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The long-term effects of bank recapitalization: Evidence from Indonesia

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ABSTRACT

Do government-sponsored bank recapitalization programs spur lending and reduce risk? This paper assesses the impact of Indonesia's bank recapitalization program on lending and bank risk following the Asian financial crisis of 1997. Using unique bank-level data, difference-in-differences estimates suggest that recapitalization increased lending (and more so for larger banks), but also boosted bank risk in the long term. Results remain robust to considerations of (1) bank-level differences in political connections, business group affiliation, ownership type, and (2) changes in macroeconomic conditions, capital requirements, accounting regulations, and public credit registry availability.

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1. Introduction

Just as systemic financial crises are ubiquitous over countries and time (Beck et al., 2006), so too are the components of government policy response. Consistent with history, the most recent global financial crisis spurred a renewed interest in the impact of financial sector policy on banking sector stability and growth (Levine, 2010, 2012; Stroebel and Taylor, 2009; Taylor, 2009). An often contentious element of government intervention during a financial crisis is the implementation of government-sponsored recapitalization programs aimed at providing emergency capital to troubled banks. Little empirical evidence exists, however, about the long-term effects of bank recapitalization on bank-level financial outcomes. As such programs often represent an economically significant commitment of resources, generate considerable political discord, and operate with extended horizons,

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understanding their long-term impact on the banking sector remains a first order question in analyzing the impact of financial sector policy during crises.

This paper examines the long-term impact of a major sector-wide bank recapitalization program in Indonesia following the Asian financial crisis on two central policy variables – lending and bank risk. Policymakers are particularly interested in lending and risk outcomes as they seek to balance the social costs of bank credit supply disruptions during financial crisis with the potential financial fragility produced in the long-run by insuring banks from failure (Keeley, 1990; Laeven and Levine, 2009).

Results indicate that recapitalization increased lending by 3.6 million Indonesian rupiah (IDR), 1.5 standard deviations above the pre-crisis control group mean, and even more so for larger banks. Results also suggest that recapitalization leads to a 40% net increase in bank risk, with recapitalized banks increasing risk and non-recapitalized decreasing risk. Further, both of these main results are pervasive eight years post-intervention. The impact of recapitalization on lending and bank risk remains robust to considerations of cross-sectional differences between banks (political connections, business group affiliation, ownership type), and significant time varying differences that may differentially affect recapitalized versus non-recapitalized banks (changes in macroeconomic conditions, capital requirements, accounting regulations, and public credit registry coverage). The study also yields evidence that changes in lending were not entirely demand driven through analysis of an additional dataset of borrower-creditor relationship patterns of a sample of Indonesian manufacturing firms. Altogether, the results suggest that bank recapitalization successfully stimulates lending yet also increases bank risk in the long run.

One of the primary motives of financial crisis recapitalization programs is the stimulation of lending by banks, in an effort to avoid spillovers from the banking sector to the real side sector of the economy. Insofar as non-financial firms can only imperfectly substitute bank credit with other forms of funding, disruptions in bank credit supply can create large social costs outside of the banking system as non-financial firms' alternative funding options are more costly.

These spillovers from the banking sector to the real side sector are more likely to emerge during financial crises when banks simultaneously face both capital losses and a high cost of raising external capital. Such simultaneity of events increases the likelihood that banks will respond to losses by contracting the supply of credit. The "bank-credit" motive of recapitalization suggests that governments can reverse this socially undesirable contraction in lending during a financial crisis with a direct replacement of lost capital (Calomiris, 1999). As a practical matter, however, such direct replacement of lost capital may not result in bank allocation of emergency capital to lending, as (a) governments generally do not formally commit banks to increase lending as a prerequisite of recapitalization and (b) bank-level objectives are not social welfare focused.[1] An empirical analysis of the long-term effects of recapitalization on lending provides evidence as to whether the theoretical results and practical application of recapitalization actually coincide.

In addition to impacting lending behavior, a recapitalization may also change bank risk. Agency theory predicts that behavior consistent with moral hazard may result when the government acts as lender of last resort, thereby increasing the propensity of recapitalized banks to take excessive risk in the future (Cordella and Yeyati, 2003; Freixas and Parigi, 2008; Goodhart and Huang, 2005). If recapitalized bank managers believe that the government will again allow them to borrow against otherwise illiquid assets in case of future distress, the expected loss to shareholders in the event of a default decreases. As a result, a bank manager's incentive to exert effort in privately costly but insolvency-reducing activities decreases, thereby increasing the likelihood of bank insolvency.

Alternatively, recapitalization may decrease risk taking by increasing the franchise value of the bank (Demsetz et al., 1996). The franchise value of a bank is the net present value of future rents that can only be captured if the bank remains in business (Konishi and Yasuda, 2004). When a bank closes, this franchise value is permanently lost due to the non-transferability of the private information in lending relationships and the limited supply of bank charters made available by the government. By ensuring that the bank will not fail, the government may therefore increase the franchise value

[1] For instance, Black and Hazelwood (2013) show that the U.S. Treasury was criticized by the oversight committee for the bailout program of the financial crisis of 2008 in the U.S. (the TARP program), for not having the ability to ensure that banks were lending money that they received from the government.

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