that money they put into their accounts would be blocked.

The *Caisses* also saw bank runs in the 1930s, most notably in March 1936 and September 1938 when French savers experienced *déjà vu* from the first World War.

When Hitler set his sights on the Sudetenland (the German-speaking region of Czechoslovakia), France was obliged to intervene under its defence treaty with the bullied country. At that point the French people were certain war was going to break out, but the Munich Agreement in late September 1938 bought them another year. However the threat of war was so vivid that savers flocked to get their money out of the *Caisses*, triggering the savings banks' most violent run in their history. Some *Caisses* lost 30% of their deposits, even though technically they had only enough funds to cover 10%. They were on the verge of running out of money and the banking system was about to seize up. One more day and France would have run out of paper money.

It was the *Caisses* that caused the most problems during the crisis. Savers took out a total of nearly FRF4 billion from the two *Caisses* networks in September 1938 alone. The total for France's four main credit institutions was half as much, or some FRF2 billion. Historians agree that *Caisses* customers are the ones who panicked the most.

At this point the French government entered into heated discussions with the *Caisses*. Whereas the government had been pleased with the savings banks' role in mitigating the early-1930s crisis, it now felt that the *Caisses* had become too large and unstable – especially for times of political uncertainty. Just after the Munich Agreement, France started preparing for war. The government scaled back the social programmes won by the left-wing *Front Populaire* movement and began ruling exclusively through governmental decrees, including one that capped annual deposits into savings banks accounts at FRF20,000. It siphoned off money from the *Caisses* and lowered the interest rates on their accounts. Some people objected that the *Caisses* were being sacrificed. But the government needed bank loans to finance the war effort – and the banks, still mindful of the previous crisis, showed the government the potential danger lying with the **Caisses**.

French savings banks were highly vulnerable to political crises throughout the “traditional period.” In addition to the two big ones mentioned above, they were also affected by around 20 smaller ones in the 20th century. However after the 1970s the *Caisses* experienced a respite from such crises. This is attributable to a number of factors. First, the stability of France’s Fifth Republic, which prevented the kind of political crisis that could afflict savings accounts. Second, many new payment methods were starting to be developed, making it less important to have a ready supply of fiduciary money. Despite these advancements, today the risk of a bank run triggered by political events is still very much present, as seen during the first Gulf War. The *Caisses* have also undergone several changes recently making them more exposed to all types of crises.

French savings banks today: modern services but higher vulnerability to crises

The *Caisses* began to implement major modernisation initiatives in the late 1970s, such as introducing checking accounts and consumer loans, and expanding into the full range of banking businesses. They also underwent a major restructuring between two French banking laws passed in 1983 and 1991, as the local *Caisses* were grouped under a single central *Caisse*. By 1999 they had become retail banks, and on 25 June of that year officially became cooperative banks.

With the change in status from a philanthropic financial institution to a cooperative bank, the *Caisses* entered the 21st century with very different ambitions than the ones upon which they were founded.

Between 1966 and 1983 the *Caisses* broadened their knowledge of the banking business considerably. They introduced two key new services: checking accounts and – most importantly – consumer loans. In fact consumer loans are what really brought the *Caisses* into the banking world. For the first time they found themselves in direct competition with retail banks and had to take on customer risk. At this point consumer loans made up only a small part of their business; most of their loans were to local governments (under France’s *Minjoz* law). But it did mean that *Caisses* had become proper credit institutions – a status formalised in a reform law passed on 1 July 1983 allowing the *Caisses* to carry out all banking activities. This was confirmed with another law passed in 1984.

However the 1983 law restricted the *Caisses* to non-commercial retail banking. It also restructured the *Caisses* to create a genuine banking network. The *Caisses* were grouped with CDC under a national organisation: CENCEP. In 1991 CENCEP's role was enhanced and the number of local *Caisses* was slashed from 464 in 1983 to 34 in the 1990s. The restructuring was finalised on 25 June 1999 with the transition to cooperative bank status. Following the creation of a national *Caisse d'Épargne* (CNCE) and a federation, the *Caisses* had a structure similar to that of French rival *Crédit Agricole*. The *Caisses'* customers and employees were given the opportunity to buy shares in the local companies controlling each of the 34 *Caisses*.

In 2001 the *Caisses* teamed up with CDC, which already had a 35% stake in CNCE, to set up the Eulia European alliance. Eulia was a holding company comprised mainly of French investment bank CDC Ixis, which was 50.1%-owned by CDC and 49.9%-owned by CNCE. The alliance let the *Caisses* and CDC achieve a critical size on a European scale – but it shackled the *Caisses* to the French government since CDC was a public-sector institution. This posed a problem because the *Caisses* wanted to follow in the footsteps of their cooperative banking peers and implement a growth strategy based on acquisitions. The country's other cooperative banks all followed the same development path: state protection until they reached a critical size, then freedom from government rule. According to André Gueslin, France's cooperative banks in the late 20th/early 21st centuries needed to restructure in a way that distanced them from the cooperative spirit. They had to acquire private-sector banks if they wanted to become large enough to compete on a European scale. For example, *Crédit Mutuel* bought *CIC* and *Banques Populaires* bought *Natexis*.⁵ The *Caisses* also felt pressure to expand and sought to come out from under the government's fold, so they could become a full-services bank. In spite of their new cooperative bank status, the tie-up with CDC was a major hurdle in their effort to break free from the state. The opportunity came in 2002 with a change in the majority party in the French parliament. Heated discussions ensued between the *Caisses*, CDC, and the Finance Ministry, as the new governance and organisational structure created tension between the two banking groups' divergent goals. The government decided to keep CDC as a public-interest bank and to sell Eulia and CDC Ixis to the *Caisses*.

5 Gueslin, André. "Les banques de l'économie sociale en France: perspectives historiques," in *Revue d'Économie Financière*, Issue 67, 2002, pp 40-41.

In July 2004 – three years after the *Caisses*' restructuring – the *Caisse d'Épargne* group was entirely rebuilt. CDC sold its stake in Eulia and its CDC Ixis investment banking business to CNCE, but kept its 35% stake in CNCE. The *Caisses* were thus able to reach one of their main goals: become a competitively-sized full-services bank with three main businesses – retail banking (the *Caisses*' traditional bread-and-butter), mortgages (where they became a major player following the acquisition of Crédit Foncier); and investment banking (where they had little experience). This last business, investment banking, is where they focused their next growth phase.

The Ixis acquisition along with the purchases of local banks in different countries gave the *Caisses* a global footprint. Yet they were still on the lookout for European or even global alliances. In June 2006, they entered into an agreement with Banque Populaire to merge their investment banks – Ixis and Natexis – to form NatIxis.

In 2008 the *Caisses* ran into serious problems following bad investments by CNCE and poor decisions at Natixis, which got wrapped up in the subprime mortgage crisis and Madoff scandal. In 2009 CNCE and Banque Populaire merged to form a new bank, BPCE. However this merger involved only the corporate entities; the retail banks continue to operate under their original brand names.

The *Caisses* came out of the many changes it went through in the 2000s completely transformed. While the early stages of this transformation were desired, the latter ones were inflicted by the current financial crisis.

So what remains of the original *Caisses d'épargne* described at the beginning of this paper? Even as late as the mid-20th century they largely resembled the savings banks initially set up. On their 150-year anniversary in 1968, savings accounts still accounted for almost all of their business. But just 50 years later, on 1 January 2009, their transformation was complete when all French retail banks were given permission to offer regulated savings accounts (Livret As).

Loosing this oligopolistic hold on what had once been their core business – and for which they had fought for nearly two centuries – completely changed their paradigm.

Our overview of how well France's savings banks, the *Caisses d'épargne*, withstood various crises over the past 200 years shows that they proved to be solid institutions in times of financial turmoil. But they did fall prey, in varying degrees, to all of the country's political crises. The major crisis-related threat for the *Caisses* before the turn of this century was not financial but political. Looking more recently, after the *Caisses'* restructuring in the 2000s they seem to have become more vulnerable to all types of crises; their decision to become a full-service bank has borne its share of risks. So what lessons can we take away from this? First we should consider the development path chosen by the *Caisses*. No doubt they had to become a cooperative bank and bring in outside shareholders to modernise. But this doesn't mean we should teleologically conclude that the *Caisses* had no choice but to become a cooperative bank – or, by the same token, to become a full-service bank. We could ask the same question about the necessity to break out of the government's sphere so quickly, considering the risk of breaking prudential rules and of seeing the hand of power return once again during the restructuring. We don't claim to have all the answers. The *Caisses'* decision to modernise was perfectly logical and followed the steps taken by other cooperative banks. But perhaps they moved too fast for an institution whose history has been built up slowly over time.

About the Author



Vincent Tournié, doctor in history at the University of Denis Diderot Paris VII, has devoted his time in investigating the history of money and savings banks during the 1930s crisis, before extending his research to cover the whole of the 20th century. He is the author of *Epargne et crises dans la France des années trente*, and *Epargne et crises politiques en France*. He has been awarded a prize by the Savings Banks Academic Award in 2008.

THE IMPACT OF THE CRISIS ON SAVINGS BANKS IN ITALY



Giovanni Manghetti

This crisis has not been limited to the real economy. Italy has been suffering a long and very serious recession. GNP has fallen 8.3% since 2008, more than during the Great Depression. We have ever increasing unemployment (a steady trend of 12%), more short-term precarious employment, a fall in effective demand and productivity (presently, the latter is only 60% of Germany's). The present expectations are negative, and we all know how important such expectations are to any recovery (GNP in 2013 will fall by around 1.5%).

What is the real cause of this crisis? To put it simply, the lack of adequate resources for investment over the last 15 years is to blame. So this crisis cannot be regarded just as the effect of the 2007 financial crisis – the illness, so to speak, had already weakened the body. The failure of Lehman Brothers was the explosive trigger that tore apart a country that had not experienced growth in over ten years.

However, I believe this crisis is something more: it is a social crisis. On one side, people living under the poverty line number approximately 8 million. I am talking about a basic income threshold which is approximately €1,000 for a family of two. The average Italian income is still stuck at the same level as it was 15 years ago.

On the other hand, there is a dense concentration of wealth among a very small élite. An astounding 3% of the population possess 25% of the overall wealth.

Interdependence between economic and social crisis is not something new: throughout crises of the real economy we have witnessed such a correlation. But the wide disparity between rich and poor is simply incomparable with previous generations. And mine is not a mere moral consideration; this reality has a direct negative impact on effective economic demand.

In my opinion, we are facing a crisis of *values*. We saw a similar crisis of values after the First World War. After that period fascism took over.

Today, there is not only a lack of trust in the economy; there is also a lack of trust in the market, in the state, in many of society's institutions and – obviously – in our politics. Values associated with the past century such as solidarity, justice, institutional duty and responsibility – in other words, public service – are no longer the main aim of private and public sectors or even of central and local political and social institutions. In any field, expectations are totally negative. But which came first: the economic crisis or the deterioration of basic values?

Notice I have not even mentioned the banking system or saving banks. They are within this bigger picture. Their essential problem, like that of most banks is that the difference between the income of money sold and the cost at which money is bought is too low to cover administrative (including governance) costs and losses on their credits. This is not a small problem; it is **the** problem. The future of banks depends on how they tackle these losses. No temporary solution will do.

