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Bank ownership and credit over the business cycle: Is lending by state banks less procyclical?

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ABSTRACT

This paper finds that lending by state banks is less procyclical than lending by private banks, especially in countries with good governance. Lending by state banks in high income countries is even countercyclical. On the liability side, state banks expand their total liabilities and, in particular, their non-deposit liabilities relatively little during booms. Public banks also report loan non-performance more evenly over the business cycle. Overall our results suggest that state banks can play a useful role in stabilizing credit over the business cycle as well as during periods of financial instability. However, the track record of state banks in credit allocation remains quite poor, questioning the wisdom of using state banks as a short term countercyclical tool.

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1. Introduction

During the recent global financial crisis, several countries were forced to nationalize failing private banks. Abn Amro in the Netherlands, for instance, is now fully owned by the Dutch government. As a result, the average share of government ownership of banks by bank assets has increased in high-income countries from 7.3% in 2007 to 10.8% in 2009, to fall back slightly to 9.9% in 2010. The increased prevalence of state banks is providing renewed impetus to the debate on the economic costs and benefits of state banking. While previous research has shown that state banks tend to perform badly, misallocate resources and lead to lower economic growth, relatively little is known about how state banks react to business cycle fluctuations. To fill this gap, this paper examines the lending behavior of state banks over the business cycle, and also fluctuations in the main types of bank funding that make this lending possible. In addition, this paper considers the relative accounting for non-performing loans by state banks, as differences in the reporting of bad loans over the business cycle by state and private banks are a potential mechanism to explain different capacities to provide new loans. Our analysis is based on a sample of 1633 banks from 111 countries over the 1999–2010 period.

We find that lending by state banks is less procyclical than the lending by private banks, especially if the bank is located in a country with good governance. We capture good governance by an index of government effectiveness, which increases with perceptions of the quality of public services, the degree of independence from political pressures and the credibility of a government's commitment to its own effectiveness. Moreover, lending by state banks located in high-income countries is even countercyclical. State banks also expand their credit relatively more during banking crises, which points at a stabilizing influence of state banks at a time of financial instability. Among private banks, we find that foreign-owned banks' lending is especially procyclical, perhaps because these banks have ready access to funding from their international parent firms to take advantage of local lending opportunities during economic upswings.

On the liability side, state banks increase their total liabilities relatively little during booms, especially if these banks are located in countries with good governance. In particular, we find that state banks' funding through non-deposit liabilities is relatively smooth over the business cycle. Since non-deposit liabilities tend to be less stable than deposits, private banks' increased reliance on them during economic booms potentially puts these banks at risk during downturns. Private banks also report relatively higher loan quality

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during economic expansions, increasing their ability to ramp up new lending during upswings compared to state banks. In contrast, state banks report loan quality more evenly over the business cycle. Hence, during recessions state banks are able to maintain higher rates of loan growth, as they are able to achieve higher rates of growth of non-deposit funding and report lower increases in non-performing loans.

Overall our results suggest that state banks can play a useful role in stabilizing credit over the business cycle as well as during periods of financial instability. However, the track record of state banks in credit allocation remains quite poor, questioning the wisdom of using state banks as a short term countercyclical tool. For this purpose, alternative policy tools in the form of macroprudential bank regulation, including procyclical capital requirements and monetary policy are more appropriate, as they are more flexible than state ownership of banking and would not lead to credit misallocation resulting in low economic growth.[1]

There is a substantial literature on the impact of state ownership of banks on banking performance and economic outcomes. A large number of cross-country studies show that state ownership of banking is associated with low bank efficiency and lower levels of financial development (Barth et al., 2001, 2004; La Porta et al., 2002). State bank ownership lowers banking sector outreach (Beck et al., 2007), and leads to wider intermediation spreads and slower economic growth as well as greater financial instability (La Porta et al., 2002; Caprio and Martinez Peria, 2002).[2] Dinc (2005) shows that state bank lending is politically motivated, since state banks in emerging markets increase their lending relative to private banks in election years. Along similar lines, Iannotta et al. (2013) find that banks in Western European countries experience higher governmental protection during election years.

Banking outcomes also worsen with state ownership. For example, Mian (2003) finds that state-owned banks report higher loan loss provisioning and achieve lower profitability than private banks using data for a large set of emerging economies. Micco et al. (2007) report that state-owned banks located in developing countries tend to have lower profitability and higher costs than their private counterparts. Cornett et al. (2010) find that state-owned banks in 16 Asian countries operated less profitably and had greater credit risk than privately-owned bank prior to 2001, although this performance gap was largely closed after the Asian financial crisis.

