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Political connections and depositor discipline

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ABSTRACT

We examine the effects of political connections on depositor discipline in a sample of Turkish banks. Banks with former members of parliament at the helm enjoy reduced depositor discipline, especially if the former politician's party is currently in power – less so if the former politician served as a minister. Banks with structural problems are more likely to appoint former politicians, but our results remain robust after controlling for selection effects. Ministers may reduce depositor discipline less because they signal severe problems and because the additional government deposits they bring to the bank during their term tend to leave with them.

1. Introduction

For the sake of financial stability, nearly every aspect of banking is shaped by regulation. Government policy affects banks' competitive position, profitability, and risk taking behavior by imposing entry and exit barriers, by setting deposit rate ceilings, by directly restricting bank activities to a safety set, by guaranteeing deposits, and by changing tax rules. Banks' activities and risk taking behavior may also be restricted indirectly by capital, liquidity or leverage requirements, accompanied by appropriate monitoring and supervision provisions to ensure enforcement of regulations. This set of government-imposed constraints provides strong incentives for banks to develop a corporate political strategy that addresses some of the constraints. This is especially the case if institutions are weak enough for regulatory bodies to be subject to political capture (Hellman et al., 2003).[1] Further, the empirical literature suggests that highly concentrated and regulated industries (e.g., Masters and Keim, 1985; Schuler et al., 2002) characterized by a few large firms (Salamon and Seigfried, 1977) are more likely to engage in lobbying and campaign activities.[2] This suggests that the banking industry, which is typically highly concentrated, regulated and dominated by big banking firms, is particularly suited to establishing political connections and other lobbying activities. Laeven (2004) and Demirgüç-Kunt et al. (2008), who find that generous deposit insurance schemes are adopted mainly by countries with poorly capitalized banks and result from extensive lobbying efforts, provide one good example of political capture.

Besides influencing policymaking by lobbying, banks may even appoint politically connected directors in order to extract more direct and bank-specific rents from the government, which would not otherwise be available to the bank. In particular, a strong political relationship can be considered an important intangible asset for dismantling bureaucratic obstacles, attracting public deposit

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[1] Especially in weak institutional environments, the state has been viewed as a predatory instrument for transferring resources from one group to another (e.g., North, 1981, Shleifer and Vishny, 1998, Olson, 2000). Hellman et al. (2003) report the emergence of a capture economy in many transition countries, where politicians sell rent-generating benefits to private firms. Acemoglu and Johnson (2005), who find that institutions that protect against expropriation by politicians and other powerful groups have a first order effect in explaining income per capita, have further emphasized the importance of strong institutions.

[2] Consistent with these conjectures, Stigler (1971) argues that industries with substantial political influence and cohesiveness circumvent/disrupt government regulation to its advantage.

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accounts, and receiving preferential treatment in the form of bank-specific reduced supervisory oversight, regulatory forbearance or even bailouts. Depositors may even perceive the presence of politically connected banks' directors or chairmen as a signal of an implicit government guarantee. As a consequence of cheap government funding, more flexible supervisory and regulatory boundaries and the presence of an implicit government guarantee, politically connected banks may be expected to be subject to less market discipline from depositors. The aim of this paper is to test the conjecture that political connections reduce depositor discipline.

The idea behind market discipline is that investors in bank liabilities actively reward or punish banks in regard to their risk taking behavior. In the case of excessive risk taking, investors can demand higher returns on bank liabilities or withdraw their funds. The disciplining of banks involves both price and quantity adjustments in bank liabilities. By making risk taking more costly for banks, depositors reduce banks' incentive to take excessive risk, which should promote the stability of the financial system. This incentive-compatible regulatory design has been greatly stimulated by the Basle II reforms, aimed in part at remedying the moral hazard cost of the mispriced government guarantees inherent in the regulatory paradigm of 1934–1984, which featured safety nets and crisis prevention. Market forces can also remedy other deficiencies of the supervisory framework, such as information asymmetries. Even though bank supervisors can conduct on-site examinations, markets may jointly know more than the inspections can reveal.

Much of the evidence of depositor discipline is from countries with mature and relatively transparent banking sectors.[3] Both price and quantity discipline have been shown to exist in the US banking sector, particularly with respect to deposits that are not fully insured. A recent study using cross-country panel data from thirty-two OECD countries confirms the presence of disciplining behavior in other mature institutional environments (Nier and Baumann, 2006). Demirgüç-Kunt and Huizinga (2004) use data from a sample of both OECD and developing countries and find a negative relationship between the implicit cost of bank funds and prior period measures of bank capitalization, profitability and liquidity. The evidence for quantity disciplining is less convincing in their study. Martinez Peria and Schmukler (2001) investigate Central and Latin American countries (Argentina, Chile and Mexico) and demonstrate that banks' deposits increase and their deposit rates generally decrease with a reduction in the percentage of non-performing loans and improvements in liquidity and capitalization. Karas et al. (2010) show that surprisingly sophisticated and capital-based depositor discipline is also present in a European emerging market – Russia.

