

**Public corporate governance of state-owned enterprises:
evidence from the Spanish banking industry**

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**PUBLIC CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES:
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ABSTRACT

We examine the role of public corporate governance in the restructuring of the Spanish financial sector. State-owned savings banks or *Cajas* provide evidence of the conflict of interest in multilevel governance. We find that choice of the integration mechanism (merger, IPS or acquisition) can be explained by two drivers: geographical and political proximity.

I. INTRODUCTION

With the current economic crisis, the Spanish banking system has been under stress, and savings banks or *Cajas*, in particular, which have a strong public status, have been going through a major reorganization. *Cajas* carry significant weight in the banking sector since they represent half of the market share for loans and deposits and, for the last decade, they have experienced strong growth. However, they have also accumulated a high percentage of loans to the Spanish real estate industry and, therefore, suffer tougher problems of solvency than the private banking sector. This lack of solvency has triggered a process of integration that highlights both the public nature of *Cajas* and the conflict of interest between the regional and national government levels. Thus, the objective of this paper is to examine the drivers behind each integration and, more specifically, to study how the tension between the different levels of government is shaping the reorganization.

Cajas share a public status common to other non-private savings sectors in many European countries such as Austria, France, Germany, Italy and Russia (ESBG, 2009).

They share a similar origin (founded by local or regional governments, churches, welfare societies and trade unions) and common goals to promote savings and provide lending to businesses and individuals in the region. This array of goals, which encompasses social and economic development, is one of the main features of *Cajas*. In addition, *Cajas* have an ownership structure involving various stakeholders: depositors (savers), local and regional governments, founders and employees. Moreover, national and regional regulation has translated this stakeholder ownership structure into different representative structures in the governing bodies of individual *Cajas*. That is, the legislator has determined the power of the governments and decision-making authorities in these institutions: both the general assembly and the board of directors have substantial representation of local and regional Governments (up to a maximum of 50% of voting rights until July 2010, and from then onwards up to 40%). Within this governance framework, the need to reorganize the sector and find new efficiencies across *Cajas* has required the public sector to play an important role at several different levels: this is public corporate governance.

In Section II we present an overview of the Spanish state-owned banks and its governance characteristics that sets them apart from private banks. Section III presents the multi-level governance structure of *Cajas* and in section IV and V we examine the drivers behind the reorganization of the Spanish banking system.

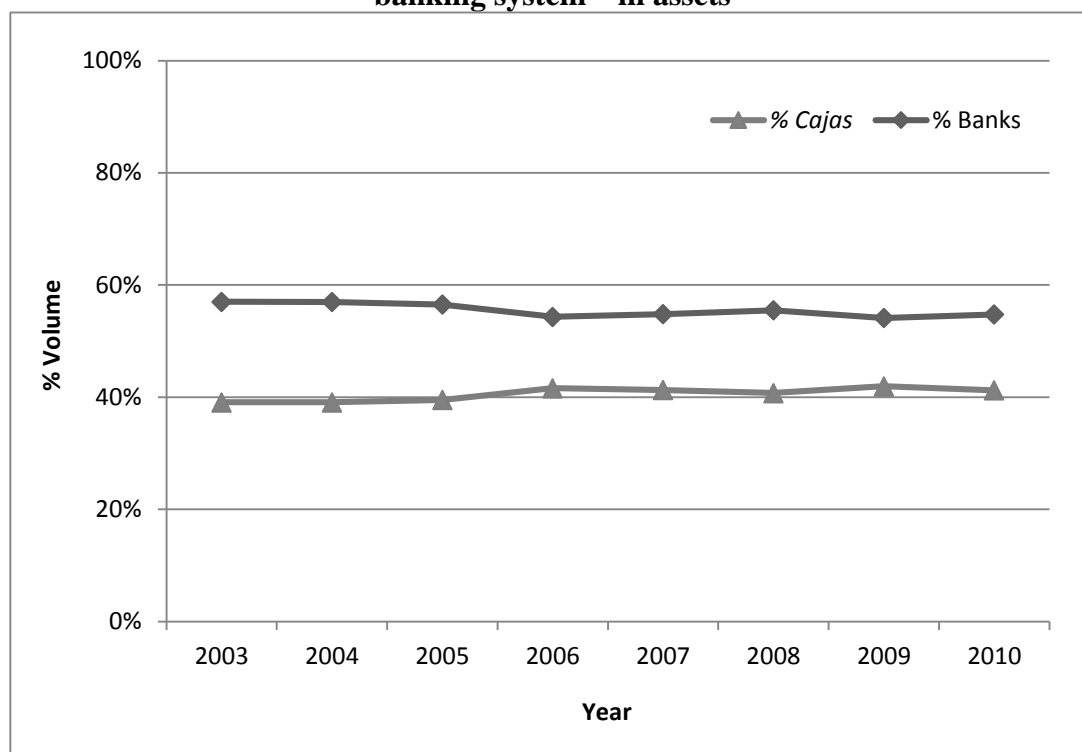
II. CAJAS IN THE SPANISH BANKING INDUSTRY

