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Good and bad banking on Europe's periphery: pathways to catching up and falling behind

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ABSTRACT
The research question here is two-fold. The article seeks to explain why bank performance varied so dramatically during and after the financial crisis on Europe's periphery, both across states and also at times within them. The dependent variable used is bank performance in terms of credit provision and banks' contribution to financial stability. The independent variable used is the particular mix at play between political/social purpose (the various forms of which are detailed below) and what is called 'market authority', which refers to the importance of market incentives, signals and pricing within a particular financial 'ecosystem'. The second, related research question is why bank behaviour contributes to economic catching up and adjustment in some countries, but sets back others.

KEYWORDS Comparative political economy; European politics; banking

Banks have been both blessings and curses for states. Banks can lay the foundations for economic power. But they can also cause economic catastrophe. The organisation of finance, starting with banks, has always been central to catching up in the global economy. Equally important to states that have approached the pinnacle of economic power has been staying there. In this regard, banks have also been critical to economic adjustment, maintaining or regaining competitiveness, and therewith states' international power positions.

To say that banks have often been instrumental in state formation, economic development and even the prosecution of war is not to claim that banks, in the service of states, have always been effective in such undertakings. Indeed, there is enormous variation in the degree to which banking systems have provided adequate credit to an economy, funded innovation, ensured financial stability, insulated countries against external economic shocks or provided countercyclical lending in downturns.

Equally, there are also variations in the extent to which the mobilisation of the financial system by the state (both national and subnational) behind

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political or social objectives (which we call 'political or social purpose') is good for the banks themselves. The bank–state relationship can be fraught with difficulty. In the banking sector, as in other sectors of national economies, market failure and state-induced failure both occur. The banking sectors' fragilities in both respects were clearly on display during the 2008 financial crisis and after. And nowhere was variation along both dimensions – market behaviour and politically or socially oriented banking – more evident than on Europe's periphery, east and south.

The research question here is two-fold. We seek to explain why bank performance has varied so dramatically during and after the financial crisis on Europe's periphery, both across states and also at times within them. Our dependent variable is bank resilience, measured first in terms of stability through the crisis and second in terms of countercyclical capacity. Our independent variable is the particular mix at play between political/social purpose (the various forms of which we detail below) and what we call 'market authority', which refers to the importance of market incentives, signals and pricing within a particular financial 'ecosystem'. Our second, related research question is why bank behaviour contributes to economic catching up and adjustment in some countries, but sets back others.

The argument

We use the concept of 'embedded discipline' to capture the optimal mix of market authority on the one hand with social or political purpose on the other (also see Epstein 2017). Banks marked by embedded discipline exhibited the highest levels of resilience through the US financial crisis and after. In other words, the banks with embedded discipline remained stable through the crisis and therefore were able to assist their economies – not just by not failing or absorbing public resources, but also through countercyclical lending.

Embedded discipline is comprised of two elements: market authority and social or political purpose. Market authority over banks refers to bank management's attention to profitability, price signals and risk. Market authority thus introduces discipline. Social or political purpose can take different forms. What is often referred to as 'economic nationalism' imbues banks with social and political goals that are meant to serve the national economy as a whole. But we extend that definition to local and regional contexts, where developmentalism in Europe (notably in Italy, France, Germany and Spain) has often been pursued. 'Embeddedness' in this context draws on Ruggie's interpretation of Polanyi in which social or political goals are privileged over market rationality (Ruggie 1982). Our argument is that for optimal bank performance, there must be both market authority and social or political purpose operating in constructive tension and constraining one another.

We contend further that achieving an optimal mix of market authority and social or political purpose is difficult and rare in the peripheral European states, as well as globally. Contrary to some of the economic literature (e.g. Véron 2017), we find that ownership structures and corporate governance that simply maximise market authority hardly saves banks from self-destruction. Calomiris and Haber (2014) document, after all, the very low number of banking sectors around the world and over time that consistently provide both stability and sufficient credit to their economies – regardless of where these banks sit on a spectrum from full embeddedness to full exposure to market authority. Evident bank fragility points to an additional problem: political influence that subverts commercial goals with cronyism, regulatory forbearance and restricted competition that can also severely damage the financial and broader economic system (Epstein 2017).

We also specify here the antecedent conditions that are most likely to lead to embedded discipline. Those conditions are a combination of robust electoral political competition, including political party turnover, together with self-sufficiency-seeking economic nationalism in East Central Europe (ECE) or developmentally oriented regionalism in Southern Europe. Our case selection of banks, which features variation on these independent variables, also shows how the absence of these antecedent conditions prevents embedded discipline from taking hold. This leads to weaker or non-existent bank resilience and therefore lower levels of credit provision (or even credit shrinkage) through a crisis.

Political competition – competitive elections and political party turnover or alternation in power – contributes both to the elevation of market authority and to government intervention in banking that provides regulatory public goods (e.g. sound, independent banking supervision) as opposed to the subversion of market incentives in favour of a partisan or personal logic. Vigorous electoral competition and party turnover prevents the stasis in government that frequently allows corruption, cronyism and clientelism to flourish (Pujas and Rhodes 2002; Schoenman 2014).[1] Because political competition prevents the complete and enduring interpenetration of political and business elites, bank management is of a higher professional quality with greater sensitivity to market authority, and bank oversight is less partisan.

Economic nationalism in ECE that is focused on preserving a degree of self-sufficiency, and regional developmentalism in Southern Europe, both contribute to social and political purpose. Economic nationalisms (and their local and regional analogues) vary in their social purpose (Abdelal

2001). We find that an ideational commitment among bankers, regulators and politicians to the collective and non-partisan interest – particularly in the service of broad developmentalism as opposed to narrow gain – encourages banks to behave not only as profit-seeking businesses, but also as quasi-public utilities, even when privately owned.