“The banking system” for most means the big banks, in which, again, a crisis of *trust* has come into play. Which is no surprise: banks live on the basis of trust and so they fail on the basis of mistrust. Let's look at two examples:

In October and November 2011, in most Italian banks there was serious tension concerning their liquidity. This situation was similar to the crisis with national bonds. It was experienced everywhere – even in savings banks. Many savers did not sell their money to the system as in the past; many borrowers did not pay back their loans; banks did not sell their money to other banks, thus destroying the consolidated interbank market. This was the first step of a liquidity crisis, as we know, when banks themselves fail. The second step never occurred – a run on deposits – thanks to the Eurosystem.

The Eurosystem helped out in the early 2012, significantly improving banking liquidity (8.5% of their total assets). But right now you can buy money on the interbank market only by producing collateral of the same amount requested. Thus I can venture to say that banks do not even trust *each other* yet.

The second example: Some months ago certain managers of 3rd largest Italian banking group were legally charged for knowingly selling faulty derivatives and to have hidden them from the Italian supervisors. From that day on, all banks had to defend their reputation, emphasising that not all bankers are criminals (or “banksters”, if you like), and that in most banks banking activity is traditional: from savings to loans. But it was and is still not enough to reassure local communities. Since the newspaper headlines announced this scandal, people have asked, “Why do you big bankers get millions in spite of what your bank has been through? Why don’t you bail out the economy?!”

But my main point is this: can savings banks be elements of stability in times of crisis? Can they be in Italy? What is the impact of the crisis on savings banks?

The 16 autonomous savings banks in Italy control a modest share of all deposits and loans (table 1), respectively, 4.4% and 4.3%. If we add savings banks under the control of bigger groups these percentages rise to 6.5% and 8%. In Italy the level of asset concentration of the five main banking groups remains very high: close to 50%. Consequently, in trying to respond to the core question of the savings banks’ role of providing stability in times of recession, these figures would not seem able to influence the market.

Table 1

	Deposits/ system (2011)	Loans/ System (2011)	Branches/ System
SBs (autonomous)	4.4%	4.3%	6.3%
SBs (inside groups)	2.1%	3.5%	6.0%
Total SBs	6.5%	7.8%	12.3%

Source: ACCRI, assets and liabilities data 2011.

Savings banks are established in specific territories: in other words, their share of national branches is larger than their share of national savings. Savings banks branches account for 12% of all bank branches in Italy, so you see just how many villages they are in. They support small and medium-sized enterprises in each territory, which is critical for the survival and growth of such businesses. During the crisis, savings banks can consolidate short loans and postpone their refund, ready to pay to the creditors of SME's and to anticipate and possibly renew their customer credits. They are not involved in risky financial activities. Moreover, the foundations that control their capital continue to support social, cultural and economic projects in the territory.

It is not surprising that in these local territories, families continue to maintain and increase their savings in the nearest bank. During the crisis (2007-2011) savings banks increased their deposits by a satisfactory 26.7% while the rest of the system increased by only 24.8%. However, savings banks' inside groups (Savings banks which are not autonomous and are controlled by other banks) experienced a decrease of around 17% (table 2).

Table 2

	Deposits (2007-2011)	Loans (2007-2011)
SBs (autonomous)	+26.7%	+24.5%
SBs (inside groups)	-16.8%	+19.8%
Banks (rest of system)	+24.8%	+30.1%

Source: ACCRI, assets and liabilities data 2007-2011..

For the same period savings banks' loans increased more than savings banks' inside groups but less than the rest of the system (24.5%, 19.8% and 30.1% respectively) (table 2). Banks with more stable funding have lent more during the crisis, as the Liikanen report concluded, which was the case in Italy when comparing autonomous savings banks to savings banks' inside groups.

Moreover, more stable funding is a safety net when banks finance long-term loans with shorter term bonds, as is happening in the present situation in the whole system. Recall that during the fascist period, the crisis of Italy's three biggest banks – Banca Commerciale Italiana, Credito Italiano and Banco di Roma – derived from this trade-off and opened the way to the first great banking reform, substantially based on the separation between short- and long- to mid-term credits. That is, it opened the way to their nationalisation. Again, we can easily understand what could happen when trust in banks is lacking at the same time as ECB liquidity is paramount to preserving the system.

All banks, including savings banks, are suffering economically: they are not able to achieve a profit on the basis of their traditional interest margin. Their mediation is not sufficient to balance their non-performing credits. The system's NPCs were 7.2% of the total 2012 credits at the end of 2012 and they are still rising (table 3).

Savings banks register, by and large, the same situation, more or less depending on their territory. Their main customers, SMEs, are more exposed to failure than the "too big to fail" enterprises. Their net NPCs nearly tripled (table 4). But comparing NPCs with those of past nationalised banks, we can see they are much lower, which is a good news.

The present crisis is too deep to permit any positive margin. Banks can tackle these losses and the cost of their retail presence in the territory only thanks to income from national bonds and the substantial liquidity given to the banks by the ECB. This is totally different from the heavy state intervention during the crisis in the 1930s, when protectionism was a general response. At the time, the bigger banks were nationalised; today they are not, but we have a whole new risk on top of the more traditional ones: the risk of the national debt, amounting to €320 billion. This is obviously bad news. During the 1960s and 1970s, savings banks and some public banks invested most of their assets in national bonds at a time of low national debt. Today's risk is far greater.

Why doesn't this liquidity go into the real economy? Why is it, on the contrary, invested in national bonds? Banks reply that it's because there are not enough business investment projects in the market. Would-be entrepreneurs and others retort that it's because banks are not granting credit, in contradiction with their high liquidity.

Table 3: NPC ratio and provision rate in Italian banking system (Percentages, December 2012)

	First 5 banks*		Banche grandi*		Banche piccole*		Banche minori		Finanziarie autonome*		System	
	%	provision rate	%	provision rate	%	provision rate	%	provision rate	%	provision rate	%	provision rate
NPC	7,7	56,1	6,1	52,2	7,4	56,0	6,1	46,1	8,1	55,1	7,2	54,6
STUCK	4,1	25,2	3,7	23,1	4,7	22,7	5,8	14,1	3,8	22,2	4,2	23,2
RESTRUCTURED	1,2	24,0	0,6	17,0	0,5	15,7	0,4	16,1	0,2	10,0	1,0	22,4
EXPIRED	1,0	10,8	1,1	7,5	1,9	10,1	1,6	4,1	1,7	13,4	1,1	9,4

* These terms are used in the statistics of Banca d'Italia
Source: Rapporto sulla stabilità finanziaria, Banca D'Italia, aprile 2013

Table 4

	Saving banks capital/assets (2011)
CR Genova	8.3%
Banca delle Marche	5.6%
CR Asti	7.1%
CR Bolzano	7.4%
CR Cento	7.4%
CR Cesena	9.1%
C.R.Prov. Chieti	4.7%
CR Fermo	9.7%
CR Ferrara	8.2%
CR Fossano	7%
CR Ravenna	11.5%
CR Saluzzo	7%
CR San Miniato	5.6%
CR Savigliano	5.9%
CR Teramo	8.2%
CR Volterra	7.7%
Totale Media	7.5%

Source: ACCRI, assets and liabilities data 2011.

But are banks really responsible for the credit crunch? I am not defending banks, but I refuse any populist argument. I highlight this fact: the long-term real interest rate is around 2%, which is lower than any such rate during the last positive cycles; even so, we do not have investment projects. Expectations in growth are so negative that entrepreneurs are unable to contemplate even modest risks. Actually, effective demand is so low that it prevents them from investing new resources. The demand for new credit is only for paying taxes, social contributions and the like.

Thus we are trapped inside that classic “vicious circle”. And this circle has not been broken by a fiscal policy which in the last 18 months has been pro-cyclical.

Fortunately, with regard to total capital of Italian savings banks, their capital to total assets presents satisfactory ratios (table 4). Therefore, we do not have any problem with their solvency. Moreover, provisions for non-performing credits are adequate, as the recent IMF inspection confirmed for most banks. This situation, again, is less stressful than that of the time of nationalisation when all the capital was lost.

The point is that savings banks can be an element of stability, even if their data are too far from the market to influence it. Why? Because if we consider them beyond their economic role, we find that it's in their values and identity that they exert national impact. For one, upper management salaries are modest compared to those of big banks, and don't dwarf those of their employees. What's more, their salaries are totally transparent, meaning they are known at local level. Savings bank leaders are civil servants and people know it.

What is the conclusion of this investigation into the comparable differences in values?

A change in economic policy is urgently needed. I do not particularly like to push myself into the arena of politics, but I simply say that Italy – and Europe – needs an anti-cyclical policy. The economy needs public support of investment and consequently of effective demand. The new government opened the way to a new approach: its programme is anti-cyclical and markets, inflated by a lot of liquidity, have appreciated it. Perhaps it is time to leave politics behind and to enter into policy reforms – reforms deep enough to create *exponential* trust.

The government's aim is not so easily achieved: the national debt has sharply risen since 2007, and now it is necessary to reduce it (with regards to GNP) and to support economic recovery. We must not forget that the whole banking system possesses €320 billion in national bonds. Any success of the government will produce a positive impact on bank risks, and vice versa. Its success will depend on a profound change in public resource composition, increasing investments and national demand, but reducing current expenses. I repeat: Italy needs to reduce current expenses, not to increase taxes. Consequently, a share of this reduction in current expenses must be addressed to the reduction of personal tax income on lower salaries and to support public investment. Thus effective demand will be increased.

Where are we headed? In my view, towards profound change, which is necessary with regards to finance markets and banks. But also to global finance markets, so it is essential to re-establish close ties with the real economy: it is totally absurd that we have to accept an amount of outstanding derivatives ten times the world's GNP.

In addition, new banking leaders, selected for their new values, are needed in Italy, and perhaps, elsewhere. We need leaders who accept remuneration systems that are coherent with this economic period. Presently, upper management salaries are 46 times the average salary of employees. Such self-analysis is the first step towards a new approach to the society we serve.

We need genuine “civil servants”: people who accept the burden of responsibility for the interest of society. What do I mean exactly? We need bankers who are not merely involved in financial risks only to passively observe the economic problems that come into play; rather, we need those who, on their own, actively propose solutions to the government, not out of some self-serving agenda, but in the interest of the common good. Shouldn't we be aware of our national duties? We do not need “Waiting for Godot” bankers.

What about savings banks?

Savings banks are providing right responses to this crisis, but their economic role in Italy is limited. Only by looking at their values and their financial behaviour – above all, their close link with the territory, thus with the real economy – can we conclude that these values must be brought to general attention, because they just might restore trust. The nation needs such moral values. I write “the nation”, but it would be better to write: all the states of Europe need to have banking and financial systems whose activity is more closely linked with the real economy. To restore trust.

But at the same time, it is my professional duty to underline that the recovery of trust is essential for all the banks in order to maintain control of the impact on the trade-off regarding different durations of banking loans and deposits and to thus reduce, in the near future, the role of ECB liquidity. In other words, trust is not only a moral value, it is connected with the basis of banking activity.

“Do not call me bank. I am a savings bank.” This is the advertising campaign of my bank, Cassa di Risparmio di Volterra. It explains quite clearly how we invite people to look at us now, in a very different way.

A savings bank president has been called upon to lead the Italian Banking Association. Shouldn't we consider this as a first step in the right direction?