As in many European countries, the Spanish banking system has two very distinct type of institutions: private banks and public savings banks. The Spanish savings banks or *Cajas* constitute an important network that have been increasingly competing with private banking institutions since the liberalization of the Spanish banking system in 1977 (see

Figure 1 and González et. al., 2011). *Cajas* are credit entities with a strong commitment to promoting savings; they focus on the development of domestic economies and small businesses by providing an extensive network of offices; and they retain an important role in financing regional economies. A trait of these savings institutions is that they are required to distribute part of their benefits in social and cultural projects. These so-called “social dividends” reflect the not-for-profit nature of *Cajas*, which may often conflict with value maximization goals (Illueca et al., 2009). As García-Cestona and Surroca (2008: 583) indicate: “Spanish savings banks pursue, by law, a wide set of goals. Furthermore, given the absence of shareholders, making a profit becomes only one among several measures of success.”

Another important characteristic of these *Cajas* concerns their links with both local governments and autonomous communities -regional governments- (their regulation itself advocates this). Local and regional governments are part of the governance structure up to a 50% as founding entities and, at the same time, regional governments are the regulators of *Cajas* inside their territories. The result is that “*Cajas* are an unusual segment of the Spanish financial sector, characterized by heavy political involvement; as a result, moves towards changing the regulation of the segment are continuously being discussed.” (Cuñat & Garricano, 2009: 2).

Figure 1. Comparison of *Cajas* and bank percentages in terms of the total Spanish banking system—in assets



Source: Constructed using data from the Bulletin of the Bank of Spain (www.bde.es)¹

Cajas are radically different from the private Spanish banking system; two striking institutional features set them apart. First, *Cajas* cannot raise capital by issuing shares. This limitation has forced *Cajas* to grow either by using debt to access capital or by merging with other institutions. In this respect, there is asymmetric competition with the private banking sector: while *Cajas* can acquire privately owned banks, their ownership structure means that banks cannot acquire *Cajas*. Moreover, *Cajas* are not quoted in the stock market. The fact that *Cajas* are completely isolated from the market of corporate control eliminates an important source of discipline for its managers. In contrast with other banks,

¹ <http://www.bde.es/webbde/es/estadis/infoest/a04a.pdf> [Accessed 17th March 2011].

Cajas are not susceptible to takeover if they underperform. Second, instead of shareholders *Cajas* have a complex system of stakeholders that includes the founding entities, the regional government, municipal corporations and their employees, among others. Thus, they do not represent only the organization's owners, as shareholders do; they represent the organization's environment.

Given the lack of shares, the distribution of voting rights within the governing bodies is determined by law. *Cajas* have three main sources of regulation: the national government –which regulates the minimum common framework for *Cajas* in Spain—, the Bank of Spain (central bank), and the regional governments, which have the power to regulate the management of *Cajas* established in their regions. Thus, *Cajas* have three main governing bodies defined by national legislation: the general assembly, the board of directors and the control commission. In addition, regional regulations have established different stakeholder categories and their corresponding voting rights in the general assembly, the senior governing body. The distribution of representation follows (minimum-maximum %): public sector organizations 50%, depositors 25–50%, founding bodies 5-35%, employees 5–15%, and other (business organizations, universities, etc.) maximum 10%. The size of the general assembly varies between 60 and 160 members, depending on the institution.

Next, the board oversees management and defines the strategy of the organization. The board also represents the different stakeholders, but here its membership is smaller, between 13 and 20, and its composition is not strictly proportionate to the general assembly (Melle, 1999). The board designates the executive director and has the power to fire him or her. It is also possible for the president to be the executive director. Table 1 shows the representation structure of the boards of directors of two important Spanish *Cajas*.