In sum, political competition together with economic nationalism or regional developmentalism helps create embedded discipline in banks, which in turn leads to greater resilience. The productive tension between market authority and political or social purpose allows governments to both facilitate and constrain banks' conduct. State facilitation supports market responsiveness. Imposing constraints prevents excesses while addressing collective social and political objectives. Thus the quality of regulation and supervision are subsumed within this framework, rather than separate from it. Bank oversight, in other words, is derivative of the tension between discipline and embeddedness.

Theorising the drivers of bank behaviour: the role of embedded discipline

Figure 1 counterposes social and political purpose on one dimension against market authority on the other. We use the spectrum from low to

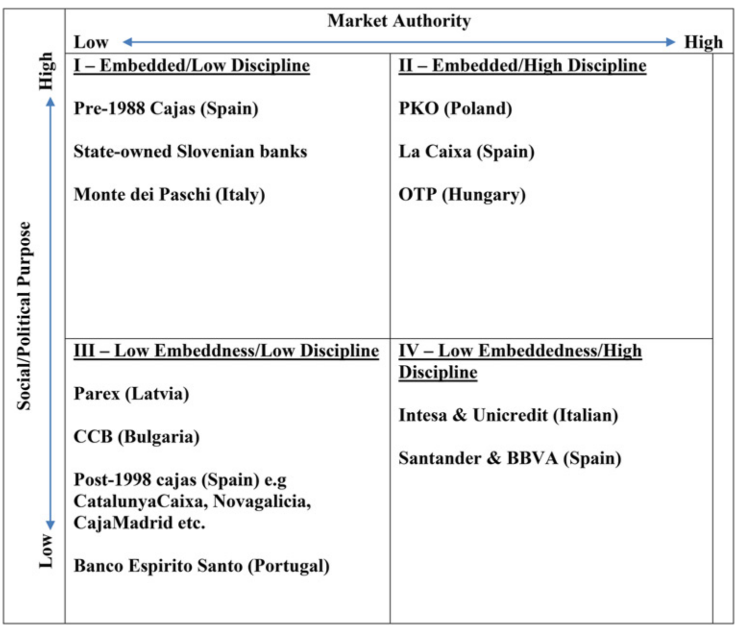

Figure 1. Social/political purpose versus market authority in national financial systems.

high on each dimension to specify a set of trade-offs. The banks were selected using a most similar systems design. They are all traditional financial intermediaries from Europe's periphery, were all subject to 'home' supervisory authority at the time the analysis was undertaken, and were all exposed to the severe shock of the US financial crisis and the long European economic crisis that followed. But they do vary on the independent variables. Those include political competition and party turnover in their contexts, as well as the nationalism or regional developmentalism. Together, these can contribute to or detract from the formation of 'embedded discipline', which in turn led to bank resilience or fragility during the financial crisis.

As noted in the previous section, it is the relationship between market authority and social/political purpose in so far as it pertains to particular banks that is important here. Thus a national financial system can differ internally as to the optimality or sub-optimality of the market-social/political purpose mix. This will arise because a certain type of bank is differentially regulated from another, linked to variation in local political competition; because the national or subnational state attributes a certain kind of political or social purpose to some banks but not others, linked to variation in economic nationalism or developmentalism; or because some banks (e.g. those with international reach) are more distant from 'home' political authority than those which are territorially limited in scope.

We therefore hypothesise the following kinds of causality:

1. In *quadrant I* there is a suboptimal mix of social/political purpose and market authority, in which the former prevails over the latter, such that banks will be politicised and/or caught in a web of related-party lending (political excess); and political cronyism will characterise the relationship with the state (local, regional or national), subverting banks' commercial behaviour.
2. In *quadrant II* there is an optimal mix of social/political purpose and market authority (both are high; one constrains the other) and we refer to this 'sweet spot' as 'embedded discipline'.
3. In *quadrant III*, weak regulation (which may be purposeful on the part of political authorities – see below) permits or incentivises market indiscipline (unconstrained borrowing and lending by banks), the mispricing of risk (market excess) and in some cases corruption.
4. In *quadrant IV*, there is the possibility of well-regulated open market banking (light-touch state intervention alongside high market authority) in which the potential for risk mispricing or herd behaviour is contained, but which offers little in terms of social or political objectives.

These hypotheses also imply the possibility that banks could move from one quadrant to another. For example, in Poland since 2015 and in Hungary since 2010, governments have taken measures to both curb political competition at the local and national levels and exercise more direct state control over their financial sectors. Such changes could undermine market authority, moving OTP of Hungary and Poland's PKO BP (PKO Bank Polski 2010a, 2010b) towards Quadrant I. At the same time, Slovenia's political context has become more competitive, which has accompanied significant bank privatisations (Piroska and Podvršič 2018). Privatisation in theory heightens market authority and/or reduces political and social purpose, which could move Slovenia's formerly state-controlled banks to quadrants II or IV. The institutionalisation of European Banking Union (EBU) in 2014 could also affect the position of banks domiciled in the Eurozone by overriding the effects of weak political competition in the quality of bank oversight – given that EBU centralised bank supervision (Epstein 2017). In the following we trace the effects of competition, nationalism and regional developmentalism on the formation of 'embedded discipline' or its opposite, and identify the ensuing consequences for bank resilience or fragility.