About the Author



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Member of Board of Association Banking System and Savings Banks Committee Member of Board of IDPF (Interbank Deposit Protection Fund)

PAST ASSIGNMENTS

- Chairman of the Task Force for the Revision of Insurance Core Principles (ICP) upon mandate of the Technical Committee of IAIS, International Association of Insurance Supervisors – such mandate included the rewriting of the Supervision Principles in order to harmonize them for all world jurisdictions. The IMF and the World Bank were among the members of the Task Force along with other 13 representatives of leading nations
- Former Member of the Scientific Technical Committee, Italian Accounting Standards Setter,
- 2005-2006 World Bank advisor in Serbia to local insurance Supervisor
- 2002-1988 Former Professor of Banking at LUISS “Guido Carli” University, Rome
- 2002- 1996 Former President – Managing Director of ISVAP – Italian Insurance Supervisor Authority
- 1996-1983 Economic Advisor of the Labour Minister, Foreign Commerce Minister and Finance Minister
- 1996-1990 Former Board member of MEDIOCREDITO – Italian investment bank – in Rome
- Many publications on insurance and finance matters.

THE SAVINGS BANK CRISIS IN SPAIN: WHEN AND HOW?



Pablo Martín-Aceña

The present financial crisis has severely hit the Spanish savings banks sector. Of 45 savings banks in 2007 by the end of 2012 the number had dropped to only 13. Most of the institutions that disappeared were consolidated into major groups, either by outright purchase by banks or as a result of merging operations among individual savings banks. The Bank of Spain and the FROB¹ have bailed out seven savings banks or groups of savings banks, and four of them have been nationalised. Moreover, nearly all merger operations have required public resources, which in turn have increased the already large government budget deficit.

As indicated, the resolution of the overall financial system crises, savings banks included, has required massive financial support from the Spanish government, which in June 2012 was forced to request external assistance from the European Financial Stability Facility (EFSF). A Memorandum of Understanding was signed on 20 July that included financial aid of €100 billion to cover losses and to capitalise all of Spain's viable banking institutions still in need of completing the restructuring process. By December 2012 the funds channelled to the banking sector amounted to the staggering figure of €61.2 billion euros, or about a 5.8% of GDP; 36.5% of these funds has come from the FROB, the rest, 63.5%, from the EFSF. The amount of help received by the Spanish banks in terms of GDP was the second largest of the European Union and the United States, and only after the assistance received by the Irish financial system (see table 1). Never before the present crisis was the Spanish savings banks sector subjected to such financial turmoil. On the contrary, 150 years of financial history show that until the 21st century all crises affected commercial and investment banks, but not savings banks.

1 Fondo para la Reestructuración Ordenada Bancaria (Fund for the Orderly Restructuring of the Banking Sector) created in July 2009.

Table 1: Public aid to all the banking system: bank and savings banks ranked by % of GDP

Countries	Aid (€ billions)	Percentage of GDP (%)
Ireland	21.2	13.3
Spain	61.2	5.8
UK	72.9	4.2
Belgium	12.2	3.2
US	327.6	3.0
The Netherlands	16.1	2.6
Germany	46.5	1.8
France	15.7	0.8

Source: International Monetary Fund.

Between 1800 and 2000, according to a recent study, Spain suffered eight banking crises, five in the 19th century and three in the 20th century.² Many of them coincided with international banking crises. In the 19th century the worst was in 1866, when half of the credit companies and banks created just one decade earlier were liquidated. In the 20th century the most severe crisis took place in 1977 and lasted nearly five years, and again half the existing banks were dissolved or merged with other banks. The overall cost of the rescue operation was about 5% of GDP.

The history of Spanish savings banks, however, shows no record of any serious crisis after the 1835 establishment of the first institution, Caja de Ahorros de Madrid (now integrated into the infamous Bankia Group). From that date onward the number of savings banks increased as new institutions were founded by wealthy local patrons, the church and charitable organisations. By 1900 there were about 55 savings banks scattered throughout the country. In this long half century no major incident occurred and only ten small savings banks disappeared, absorbed by larger institutions within the same territorial area of influence.

2 Concha Betrán, Pablo Martín-Aceña y María A. Pons, "Financial Crises in Spain. Lessons from the last 150 years", *Revista de Historia Económica. Journal of Iberian and Latin American Economic History*, 30, 3, 2012, pp. 417-446.

Between 1900 and 1935 the number of savings banks increased to 171, due to new foundations promoted by local public entities, such as municipalities and provincial councils. In this period, which was turbulent for commercial and investment banks, there is no record of difficulties for the savings banks sector. In the 1931 crisis four small savings banks suffered liquidity difficulties, although only one of them had to be rescued by a joint operation orchestrated by the *Confederación Española de Cajas de Ahorro*s (Confederation of Spanish Savings Banks) – CECA – created in 1926,³ and a group of institutions rooted in the same geographical area. Thereafter, the *Instituto de Crédito de las Cajas de Ahorro*s (Institute of Credit for Savings Banks) – ICCA – created in 1933, did not undertake any rescue operation as “lender of last resort”, precisely the function for which it had been established. Savings banks specialised in mortgage credit and in personal short-term loans of small amounts. They also held treasury bonds of differing maturities in their portfolio, and a limited volume of major company securities listed on the stock exchange. Their holdings of both public and private securities were then quite safe investments. On the other hand, the source of their financial resources consisted basically of time deposits and accumulated reserves.⁴ They did not depend at all on the domestic or international capital market to finance their financial operations. They restricted their activities to their own local market and had a good knowledge of their customers (firms and families) to which they lent. Management was usually prudent and conservative, and not subjected to the pressure of stakeholders demanding high returns for their share. The principle of territoriality was paramount, and hence their operation restricted generally to a single province.

During Franco’s long dictatorship savings banks were subject to strict government control, even more extreme than the surveillance exerted over commercial banks. However, despite all the restrictions on their operations, the savings banks sector expanded considerably, not in number (88 in 1975), but in share of the national credit market, to 30%. However, they lost the autonomy they had enjoyed since their origin.

3 F. Comín, *Historia de la cooperación entre las cajas de ahorro*. La Confederación Española de Cajas de Ahorro, 1928-2003. Madrid, Confederación Española de Cajas de Ahorro.

4 As elsewhere, savings banks were originally non-profit institutions (charitable institutions, private foundations, and mutual aid funds) without neither capital nor shareholders. Hence, they do not have, *strictu sensu*, owners, and profits must either be invested or used to promote community welfare programmes.

First the Ministry of Labour, then the Ministry of Finance after 1957, oriented savings banks resources towards the economic and industrial priorities of the dictatorship. Their portfolio was loaded with government bonds and public enterprise securities, and the rest of their investments consisted of long-term credit to the building sector at official interest rates. The number of savings banks decreased, not owing to bankruptcies but to diverse processes of strategic alliances. The absence of crises during this period was the result of the strict regulations imposed on the financial system. As in the rest of Europe, mergers and acquisitions of troubled banks and savings banks by sound institutions, with the fiscal support and under the auspices of the supervisory authorities, were the alternatives used to avoid chaotic liquidations. The absence of crises was also the result of the savings banks low risk investment profile. Moreover, CECA promoted a policy of internal cooperation and a self-defence strategy of "internal solidarity": a so-called competitive collaboration which allowed participants to internalise competencies and also learn from their associates, while cooperation aimed to overcome regulatory and environmental restrictions to market penetration.⁵ This implied that when any member of the group was temporarily in trouble, CECA discretely mobilised the sector to avoid a possible failure. On the other hand, ICCA was the institution that provided the resources, if necessary.⁶

The late 1970s and early 1980s saw the largest failures of the Spanish financial system since the crash of 1866. Twenty-four institutions were rescued, four were liquidated, four merged, and twenty small and medium-sized banks were nationalised. These 52 banks out of 110 represented 20% of the deposits of the entire banking system.

The crisis also affected a number of savings banks. The impact was less severe and more gradual and this, together with the solidarity of these institutions, meant that the problems were born and resolved discretely.

5 B. Bátiz-Lazo, "Strategic Alliances and Competitive Edge: Insights from Spanish and UK Banking Histories", *Business History*, 46, 1, 2004, pp. 23-56; F. Comín, "Spanish saving banks and the competitive cooperation model, 1928-2002", *Revista de Historia Económica. Journal of Iberian and Latin American Economic History*, XXV, 2, 2007, pp. 199-230; and J.C. Maixé-Altés, "Competition and Choice: banks and saving banks in Spain", *Journal of Management History*, 16, 1, pp. 29-43.

6 F. Comín, "The Saving Banks, 1900-1975" in J.L. Malo de Molina and P. Martín-Aceña (eds), *The Spanish Financial System. Growth and Development since 1900*. Palgrave-Macmillan, 2012, pp. 145-181.

There were no threats of collapse, but by 1986 the Savings Banks Deposit Guarantee Fund (FGDCA – Spanish acronym) had granted a large volume of resources to sustain four institutions in difficulties. Throughout the rest of the decade, some continued to record difficulties, and even to need further assistance. In many instances insolvent small and medium-sized savings banks were absorbed by larger and better managed institutions. In other cases, merging was the procedure used to solve the problems. All in all, between 1977 and 1986 more than a dozen savings banks closed. Thereafter, in 1991 and 1992 came a wave of savings banks mergers with support from the FGDCA, which reduced their number to 51 but maintained their market credit share. By 2007, before the present crisis, they accounted for about one half of the Spanish financial system.⁷

The severity of this first 21st century crisis in the savings banks sector is therefore a new phenomenon, with no historical antecedent. As we have seen, savings banks weathered better than the banking system most of the crises since 1850. Not anymore. Large and medium-sized institutions have been rescued with taxpayer (Spanish and European) money, and many small size institutions have been merged with others or absorbed by the few financially solid savings banks which have surmounted the convulsions with their own means.

Why has the Spanish savings banks sector collapsed? Why have so many long-standing institutions gone bankrupt? What are the causes of this ongoing savings banks crisis?

The first explanation has to be found in some of the unexpected consequences of the sector's reforms undertaken in 1977 and thereafter. In 1977, when the banking sector crisis began to unfold, savings banks went through a period of notable institutional changes. The functioning of the old and traditional savings banks was made comparable to that of the commercial banks. Its financial activities were liberalised and the range of their operations enlarged. In 1988 they were also allowed to open branches all over the country, which put an end to the territoriality principle. Also in 1988 a new financial instrument was created, the so-called "*cuotas participativas*" (non-voting shares), specific titles issued by the savings banks to increase their resources.

7 R. Poveda, "Banking Supervision and Regulation over the Past 40 Years", in J.L. Malo de Molina and P. Martín-Aceña (eds), *The Spanish Financial System. Growth and Development since 1900*. Palgrave-Macmillan, 2012, pp. 219-271.

Holders of *"cuotas participativas"* could participate in the benefit obtained by the institutions but they had no voting rights. The reform of 1977 modified as well the government structure of the savings banks, which until then was determined, according to their particular statutes, by a small number of individuals and composed almost exclusively of the original members of the founding institutions and corporations. The reform was intended to democratise the composition of the boards of directors by including members representing the interests of various stakeholder groups: founding entities, depositors, employees, trade unions, and public authorities. It also aimed to professionalise the governance of the institutions by reinforcing the role of the general managers in charge of the day-to-day operations and of the financial strategy. But in 1985 a new act altered the composition of the governing bodies by increasing the presence of the public authorities. The boards of directors fell into the hands of the local and regional (Autonomous Communities) corporations controlled by the political parties and the trade unions connected to them. Moreover, the powers of the general managers were curtailed and some of their functions assumed by the president of the board of directors, usually a person appointed by the local or regional governments. For a time (during the economic expansion of the late 1990s and early 2000s), this peculiar arrangement coupled with free competition (after the removal of the financial differences with the commercial banks) served well the desires and goals of both savings bank managers and their "political supporters". For a decade the savings banks were very successful in capturing the excess resources of small and medium-sized investors and lending to small and medium-sized firms. They multiplied their presence by opening branches all over the country (from 9,386 in 1979 to 24,202 in 2009), as well as by expanding beyond their traditional business products to reach new customers.