Table 1. Board representation

	La Caixa²	Caja Madrid
Representatives	Num. Board Members	Num. Board Members
Public administrations (local and regional governments)	4 (19%)	10 (47%)
Representatives of depositors	8 (38%)	7 (33%)
Founder entities	6 (28%)	0 (0%)
Employees	3 (14%)	2 (9%)
Representative entities	-	2 (9%)
Total	21 (100%)	21 (100%)

Source: Constructed using data from corporate information published on Cajas websites 2010³.

Finally, the control commission has between 5 and 15 members and its role is to monitor the board and report to the central bank. In a nutshell, this structure of representation and control induces potential conflicts of interest among the myriad stakeholders who make up the governing bodies. Seen through the lens of agency theory, these institutions exemplify a serious governance challenge. The existence of multiple stakeholders with actual governing ‘voice’ may generate problems in deciding value-maximizing strategies for the *Cajas*. It may also generate weak internal corporate governance mechanisms, poor monitoring and lack of systems to discipline management.

III. THE ROLE OF THE PUBLIC SECTOR: MULTILEVEL GOVERNANCE IN SPANISH CAJAS

The OECD (2005) defines banks with public participation by national and/or regional governments as state-owned banks –such as Spanish savings banks or *Cajas*. This

² La Caixa and Caja Madrid ranked as No. 56 and No. 98, respectively, in The Banker 2003 Top 1000 World Bank ranking.

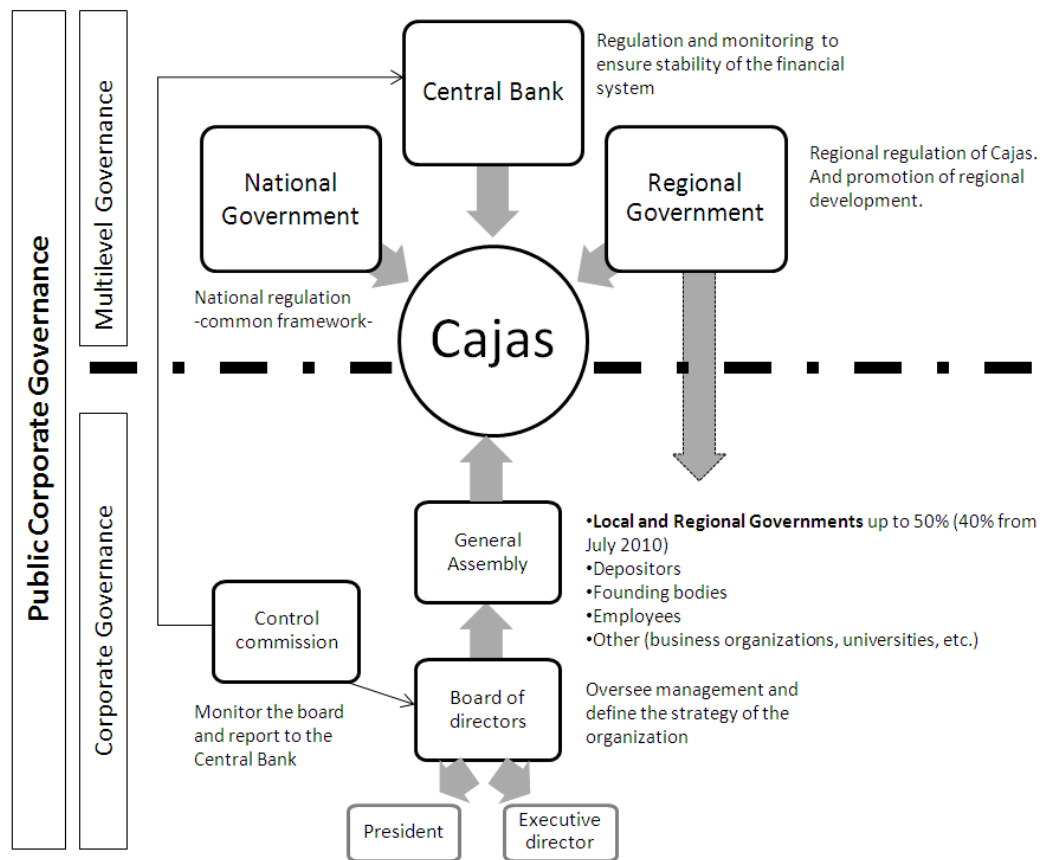
³ La Caixa http://portal.lacaixa.es/infocorporativa/gobiernocorporativo_es.html [Accessed 17th March 2011].