Bank behaviour in East Central and Southern Europe

Embedded discipline (quadrant II)

PKO Bank Polski: the strongest case of embedded discipline

We categorise Poland's Powszechna Kasa Oszczędności Bank Polski (PKO BP – majority state-owned in 2008) as having contained risk in the run-up to the US financial crisis and as having acted countercyclically and in support of the Polish economy since. Expanded lending distinguished PKO BP from most banks operating in the Polish market, particularly foreign-owned ones. By 2011, PKO BP had overtaken Pekao SA, then owned by Italy's UniCredit, as Poland's largest bank, measured in terms of loans, deposits and market capitalisation. PKO PB also embarked on its own international strategy, purchasing Sweden's Nordea holdings in Poland in 2014, and expanding to serve its corporate clients in other European countries, including in Germany, France, Czech Republic and the UK.

We argue that PKO BP was strongly characterised by embedded discipline. Its constructive performance vis-à-vis the Polish economy is explained by the following reasons.

1. PKO BP's embedded discipline was rooted in Poland's economic nationalism, which, since the transition began, revolved around

preserving some degree of economic self-sufficiency, despite demands by international organisations and the EU that Poland (like other post-communist countries) relinquish policy autonomy in favour of international interdependence and market openness (Epstein 2008). Poland is famous for liberal 'shock therapy' under the Balcerowicz Plan after 1990, but the debate in Poland concerning the role of the state in the economy was always more complex. Bohle and Greskovits (2012) refer to Poland as an 'embedded neoliberal' state and point to the long-standing debate in the country regarding the appropriate role of the government in economic management – including through the select ownership of strategic assets.

2. PKO PB was a direct outgrowth of Polish desire to maintain a degree of economic self-sufficiency, but banking nationalism was tempered by political competition and party turnover at the national level. Because political parties were continually debating the appropriate role of the state in backstopping the bank, bank managers kept the bank ready for imminent privatisation and adopted a more disciplined and conservative strategy than some of their counterparts elsewhere in Poland and in ECE. The principle behind the state's controlling ownership stake was that Poland needed its own major financial player, but this idea was also constantly contested in the Polish context. So in addition to discipline, national economic and political goals were salient.

PKO PB's resilience was ensured by a loan-to-deposit ratio below 100% – against a sectoral average of 120% by mid-2011 – which meant its deposits, not foreign or domestic wholesale borrowing, funded lending. By contrast, Parex Bank in Latvia or the state-run banks in Slovenia were heavily dependent on cross-border borrowing. PKO BP also engaged in considerably less foreign exchange lending than many banks elsewhere in Poland or ECE. And it provided credit or guarantees to economically important enterprises, namely the state-owned Social Insurance Institution (ZUS) in 2009 and, with the help of the government and UniCredit's Pekao SA, Polimex-Mostostal (a construction and engineering firm engaged to upgrade and expand Polish power plants) in 2012.

Poland's 'national champion' strategy has been viewed at times as hostile and unfair. But its financial protectionism was much milder than in of some of its West European counterparts (Epstein 2014a), and there is little doubt that the Polish economy had access to more credit, was less vulnerable to withdrawal of foreign capital flows and enjoyed stronger growth as a consequence of PKO BP's activities than would have been possible without them.

Hungary's OTP: highly embedded but more weakly disciplined than PKO

Hungary's OTP (Országos Takarékpénztár és Kereskedelmi Bank Nyrt), the country's biggest bank by market share, has also proven highly embedded in carrying out the state's economic and political goals, retaining domestic depositors and supporting government policies – even those directed against all banks indiscriminately. But it had a higher risk profile than PKO BP, which is surprising because OTP, though domestically managed, is mostly privately – and majority foreign-owned – through dispersed shareholdings. In theory – as noted by Véron's (2017) analysis of ownership, governance and bank behaviour – Hungary's OTP should have been more disciplined by the market than state-owned PKO BP. But it was not.

Thus, while OTP contributed to Hungary's vulnerability along some dimensions (it engaged in foreign exchange lending and benefited from mortgage schemes favourable to banks at great cost to Hungarian taxpayers) it also tried to prevent some of the worst excesses. Overall, OTP would seem to be a second case in which a domestic bank is more insulated from an international crisis than foreign banks. OTP had a lower loan-to-deposit ratio than the sectoral average, which allowed it to sustain countercyclical lending in the crisis. And while it engaged in foreign exchange lending, it was more constrained in doing so than many of its competitors.

More controversially, OTP has helped, or at least not obstructed, the FIDESZ (Hungarian Civic Union) government's efforts to limit the role of foreign actors in the economy (Johnson and Barnes 2015). Victor Orbán's government implemented Europe's biggest bank tax, as well as a financial transactions levy. OTP paid these fees like every other bank, but it was quiescent – at least publicly. While foreign-owned banks took their grievances to the EU, Hungarian and International Monetary Fund (IMF) authorities, OTP was noticeably absent from those efforts.

We explain OTP's embeddedness and relative banking conservatism as follows:

1. First and most critically, like PKO BP, OTP's embedded discipline is rooted in economic nationalism and political competition. As in Poland, segments of Hungary's political class were concerned about maintaining relative domestic control over banks, while competing elements fought for market openness. The first conservative democratic government in Hungary was even more intent than Polish nationalist and leftist elements to maintain a high degree of domestic bank control, via state ownership and private Hungarian owners.

While agreeing with the EU and international financial institutions that some foreign competition would benefit banks, the centre-right MDF government (1990–1994) privileged domestic owners. It was only after negative reporting in the international financial press in mid-1993 that the government agreed to a recapitalisation and privatisation plan with the World Bank that involved foreign buyers for two banks, MKB and Budapest Bank. It was the socialists in Hungary (MSzP – the communist successors) that pushed privatisation in the banking sector forward more broadly. But notably, OTP's privatisation, which began in 1995 (again under the socialists) barred foreign strategic investors from buying a controlling stake, allowing it to maintain a Hungarian identity and ties to the Hungarian state, even though it was majority foreign-owned through dispersed shares. Importantly, it was political competition in Hungary, in addition to political party turnover, that constrained nationalist impulses, without eradicating them entirely.