While the economic cycle lasted the savings bank sector showed its better face and all entities, whether big or small, seemed to have a bright future. During the so-called Great Moderation and thanks to the early integration into the Eurogroup, the Spanish economy enjoyed a decade of steady growth. Fuelled by low interest rates and a constant flow of external capital, the financial sector expanded and a huge amount of resources were channelled to building development and construction. The boom in the building sector was comparable to the boom in the UK and the US. With easy access to the international financial market the savings banks participated in the building boom of the 2000s, either by financing new developments or granting mortgage credit.

Total credit to the private sector in 2007 was four times greater than in 2001, and the share of loans to building and development companies in their books at the onset of the crisis ranged from just over 10% to almost 50%. To finance the expansion of their balance sheets, instead of reinforcing their own resources or increasing the volume of deposits, they resorted to the wholesale international financial market, primarily based on the emission of mortgage bonds, endorsed by their portfolio of mortgages, and also based on an array of new instruments.

Before long, an important segment of the sector accumulated imbalances of various kinds whose magnitude was evident when the economic environment changed. The most serious problems were its high exposure to real estate development and construction, dependence on wholesale external financial markets, an excess capacity relative to the sector's demand, and the fragmentation of the industry into a large number of small entities. And although Spain's banking institutions avoided the worst excesses of the originate to distribute model, the truth is that savings banks had made widespread use of securitisation and covered bonds to refinance mortgage portfolios. When the real estate boom collapsed, it left in its wake a huge amount of unsold housing and unfinished development and a mountain of unrecovered loans.

A second explanation to understand the crisis of the savings banks has to do with their peculiar nature. Savings banks are (or rather were) not banks. Their mission, the outcome of a historical evolution from institutions, was focused on providing financial services to avoid financial exclusion, conducting community welfare activities, and pursuing the economic development of the region in which they operate. Their internal organisation is complex and rigid and far from the international practices of corporate governance. With the impetus of their founding fathers long gone, the process of appointments of senior executives degenerated into corruption, nepotism and inefficiency. Although attempts were made to remedy the situation with well-meaning formulas, the fact was that representatives of regional and local governments gained a significant presence in their governing bodies, a situation which, apart from creating occasional tensions when it came time to renew these appointments, affected investment policies.

On the other hand, legal restrictions to obtaining core capital posed a serious obstacle to their urgent need of capitalisation in order to raise their solvency ratios. As the crisis deepened, their profit margins declined and so did their accumulated reserves, the most important source of core capital, since savings banks, which are basically foundations, cannot issue shares. While the savings banks maintained a business model based on the geographical proximity to their customer, marketing of non-complex financial products, and moderate growth strategies, it was sufficient to obtain equity by capitalising self-generated profits. But when they deviated from this model, traditional funding sources were insufficient.

The difficulties began in March 2009 when the Bank of Spain rescued the first savings banks (Caja de Castilla-La Mancha). To avoid a catastrophic liquidation the FGDCA bought €593 million in non-performing assets. Later the sale of the Caja required additional aid of €2.5 billion. It was then that the financial authorities realised that this was not an isolated case and that they might have to face problems in some other institutions with deteriorated balance sheets and low capital to assets ratios. They also realised that, after a decade of uncontrolled expansion, the savings banks structure was oversized. According to various consulting firms the excess capacity required closing 10,000 branches and cutting 35,000 jobs. A list was made with undercapitalised institutions (low solvency ratios). The list included the four giants Bancaja, Catalunya, Caja del Mediterráneo and Caixa Galicia, which a year later were bailed out by the FROB.

The constitution of the FROB in July 2009 put into motion a consolidation process which required a significant volume of public funds. In 2010 there were four big merging operations and three outright purchases of small entities by larger and financially sound entities. In several cases, the merger did not follow the classic formula, but instead used Institutional Protection Scheme (IPS), an atypical EU banking regulation unknown to date in Spain. Savings banks that joined an IPS maintained their legal personality, community welfare projects and retail business, but they had to sign a long-term agreement, meaning the creation of a central unit and strong mutual solvency guarantees between member institutions. All in all, 22 savings banks were involved in the formation of five new IPSs.

Notwithstanding these operations, the general macroeconomic evolution of the country, with negative rates of growth and increasing unemployment, worsened the financial position of the majority of the savings banks, no matter their size. The proportion of non-performing assets and loan defaults in their balance sheets rose. In May 2010 the Bank of Spain intervened again to rescue a second institution (Cajasur). At the same time the European Supervisory Authority undertook the first of a series of “stress tests” to examine the financial strength of the Spanish banking system. Almost all entities (banks and savings banks) were under the close scrutiny of the Committee of European Banking Supervisors. The results of the “stress tests” revealed that banks were in a solid financial situation to absorb potential losses in an adverse macroeconomic scenario. However, the results also revealed that five big savings banks were in a very fragile position, with very low solvency ratios and in urgent need of capitalisation.

The year 2011 was frantic. The FROB had to engage in four massive rescue operations with an astonishing consumption of public resources. The nationalisation of institutions and the array of measures implemented by the Bank of Spain, raising capital ratios and the provisions for potential defaults in order to strengthen banks’ balance sheets, did not dispel the mistrust in the Spanish financial system. The lack of confidence in Spain’s economy and in Spain’s banks closed the international market for new issues, increased the risk premium and generated serious liquidity problems. All Spanish financial institutions came under suspicion.

The year 2012 was even more complicated. The pressure exerted on savings banks by the Bank of Spain and the European Supervisory Authority intensified. Provisions to cover the credit granted to construction and property development firms were increased and the capital-to-asset ratio was elevated once again. A new “stress test” was conducted in order to determine the financial needs of the entire financial sector (table 2). In July, a Memorandum of Understanding was signed between the EFSF and the government of Spain according to which the latter was to receive €100 billion in financial aid to capitalise institutions in need of core resources and to wrap up the restructuring process of the savings banks sector. It was also agreed to establish a special institution (an Assets Management Company, with private and public capital) that would receive foreclosed real estate assets of the financial entities subject to the process of capitalisation and restructuring.

Table 2: Stress test, capital needs (€ millions)

Institutions	Baseline scenario	Adverse scenario
Santander	19,181	25,297
BBVA	10,945	11,183
Caixabanc	9,423	5,720
Kutxabank	3,132	2,188
Banco Sabadell	3,321	915
Bankinter	393,0	399
Unicaja	1,300	128
Ibercaja	389	-226
Caja3	-188	-779
Liberbank	103	-1,198
BMN	368	-2,208
Banco Popular	677	-3,223
Banco de Valencia	-1,846	-3,462
Novagalicia Banco	-3,966	-7,176
Catalunya Banc	-6,488	-10,825
Bankia-BFA	-13,230	-24,743
Total system needs	-25,718	-53,840

Source: CECA, Restructuring Process. Spanish Savings Banks. Progress Report (19 April 2013).

The websites of the Bank of Spain and CECA offer detailed and up-to-date information of the restructuring process and of the aid channelled to the financial sector as a whole, and to each of the institutions that have required funds. The financial aid has sprung from three sources: FGD (Deposit Guarantee Fund of Credit Institutions), FROB and ESM (European Stability Mechanism, the successor of the EFSF). All in all, the Spanish financial system by the end of 2012 had received €61.2 billion, of which 63.5% came from the ESM. The Bankia-BFA holding company (which includes the old Caja de Madrid) alone has taken the astronomical figure of €22.4 billion. The rescue of Catalunya Caixa has so far required €12.052 billion in public support. And the third major bailout, that of Caja del Mediterráneo, has consumed €5.2 billion of European and Spanish taxpayer money.

Spain has not been the sole country to use public financial resources to rescue its financial system from collapsing, as table 1 shows. In absolute terms, banks in the US and the UK have needed more money to survive. German and French entities have been bailed out as well, with an enormous cost to taxpayers. Nevertheless, relative to each nation's GDP, after Ireland, with an astonishing 13.3%, Spain, with 5.8%, stands in second place.

The impact of the economic and financial crisis on the savings banks sector has been devastating, if measured in the number of entities that have been rescued by the government, and in the number of units: from 45 independent savings banks of various sizes in 2010, the sector now has only 13 institutions (eleven groups and two small savings banks). The consolidation process has entailed a substantial increase in the average size of the remaining entities: from €29.4 billion in assets in 2009 to €89.5 billion in December 2012. As of December 2012, the number of branches had decreased to 18,409, a reduction of 20.5%, and employment had been cut by 20%, representing a loss of 24,313 jobs.

The impact of the crisis can also be gauged by looking at the volume of troubled assets in the portfolio of all savings banks. Table 3 shows that they represent more than half of total assets. In December their coverage was a mere 29%, while one year later the coverage had increased to 54%, owing to higher provisions and higher solvency requirements.

Table 3: Performing and non-performing assets in savings banks' portfolio (€ millions)

	Total balance	Coverage December 2011	Coverage December 2012	Coverage %
Troubled assets	184,000	54,000	99,000	53.8
Non-troubled assets	123,000		37,000	30.1
Total assets	307,000	54,000	136,000	44.3

Source: CECA, Restructuring Process. Spanish Savings Banks. Progress Report (30 November 2012).

The nature of the savings banks has been radically altered. A main reform took place in November 2010 introducing new organisational models and affecting the governance of the institutions. With the new corporate formulas saving banks may choose to exercise their financial activity directly, indirectly through a bank, or by becoming a foundation and transferring their financial business to a bank. The reform also changed the composition of the board of directors, reducing the weight of public authorities, whether national, autonomous or municipal, and the presence of representative of political parties and trade unions.

Although these changes have yet to prove their virtues, it is apparent that the crisis has in fact dismantled the old savings banks system. Its present structure hardly resembles the structure in place before the crisis. The main features of what five years ago defined a "savings bank" are no longer there. It is true that both the surviving savings banks and those that have been consolidated into a major group retain their old and traditional denomination as "*cajas de ahorros*", but they are in fact "*bancos*". As a matter of fact, the difference between banks and savings banks has been blurred. The crisis has meant the liquidation (by transformation) of a financial sector with more than 150 years of existence.

What lessons can be learned from the crisis? Are there any lessons that should be taken into consideration in order to prevent a repetition of what has happened? What has the experience of these last five years taught us?

The crisis has demonstrated once again the relevance of the financial system in a modern economy. When it breaks down, the economic system collapses. When credit stops flowing, the economic body is paralysed. A solid economy requires an efficient and profitable banking sector. And a well-functioning banking sector requires expert managers and well-informed public supervisors to detect any wrongdoings in the administration of financial resources. Banks are not like any other private companies. The crisis has taught us that the banking system needs to be regulated and needs to be closely supervised. Another lesson is that the management of the savings banks should be in the hands neither of the political class nor of parvenus and adventuresome entrepreneurs. The crisis has highlighted the need to strengthen the governance of the savings banks, by reinforcing internal and external control mechanisms and shielding them from political interference. It has also revealed the need to equip them with mechanisms to increase their capital.