Caja Madrid

<http://www.cajamadrid.com/CajaMadrid/Home/cruce/0,0,84630%24P1%3D401,00.html> [Accessed 17th March 2011].

participation is represented in the board of directors of the bank, and its ownership percentage can vary from a minority to more than the 50%, depending on the country (OECD, 2005; Ianotta et al., 2007). In the Spanish case, there is as well a regulatory channel that regional governments may use to exert power over *Cajas* given that, from 1985, the Spanish Constitutional Court recognized that the regulation of *Cajas* should be granted to regional governments (as part of the devolution process). Figure 2 depicts the different paths regional governments may use to influence the governance of *Cajas*: either via regulation or through direct participation in governing bodies.

Figure 2. Cajas public corporate governance



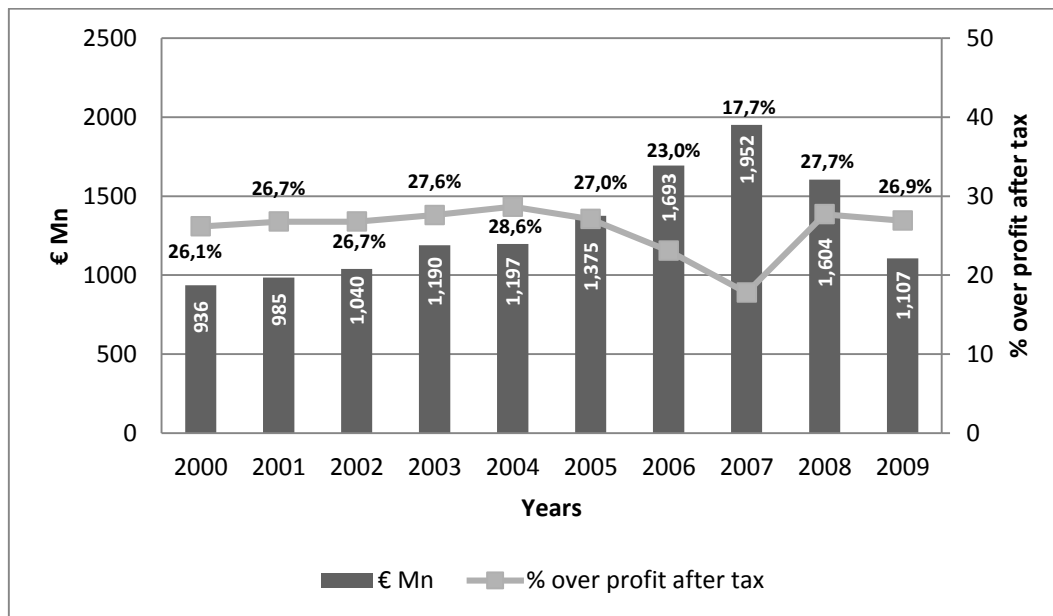
Given this regulatory framework, the risk of politicizing the governance of these entities has always been a source of conflict (Melle & Maroto, 1999; Azofra & Santamaría, 2002; La Porta et al., 2002; Sapienza, 2004; Fonseca, 2005). Each regional government has developed *ad hoc* regulatory solutions to preserve the control inside their territories – for example, the maximum age at which presidents can retire, or the veto power for approval of mergers. Until July 2010, under Spanish legislation, regional governments could veto unwanted integrations.

Moreover, regional governments may use the law to distribute the benefits to social and cultural projects in their region. Historically, *Cajas* have been perceived as an ally for

local development policies. It is often the case that key regional development projects are carried out with the financial support of the regional *Caja* (Melle & Maroto, 1999; Azofra & Santamaria, 2002; Fonseca, 2005). The interplay between social-economic and political interests is a lever for these types of project. Indeed, the territorial and identity component of the *Cajas* has always been an important factor in their social integration and economic success.