2. Second, OTP's strategic caution was driven in part by the fact that it did not have a foreign parent bank's funding upon which to draw – which also stemmed from the same nationalism that insisted on retaining at least one major domestic player. OTP's relative insulation from the crisis, which nevertheless required an IMF bail-out for Hungary in 2008, was further evidenced by the fact that OTP did not join the coalition of banks that requested the European Central Bank (ECB) and EU to extend crisis management measures beyond the Eurozone. OTP's balance sheet grew by 0.8% between 2007 and 2009, while client loans declined by only 1%. The bank's superior position was also reflected in robust profit growth: its after-tax profits increased by 28.4% in 2007–2009 when almost every other bank lost money (Várhegyi 2010: 843).

Spain's La Caixa – socially embedded, effective market engagement

Turning to Southern Europe, Barcelona-based Caixabank – a bank controlled by minority shareholdings rather than the dispersed ownership that some (e.g. Véron 2017) deem essential for good bank governance – has been one of the most active entities in terms of acquisitions from among the plethora of failed smaller Spanish *cajas*. This highly successful banking entity, presided over by Isidro Fainé until 2016, acquired two smaller entities in the crisis in 2010 – La Caixa and Cajasol. In 2011, it moved on to larger acquisitions when it took over Banca Civica (the first Spanish Institutional Protection Scheme, or IPS – typically an emergency precursor to further banking consolidation – composed of Caja Navarra, Caja Burgos and Caja Canarias with a later incorporation of Cajasol), and in 2013 merged with Banco de Valencia (Cardenas 2013). The question is, what differentiated La Caixa from Spain's other *cajas*, which, as argued further below, became both disembedded and undisciplined with the deregulation and liberalisation of the sector from the late 1980s onwards, with typically disastrous consequences in the crisis after 2008?

La Caixa – now Spain's largest domestic bank after the mergers of recent years – was the only large bank to emerge from Spain's banking crisis unscathed. There seem to be several factors behind its superior performance. Like other savings banks in Spain, its original purpose after its foundation in the early 1900s as the Caja de Pensiones para la Vejez (Old Age Pension Society) was to take deposits for pensions and subsequently to channel those savings to local social and economic investments (evidence of embeddedness). But in contrast to other smaller *cajas*, while retaining its original developmental mission La Caixa also managed to isolate itself from the increasingly uncompetitive and cronyistic political context which affected most Spanish savings banks after the 1960s. Cronyism typically resulted from the presence of local government politicians on general assemblies and boards of directors, and the sharing of regulatory and supervisory powers between the Bank of Spain and national and local and regional authorities. Escaping that trap in La Caixa's case was facilitated by the competitive nature of Catalonian politics (evidence of political competition). The autonomous community of Catalonia has evidently witnessed strong nationalism, which might otherwise have politically overwhelmed the bank. But that outcome was averted in part because of vigorous regional political competition. That competition and turnover in power has derived from the diversity of social and political identities (created by an overlap between the left–right axis and positions on national identity) and a proliferation of parties and complex coalition governments under Catalonia's proportional (d'Hondt) electoral system (Baras *et al.* 2015; Moreno *et al.* 1998).

La Caixa eventually became too big to control in any case via a simultaneous cross-national expansion beyond Catalonia (which began early with its 1930 merger with the Caja Rural para la Federación Católico-Agraria de Ibiza in the Balearic Islands), an extension of its investments to foreign markets, and the elevation of long-term professional and market-disciplined management, most notably under its 2007–2016 CEO Isidro Fainé. His commitment to skills and competence in La Caixa, its prudential lending practices in the run-up to the crisis, its ongoing commitment to its social role through its charitable foundation, as well as to deep, long-term relational lending, contributed to La Caixa's success as an embedded yet highly competitive bank. It is also worth noting that a correlation between savings bank size in Spain, a distancing from political interference, and the elevation of commercial management has been demonstrated more broadly across the Spanish banking system (e.g. García-Cestona and Surroca 2008).

La Caixa's size, long-term diversification and the competitive politics of Catalonia have allowed the bank to escape politicisation. It has acquired a unique governance structure that under Fainé was in fact carefully designed to guard against political influence and maintain the bank's commercial probity. Those holding public offices by political appointment are forbidden from holding office in the bank's General Assembly and on the Board of Directors and Control Committee. Further, there is an indirect election of delegates representing deposit holders to the General Assembly. They are drawn by lots and elected by General Assembly members from delegates in each electoral district to avoid interference by political parties (Caixabank 2009).

To this list of factors contributing to the bank's successful navigation of the financial crisis should be added the importance of price signals related to its broad portfolio of investments that has allowed La Caixa to eschew borrowing and the building of debt obligations on the international wholesale market. Market strength is also derived from La Caixa's broad deposit base and its high income from large-scale equity investments both in Spain (ranging from oil and gas group Repsol, to energy provider Gas Natural and mobile phone giant Telefónica) and abroad (telecoms in Brazil, oilfields in Canada and power stations in Mexico) (Buck 2015). In 2015, Caixa Bank took over the British Barclays' Spanish retail bank and corporate banking business, and two years later it completed a takeover of the Portuguese Banco Português de Investimento (BPI), making it the leading financial group in the Iberian market.

La Caixa's simultaneous preservation of its original social mission as a *caja de ahorros* demonstrates that an optimal mix of market discipline and social/political purpose is far from impossible in a liberalised and deregulated financial system. La Caixa retains some €500 million every year for investment in extensive social activities (in health, education, science and international development) through its charitable foundation, which it argues is the third largest in the world (Buck 2015).