The restructuring process of the Spanish savings banks sector has been complex, time-consuming and costly. At the dawn of the crisis in 2007 the Spanish authorities did not recognise the magnitude of the international events and potential contagion effects, and believed that the country's banking system was solid and well prepared and would avoid the banking failures that were taking place in the US and Europe. It was thought that the building boom would peter out slowly and gently, and the Spanish supervisor delayed the recognition of deterioration taking place in the savings banks' books as the recession deepened. Instead of anticipating the obvious solvency problems of many entities, highly indebted in the wholesale external market and with a large volume of credit committed in the construction sector, they attributed the difficulties of the savings banks to the liquidity issues of a few institutions. That forecast was plainly wrong. The problems were general and caused by solvency. Due to the delay in admitting the poor financial position of the savings banks, the cost of the rescue operations has been staggering. The lesson to be learned is that the sooner the illness is admitted, the better for the patient. An earlier and quicker intervention in the first phases of the crisis, as in the US and other European countries, would have been less costly.

The supervision has proven to be inadequate. There are therefore lessons from the crisis for regulators. First, the excess reliance on wholesale funding is dangerous. Second, regulators need to pay attention to a concentration of risk in a single sector (in this case the real estate sector) and act quickly and effectively as soon as the institutions face solvency problems. Once the crisis has erupted regulators must be particularly vigilant to ensure that banks recognise their losses and that balance sheet reorganisation is not postponed. The latter has been a recurrent problem in financial crises and makes them last longer and raises their cost. Finally, regulators must recognise the need to promote transparency, raise capital requirements and impose credible and safe liquidity ratios.

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BANKS AND CRISIS: SWEDEN DURING 150 YEARS

*Mats Andersson
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Introduction

All along history, economic and financial crises occur at irregular intervals, usually without previous warning. However, even though there are indicators or phenomena that should remind us of the presence of the crisis, actors go on working as if these signs did not exist. For, in general, nobody really wants a crisis.

In this paper, we are not going to discuss crises in general, but only some examples of crises that have struck the Swedish banking system during the past 150 years. The central idea is to observe how crises have affected different types of banking institutions, and if there are specific characteristics that distinguish those banks which turn out to be better prepared to survive the course of the crisis.

Financial crises are reflected in dramatic falls in asset prices, such as shares, bonds, and real estate. Financial crises may take forms such as bank crises, stock exchange crises, debt crises, or mortgage crises. (Jonung Lars, *Ekonomisk Debatt* nr 4 2009, p. 73). Deep financial crises may be caused by real economy crises, and as a rule, crises in the financial system affect the real economy.

Financial crises have a general pattern: A period of strong expansion in credits, increasing debts, optimism, and risk-taking, that lead to a sharp rise in asset prices, which grows into a phase of pessimism, credit restraint, and declining prices.

What really makes the difference between one crisis and another is the phenomenon that triggers the transition. It may have an economic or political character. It may stem from other countries. In certain cases, it may initially be difficult to identify the triggering mechanism.

As we shall see, there are often new markets, new financial instruments or new objects of speculation behind the course of every crisis.

The most severe crises are the ones that affect the real estate market, since housing usually is the citizens' most important asset. Therefore, such crises have swift effects upon consumption and savings. Frequently, crises lead to changes in regulatory frameworks, and rather quickly the financial system finds new methods and new institutions, in order to evade the new rules. Thus, finding a regulatory framework capable of mitigating future crises is very complicated. The most efficient way to avoid crises may be regulating all parts of the financial system in detail, which Sweden did after the Second World War.

As a rule, financial crises lead to various forms of government intervention in order to save the system. At the risk of anticipating the contents of the next chapter, we may mention, for example, that "*Jernvägshypoteksfonden*", (the Railway Mortgage Fund) instituted by Parliament, granted loans to credit institutions against security in promissory notes issued by Swedish railway companies. Consequently, they were part of the steps taken in connection with the "bond crisis" (Jonung, Lars, see above, p. 80).

The Bond Crisis

In the mid 19th century, the Swedish financial system was dominated by private bankers and banking firms. Stockholms Enskilda Bank was founded in 1856, and during the 1860ies and 1870ies Skandinaviska Kredit AB and Stockholms Handelsbank. Savings banks, which had started in Gothenburg, in 1820, rapidly expanded and played an important role in the development of the local credit and savings market. The joint stock company form, which developed during the second half of the 19th century, created the basis for the new financial system.

In December 1878, then banking firm Guilletmot&Weijlandt suspended payments, which was directly related to the financial crisis that hit Sweden (Lindgren, H., in Bankkrisen 1994, p. 9 Nors-tedts). Several other banking institutions were affected in various ways, which practically meant the beginning of the decomposition of the traditional financial system. During the 1860ies and 1870ies boom, a financial instrument thrived that was new to a certain extent, in the form of bonds linked to the prosperous iron and railway industry. Therefore, those bonds were considered to be safe investments. The recession in the late 1870ies affected the new bond market, when declining exports and production originated serious economic problems in railway companies. The financial institutions that had pinned their faith on this relatively new market and the new financial instruments were the most seriously affected. Commercial banks increased their bond holdings during the boom. By the end of the boom, Stockholms Handelsbank had 20 percent of its assets and Stockholms Enskilda Bank 36 percent invested in bonds. The crises led to huge problems for the entire banking system, and particularly for the financial companies that operated banks without being organized the way commercial banks were. (Lindgren H. see above, p. 13)

In the 1870ies a prosperous industrial sector was created in Sweden, whereas the role played by commercial banks was rather modest. Bankers, merchants, and trading houses brought about an important part of the capitalization. Mortgage associations gave impulses to the bond market, and shares began to play a certain role in society. New financial instruments were introduced.

During the recession that struck Sweden around 1877, not all railway companies were able to pay dividends on their bonds, and several large investments turned out to be mistakes. The critical situation that followed particularly struck the trading houses and banks in Stockholm that had financed railways and heavy industry. Enskilda Banken, which had great amounts of money invested in railway bonds, and which additionally had close business relations with some important trading houses, were saved by a combination of own efforts and the Government through *Järnväghypoteksfonden* (the Railway Mortgage Fund). Several traditional finance providers had to fend for themselves, meaning that their role in the financial system weakened, and banks reached a leading position.

The private banks that existed in Sweden had been founded during the past few decades, and still lacked maturity and consolidation. As a rule there were short-term borrowing transactions, and banks experienced strong competition from the private credit market, i.e. private persons, trading houses, pension institutions, etc. The last-mentioned represented the least regulated financial system of those days, which was able to adapt to the needs of the market, but which would eventually turn out to be inadequate and anachronistic.

In industry as well as in agriculture, demand decreased substantially between 1877 and 1878. For banks and bankers, losses quickly increased. Some investments, especially in heavy industry, were based on erroneous calculations and some speculative ideas, which contributed to intensify crisis tendencies and losses. When times were good, Enskilda Banken and Skandinaviska Kredit had been taking part in most industrial projects, and thus, without Government help, their subsistence had been in jeopardy.

Both banks experienced a favourable development from the late 1870ies, concurrently with the strong demand for export commodities such as iron and wood. Increase in prices and deposits fostered investments in private railways and industrial projects. The crisis affected both banks thoroughly, particularly Stockholms Enskilda Bank. Handelsbanken was relatively spared from the crisis, probably due to the bank's shortage of resources to engage in such sizeable projects.

By creating the afore-mentioned *Järnväghypoteksfonden* (the Railway Mortgage Fund), which was a loans association where banks could borrow money on their partly worthless bonds, Government was able to save "the new banking system". Banking firms, trading houses, and private bankers, particularly the ones connected with the new banks, were seriously affected, and they eventually lost their prominent position in financing Swedish trade and industry. The financial system was modernised.

Swedish savings banks were created in a society marked by poverty. Their founders were largely philanthropists who wished to improve living conditions for the vast majority of the people. It would hardly occur to them that the savings banks system was to be of great importance for the capital accumulation in the country.

Three basic principles can be defined. The first principle is the savings bank's aim to encourage savings. The second principle is the savings bank's close local roots, and the third principle is their particular non-private profit company form. It may be argued that these fundamental principles have provided a stable foundation that has protected savings banks against external interventions.

The first principle means that savings banks have mobilized minor savings contributions and handed minor credits, which have given rise to great respect in the government sector and even among commercial banks. By encouraging individual savings, savings banks have contributed to stabilize the value of money and hence lead to curb inflation, and particularly to finance important public projects and create funds with a view to crisis situations. Naturally, politicians of all camps have appreciated this. The second principle has been just as appreciated, particularly by those in power at a local level. Savings banks have been local institutions with a defined sphere of activities and specific rules adapted to local circumstances. As a rule, the savings collected in one region are used in that very region. This has enabled savings banks to embark on new sectors, in accordance with local needs, to develop local industries, thus contributing to improve the regional balance.

The third principle for the savings banks' activities consists of the company form as such. Savings banks have neither been government institutions nor private stock companies. In a savings bank there is no private profit interest. Any surplus generated in the business stays there as a contribution to continued consolidation. This too has created great respect in society, particularly in view of the fact that this company form was able to offer cheap and personal service, new technique, and hence better competition in the banking trade.

Those principles constituted the core of the savings banks' social work and the basis for their stability in crisis periods. In general, savings banks aimed at granting small loans. For example, during part of the 19th century, several savings banks only granted loans below half the ratable value of real estate. By limiting the size of loans, savings banks were able to increase the number of loans to different individuals, thus achieving better apportionment of risk.

The bond market too was an investment object for savings banks. In the 1820s, the Stockholm Savings Bank built nearly 40 percent of its investments on bonds, mainly Government and local community bonds. This savings bank was situated at the center of Sweden's bond market, and the board was dominated by persons closely related to the Government. Bonds also contributed to the development of the country by facilitating financing of locally important projects.

Bonds also had a balancing effect for savings banks, when deposits could not be invested against usual securities. For instance, investments of funds in bonds in the Stockholm savings bank multiplied by four between 1831 and 1840, and between 1841 and 1850. The same development can be observed in lending to local authorities and associations between 1842 and 1850, at the same time as there was little change in loans on Stockholm's real estate.

In 1876, bond holding amounted to 17 percent, i.e. 26 million of the savings banks' total investment of 151 million SEK. (Nygren, I. 1981, page 102)

The economic prosperity in the early 1870ies brought about an increase in deposits for many savings banks. At the same time, during that period, national finances were monetarized. This gave rise to a tendency to look for new forms of investment. Bonds came in handy, and they were bought not only by urban savings banks but also by savings banks in general. In addition to that, deposits increased in other banks as well. Even though the breakthrough of bonds occurred in the early 1870ies, a small number of large savings banks already played an important part in the bond market during the 1820ies. The Stockholm Savings Bank, for instance, bought bonds to help financing projects of local importance at the beginning of their business already, as did other savings banks, mainly in the cities. As we have mentioned, for savings banks buying bonds became a means to solve the surplus capital problem. To a certain extent, those purchases levelled out the lack of balance between the periods of surplus and deficit of money. For some larger savings banks, however, investments in the bond market were a more systematic strategy.

