



Politically connected lending, government capital injection, and bank performance



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ABSTRACT

This paper takes a contingent claim approach to evaluate the equity and risk of a bank. The paper investigates how government capital injection affects the bank's lending and equity risk, and how these effects vary across remaining privately owned and becoming government-owned. In particular, we argue that the strength of government ownership is useful in disciplining management of preferential access to debt financing for politically connected borrowing firms. It is shown that government capital injection leads to superior performance and greater safety for the bank remaining privately owned. The advantage of large capital is likely to be more pronounced to equity return, but less to safety for the government-owned bank. Moreover, political connection reinforces the increased return performance and safety. Government capital injection as such makes the bank less prone to risk-taking, thereby affecting the stability of the banking system.

1. Introduction

Recent anecdotal evidence indicates that politically connected borrowing firms have preferential access to debt financing (Khawaja & Mian, 2005; Faccio, 2006). This evidence begs the question as to what it is politically connected borrowing firms that makes banks more willing to extend credit to them. It could be that banks receive direct economic support from the government, such as the Troubled Asset Relief Program (TARP) during the financial crisis (Duchin & Sosyura, 2012), to which the borrowing firms are politically connected (Faccio, Masulis, & McConnell, 2006).¹ Although the link between political connections and bank value is reasonably well established, we know less about the mechanisms through which such connections affect performance and safety for the bank under government capital injections. In particular, government capital injections may alter bank ownership structure. This paper investigates one such mechanism: the interaction of bank ownership structure and political connection.

Banks should allocate financial resources to their best uses. Nevertheless, in reality, banks may engage in politically connected lending. Specifically, banks may extend loans to some borrowers based on the fact that they are politically connected or related, rather than on borrower characteristics. Dheera-aumpon (2016) argues that bank ownership concentration may not only induce banks' controlling owners to become involved in connected lending but also deter them from doing so. In addition, during the global financial crisis, the financial authorities have implemented rescue programs, for example, involving individually targeted capital injections. In some extreme but not isolated cases, we have even seen nationalizations of private banks, such as in the case of Iceland,

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¹ For example, Citibank received government bailout package on November 24, 2008, and Bank of America received government bailout package on January 16, 2009 (see Breitenfellner & Wagner, 2010).

England, or Ireland (Brei & Schclarek, 2015). This paper, which aims to study how the government's capital injections affects the bank's performance, and how these effects vary across remaining privately owned and becoming government-owned, thus contributes to the literature on political connections and bank performance.

Equity return and equity risk are two key performance issues that concern bank managers. Equity return is an important goal for banks (e.g., Allen, Carletti, & Marquez, 2011), and banks often assess their performance relative to each other on this basis. Equity risk is central not only in strategic decisions made by banks (e.g., Ronn & Verma, 1986), but also in decisions made by regulators concerned about financial stability. Knowing how bank capital affects bank performance, shifting to the government-owned from the privately owned state by increasing the government's capital injection, is also of paramount importance for bank managers and regulators. In particular, comprehending whether higher capital via government capital injection possibly coming with politically connected borrowing firms having preferential access to debt financing has significant effects on equity return and equity risk.

In this paper, we construct a contingent claim model along the lines of Ronn and Verma (1986), Brockman and Turtle (2003), and Episcopos (2008) for the valuation of the equity return and the equity risk of a bank. Their contribution is to explicitly consider default risk in a contingent claim model to value the equity and the equity risk of a bank. In Ronn and Verma (1986), default can occur at the maturity date, whereas in Brockman and Turtle (2003) and Episcopos (2008), default can occur at any time before the maturity date. However, a significant weakness of the models is that they evaluate stakeholders' claims in separate terms of the like of equity return and the dislike of equity risk related to default risk, which may reflect the reality well. This paper aims to correct this weakness and reintroduce the equity return and the equity risk weighted by the default probabilities as an objective function in the spirit of Hermalin (2005) by imposing the issues of political connection, government capital injection, and bank performance. This introduction is understood that the objective of government-owned banks, in contrast to their private peers, is not to maximize returns, but also to stabilize and promote the recovery of economy (Brei & Schclarek, 2015). The extension opens for a wide range of interesting analyses in relation to the issues discussed earlier in this introduction.