Embedded/low discipline (quadrant I)

State-owned Slovenian banks – pro-cyclical borrowing and lending

Slovenia had precisely the kind of nationalism in the 1990s and early 2000s that produced highly embedded banks. But without significant political competition in the transition, economic nationalist impulses and embeddedness went unchecked. Slovenian banks therefore lacked market discipline, becoming highly reliant on cross-border borrowing with maturity mismatches for their operations. When interbank markets froze in September 2008, Slovenian banks were vulnerable. The country then suffered the biggest output decline – an 8% contraction in 2009 – of any post-communist EU member, excluding the Baltics. Borrowing costs spiked dramatically at the height of the Eurozone crisis because of bank weakness and the interconnectedness of bank–state finance. The banking sector had been a major source of Slovenia's economic malaise, which threw its convergence process into reverse (Epstein 2014b).

Nationalist striving in Slovenia was designed to achieve economic autonomy and self-sufficiency. Its two largest banks, Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM), were majority state-owned and accounted for nearly half the Slovenian market before the US financial crisis (EBRD 2010: 144). And while profitability at these two banks and a third state-owned one, Abanka Vipa, was a priority, 'managers also had an implicit mandate to provide affordable credit to Slovenian citizens and businesses' (Spendzharova 2014: 50), which led to a toleration for a less profitable banking sector (IMF 2007). But these banks were also highly pro-cyclical before and during the crisis, and by mid-2011 non-performing loan ratios at the two largest banks were estimated at 15%. Using bonds to bail out its banks helped push the government deficit to 5.5% of GDP in 2009, which was in violation of the Stability and Growth Pact and prompted the Eurozone's 'excessive deficit procedure'.

Although both NKBM and NLB passed the European Banking Authority's stress tests in the summer of 2011, NLB did so only by a slim margin. That bank was required to raise more capital by the spring of 2012. But again at the end of 2013, with Non-Performing Loans (NPL) in the sector equalling over 20% of Gross Domestic Product (GDP), the Slovenian state was providing an additional €4.78 billion to eight of the country's banks. In a reversal of previous Slovenian strategy, in 2015 NKBM – one of 15 state-owned firms slated for sale as part of the recovery plan – was fully privatised to the European Bank for Reconstruction and Development (EBRD) and the American investment firm Apollo Global Management.

Italy's Monte dei Paschi di Siena

The story of Italy's Monte dei Paschi – the world's oldest bank, founded 545 years ago – reveals many similarities to that of the post-1988 Spanish *cajas* discussed below. Like the failed *cajas*, but also interestingly like the successful Spanish Caixabank, Monte dei Paschi had been a locally embedded lender, in Siena, Tuscany, with a foundation that funded local social and economic initiatives (the Sienese called the bank their 'Bancomat', or 'ATM'). Unlike Caixabank, however, it had always had close relations with the dominant party in the local (electorally uncompetitive) political system – the Italian Communist Party until the 1990s, and subsequently with its successor the Italian Democratic Party. And it remained located within this system – which ultimately led to its degradation under inexperienced and incompetent politically appointed leadership – until its near collapse in 2012–2014.

Initially created as Monte Pio in 1472 to help the poor and indigent after the plague wiped out half of the city-state of Siena's population, the organisation grew into bank lending to local farmers. Renamed in 1624 when Siena was absorbed into the Grand Duchy of Tuscany under the Medici, Monte dei Paschi became a corporation controlled by local politicians in 1936, with profits used to support civic activities, including the world-famous Palio horse race. In 1995, the bank became a joint-stock company and was split into a bank, the Banca Monte dei Paschi di Siena SpA (MPS), and a non-profit foundation, the Fondazione Monte dei Paschi di Siena. The latter organisation, whose board was composed mainly of local political appointees, has been the majority shareholder of Monte dei Paschi (Jassaud 2014).

Monte dei Paschi's big problems began in 2006, when banking inexperience and incompetence collided with the new world of high finance. Greed conspired with politics to produce spectacularly imprudent borrowing and expansion. Giuseppe Mussari – a local lawyer with extensive political connections but no banking experience – was appointed chief executive in 2006. In an example par excellence of political cronyism, Pierluigi Piccini, the mayor of Siena from 1990 to 2001, made his friend Mussari a member of the Monte dei Paschi foundation in 2001. With 60% of MPS shares, the foundation controlled the bank. Shortly thereafter Mussari became the foundation's director, and in 2006 was appointed by the foundation to the position of MPS CEO. In 2007, Mussari led the financially disastrous acquisition of the Padua-based Banca Antonveneta S.p.A. from the Spanish Santander Bank Group for €9 billion, when Santander itself had valued the bank at only €5.6 billion just months before. Apparently, Mussari neither negotiated nor checked Antonveneta's books to ascertain its real value – or compatibility as a merger prospect for MPS. To finance the Antonveneta deal, MPS sold €2 billion worth of 10 year subordinated upper tier two bonds to retail investors in 2008, and used undisclosed derivatives contracts – with Deutsche Bank and the Japanese Nomura – to cover losses. The latter were to be Mussari's, and the bank's, undoing (Sanderson 2013).

Between 2011 and 2015 Monte dei Paschi lost €14 billion – including €10 billion under the leadership of Fabrizio Viola, who replaced Mussari in January 2012 with the aim of rescuing the bank (Sanderson 2016). In October 2014, Giuseppe Mussari, along with former chief executive Antonio Vigni and ex-finance boss Gianluca Baldassarri, was sentenced to three years and six months in jail for misleading regulators in relation to the undisclosed derivatives trades. MPS failed the European Banking Authority's stress test in July 2016. In the third week of December 2016, MPS was effectively nationalised with a government recapitalisation after a private sector based recapitalisation failed.