During the first half of the 19th century, the Swedish bond market was little developed. It consisted mainly of mortgage and local government bonds, plus some issues made by industries and economic institutions. Therefore, during those years bonds were of insignificant importance to savings banks. The breakthrough of the savings banks' bond purchases occurred in the early 1870ies. At that time, investments in several railway stock companies began (Nygren, I. 1967, p. 112).

In many instances, investments in bonds consisted of a combination of local government and industry bonds, and bonds issued by local railway companies, i.e. a type of bond holding connected with the local market. There are hardly any speculative investments to be traced in the savings banks' business. The few losses that savings banks suffered are related to railway company bankruptcies. During the period of crisis, the savings banks' holdings of railway bonds stagnated. Holdings of railway bonds were concentrated to a few savings banks, whereas the majority had small holdings.

Savings banks rarely invested in the industry's bond loans. Investments were often limited to giving support to local governments and building railways in their own business territory. There are few examples of bond purchases that are not directly linked to the savings banks' own regional borders. The Lund Savings Bank, in Southern Sweden, a fairly developed bank, was an exception. (Nygren, I. 1967 p. 113). There are few examples of substantial losses. On the other hand there were write-offs in several savings banks after the bond holding crisis, for instance, in Norrköping, Västerås, and Uppsala.

The 1875 Savings Banks Ordinance brought about the possibility for County Administrative Boards to monitor the savings banks' financial operations, among other things. Later on, during the 19th century, this possibility instead turned into an obligation to verify the savings banks' accounts. This Ordinance probably limited the savings banks' investments in risky bonds, but so did also the opportunities of useful contacts with issuers or intermediaries.

As is well known, savings banks played a minor role in financing national companies in the industrialization process. On the other hand, savings banks created the local bases for the industrial break-through.

Investments were made in bonds issued by well-known companies or credit institutions, but rarely in bonds with any direct connection to the region. (Petersson, T. 1999, p. 46) The crisis towards the end of the 1870ies lead to a substantial drop in bond prices, and savings banks had to sell and reorient investments. In certain cases, however, it was possible to avoid selling bonds, for instance, by means of letters of credit issued by the National Bank of Sweden.

Bonds may be considered to be the more sophisticated financial instruments that drew the banks' attention during this period. Banking institutions put their money in this relatively new market, but savings banks got through the crisis better, partly thanks to their local focus. In cases where savings banks had invested large amounts of money in local railway bonds, the railway crisis meant painful economic problems. The crisis occurred after the modernisation that started as early as the 1850ies. New banks were created and rapidly increasing deposits built the foundation for the expanding bond market and thus for the instability within the banking system.

The Deflation Crisis

The co-operative banking system developed rather late in Sweden compared to other European countries. In 1915, when Parliament created possibilities for giving farmers a credit institution of their own, built on co-operative principles, the basic ideas had been discussed for decades. In several European countries, the co-operative banking movement had taken on significant proportions, particularly in Germany where "Raiffesen" banks were established all over the country. One explanation of this tardiness may be that the Swedish savings banks movement had gained strength and was able to meet farmers' needs for credits, in spite of the fact that savings banks were mainly established in larger communities.

Co-operative banks, i.e. agricultural associations and savings banks, had obvious features in common. Both had their origin in popular movements with close local roots, structured according to democratic principles and with the aim of creating help to self help for large segments of the Swedish population. Co-operative Banks were scarcely affected by the 1920ies crisis. Their turnover was very limited and these associations had concentrated on small farmers.

In 1910, Skandinaviska Kredit and Skånes Enskilda Bank announced a merger, which started a period of mergers. Banks needed to be bigger in order to be able to service the expanding Swedish companies. At the same time as competition among banks became tougher, the stock market expanded alongside bonds. Asset prices rose, with consequent credit expansion and low quality credits.

1922, however, is a black year in the Swedish banking history. After the many bank mergers and speculative stock exchange trading between 1910 and 1920, unemployment, deflation, and decreasing production set the banking system rocking. The stock exchange had fallen since 1918, and after several gloomy years, the stock exchange was hit by the depression in the early 1930ies and by the Kreuger crash, one of the great industrial crises in Sweden.

During the interwar period, politicians' interest in controlling trade and industry, as well as the financial sector grew. A vast discussion on socialisation ideas began, particularly among Social Democrats. They realised, however, that total socialisation would have negative consequences for trade and industry, but when commercial banks were struck by the crisis, in the early 1920ies, there was more talk about socialisation. AB Kreditkassan was founded in 1922 by the National Bank of Sweden, in co-operation with commercial banks, and this institution participated in the reconstructions that the crisis brought about. For instance, the Government took over Jordbrukarbanken (the Agricultural Bank) in 1923.

Trade and industry had expanded during the war and export earnings led to increasing deposits. This development meant that the banks' amount of credits grew, strengthening the expansion. Issuing companies were established, closely linked to the banks, which gave banks more possibilities to increase loans towards the stock market. Moreover, after 1911, banks could act as owners in trade and industry, by investing directly in stocks. Little by little, the expansion towards stock trading developed strongly. New banks were also established in the shade of the financial expansion.

The production decrease that followed the war and the end of the boom affected the entire economy. The decision to return to the gold standard and restrained monetary policies triggered a fall in the prices of society's resources. In order to try to mitigate the crisis that followed AB Kreditkassan was founded, just like *Järnväghypoteksfonden* (the Railway Mortgage Fund) during the crisis in the late 1870ies. Government, in co-operation with private banks in this case, created an institution to safeguard the credibility of the banking system. Handelsbanken and Skandinaviska Kredit were struck to the extent where there was even talk about nationalization.

As was customary before the period of crisis, loans had been granted against week securities, and sometimes without sufficient risk-sharing. Commercial banks got through the crisis by means of reconstructions, but their credibility was damaged. Thanks to long-term investment policies, savings banks got through the crisis without great losses, and even gained confidence throughout society.

Thus, during the First World War boom, trust in the stock market rose to enormous heights. In 1918, the Swedish stock exchange reached a turnover that was not to be surpassed for many decades. Loans on shares were an important part of the loans granted by the banks. It was an epoch of innovations, such as the radio, the automobile industry, synthetic fibres, etc. which contributed to a speculative boom in 1920.

The stock market contributed to create a large number of issuing companies that later on disappeared during the crisis. Since most of these companies had close business relations with banks, they dragged banks with them when they fell. Prices dropped sharply in 1921 and 1922, as did the GNP. The drop in prices was boosted by the deflation policy. The National Bank of Sweden raised the discount rate, which contributed to very substantial drops in prices, and the Swedish Gross National Product decreased.

Banks were severely affected, and in 1922, Kreditkassan (the Credit Association) was founded, with a significant Government guarantee fund of 50 million SEK and a small contribution from banks. The number of banks diminished and major banks were forced to make sizeable write-offs. Several post-war economic ventures in iron, steel, wood and engineering industry turned out to be excessive, and several traditional banking firms, as well as stock trading companies, got big problems.

The actors of the financial system had made bold investments on the stock market. As one consequence of the crisis, a large number of Swedish companies ended up in the hands of banks, and thus the basis originated for the modern power groups that are characteristic of trade and industry.

Handelsbanken had to write off large amounts of money due to losses in 1921, as did Skandinaviska Kredit. Especially the recently established stock market had to experience the overheating. (Lindgren, H. 1994 p. 17) The crisis led to a distrust in the stock market that lasted for several decades.

The savings banks' loans consisted to a great extent of mortgages in real estate, except industry buildings. Investments in bonds and loans against personal guarantees and to local governments were large items. In practice, they were rather safe investments. Long-term credits were the savings banks' strategy during long periods, whereas commercial banks met the need for short-term credits. Thus, the savings banks' business was based on real values in the housing market and in agriculture. This created a strong position with a view to the crisis situation. The idea was to create financial services for local trade and industry. In cases where savings banks needed more capital and competence, co-operation was initiated with the nearest commercial banks. Around those savings banks networks of businessmen and finance providers were built, who usually had a relationship with the boards. Thus, efficient use could be made of local resources.

The first part of the 1920ies was characterized by a lack of ideas and new activities. Savings banks adopted a passive attitude, whereas commercial banks and agricultural associations were very active on the market. The situation changed in the mid 1920ies, after the international congress in Milan, when savings promotion activities and propaganda became a main task for savings banks. These banks could avoid the effects of the deflation crisis, since loans mainly consisted of credits to local governments and private persons, especially residential mortgage loans. Savings banks also had large amounts of money invested in bonds, which to certain extent contributed to stabilize the economy.

Thus, savings banks strengthened their position on the market, at the same time as the above-mentioned passivity prevailed. In most cases, savings banks' lending against shares was a small part of the total lending. Later on, when the value of shares plummeted compared to the almost abnormal values during the preceding years, savings banks could experience a lack of security to cover the amounts of the loans granted. Some losses could not be avoided. By means of a number of write-offs and liquidations of loans against securities in shares, savings banks survived the crisis.

Savings banks managed to maintain deposits in times of crisis, despite the customers' need for their savings, particularly due to unemployment and decreasing income. All facts indicate that the confidence in savings banks did not diminish during the crisis, whereas there was a growing distrust in commercial banks, particularly after the Kreuger crash.

In the 1920ies, savings banks increased their industry bond holdings. Loans on shares also expanded during the times of prosperity that preceded the crisis. The drops in share prices in 1921 and 1922 caused problems in savings banks and in some cases these assets lost half their value. It is difficult to ascertain the losses that savings banks had to suffer during that period, Statistic data are insufficient, but loans on shares were relatively limited.

In order to protect depositors, considering the experiences from the crisis, the 1923 Savings Banks Act established that loans on shares could only equal half of the bank's fund. It was considered that there was rather limited knowledge of business life, and that speculation in shares should be rejected. Moreover, savings banks should hang on to their dominant position as lenders to the housing sector.

In spite of the fact that the crisis did not affect savings banks in any alarming way, there was a growing consciousness about the complex of problems caused by the crisis. Two ideas were discussed in the early 1920ies. One of them was the creation of a central bank for savings banks. A central bank would be in a position to handle the funds for which savings banks had no direct need; they could operate banking business, and in addition create a kind of firmer solidarity among savings banks.

The hard depression times had given proof of the feeling of solidarity that existed among individual commercial banks, for several bank reconstructions had been carried out by means of co-operation between public institutions and small commercial banks that had been affected. (Sv. Sparbankstidskrift, 1923, p. 2).

The other idea was to find a fund that could give the savings banks sector a chance to act in support of the savings banks that needed support.

Therefore, the Savings Banks Association proposed the creation of a joint Guarantee Association, which was established in 1926. This Association would also contribute to uphold the public's trust in savings banks.

During the years of crisis, savings banks were protected by the traditional lending policy that was based on good knowledge among board members about individuals, real estate, and other financial activities within the savings banks' sphere of action. Moreover, savings banks did not depend on private profits, which protected the boards from risky investments.

In fact, there was no interest in diverting capital from the activities in the savings banks' own communities towards the national engineering industry, nor international trade. Thus, savings banks could pursue less risky branches of business. The savings banks' long-term policy could partly counteract the factors that contributed to powerful fluctuations in the country's trade and industry. The absence of share-holders meant great freedom for savings banks in their business, in contrast to private banks, they were not forced to aim at high yields. On the other hand, it may be possible that encouraging savings as the best cure for the crisis contributed to boost the deflation.

As another consequence of the economic depression, the banking system was also consolidated when small commercial banks fell into crisis and were absorbed by the major banks. During the crisis, the remnants of the old financial system disappeared.