Individual country studies provide consistent results. Berger et al. (2005) find that the performance of state-owned banks in Argentina, for instance as measured by cost efficiency, was low in the 1990s, and improved considerably after privatization. Lin and Zhang (2009) find that the "Big Four" state-owned commercial banks in China are less profitable, are less efficient, and have worse asset quality than other types of banks that involve some domestic or foreign private ownership. Importantly, country level studies also show that politicians use government bank lending to provide political patronage leading to significant credit misallocation (see for example Cole (2009) for India, Khwaja and Mian (2005) for Pakistan, Carvalho (2014) for Brazil, and Sapienza (2004) for Italy). Not only is state bank lending more politicized and inefficient, it in addition generally does not serve the more credit constrained segments of the population, such as small and medium enterprises (Berger et al., 2008; Ongena and Şendeniz-Yüncü, 2011). Hence, there is an overwhelming amount of consistent literature suggesting that state ownership of banks lowers bank performance, with negative consequences for economic growth.

In contrast, the literature examining the lending behavior of state banks during business cycles is quite sparse with mixed results. Micco and Panizza (2006) relate bank credit growth to GDP growth and an interaction term of GDP growth and a state ownership variable for an international sample of banks over the 1995–2002 period finding that credit growth of state banks is less procyclical than for private banks. Cull and Martinez Peria (2013) examine the impact of bank ownership on credit growth in a sample of Latin American and Eastern European developing countries before and after the global financial crisis, finding mixed results. They show that state banks in Latin America acted in a countercyclical fashion during the crisis, whereas those in Eastern Europe did not, hence emphasizing regional differences.

In this paper our approach is similar to Micco and Panizza (2006), but unlike this study we control for possible endogeneity of GDP growth to credit growth by using system GMM estimation. In addition, we consider a large worldwide sample of banks for the recent period from 1999 to 2010, including the recent global banking crisis. Furthermore, unlike previous papers we consider the dynamics of the main categories of bank funding and of the accounting for non-performing loans and loan loss provisioning to better understand the various 'channels' that influence state bank lending over the business cycle. Finally, we also examine differences in lending behavior among domestic private banks versus foreign banks for a large number of countries.

Using an international sample of banks from 50 countries over the 1994–2009 period, Brei and Schclarek (2013) find that state banks lend relatively more than private banks at times of financial crisis. We extend their analysis by considering whether state banks lend relatively more in response to the occurrence of a financial crisis while controlling for a differential lending response to GDP growth, finding that this is not the case. State banks thus appear to lend countercyclically in GDP terms independently of the occurrence of a financial crisis.

The remainder of this paper is organized as follows. Section 2 discusses the data including our bank ownership classification. Section 3 presents the econometric methodology, and the empirical results. Section 4 concludes.

2. Data

The empirical analysis is based on an international sample of 1633 banks from 111 countries for the period 1999–2010. See Table A1 in Appendix for details on the number of banks per country. The main data source is Bureau van Dijk's Bankscope which provides information on statements of banks and their ownership structure.[3] To create time series information on the ownership of banks, we used Bankscope CDs starting from 1999 and Wharton Research Data Services (WRDS) for recent years. The CDs include snapshots of ownership structures in relevant years. In addition, we use various websites to classify the owner as private or state including Bankscope's online database, Factiva, Banker's Almanac and company websites of the banks. In our sample, we only include banks that we can identify to be owned by another entity with a 50% or higher ownership share. Thus, a bank is categorized as a state bank if it is majority-owned by a state-owned entity.[4]

Fig. 1 illustrates the development of the average share of state ownership by bank assets. Specifically, the figure plots the average state ownership share for all countries, and separately for the

[1] For an analysis of countercyclical bank regulation in Basel III, see Repullo and Saurina (2011).

[2] A recent paper by Andrianova et al. (2012), however, reports that the negative relationship between economic growth and state ownership of banking found in La Porta et al. (2002) is fragile to including additional determinants of economic growth such as institutional quality in the analysis.

[3] For all banks, we consider the financial statements at the highest level of consolidation within a country to avoid duplication of the data.

[4] Alternatively, La Porta et al. (2002) and Cornett et al. (2010) use a 20% government ownership threshold to identify state banks yielding comparable data.

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