Finally, there was a serious regulatory problem in the supervision of MPS – and other Italian banks in which politically constituted foundations had a controlling or influential stake. While the Bank of Italy – Italy's most respected institution – appears to have carried out its supervisory responsibilities of the MPS bank to the letter, the MPS foundation fell under the responsibility of the Italian Treasury, whose surveillance of the foundation's conduct appears to have been much weaker and more accommodating of its behaviour because of the bank's political connections (Boeri 2013).

Low embeddedness/low discipline (quadrant III)

Latvia's Parex Bank

While Poland and Hungary balanced European integration alongside some self-sufficiency oriented nationalism, Baltic nationalism and economic policies that followed were not so much predicated on striving for relative autonomy, but rather on reorienting economic and political relationships westward to the EU and North Atlantic Treaty Organization (NATO) (Abdelal 2001). This included trade, currency and monetary policy, principally as a means of escaping Russian influence. As for banking, Latvia generally followed the bank privatisation policies of other ECE countries, selling most state assets to foreign capital. However, its biggest domestic bank, Parex Bank, did not emerge from state socialism but was founded in 1988 by two private entrepreneurs: Viktors Krasovickis and Valerijs Kargins – the first people (in 1990) to get a private licence in the Soviet Union to trade in hard currency (Bohle and Greskovits 2012: 130).

Parex Bank 'was one of the early, highly entrepreneurial post-Soviet banks, complete with all the baggage' (Åslund and Dombrovskis 2011: 39–40). Not only was Latvian economic nationalism focused on maximising integration with wider Europe, but in its founding Parex was divorced from any notion of social purpose. Moreover, the bank proved to be procyclical and destabilising. Parex was Latvia's second largest bank before the crisis, with three competitive rivals in the Latvian market, all from Sweden (Nordea, Swedbank and SEB), together comprising 75% of the market (EBRD 2008: 146). None of these banks had a robust local deposit base in Latvia. If the Swedish banks mostly financed lending there through borrowing from parent banks, Parex relied on European wholesale markets. Parex Bank also attracted depositors, but they were often from abroad – both East and West.

Parex Bank's reliance on foreign funding, both deposits and wholesale, explains why following Lehman's collapse in September 2008 Parex was already on the brink of disaster (EBRD 2009: 184). The bank lost 25% of its deposits as early as August–November 2008. And just as the US financial crisis was going global and interbank funding markets froze in early 2009, €975 million worth of Parex Bank's syndicated loans came due. This was the equivalent of 4.6% of Latvian GDP (Åslund and Dombrovskis 2011: 43). It was therefore Parex Bank's imminent collapse that led Latvia to call in the IMF for an international rescue. The bank had contributed much to Latvia's extreme economic vulnerability.

Bulgaria's Corporate and Commercial Bank (CCB)

If Latvia is a good case for showing that domestic bank ownership per se does not ensure limited risk-taking, countercyclicality or social lending to counter a downturn, the Bulgarian case is useful for showing the limits of a strong regulatory and supervisory context. Bulgaria also highlights how the absence of nationalism (or political/social purpose) as well as the absence of political competition (and thus market authority) can harm bank resilience.

If Polish and Hungarian economic nationalism had been defined in part by striving for some economic self-sufficiency and Latvian nationalism, though highly contested, was geared toward escaping Russian influence through intense westward economic integration, Bulgarian nationalism was notable for its lack of an economic programme. As Spendzharova (2014: 34) argues, Bulgarian privatisation and regulatory reform in the post-communist transition were characterised by a 'grabbing hand strategy … where governing elites created intransparent markets and fueled corruption'.

After the banking crisis of the late 1990s, however, Bulgaria created a currency board and a highly independent central bank, which ultimately engaged in strong prudential supervision. Most banks were sold to foreign owners. Thus the institutional set-up boded well for rigorous and independent bank oversight. But while the central bank effectively supervised foreign banks (see especially Spendzharova 2014), political connections stemming from weak party turnover meant that domestic Bulgarian banks were apparently given a free ride and were able to grow as a consequence.

This mattered by 2014 when two domestic banks had grown in market share to become the third and fourth largest lenders in the country. One of those banks – Corporate and Commercial Bank (CCB) – experienced devastating deposit runs starting in June 2014. The bank was closed in June and its licence was revoked in November. By the end of 2014, its liquidation was being planned. Although the origins of the deposit runs are still disputed, personal rivalry between CCB's majority shareholder, Tzvetan Vassilev, and a major borrower at the bank, Delian Peevski, was at the centre of events that sparked the panic-creating deposit withdrawals in mid-June. There were other family members, media empires and multiple cross-shareholdings involved in the crisis, but the allegation that Vassilev attempted Peevski's murder through a hit squad was at its core.

The original bank runs also put enormous liquidity pressure on Bulgaria's First Investment Bank, which required a government bail-out. FiBank was also long suspected of illegal activity, including money laundering on behalf of Bulgarian and foreign criminals, in addition to its legitimate retail business. It is therefore the absence of any economic nationalist programme with social purpose at its core, and the subversion by powerful (often criminal) interests of bank oversight that explains the rise of undisciplined and disembedded domestic banks in Bulgaria.