The number of commercial banks decreased from 74 in 1913 to 28 in 1927. On the other hand, at the beginning of this period, the number of branch offices grew.

The 1920ies financial crisis presented features that are similar to the preceding crisis: Strong optimism and competition that leads to speculation and rising asset prices. Banks concentrate on the expanding stock market. Companies linked to this market grow fast and part of the lending is based on future values. The recession stops this development. Banks with close local roots and clear guiding principles are mildly affected and partly strengthened.

The 1920ies and 1930ies brought about black periods in the Swedish economy, and consequently in the banking business. In the early 1920ies, Sweden experienced a strong deflation, sinking GNP, and subsequent unemployment. Due to the strong expansion of the banks' lending in the preceding good times, several companies fell into the hands of the banking system. In order to save the banks, the Government had to create a credit commission, and Svenska Handelsbanken, for instance, was close to a catastrophe.

In 1929, the stock market crash occurred in the United States, and so the deepest depression in the history of the Western world began. To a certain extent, this situation brought about a critical outlook on economic liberalism and laid the foundations of the control times.

Unemployment was alarmingly high in the early 1930ies, the Kreuger crash dragged along companies as well as banks. Skandinaviska Kredit, which had granted the greater part of the credits to the Kreuger companies in Sweden, was severely hit. Nevertheless, Swedish trade and industry recovered quite soon. The 1920ies crisis had brought about a necessary consolidation of the banking system, which created a basis for easier survival during the 1930ies. For the Swedish banking system, the effects of the 1930ies crisis were relatively mild.

The Real Estate Crisis

Periods of crisis are often preceded by various deregulation measures. Speculative tendencies, money redundancy and optimism are also characteristic of times that precede financial crises.

Regulations and various kinds of solvency and liquidity and similar requirements are sometimes counterproductive. Such requirements encourage banks to become strong, for instance, in new financial instruments, high-growth markets, innovative financial companies, and are consequently also driven into unregulated fields, and this creates the basis for new imbalances.

Before the crisis, SEB was the most international bank, with large companies and wealthy individuals as customers. However, Handelsbanken, a competing bank, was the least affected by the crisis, mainly due to its consistency in important policy issues, such as the concept of the branch office as a basis, simple organization, focus on profitability instead of volume and caution as regards great changes.

The parts of the banking system that managed to avoid major focus on the new-fangled ideas that were typical of the 1980ies, such as real estate mortgage loans, fund management and various financial innovations, also managed to handle the crisis.

The banks that got through the crisis also presented another feature, which was concentration on the local market; small savings banks thanks to their traditional local roots and Handelsbanken due to the local branch office's strong position.

Gota Bank represented the opposite option. This bank wished to be a large financial firm, where all financial services could be offered. It was an innovative idea, but in the prevailing circumstances it was unstable.

Within the framework of the co-operative banks and the savings banks, in the late 1980ies the mistake was made of abandoning their basic ideas. Both mainly provided banking services for common people and small companies with strong local or regional roots. As is well-known, these banks deserted both ideas and customers, trying to chase volumes in new markets, which lead to enormous credit losses. The small savings banks that upheld their principles and their market strategy, however, were able to survive the crisis without major problems.

After the Second World War, the banking system presented a clear structure. Commercial banks were mainly engaged in financing trade and industry, the co-operative banks in agriculture, and savings banks handled credits to private persons and small companies. Eventually, this structure was to change as a result of legislative changes in the 1950ies and 1960ies.

Owing to a new regulation in 1969, a homogenous lending policy for all credit institutions was created. Savings banks and even the co-operative banks were able to compete with commercial banks on similar conditions. This, however, did not lead to any rapid change in the financial structure.

Thus, the critical transformation of the financial sector in Sweden did not occur after the introduction of the new laws in the late 1960ies. In part, strong regulations and traditions halted the potential change.

The credit regulations brought about great change in the 1970ies already. Foreign debts grew and a grey market emerged alongside the regulated market. The financial departments of several companies moved abroad and the financial companies gained a leading position. In the end, the National Bank of Sweden was powerless and the regulations inoperative.

The transformation occurred during the 1980ies, mainly as a result of the deregulation of the foreign exchange and credit market that was launched at a quick pace, with no regard to the consequences, and with a tax system that favoured credit expansion. The period of regulation made the financial sector fall behind other kinds of business, a distance that might have been recovered during the times of expansion and after the financial crisis. Government control influenced risk management in the financial system. Actors took moderate risks, which lead to strengthened stability, but also to less development of knowledge about risks and financial instruments.

After the Second World War, the economy grew in spite of the regulation of the financial sector. Later on, growth is brought about mainly through devaluations of the Swedish crown, and in the 1980ies through credit expansion. The Swedish financial market has traditionally been bank oriented, i.e. banks have been the most important actors.

Market oriented financial systems, like the ones in the United States and England are characterized by relatively less dependence on banks. In these countries, financing is based to a larger extent on the issue of shares, bonds, other securities, etc. Thus, in Sweden the development of banks has been particularly important for the country's economic history.

During this period, the commercial banks' position was reinforced in relation to savings banks, partly due to the legislation that restrained the savings banks' field of work. After the Second World War, the savings banks' share of the lending was more than 40 percent, in the mid 1970ies around 35 percent, in the mid 1980ies less than 30 percent. The co-operative banks' market share grew from close to 6 percent to 7 percent between 1970 and 1980. (Larsson/Sjögren, 1995, p. 65). Alongside banks, financial companies expanded in the 1980ies. They were not as regulated as banks, and granted loans to the private sector and real estate. These companies often took great risks, and were the first to get struck by the upcoming crisis. Given the strong relations with the banking system, financial companies dragged banks along when they fell.

The banking crisis began in the late 1990. The Government had reformed the tax system, reducing marginal effective tax rates and tax deduction possibilities. Inflation and the worsened economic outlook contributed to a dramatic decline in real estate prices, and households began to pay off instead of running into debt. The banks' situation deteriorated, particularly that of Nordbanken and Gota Bank. With the exception of Handelsbanken, the very existence of the Swedish credit system was under threat for a short period of time. Unlike previous crises, this one hit the entire banking system.

Co-operative banks as well as savings banks took advantage of the possibilities offered by the 1968 legislation, and encroached on the commercial banks' traditional market. This was particularly important in view of the relative decrease in the credit demand of the agricultural sector. Of the co-operative banks' total lending, the share of loans to private companies grew from 8 percent in 1975 to close to 35 percent in the early 1990ies. Both savings banks and co-operative banks were very active towards the companies that grew in the 1980ies, mainly in the real estate, fund management and financial sectors.

Thus, co-operative banks and savings banks established themselves as banks for business. Whereas the commercial banks' share of the lending to the traditional industry decreased, the savings banks' and the co-operative banks' shares grew from 6 percent to 20 percent, and 2 percent to more than 8 percent during the 1980ies.

Moreover, the new regional savings banks began to compete with one another in large cities. The household market was partly forgotten. When the crisis arrived, savings banks made great losses in the branch offices that had been opened in the other savings banks' territories.

When the deregulation of the credit institutions' business took effect, during the second half of the 1980ies, the above-mentioned process intensified. By expanding at the cost of weaker securities, greater risk exposure and more complicated organizations, the foundations were created for the 1990ies financial crisis.

1990 was a dramatic year for the entire banking market. Economic slow-down and inflation lead to weakened competitiveness and higher unemployment. Credit losses increased and the situation deteriorated during the three following years. *Sveriges Föreningsbank's* (the Co-operative Bank of Sweden) operating losses led to a discussion on profitability, refinancing, and solvency, among other things. The obvious conclusion was that the conversion to banking companies was an absolute condition for covering the need for new venture capital. The decision to convert *Sveriges Föreningsbank* into a joint stock company was made at the beginning of 1992 already. The fact that co-operative banks as well as savings banks had a weak or vague set of owners, clearly contributed to worsen results, but above all the fact that several of those banks had been forced to take greater risks than the established commercial banks in order to enter the corporate market. The co-operative banks' credit losses grew in terms of percentage of lending from 1.2 percent in 1990 to 6.1 percent in 1992.

Other parts of the banking system experienced similar processes. The savings banks' credit losses grew in terms of percentage of lending from 1.4 percent in 1990 to 8.4 percent in 1992. For commercial banks, the corresponding figures were 1.1 and 7.6 percent. Government payments to secure the banking system amounted to about 64 billion Swedish crowns.

In 1992, co-operative banks abandoned the co-operative ownership structure, and in the shade of the banking crisis, Sveriges Föreningsbank went public on the stock exchange. Savings banks followed the same road when creating Sparbanken Sverige. The crisis and the conversion into stock companies required rationalization and reduced costs. The number of employees decreased and lending was carefully controlled.

In 1994 already Swedish banks presented significant improvement of their results, mainly as a result of diminished credit losses. The conversion into stock companies, the issue of new shares and the government's guarantee of the banking system was the basis for survival. Thus, it seems obvious that in 1992, in order to gain access to the necessary equity, savings banks and co-operative banks had no other alternative but to abandon the traditional form of association. It would have been impossible to overcome the effects of the financial crisis within the framework of the traditional foundation or economic association structure.

The mistake made both by co-operative banks and parts of the savings bank system, was to abandon their basic ideas and some of their customers and start chasing volumes instead of credit quality, and furthermore in new markets. A significant part of the credit losses during 1991 and 1992 was caused by expansion in new markets, particularly the price drop in the real estate market. During the years of crisis Handelsbanken lost between 5 percent of the lending during the preceding years, and Nordbanken and Gota Bank almost 15 percent.

In the late 1960ies Handelsbanken fell into a serious crisis. The management was replaced and a farreaching decentralisation was decided upon. Regions were given boards of their own and a significant independent position. The new Handelsbanken targeted profitability instead of volume. These principles were upheld during the strong credit expansion. During the subsequent banking crisis, Handelsbanken was the only large Swedish bank that was not forced to discuss government support. Therefore, this bank was able to advance its positions in the 1990ies.

The savings banks' development went in the opposite direction. The difficulties in securing equity during the expansion were discussed, and the investigatory work carried out concluded in a proposal to transform the large savings banks into stock companies and to unify the savings banks system. The traditional principles lost relevance and were considered to be partly obsolete.

However, this was not true about the whole savings banks sector. Around 90 small savings banks decided not to join in, but to uphold their role in the local community. Unfortunately, there were some exceptions. The Tomelilla Savings Bank went beyond the local boundaries, and extended their lending to large urban regions. In the early 1990ies, this small bank had a considerable foreign debt that amounted to 183 million SEK. This bank had to be saved by other parts of the savings banks system.

During all these crises a number of innovations in the financial field may be observed to appear. As a rule, these innovations have also brought about negative impulses. In particular, new instruments and markets have generated expansion and instability in the system.

Following the great losses suffered by the major banks of Sweden, the Government had to create a support system consisting of interest-free loans, shareholder contributions etc. In 1992, Nordbanken became a state-owned bank, and Gotabanken disappeared. The Bank Support Committee had to play a role similar to the one played by *Järnväghypoteksfonden* (the Railway Mortgage Fund) during the crisis in the late 1870ies and AB Kreditkassan during the 1920ies crisis.

The Global Crisis

Large parts of the industrialized world experienced a positive development, which eventually gave rise to excessive optimism. The concept of recession was almost abolished and the financial system grew rapidly, aided by new financial instruments, which expanded and were packaged and were later to result in dubious equity packages.