In this paper, we propose a barrier option model for corporate security valuation to examine bank performance with alternative bank ownership structures. We follow Episcopos (2008) to explain the barrier option theory of corporate security valuation applied to the contingent claims of a bank. The Federal Deposit Insurance Corporation (FDIC) acts as a federal insurer and receiver for administering and resolving failing banks. As an insurer, the FDIC maintains the deposit insurance fund and is responsible for controlling risk to the fund. As a receiver, the FDIC has a fiduciary obligation to all stakeholders of the failing bank. Specifically, banking is an ideal environment for the barrier option model because the FDIC, playing not only an insurer but also a receiver, can control the barrier in a very direct manner by the power vested in it by the FDIC Improvement Act. In practice, coordination costs would make it difficult for depositors to jointly take legal action against the bank. A much more suitable environment for the barrier option model to hold is created if regulation is in effect. It is found that raising the barrier induces a transfer of wealth from shareholders to the FDIC, implying better protection of the insurance fund (Episcopos, 2008). In addition, during a financial crisis, capital level of a bank is depleted and raising new capital in public markets is difficult. In other words, the bank in distress faces the problem of early closure. A government capital injection program is expected to stabilize the bank by providing a source of capital when public alternatives are unavailable. Capital injections may be expected to change the ownership structure of the distressed bank, shifting to government-owned from privately owned state if the injection amount is sufficiently large, and hence resulting in alternative management objectives. The model shows that a government owner is strong vis-à-vis management, because such an owner gathers information to stabilize the banking system. This information also allows the owner to implement alternatives to management proposals, extending credit to political connected borrowing firms encountering financial difficulties. A privately owned bank is also strong vis-à-vis management, by contrast, because such an owner gathers information to maximize its equity return and hence may not be willing to extend its credit to borrowing firm in distress.

In light of previous work, we address questions such as: (i) Do government capital injections lead to superior performance for the bank remaining the privately owned state? (ii) Are the results applicable to the case when the bank becomes government-owned? (iii) Are larger government capital injections guaranteed to produce higher equity return and/or greater safety for the bank if becoming government-owned? (iv) Does the political connection reinforce the effect of government capital injection on bank performance? The answers to the first two questions are yes. An increase in the government capital injection increases the optimal bank interest margin (and thus the equity return), and further decreases the equity risk for either the bank remaining privately owned or the bank becoming government-owned. With regard to the third question, the positive effect of the government's capital injections on the bank's equity return is more significant when the bank is a private bank than when the bank is a government-owned bank. In addition, the negative effect of the government's capital injections on the bank's equity risk is less significant when the bank is a private bank than when the bank is a government-owned bank. With regard to the last question, the answer is again yes: political connection reinforces the increased equity return and the decreased equity risk of the bank.

There is a growing body of economic literature on the implications of political connections in the business world. For example, it has been found that political connections help firms to access to resources such as bank loans (Khwaja & Mian, 2005), which ultimately increases the value of the firms (Ramalho, 2007) or improves their performance (Johnson & Mitton, 2003). The present paper attempts to fill a gap in the existing literature by proposing a theoretical framework for corporate security valuation based on path-dependent, barrier option models instead of the commonly used path-independent approach. We provide numerical validation of the barrier model to correct bankruptcy only at the maturity date. This extension opens for a wide range of interesting analyses in relation to the issue discussed earlier in this introduction. The cost of adding realism to the model in this way will be increased complexity of the options involved. Luckily, the possibility of deriving closed formulas is not destroyed by this extension. In particular, we conclude that politically connected lending reinforces the increased equity return and the decreased equity risk under the government's capital injection during a financial crisis.

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