Spain's cajas *(CatalunyaCaixa, Novagalicia, Caja Madrid etc. – and Bankia)*

Many of Spain's most problematic savings banks, or *cajas de ahorros*, became crisis-ridden as a result of a series of factors not dissimilar to those found in the Latvian and Bulgarian cases. Once locally embedded regional banks, linked to charities, and with important social and cultural functions (as outlined in the study of La Caixa above), following the deregulation and liberalisation of Spain's financial sector they either engaged in banking activities beyond their localities and in areas where they had little competence and/or were undermined by political corruption (Cardenas 2013; IMF 2006, 2012). Incompetence, corruption and undisciplined borrowing were often apparent in the same institution. Research shows that *cajas* led by CEOs with no previous banking experience, no graduate education, and who were politically connected did much worse (unsurprisingly) than others in the run-up to the crisis (Cuñat and Garicano 2010). The costs – social and economic – of the failure of a great many *cajas* in the crisis have been huge. Just three of the most problematic *cajas* – Bankia, CatalunyaCaixa and Novagalicia – had capital deficits (to be covered partly or fully by the taxpayer) of €54 billion, equivalent to 5% of Spanish GDP (Garicano 2012.)

The *cajas* had always had quite different corporate governance structures from commercial banks. Indeed, local and regional governments have directly appointed many board members, and politicians have often exerted a powerful influence over their operations. Originally, these were highly embedded banks in the sense that they were imbued with social purpose and their activities limited to particular communities. But over time, following financial reforms, they quickly extended their business to other parts of their region. After liberalisation in 1988, all restrictions on location were lifted, and the process of *caja* branch expansion and reach began, which accelerated from the early 1990s until the crash in 2009. In terms of Figure 1, the *cajas* moved from quadrant I (market discipline was low, but this mattered little when they were limited to lending from deposits to solvent clients) to quadrant III. In the process, their role in constructive local relational banking was destroyed – even if many also continued with their charitable social welfare work.

Many *cajas* also either invested in or lent heavily to real estate developers in the absence of reliable risk analysis. Extensive corruption emerged from the nexus of *cajas*, real estate developers and regional politicians, with particularly blatant examples found at Caja Madrid (where subprime lending was a big problem) and Valencia's Caja de Ahorros del Mediterráneo (CAM), which engaged in dubious loans to developers and the regional Popular Party government (Cardenas 2013). These and other problematic *cajas* were busy reclassifying, refinancing and extending loans to cover up their losses in the years running up to their collapse, which raises the question as to why the Bank of Spain (an otherwise solid and highly professional institution) failed to fulfil its supervisory mandate and tackle the root problems with an audit of the sector early on.

Part of the explanation comes from standard issues of regulatory failure: the career concerns of regulators, an unwillingness to expose problems that should have been detected earlier, and the lack of an adequate bank resolution fund. The unintended consequences of the adoption of dynamic provisioning – a tool endorsed by Basel III in December 2010 – have also been mentioned as a factor encouraging imprudent lending and borrowing (Garicano 2012). By forcing banks to increase provisions without reference to any specific loan, dynamic provisioning may actually have helped conceal for a certain amount of time the extent of the *caja*'s liabilities. But as in the case of Bulgaria's central bank, political connections also constrained the Bank of Spain from intervening effectively in the sector. As Garicano (2012) argues, 'the supervisor, confronted with powerful and well connected ex-politicians decided to look the other way in the face of obvious building trouble'. Political considerations also determined the less-than-effective solutions ultimately put in place, as in the mergers of sick *cajas* in Catalonia and Galicia (as well as the Bank of Spain's approval of Bankia – see below), which were implemented in accordance with a political rather than economic logic.

The worst such case – the result of Spanish Popular Party influence and control of savings banks, in addition to the inability of the Bank of

Spain to fight political influence – involved the merger of a number of failed *cajas* including Bancaja from Valencia and Caja Madrid in the same under-capitalised entity, Bankia BFA. Both Bancaja and Caja Madrid were responsible for related-party lending, while Caja Madrid (with echoes of the Monte Dei Paschi debacle) also bought City National Bank of Florida in 2008 for an estimated U.S. $1.7 billion – a price equal to three times its book value – leading to losses totalling €500 million (Cardenas 2013). The merged entity Bankia also suffered from corruption, incompetent management, poor supervision and political meddling by the Spanish Socialist government led by Luis Rodríguez Zapatero. Zapatero backed an Initial Public Offering (IPO) of Bankia – which was floated on the basis of unaudited accounts (see Mallet and Johnson 2012) – and convinced Spanish banks and corporations to take on shares 'in the national interest' when international investors showed insufficient interest. The rest of the shares were sold to some 400,000 individual savers.

Two years after Bankia's 2011 IPO, its stock was trading at around 90% below its listing price. By late 2012, its shares were worthless and it had received €22 billion of taxpayers' money in a series of bailouts. The bank reported a loss that year of €19.2 billion, the largest in Spanish corporate history. In February 2017, Rodrigo Rato, the former president of Bankia (also a former managing director of the IMF) was sentenced to four and a half years in jail, and Miguel Blesa (former chairman of Caja Madrid) was sentenced to six years in jail – all due to their use of Bankia's funds for personal expenses. Blesa – who was identified by the court as the architect of the fraudulent corporate credit card scheme that Mr Rato then took over – committed suicide in July 2017 (Minder 2017a, 2017b).

Low embeddedness/high discipline (quadrant IV)

Southern Europe's multinational banks

Southern Europe's increasingly multinational banks – notably two Italian banks, Unicredit and Intesa San Paolo, and two Spanish banks, Santander and Banco Bilbao Vizcaya Argentaria (BBVA) – have transitioned, to use Richard Deeg's felicitous phrase, from 'zeros to heroes' over the span of the last three decades (Deeg 2012). From relatively small domestic retail banks, these banks have become disembedded from their domestic markets (and the political milieu of their erstwhile local counterparts) and created powerful international empires that emerged relatively unscathed from the international financial crisis – although Santander did better in this respect than Unicredit, which, as Deeg (2012: 24) writes, 'was less efficient, held lower reserves, and was badly hurt by the general financial crisis of 2008–09 which was especially acute in much of [ECE]'.