Cajas have acted for the general interest benefit through complying with their social function: “*Cajas* benefits devoted to social goods and services in the regions has been a supporting feature of the Spanish welfare state” (General provisions of *Cajas* law, L11/2010). Currently, 88% *Cajas* have collaboration agreements with the public sector regarding welfare services (CECA, 2010). This mission has been channelled through the “Social and Cultural Welfare Project” (SCWP), which in 2009 invested €1.775 Mn (almost the same amount that Spain received in Structural Funds from the European Union: € 1.845 Mn) –see Figure 3 for an evolution-.

Figure 3. Cajas funds initial provision to finance the “Social and Cultural Welfare Project”



Source: CECA “Social and Cultural Welfare Project” reports 2000-2010. The Spanish Confederation of Savings Banks.

The allocation of these resources is focussed in four main areas (2009): social welfare and healthcare (41%), culture and free time (33%), education and research (17%) and historic and natural heritage (9%) (CECA, 2009). It is noticeable the importance of the foundations that manage the SCWP inside *Cajas*. Two of them, La Caixa Foundation and Caja Madrid Foundation are 3rd and 6th among the top 50 European foundations by expenditure (Philanthropy, 2009). And they have to invest, by law, this SCWP in the regions where *Cajas* are based.

In sum, *Cajas*, as state-owned banks, operate within a duality of objectives: on the one hand, it seeks profit maximization as any other commercial bank; but on the other hand, it provides financial support to economic and social activities in the region it operates (Apreada, 2006).

In the next section, we present the outcomes of the restructuring process due to the financial crisis. In order to do so, a process of data collection has been developed including the following sources: national regulation, regional regulations, orders of the central bank, policy makers public declarations for three years (President of Spain, ministry of economy, president of the central bank, presidents of regions and its ministers, European commissioners) and stakeholders (presidents from *Cajas*, Association of *Cajas*, unions, and think tanks).

IV. THE RESTRUCTURING OF THE SPANISH BANKING INDUSTRY

Cajas have had an important role in the Spanish financial system. García-Cestona and Surroca (2008) state that “the market share of savings banks in 2004 was slightly higher than that of commercial banks: 48% vs. 47% in the loan market and 52% vs. 42% in the deposit market.” Since the 1990s, *Cajas* have experienced a dramatic expansion of branches as well as volume of assets. Moreover, they argue that the expansion out of the regions is associated with more aggressive growth in lending and reallocation within the loan portfolio. There has been a shift away from safer lending towards riskier commercial and mortgage lending. For instance, the share of real estate loans in the *Cajas* books in 2006 has ranged from 10% to 50%. These percentages are extremely large considering that by the end of 2008, the volume of loans to real estate developers and builders reached almost €500 billion, equivalent to 50% of Spain’s GDP (Cuñat & Garicano, 2009). Indeed, this increase in debt in a sector with high default rates (around 5.05%) has generated severe solvency problems and prompted the current transformation of the Spanish banking sector.

In 2008 the central bank decided to recommend a reorganization of *Cajas* to ensure their financial survival. It demanded a reform focused on two areas. First, it advocated for a reorganization of those *Cajas* under the greatest economic stress, urging them to merge. Second, it attempted to reduce the power of the regional governments by requesting a reform of the *Cajas* law. The central bank's plan was based on three ideas: 1) *Cajas* need to rationalize their resources; 2) this should be achieved via mergers between entities; and 3) the adjustment should be completed by the summer of 2010 and, if needed, financial assistance would be provided by the central bank's Fund for Orderly Bank Restructuring (or FROB).

The FROB is a public entity concerning bank restructuring and reinforcing the equity of credit entities. Access to FROB funds (with an initial allocation of € 9,000 Mn) is conditional on *Cajas* reorganizing their extensive branch networks and resizing via integration. One of the reasons behind the haste to use FROB (approved in July 2009) is that the European authorities have set a limit before they force its closure⁴. The European Commission has established a calendar for fund duration since they consider that state aid damages competition and breaches the regulation of the interior market.

As of December 2010, 40 *Cajas* out of a total of 45 had been involved in the restructuring of the sector starting in 2008. Table 2 displays the 14 integration processes detailing the members of each case, the type of process, whether the integration is within or across regions and the level of funding support from FROB. Nowadays, the number of *Cajas* has been reduced to 19 via several mechanism: mergers, Institutional Protection Schemes (IPS), or acquisitions.

⁴ On January 2010, the European Commission approved the Spanish recapitalization scheme for banks aimed at enhancing the strength and solvency of credit institutions (State Aid N-28/2010). This scheme has been in place till December 2010.