At the same time, the imbalance between the savings deficit of the industrialized countries and the surplus in the Eastern countries grew. Several industrialized nations had increasing debts, or in other words, they lived beyond their means. Rating Agencies continued to give high ratings to the new financial instruments and even to institutions that were to become the start of the visible crisis.

When trust amongst institutions was affected, a liquidity crisis was triggered that hardly anybody would have imagined. The banks that had been the most active ones in the globalization process and had pinned their faith in new instruments, quite soon had to suffer the consequences.

Thus, the crisis that started in 2008 has been a global crisis that has even called globalization itself in question. A breakdown in confidence has features which significantly surpass economic issues and which therefore are more difficult to analyze and control. Belief in the future and the concept of risk are altered and instruments used before to mitigate the crisis evolution turn out to be inoperative.

During the optimistic years, new financial institutions appeared, which often acted as common banks and created a shadow sector, i.e. a sector which could operate without transparency and control by public institutions. In this respect too, one will recognize the process behind the 1990ies financial crisis in Sweden.

Sweden's economic situation was fairly positive when the crisis began. Sweden had a surplus both in its external balance and its state budget, but this country has been very dependant on exports. Therefore, Sweden has been able to get through the crisis considerably better than other countries. On the other hand, dependence on exports created serious problems in real economy.

The National Bank of Sweden quickly took steps, which mainly consisted of an expansive monetary policy and a vast guarantee program for the banking sector, which have helped bring increased liquidity to the financial system. There is a stability fund which is intended to reinforce the system in future crisis situations.

The 1990ies financial crisis began after a period a rapid deregulation, which contributed to strong increases in housing and commercial real estate prices. During this crisis, banks had numerous and far-reaching loans, and many securities of no value. In the late 2000ies, banks had a stronger basis in Sweden. The bad loans were not as sizeable as during the real estate crisis. On the other hand, lending in the Baltic countries brought serious problems to some banks, particularly Swedbank and SEB. (Financial Stability Report 2010:2, page 54).

The crisis spread from the United States, but also from Great Britain, Ireland, and Spain, where housing prices had expanded at a quick pace to the rest of the world. The downward economic trend affected Sweden through decreasing exports, stagnant credit markets and credit losses, particularly for the banks that were taking an active part in the expansion towards the Baltic market.

During the previous crisis, Swedish banks had acquired a crisis consciousness and a risk culture which strongly contributed to the recovery, but the decreasing international demand eventually affected the real economy. Moreover, in the past years Swedish banks had relied on the international credit market to a greater extent. This greater dependence on the global market also contributed to imbalances in the Swedish financial system during the crisis.

The losses in the financial market were limited compared to those of other countries. Swedbank was seriously affected, and Handelsbanken much less. Swedish savings banks, which may be considered as the fifth actor in the bank market, got through the crisis without major problems. The liquidity crisis affected the entire banking system, but whereas Handelsbanken's liquidity was good, Swedbank had to ask for support from the National Bank of Sweden, among others, in order to get through the crisis. SEB and Nordea too received support, to various degrees. Furthermore, Swedbank, SEB and Nordea issued new shares in order to procure new capital. The difference in credit losses was significant. Whereas Swedbank lost 3.156 MSEK in 2008, the loss suffered by Handelsbanken amounted to 1.605 MSEK. This difference grew substantially in 2009.

For several years, the world economy had been stimulated by low interest rates, rising asset prices, and growing credit expansion. At the same time, imbalances grew throughout the world and so did indebtedness in many economies. After the Lehman Brothers collapse in September 2008, the economic problems and the unrest in the financial market turned into an acute breakdown in confidence in the world economy.

The financial crisis immediately influenced the real economy, in terms of higher risk premiums, worsened loan conditions and falling asset prices. Consequently, it also influenced investments and consumption. The Swedish economy, which had become more internationalized since the early 1990ies, was eventually affected and fell into a recession. The Baltic countries, which had experienced a quick economic growth, aided by a strong credit expansion, quite soon experienced a recession. Domestic demand decreased substantially and for exports the outlook deteriorated. In 2010, uncertainty in the financial markets was still the same. Now the issue was rather problems in state finances in several countries.

Problems in state finances in several countries had prolonged the financial crisis. They had created new problems for the banks to find funding and new channels for spreading unrest. Sweden has been relatively mildly affected, since the Swedish banks' direct exposure to the countries involved, particularly in Southern Europe, is limited.

Liquidity risks in the Swedish banking sector persist. On the one hand, there is a great dependence on loans in foreign currency and in addition, Swedish banks have relatively less liquid assets, for instance residential mortgage and real estate loans. Another factor of concern is that Sweden has a very large banking sector in relation to the country's production.

In the past few years, the Swedish banking system has returned to the traditional domestic market. Business in the Nordic countries is the basis of the Swedish banks' results. In 2010, 90 percent of the results originated from the Nordic countries, and lending to the Baltic countries continues to decrease.

According to the scenario of the National Bank of Sweden from 2009, the four major banks were expected to suffer a total credit loss of 155 billion SEK in 2009-2011. Close to 50 percent of the credit losses were to stem from the banks' business in the Baltic countries.

The substantial decline in economic growth, both in Sweden and the rest of the world, has led to great credit losses. In Sweden, the credit losses consisted to a great extent of provisions for feared credit losses in the Baltic countries. Even though economic problems in Sweden led to credit losses, the situation in this country and in the Nordic countries was easier to handle than the effects of the banks' business in the Baltic countries. The strong credit expansion in euros, carried out particularly by Swedbank and SEB, has originated considerable risks that were hitherto relatively unknown. Earlier financial crises have mainly arisen in a country or in a region, and therefore it has been easier to identify measures and guidelines to alleviate the situation. The global character of the last crisis calls for new ideas on regulation and crisis management. International co-operation will be necessary, but also renovated crisis theories and principles for the banks' internationalization.

Exposure in foreign currency has originated considerable risks, as has the financing of business in cultures where the Swedish banks' knowledge is rather scarce (Financial Stability Report, 2010, page 58). After the first years of crisis, lending to the Baltic countries has continued to decrease, and Swedish banks have been working actively to handle all the problematic credits and assets that have been taken over. However, it is a demanding job.

The Swedish savings banks' operating profits amounted to approximately 2.000 million SEK in 2010, and to approximately 2.500 million SEK in 2009, i.e. in the very middle of the crisis period and in spite of the effects caused by the deterioration of the real economy. Savings banks, however, are a somewhat different kind of banks. Sweden's approximately 50 savings banks operate locally and have their head offices in small communities all over the country. The savings banks' main idea is to contribute to the development of the local community, in accordance with the traditional principles that were established at the beginning of the 19th century: The money created by the banks' business must be of use to the local community.

Savings banks make their decision as close to the customer as possible, and the basis for their decisions is the knowledge that exists about the community where savings banks operate. Thus, savings banks make assessments of risks and businessworthiness than most other banks. The long term vision and the local roots have contributed to the fact that savings banks have gotten through many bank crises fairly well. In 2010, the savings banks' market share of deposits amounted to more than 8 percent, which is a modest share compared to that of the four major banks, which amounts to between 15 and 20 percent. However, the savings banks' market share increased somewhat during the years of crisis.

During the years that preceded the financial crisis, Swedbank and SEB carried out a speedy expansion of their lending in the Baltic countries. For Swedbank, this lending amounted to around 13 percent of this bank's total lending in 2010. For SEB the share was around 12 percent. Moreover, Swedbank in particular, expanded in new markets characterized by uncertainty, such as the Ukraine and Russia.

These banks quickly expanded to new markets, in relatively uncontrolled forms and by means of centralized decisions that were hardly based on profound knowledge of the new countries, and they eventually had to suffer huge credit losses.

Handelsbanken, on the other hand, grew in territories that were familiar to the bank and was helped by traditional principles such as continuity, decentralized decision-making, thrift, etc.

It is rather obvious that those banks which took an active part in globalization and expanded beyond well-known markets, while forgetting established guidelines and principles, where the ones most severely struck by the financial crisis.

Many things seem to indicate that in the global reality, attention should be paid to decentralization and delegation of decisions, particularly in retail banking. Locally supported, decentralized decisions may become more relevant, as globalization advances. Being closer to the customer and making decisions as close as possible to the local reality may be the basis for competitiveness in the global market.

The new crisis tendencies, from 2010 and on, require an account of their own.

Closing words

The same or similar patterns characterize the Swedish banking crises. They are preceded by a quick expansion of credits and investments with speculative features. Competition amongst actors grows stronger and asset prices rise. New financial instruments or markets emerge and actors tend to widen their risk-taking with no direct control of the credit quality. Optimism boosts itself, and turns into uncritical belief in the future. In the end, certain alterations of various kinds may cause a necessary return to reality.

In the context of all crises, Government has assisted to differing extents, and the subsequent period has been characterized by new regulations, return to well-known paths, prudence in lending and rationalization, with a view to controlling costs. Similar crises and crisis processes have occurred in most industrialized countries, at different times.

Circumstances and specific features vary, according to the countries' economic situation. Real estate crises, bond crises, deflation crises and share crises have occurred in most economies.

As a rule, crises create great economic problems in society. However, the crisis process contains positive features. New instruments and markets are put to the test. The market is modernized, when new institutions replace old systems. Financial markets are consolidated, and new regulations intended to control and mitigate new crisis situations are established. Before periods of crisis, competition among financial actors hardens, and thus the crisis process contributes to restructure the financial market. Therefore, crises have renewed the role of the financial system in society and made it clearer.

What is clear and obvious is that banks that avoid risks and risk situations have greater possibilities to survive the crises without serious problems. One of the most important tasks of the banking system, however, is to handle risks, and therefore the banking system would neither develop nor survive in the long run by avoiding risks systematically.

Banking and financial products or instruments are created as a natural process, where the banking system develops and learns to diversify and control different forms of risks.

The intention of this study has been to present a survey of the ways in which banks handle risks, i.e. how banks approach risks, how risk situations and risk instruments are handled, and how banks have gotten through the crises.

Setting out from the overall description of Swedish banking crisis presented here, the following conclusions may be drawn.

- In times of crisis, new or expanding instruments are to be found. Those banks that adopt and rapidly expand the use of these new instruments are the ones most severely hit by the crisis. The same thing can be said about banks that expand in new markets that often grow before crises.

- Banks that give priority to quality in credits and knowledge in their banking business have better possibilities to handle crises. This requires a stable organization within the banks.
- Decentralization of decisions and local roots give strong protection against crises. Decentralization may be decided upon by companies, whereas local roots are rather a part of a historical process. The combination of these two features is what creates the best protection.
- Consistency in principles, strategy, and business proposals, grants banks a strong position on the eve of crisis situations. This requires simple and stable financial institutions that are also flexible and able to take action.
- Working with a view to developing and widening the local community will protect from crises. Banks that have local roots in the community that surrounds them and that work for the build-up of the community have much greater power of resistance in crisis situations than banks that work to develop themselves.

Therefore, banks that co-operate with the local community have significant advantages. On the one hand, they contribute to develop local trade and industry, and on the other they contribute to financial stability thanks to the strength they show in economic crises.

As can be seen, the conclusions of this study are far from sensational, but they may be important to be reminded of. Local banks or branch offices that work actively to develop the local community may have, in a global context, a very important role to play.

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ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings and Retail Banking Group) brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union acts only when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