By verifying whether depositors impose less discipline on politically connected banks, this paper connects two hitherto separate strands of the literature. The deposit insurance literature suggests that deposit insurance entails a tradeoff between greater protection against bank runs and an increasing propensity of banks to take on additional risk, because depositors no longer have incentives to monitor banks and, hence, do not claim an interest payment commensurate with the bank's risk choice. For instance, Demirgüç-Kunt and Detragiache (2002) find evidence that explicit deposit insurance schemes tend to increase the likelihood of banking crises in a sample of 61 countries over 1980–1997. Most empirical studies do confirm that explicit deposit insurance indeed undercuts market discipline. The cross-country study conducted by Demirgüç-Kunt and Huizinga (2004) shows that the introduction of a blanket guarantee disturbs market incentives too deeply to discipline banks via deposit rates. Karas et al. (2013) conduct a natural experiment to show convincingly that this is also the case for Russia. On the other hand, Martinez Peria and Schmukler (2001) provide evidence that small insured depositors still react to bank risk after the introduction of deposit insurance. This indicates that depositors are not only concerned about individual bank insolvency, but also about the solvency of the insurance fund and willingness of the government to support the insurer (Flannery, 1998). These insights may also extend to the effect of political connections on market discipline. If political connections imply an implicit government guarantee, or increase the likelihood of bailout in any other way, they may disturb efficient price formation in deposit markets and hence reduce depositor discipline. This will, however, only occur if depositors believe that the political connection will help the connected bank to secure government support.

Our work is also related to an emerging body of research that focuses on the economic value of political connections. Fisman (2001) finds that stock prices of firms connected to the Suharto regime are negatively affected by rumors about Suharto's health. In a cross-country setting, Faccio (2006) examines internationally active firms and finds a positive value effect from the entry of a shareholder or director into politics, whereas politicians joining company boards do not increase firm value.[4] Further, it is documented that firms with political ties enjoy preferential treatments such as, soft budget constraints (Claessens et al., 2008 for Brazil; Khwaja and Mian, 2005 for Pakistan), easier access to government contracts (Agrawal and Knoeber, 2001), favorable IPO conditions (Francis et al., 2009), relaxed regulatory oversight (Stigler, 1971; De Soto, 1990) and bailout options (Faccio et al., 2006). In addition, Faccio (2006) finds a greater prevalence of favorable treatment in association with political connections in countries with weak property rights regimes.[5]

Although, on balance, the literature favors the view that close ties with the government help in finding a helping hand, there are some studies that come to the opposite conclusion. In a cross-country setting, Boubakri et al. (2008) observe a negative relationship between political connectedness and accounting performance. Fan et al. (2007) find that newly privatized Chinese firms with politically connected CEOs are associated with poor post-IPO performance. Qian et al. (2011) find that minority shareholders are expropriated by controlling owners through their political connections. Bertrand et al. (2006) show that connected French firms pursue political goals by creating jobs at the expense of profitability. These results can be explained by the grabbing hand view (Shleifer and Vishny, 1998), i.e., former politicians are more inclined to divert resources for political and personal objectives than to pursue maximum value of the firm. This paper differs from the above studies by examining the economic effect of a bank's rather than a firm's political connections. We focus on the mechanism of moral hazard. Depositors of politically connected banks may exert less discipline on their banks, which helps the connected bank to expropriate rents in the form of an expanding deposit base and lower funding costs, as compared to its peers.

We employ a unique dataset of 79 Turkish banks for the period 1980 to 2008 that comprises data on balance sheets, income and

[3] See, amongst others, Flannery and Sorescu (1996), Park and Peristiani (1998), Calomiris and Powell (2001), Evanoff and Wall (2001), Goldberg and Hudgins (2002), Maechler and McDill (2006), and Sironi (2003).

[4] Other papers that found a positive relationship between political connectedness and firm valuation include inter alia: Ferguson and Voth (2008) for Nazi Germany and Johnson and Mitton (2003) for Malaysia.

[5] The evidence provided by Roberts (1990), Goldman et al. (2009) and Cooper et al. (2010) suggests that the value of political connections can also be important for industrialized countries like the US, where markets are well developed and shareholders enjoy a higher level of legal protection.