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The impact of TARP on bank efficiency[☆]

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ABSTRACT

This paper examines the impact of the Troubled Asset Relief Program (TARP) capital injections on the operational efficiency of commercial banks. Using a nonparametric Data Envelopment Analysis to measure bank efficiency, we document a deteriorating pattern in the operating efficiency for banks that received the capital injection from TARP funds that is not evident in non-TARP banks. We test the impact of TARP on the change in bank efficiency as well as the abnormal change in bank efficiency; yet, our results continue to hold. We attribute the decrease in the operating efficiency of TARP funded banks to the abated incentives of bank managers to adopt best practices that improve asset quality, and the moral hazard associated with bailouts.

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1. Introduction

The latest financial crisis is often described as the worst economic downturn in the United States since the Great Depression. According to a report released by the U.S. Treasury's Office of Financial Stability, the financial system was on the verge of collapse for the first time in 80 years. Confidence in financial markets, and in the financial system as a whole, was quickly fading. Consequently, the Federal government enacted the Emergency Economic Stabilization Act (EESA) of 2008 that created the \$700 billion Troubled Asset Relief Program (TARP). The purpose of TARP was to stabilize the financial

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system by purchasing troubled assets¹ from banks, to inject liquidity into the financial system, and to reactivate the credit markets.

TARP represents the largest U.S. government bailout in history, and so its design and implementation inevitably provoked a flurry of criticisms (Harvey, 2008; Hoshi and Kashyap, 2010). The most notable and controversial provision within TARP was its Capital Purchase Program (CPP) that authorized the Treasury to candidly inject capital into troubled institutions by purchasing senior preferred shares. Under CPP, the Treasury acquired preferred equity and debt securities in excess of \$205 billion in 707 banks from October 2008 to December 2009 (Office of Financial Stability, 2010).² This injection of capital was intended to restore the financial health of these institutions. TARP funded banks are scheduled to repay or redeem the preferred stock at an undetermined time, but the program requires them to pay an established dividend rate and interest rate to the Treasury as long as the securities are outstanding.

Empirical evidence indicates that TARP helped to mitigate the credit crisis and restored some confidence in the financial system. While lending activity in the U.S. decreased sharply during the crisis (Ivashina and Scharfstein, 2010), lending increased after the distribution of TARP funds (Li, 2011). TARP also created real economic value (Veronesi and Zingales, 2010; Bayazitova and Shivdasani, 2012) and reduced stock market volatility (Huerta et al., 2011). Policy makers also tout the program a success. The Treasury emphasizes that more than \$204 billion of TARP funds have been repaid, that taxpayers have earned about \$30 billion in income, and that the total estimated cost of TARP is now less than \$50 billion (Office of Financial Stability, 2010).

Yet, Hoshi and Kashyap (2010) criticize the government for adopting policies in TARP that failed in Japan during its banking crisis in the 1990s. Bayazitova and Shivdasani (2012) underscore that the preferred equity acquired under TARP is senior to common equity, thereby reducing the upside potential for ordinary shareholders. In addition, while the government urged banks to lend the newly injected TARP capital, it also advised banks against risk taking (Cocheo, 2008). Black and Hazelwood (2010) argue that TARP had differing effects on risk-taking based on bank size due to these two opposing goals. The authors find that following the TARP capital injections, the risk rating of loan originations significantly increased at large TARP banks but significantly decreased at small TARP banks relative to non-TARP banks.

While much attention has been paid to the lending activities and the risk taking of TARP recipient banks, the impact of the capital injection on bank efficiency has been largely ignored. This study adds to the literature on TARP by documenting the effects of the TARP capital infusions on the operating efficiency of the recipient banks. TARP may impair bank efficiency because bailouts encourage moral hazard behavior (Cordella and Yeyati, 2003). To the extent that government assurances might lead to more risk taking (Flannery, 1998; Sironi, 2003), operational efficiency among TARP recipients may decline because managers will engage in aggressive banking practices that lower asset quality and profitability.

In addition, banks' efforts to comply with the TARP requirements may increase operating costs, thereby lowering banking efficiency. Thomson (1991) suggests that increased regulatory scrutiny reduces the flexibility of bank management. Consequently, the operational efficiency of TARP banks could also wane due to government involvement in bank management decisions. Banking efficiency may also debilitate subsequent to the distribution of TARP funds because the capital injections may allow some mismanaged banks to continue to operate without appropriate restructuring or management turnover. Furthermore, the political pressure imposed on banks to increase lending activities after receiving funds from TARP may have prompted some banks to issue low-quality loans.

For these reasons, we expect the operating efficiency at TARP banks to decline following the capital infusions. Our hypothesis is also buttressed by studies suggesting that government bailouts are wasteful. For instance, Faccio et al. (2006) study the bailouts of industrial firms in 35 countries and

¹ A troubled asset was defined in the EESA under Section 3 as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages", as well as financial instruments deemed necessary by the Federal Reserve to promote financial market stability.

² <http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/agency-reports/Documents/TARP%20Two%20Year%20Retrospective.10%2005%2010.transmittal%20letter.pdf>.

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