Table 2. Map of integration processes of Spanish *Cajas* opened with the crisis

Process	Savings banks involved	Type	Within/ or across regions	Assets in € Mn	Requested aid from FROB (€ Mn)
1	CATALUNYA CAIXA Catalunya Tarragona Manresa	Merger	Within	76.649	1.250
2	UNNIM Sabadell Terrassa Manlleu	Merger	Within	28.548	380
3	La Caixa Girona	Merger	Within	271.338	-
4	Cajastur CCM	Acquisition	Across	[View process 5]	-
5	BANCO BASE CAM Cajastur-CCM Caja Cantabria Extremadura	IPS	Across	125.562	1.493
6	BANCO MARE NOSTRUM Murcia Penedes Sa Nostra Granada	IPS	Across	71.026	915
7	Unicaja Jaen	Merger	Within	54.817	-
8	BANCO CAJA 3 CAI Circulo Badajoz	IPS	Across	20.145	-
9	BANCO FINANCIERO Caja Madrid Bancaja Insular Laietana Avila Segovia Rioja	IPS	Across	334.508	4.465
10	NOVA CAIXA GALICIA Galicia Caixanova	Merger	Within	75.549	1.162
11	CAJA ESPAÑA-DUERO Caja España Caja Duero	Merger	Within	46.017	525
12	BANCA CIVICA Cajasol Guadalajara Navarra Burgos Canarias	IPS	Across	71.306	977
13	Cajasur BBK	Acquisition	Across	47.000	-

14	BBK Kutxa Vital	Merger (Failed, leaving door open for future process)	Within	78.300	-
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Source: Constructed using data from FROB (2011) and economic media follow up.

Three integration mechanisms have been used: in 15% of the cases an acquisition took place, in 46% of the cases were mergers and 39% were IPS. One innovation in the integration process is the use of a new restructuring formula: Institutional Protection Schemes (or IPS), also called virtual or cold integration. Integration under IPS allows entities to operate separately within their own territories, maintaining their own legal personality, commercial brand, governance systems, and regional commitment, but functioning as a single group regarding risk policies and management: credit risk, market risk, liquidity risk, interest rate risk and operational risk. Instead of creating one new entity from the union of others, a new, higher organizational entity -an umbrella- is formed. This formula allows operational integration in the form of shared services, technology and additional commercial networks. In these cases, the central bank must approve the project, and this requires the presentation of a viability plan, including synergies and cost reductions. Although the central bank prefers mergers to IPS, it recognizes that this channel allows for some cost saving, though it does not eliminate duplication of management and governance systems.

V. DOES MULTI LEVEL GOVERNANCE CONFLICT MATTER? OUTCOME OF THE RESTRUCTURING OF THE SPANISH BANKING SYSTEM

So far we have provided evidence for multilevel governance in *Cajas* and we have presented the mapping of the restructuring process. In this section we examine the variables driving each type of restructuring process and the role of multilevel governance in determining the final outcome.

The hot political and economic debate on the integration process has been between two arguments that refer to the duality of *Cajas*' mission: first, gaining efficiency to deal with the solvency problems and second, keeping their "Social and Cultural Welfare Project" (SCWP, or "Obra social" in Spanish). Table 3 presents the key motivations and sources of power by the different decision makers involved in the restructuring process. The national government main goals have been to push for efficiency gains and a less politicized financial sector. It has used regulation at the national level as a means to achieve it – for example, in July 2010 a new regulation was passed that limited the voting rights of the regional and local governments from 50% to 40%, and required that a third of the board members of the resulting financial entities to be independent. In contrast, regional governments aim to maintain the economic involvement of *Cajas* in their regional areas and to maximize the investment in SCWP. Their sources of power are veto power, regulation and voting rights at the governing boards.

