



Public bank lending in times of crisis

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ABSTRACT

This paper studies the role of government-owned banks in the event of financial crises. The study takes an empirical perspective focusing on bank lending. We compare the lending responses across government-owned and private banks to financial crises using the balance sheet information of 764 major banks headquartered in 50 countries over the period of 1994–2009. Using a nested panel regression framework that allows for parameter shifts in the bank lending equation, we find robust evidence that government-owned banks increase their lending during crises relative to normal times, while private banks' lending decreases. Government-owned banks thus counteract the lending slowdown of private banks. The findings suggest that governments can play an active counter-cyclical role in their banking systems directly through government-owned banks.

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1. Introduction

With the onset of the global financial crisis, the balance sheets of major banks have come under stress as significant write-downs on assets have led to sizable reductions in bank capital. In some countries, these events have caused a credit crunch in which banks cut down lending and firms find it difficult to obtain external financing. Concerns have been raised that these adverse financial conditions will continue to undermine the economic activity; much like shortages in bank capital slowed down the US recession recovery in the early nineties (Bernanke and Lown, 1991). Following the collapse of Lehman Brothers and the subsequent financial turmoil intensification, many central banks and governments responded with unprecedented rescue operations that involved the provision of liquidity, debt guarantees, asset purchases, and recapitalizations of individual banks (Brei et al., 2013; Klomp, in press). The policy responses were aimed at preventing the collapse of the domestic banking system, but they were also implemented with the

objective that the injection of liquidity and capital would allow domestic banks to supply more credit to the real economy. The empirical results on the effect of the rescue measures on bank lending, however, are mixed and difficult to elaborate since the counterfactual is unknown (Ivashina and Scharfstein, 2010; Allen and Paligorova, 2011; Brei et al., 2013).

Regarding the academic debate on public sector involvement in the banking sector, there are two major schools of thought. The “development” view promoted by the work of Alexander Gerschenkron is based on the argument that a prerequisite for economic growth is financial development. In Gerschenkron (1962), he pointed out that in a number of industrialized countries private banks have been the main vehicle through which savings were channeled to the industrial sector during the second half of the 19th century. In other countries, however, such as in Russia, economic institutions were not sufficiently developed and private banks did not play a major role in the development process. He therefore argued that governments should step in and foster both financial and economic development. In contrast, the “political economy” view argues that government control over financial institutions tends to be associated with distortions in the allocation of resources, because banks may be used by politicians to soften the budget constraint of governments (Krueger, 1974; Shleifer and Vishny, 1994). Accordingly, government involvement in the banking sector should be kept at a minimum and the role should be left

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to the more efficient private banks. Many governments followed the political economy view and privatized their banking systems during the 1990s, especially in Latin America and the transition economies in Eastern Europe.

The evidence of the recent empirical literature on government involvement in banking is mixed. The work of La Porta et al. (2002) shows evidence – of 92 countries – that the degree of public ownership in banking sectors is negatively related to financial development and economic growth, and positively associated with financial instability. If these relationships were causal, then the privatization of banking systems would lead to an increased financial development and economic growth. Dinç (2005) finds in a cross-sectional investigation of 43 countries that lending by government-owned banks is positively related to the electoral cycle. The results of the two mentioned papers would therefore favor the political economy view and the privatization of banks. The work of Andrianova et al. (2009), however, questions these conclusions as it shows evidence that, once institutional quality is taken into account, the results of La Porta et al. (2002) are insignificant, and it appears that state-owned banks can foster economic growth if they are managed by sound and transparent institutions. Using bank-level data for 119 countries, Micco and Panizza (2006) found that government-owned banks' lending is less sensitive to business cycle fluctuations than that of private banks. The results of these two studies would therefore favor government involvement in banking. A number of empirical studies on the role of state-owned banks emerged in response to the recent financial crisis. While most studies show evidence in favor of the view that lending of state-owned banks has been less sensitive to the business cycle than that of private banks (Calderón, 2012; Cull and Martínez-Peria, 2012; Bertay et al., 2012; De Haas et al., 2012); the work by Iannotta et al. (2011) on the other hand, does not find significant differences in the cyclical pattern of lending across government-owned and private banks.