The story of this success, although closely connected to cautious and prudent management while under an expansionist phase, reveals a high level of market discipline on these banks' operations. There is clearly a political dimension as well – but one that is quite different from the cosy cronyism of the smaller and politically embedded Italian and Spanish local banks. As financial investors in multiple foreign markets – mainly Latin American in the two Spanish cases (though Santander also has extensive European operations, and took over the British Abbey National in 2005) and Central and East European in the two Italian cases – these banks managed to escape the political machination of their system's politicians. But that was only after they went through a phase of national financial 'developmentalism' during which political support for domestic consolidation was provided to make these banks too large to be taken over. This financial 'national champion' strategy – part and parcel of domestic banking liberalisation and deregulation, combining internal consolidation and external expansion – was politically inspired but created transnational entities that were no longer exclusively beholden to domestic political impulses (Epstein 2014c). Banking developmental nationalism in these cases, including restricting the entry of foreign banks, created the domestic conditions for outward expansion (Epstein 2017). The international profile that these banks ultimately assumed led them to repudiate their national embeddedness and national regulation and they became powerful supporters of the EU's shift since 2012 to European banking supervision under the European Central Bank (Epstein and Rhodes 2016).

In the cases of both Unicredit and Santander, strong leadership, astute market positioning and unusual (for Europe) carefully considered cross-border acquisitions (with Abbey National for Santander, and the German HypoVereinsbank (HVB) for Unicredit), all combined to create a strong contrast with banks such as Monte dei Paschi. While the latter remained mired in opaque structures of control, Santander and Unicredit both shifted their corporate governance systems towards an Anglo-American style shareholder-value philosophy and operation. National regulation by the Spanish and Italian central banks also worked much more effectively at home for Santander and Unicredit than for their smaller, more politically embedded domestic peers. Low embeddedness and market discipline therefore paid off for these new transnational financial groups, if not for their home jurisdictions in the form of political or social purpose.

Conclusion

In East Central Europe we have two cases of nationalist striving for some economic autonomy with political competition (Poland and Hungary), one case of integrationist nationalism (Latvia), one case of weak or even non-existent economic nationalism (Bulgaria), and a fifth case of strong nationalism and highly embedded banks with little market discipline because of weak political competition (Slovenia). All five East-Central European cases confirm the importance of embedded discipline: where states were driven by the perceived need for some self-sufficiency and domestic banks were carved out of state-socialist monobanks for that purpose, they have tended to be risk-averse, countercyclical stabilisers – but only if political competition and therefore market discipline also constrained nationalist impulses. Where economic nationalism ignored self-sufficiency, was unchecked or was absent, domestic banks offered no political or economic upside to the state and even did damage to their national economies.

In Southern Europe we have greater variation both within and between systems. Both Italy and Spain have their problem banks, which began to engender systemic instability during the financial crisis. The only example of a Southern European bank in our 'embedded discipline' sweet spot (quadrant II) is the Spanish La Caixa, also the only large bank to emerge from Spain's banking crisis unscathed. Other southern cases lacked market discipline, whether politically or social embedded or not, unless the banks in question had international reach. Indeed, both countries have also produced a number of highly successful transnational banks, which emerged from the processes of deregulation and liberalisation of banking markets in the 1990s and whose domestic consolidation via bank mergers created a platform for subsequent international expansion, but with low embeddedness.

A remaining question is whether our argument is restricted to the two European peripheries or whether it also has applicability in other contexts, either elsewhere in Europe or beyond. Looking at the German case strongly suggests that it does. There, as in Italy and Spain, there has been a long history of publicly controlled developmental banks in the form of regional *Landesbanken*. The absence of political competition in the case of certain of those banks has also fostered conditions in which cronyistic links between politicians and public bankers have developed and endangered prudential bank management. A comparative study of the North Rhine-Westphalian regional bank Westdeutsche Landesbank (West LB) (which collapsed in 2012 and disappeared) and the Hessian regional bank Helaba (which not only survived the crisis in good health, but took control of some of West LB's key assets in 2012) reveals that imprudent bank behaviour was closely linked with a particular governance model in which political competition was muted.

In the case of Helaba, an earlier crisis in the 1970s induced the local state government and the Savings Banks Association of Hessia to switch to a risk-averse business model and reduce political and other informal influences to a minimum (Polikhronidi and Scherrer 2017: 200ff.). Local political competition helped prevent long-term cronyism: from the late 1960s there has been a process of constant alternation in power between Social Democratic Party (SPD) and Christian Democratic Party (CDU) coalitions in the region, usually (except between 1984 and 1986 and from 2003 to 2009) in coalition with the Free Democrats (FDP). The contrast with West LB is striking. In North Rhine-Westphalia, the political system has been characterised by single party (SPD) dominance since the 1960s, with the sole exception of 2005–2010 when the CDU assumed power. In that context, the SPD-controlled state government interfered extensively in the bank's operations, backing an undisciplined management and growth strategy, and failed to implement reforms such as those pursued at Haleba when West LB experienced its own early crisis in the mid-1970s (Polikhronidi and Scherrer 2017).

By 2018, two political trends in banking were visible on the European landscape. One was the tendency to escape perceived market excesses and return to very strong forms of economic nationalism – particularly in Poland and Hungary. The other inclination was to cut bank–state ties and marketise banking more aggressively through European Banking Union (Epstein 2017). The analysis here suggests that neither impulse leads to optimal bank performance. Rather, actors are more likely to secure 'embedded discipline' and therewith bank resilience by constructing the conditions that allow market authority and political and social purpose to operate in constructive tension – supporting but also constraining one another.

Note

1. Although in some parts of the world political competition could conceivably be structured around rival cronyisms, political competition in EU member states typically includes one or more grouping committed to EU norms of civil service depoliticisation.

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