Table 3. Decision makers' goals in integration process

Decision maker	Goals	Sources of power
National government	<ul style="list-style-type: none"> • Gaining efficiency to access markets • A non politicized financial map 	<ul style="list-style-type: none"> • National regulation • Economic policy • Alignment with central bank
Central bank		<ul style="list-style-type: none"> • Fund for Orderly Bank Restructuring (FROB) • Orders⁵ • Autonomy from the national government (credible voice)
Regional governments	<ul style="list-style-type: none"> • Maximization of the Social and Cultural Welfare Project (SCWP) as co-builder of the regions welfare state • Regional development: <i>Cajas</i> as bond buyers, credit givers and investors 	<ul style="list-style-type: none"> • Founder members of <i>Cajas</i> • Corporate management voting rights • Regional regulation – devolution rights- • Veto power on alliances

How have the different motivations stemming from multilevel governance affected the outcomes of the restructuring process? We investigate whether the alliances are following a geographic proximity (within region alliances, or neighbouring regions), political proximity (the same party in the regional government) or business efficiency and diversification (out-of-region integrations). The response to the call for the integration of *Cajas* has been to use criteria of geographical (same region) and political proximity, giving way to a third alternative when the former is not applicable (see Table 4).

⁵ I.e. the central bank can impose restrictions on *Cajas*' SCWP (since Feb 2011) to strength their reserves.

Table 4. Drivers of restructuring processes

Proximity		Political	
		Same political party in gov't	Different political parties in gov't
Geographical	Same region	MERGERS	-
	Out of region	ACQUISITIONS	INSTITUTIONAL PROTECTION SCHEMES

From the 13 integration processes outlined in Table 2 (the failed process is out of the analysis), we find all the cases of mergers took place within the same region. None of the 13 integration processes took place among neighbouring regions. That is, either we find mergers within the same region or IPS across regions. In the case of the two acquisition processes we find that they are driven by political proximity since both regions are governed by the same party (PSOE). Moreover, we find that IPS are the preferred option when *Cajas* need to integrate beyond regional borders and there is no political proximity among the participating regions.

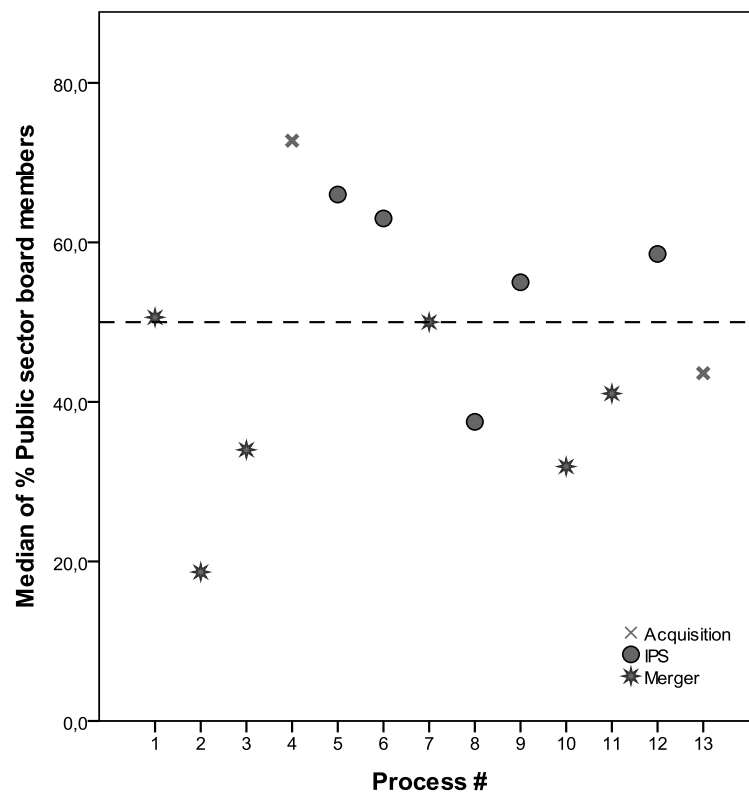
Initially, in late 2008, most management teams of Spanish *Cajas* were negotiating merger plans that included entities in other regions. However, it is surprising to see that, as of December 2010, 46% percent of the integrations occur between *Cajas* within the same region. This result fits the main goal of regional governments, that is, to keep *Cajas* as partners in their economic policies for regional development⁶. For mergers across different regional areas, Institutional Protections Schemes (IPS) have been the solution: a virtual integration across different territories with different clients profiles and risk diversification.

⁶ The regional presidents themselves were making those claims. And *Cajas* presidents were informing about these political interferences in the process.

Through the IPS a certain level of influence is kept in *Cajas'* original regional territories, while following the central bank goal for efficiency.