Against these backdrops, the present paper investigates the lending responses of government-owned and private banks headquartered in Europe and Latin America over the period of 1994–2009. A special focus is set on their lending responses to systemic financial crises. To shed light on this issue we use the annual financial statements of 764 major banks from 50 countries, of which 63 institutions are government-owned. Using a nested panel regression framework that allows for parameter shifts in the bank lending equation, following Gambacorta and Marqués-Ibañez (2011) and Brei et al. (2013), we find robust evidence that government-owned banks have played a countercyclical role in their banking systems. They lend on average at a slower growth rate than private banks in normal times, however, in response to a systemic financial crisis, state-owned banks increase lending. Private banks, on the other hand, shy away from lending. It appears that government-owned banks counteract the slowdown in lending of private banks during crises.

We corroborate our findings with an investigation of the factors that could explain the differential crisis response. There are at least three possible explanations (Brei and Schclarek, in press). Firstly, government-owned banks could tolerate more risks than private banks in the event of a crisis, and increase lending in a turbulent and unstable environment with the objective of counteracting the negative spillovers of the financial shock to the real economy. Secondly, during times of crises, government-owned banks could find it easier to access new capital in the form of equity using government funds, or issuing debt on financial markets at lower costs than private banks, implied by the government's explicit guarantee. And lastly, government-owned banks could suffer less deposit withdrawals than private banks, because the public might perceive them as safer given that they are governmentally owned. While

the first hypothesis is more difficult to test empirically, the two latter ones can be tested with our bank-specific information. Using a similar framework than that of the bank lending equation, we do not find robust evidence that government-owned banks experienced significantly higher growth rates of equity and deposits compared to private banks during systemic banking crises. These findings seem to support the view that government-owned banks are more willing to support lending in risky crisis environments.

The paper is organized as follows. The data and descriptive statistics are presented in the next section. The econometric methodology and empirical results are discussed in Section 3. Section 4 provides some robustness checks, and the final section provides the conclusion.

2. Data description

The bank-level data on annual financial statements are taken from the BankScope database compiled by the International Bank Credit Analysis Ltd. and the Bureau van Dijk. We have used consolidated statements when available, in line with the view that banks take decisions on their whole spectrum of assets and liabilities including their domestic and foreign subsidiaries. On the other hand we exclude majority-owned subsidiaries. The data covers the period from 1994 year-end to 2009 year-end spanning over periods of economic booms and downturns. Local GAAP statements have been used to reconstruct historically the IFRS statements as many banks switched accounting standards in 2005.

The initial sample of banks included 2119 financial institutions (mostly commercial, savings and cooperative banks, and bank holding companies) headquartered in 69 countries located in three regions: (i) Latin America and the Caribbean, (ii) advanced European countries and (iii) Eastern Europe. Because an important number of banks report only over a short time period in BankScope, we have excluded banks that report less than 4 consecutive years, which is often the case for small banking institutions.¹ Given that we compare pre-crisis and crisis responses on the bank-level, it is important to have a minimum of consecutive financial statements per bank over time. Another selection criterion is to choose those banks per country (beginning with the largest bank) that cover close to 70% of the total banking system.² Finally, to avoid the panel being dominated by the huge number of banks in particular banking systems (as in Germany or in Italy), we have removed banks that have average assets below a country-specific threshold.³ As can be seen in Table 1, the final set of banks includes 764 financial institutions operating in 50 countries. The sample of banks is representative as they account for 41 trillion USD of assets at end-2007, corresponding to close to 50% of the global banking system. Most of these assets (87%) are controlled by 436 European banks headquartered in 19 countries, followed by 281 banks (with 3 trillion USD of assets) from 22 Latin American and Caribbean jurisdictions, and 47 banks from 9 Eastern European countries with a total of 2 trillion USD of assets.

We identified state-owned banks with the criterion that a government or a similar public institution owns more than 50% of the bank's capital. We use BankScope information on the global ultimate owner as the principle source, but we complement the

¹ Bank information for banks with few observations is also more likely to be reported with errors.

² The total size of banking systems was calculated with the sum of total assets of domestic banks listed in "The Banker" at end-2008.

³ For example, in the case of Germany we removed banks with average assets of less than 5 billion USD to reduce the number of German banks from 611 to 90 institutions.

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