Further analysis on IPS offers information regarding which kind of saving banks are clustering together. Historically, *Cajas* in Spain have been considered with a more or less public status depending on the percentage of public sector participation in their governing bodies. Using a well established classification by Fonseca (2005) we map the level of public sector representation for each integration process in Figure 4.

Figure 4. Public cajas and IPS



Source: Constructed based on the classification of public *Cajas* by Fonseca (2005) and FROB (2011).

The vertical axis in Figure 4 represents the median of the percentage of public sector representation at the board of each participating *Caja*. We use this measure as a proxy for

the political influence regarding the decision making in the *Cajas*. In the horizontal axis, each number corresponds to a restructuring process, in same order as Table 2. We find that mergers are associated with *Cajas* with less public representation in their boards; while most IPS are bringing together *Cajas* that traditionally have had a more public status.

This result fits with the framework provided in Figure 2 on the two main channels that regional government may use to exert influence. In sum, since all mergers cases have remained in the same region, regional governments will continue to use regulation as the main vehicle to exert influence. In contrast, for IPS cases across regions, it is necessary for the different regional governments to have direct representation in the governing boards.

VI. CONCLUSIONS: LESSONS FOR POLICY MAKERS

Since July 2008, the Spanish banking sector has gone through a major reorganization of its State-owned Savings banks or *Cajas* —which represent half of the financial sector. These entities have a public status since both local and regional governments have historically been important stakeholders and have voting rights in their governing bodies. Given the public nature of *Cajas*, the central bank of Spain and the national government have additional roles as regulators and monitors of these institutions. The much needed reorganization of the sector has evidenced the contrasting goals and conflict of interest among the different governments. The objective of the paper has been to examine how this multilevel governance frame plays a role in determining the outcome of the current financial reorganization.

The first contribution of the paper is to provide a framework for Public Corporate Governance. Figure 2 highlights the two main components: first, the traditional corporate governance mechanisms (via governing bodies and voting rights) and, second, the

multilevel governance across public sector institutions that exert influence via regulation and monitoring.

With this framework in hand, we describe the different goals and sources of power among the three main players in the reorganization process: the regional governments, the national government and the central bank. We provide evidence for the conflict in multilevel governance which revolve around two main goals: either aiming for efficiency gains and to reconvert *Cajas* into non-politicized financial entities, or aiming for the maximization of Social and Cultural Welfare Projects within the regions.

Next, we provide a general picture of the reorganization of the Spanish banking system: from the initial 45 *Cajas*, there have been 14 integration processes resulting into 19 new financial entities. Three integration mechanisms have been used: in 15% of the cases an acquisition took place, in 46% of the cases were mergers and 39% were IPS.

It is striking to find that all mergers are within region and all IPS across regions; the acquisitions cases respond to political proximity. Regional governments have been using their sources of power within region (regulatory power and, most importantly, veto power) to defend that mergers occur among *Cajas* sitting inside their areas of regional influence. When the mergers within regions have not been deemed possible, the option of the IPS or virtual merger has become the alternative. In the IPS cases, the channel to continue to exert influence in the new financial entity is via boardroom representation -since the regulation channel does not apply anymore. We find that IPS across regions take place among *Cajas* with high level of public representation in boards prior to the integration. This may induce similar levels of public representation in the new governing bodies of the resulting *Cajas*.

In sum, regional governments are using different strategies to influence the governance of the resulting *Cajas*: either via regulation in the cases of mergers within-

region or through direct participation in governing bodies in the cases of IPS. The case of the reorganization of the Spanish financial sector is an example of Public Corporate Governance at work – where it is necessary to include the multilevel governance of public sector institutions to the standard corporate governance mechanisms.

Finally, the case of the restructuring of the Spanish banking system may have relevant policy implications for policy makers in other countries with state-owned banks – government ownership of banks is a phenomenon that affects at least 80 countries around the world (La Porta et al., 2002). In such countries, the multilevel governance issues that have arise in the Spanish case should give guidance regarding the divergence of interests among the different levels of public administration players. For instance, in our case, the Spanish government tried to spur the integration process via national regulation and it did not progress successfully given the veto power of the regional governments. Hence, policy makers should foresee the tension between goals and implementation mechanisms – i.e. the IPS formula, together with the FROB funding and the oversight of the central bank have managed to reach the desired integration outcome while encompassing the interests of all the involved parties.

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