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Government intervention, bank ownership and risk-taking during the Indonesian financial crisis

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ABSTRACT

The 1997/98 financial crisis forced the Indonesian government to inject capital into selected banks, introduce deposit insurance and change capital requirements. This study investigates the relation between highly concentrated ownership and bank risk-taking using a sample of 52 insured private commercial Indonesian banks during the 1995–2003 period. For restructured banks, ownership concentration is positively related to overall risk, and negatively related to credit and liquidity risks, especially during the relaxed capital adequacy requirement period. Liquidity risk is reduced when the government and owners contribute additional capital, and credit risk is lowered as the government removes bad loans from problematic banks.

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1. Introduction

The 1997/98 Southeast Asian financial crisis occurred unexpectedly and was exacerbated by the excessive use of bank borrowing due to a lack of debt financing alternatives. Miller (1998) suggests that the banks' widespread use of short-term debt to fund long-term investments and the U.S. denomination of the loans exposed the banks to severe maturity-gap risk and exchange rate risk. In addition, Chowdhry

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and Goyal (2000) suggest banking supervision was lax, much of the lending was politically motivated and no adequate regulatory procedures for handling bankruptcy were present. Kho and Stulz (2000) analyzed bank stock return performance during the Asian crisis when the market indexes fell some 60%. They report that Indonesia's market decline was directly related to their currency exposure and that the IMF programs had little impact on the values of banks.

In Indonesia the government intervened by implementing a Blanket Guarantee Scheme to protect depositors, by providing liquidity through less stringent requirements to access central bank funds, by guaranteeing debt issues of financial institutions, by taking over bad loans from banks, and by directly injecting funds into banks through equity positions.[1] Bank solvency was the central issue during this period. Without additional capital, individual banks, and the banking system, could have collapsed. Under the bank recapitalization program, the government selectively contributed capital and also forced existing shareholders to provide additional funds. This government intervention changed the ownership concentration.

The objective of the current study is to investigate the relation between ownership concentration, government intervention and bank risk-taking in Indonesia during 1995–2003. This study also examines how the relation between ownership concentration and bank-risk taking in Indonesia is affected by government intervention, particularly the bank recapitalization program, under different regulatory regimes. By doing so, we expect that we can demonstrate that government intervention which led to more concentrated bank ownership has had unintended consequences for bank risk taking in Indonesia.

Saunders et al. (1990) argue that, at least in the short term, risk-taking is an endogenous decision of the bank affected by ownership structure, the regulatory environment, and variables such as size and leverage. We follow Saunders et al. (1990) and argue that "at least in the short term", government intervention that leads to more concentrated bank ownership will have a significant impact on risk-taking. We use the same expression as Saunders et al. (1990) "at least in the short term" because in Indonesia the government interventions/ownerships were only temporary. We focus on Indonesia because of its unique setting. In particular, ownership is extremely concentrated with most banks having only two owners. Additionally, the Indonesian banks were so severely affected by the crisis that the government instituted a significant bank recapitalization program[2] and initiated regulatory changes including the introduction of deposit insurance in the form of a Blanket Guarantee Scheme (BGS) in 1998 and changes in the Capital Adequacy Requirement (CAR) in 1998 and 2001.

The present study contributes to the literature in several ways. First, it extends the literature by investigating the relation between ownership and bank risk-taking in Indonesia, a developing country, while the focus of most prior research considers developed countries. Second, this study examines the impact of government intervention on the relation between pronounced ownership concentration and bank risk-taking. Moreover, to capture the dynamics of regulatory changes necessitated by crisis conditions, we incorporate the impact of the changes in deposit insurance and bank capital regulation. This is also an important contribution since existing studies mainly focus on the relation between managerial ownership and bank risk-taking that involve discretionary regulatory changes, such as deregulation versus reregulation (see for example, Saunders et al., 1990; Chen et al., 1998; Anderson and Fraser, 2000).

Using panel data regressions, the present study examines a sample of 52 insured private commercial banks in Indonesia during the period 1995–2003. The results suggest that there is no relation between ownership concentration and overall risk; however, the relation is significantly positive for banks that have been recapitalized. Moreover, for these recapitalized banks, the relation is most pronounced during the period when capital adequacy requirements were lowered. Our results also show that overall liquidity risk is unrelated to ownership concentration, but, unsurprisingly, in banks where the government or shareholders provided liquidity under the recapitalization agreement, the relation is strongly negative. Therefore, the relation between ownership concentration and liquidity is exclusive to the recapitalized banks.

[1] Anginer et al. (2014a) use banks in 74 countries to observe risk bearing by the state. During financial crises governments came to the rescue of troubled financial markets and institutions. State banks provide liquidity support by purchasing bad assets, injecting fresh capital and relaxing collateral requirements.

[2] Batunanggar (2002) notes that the fiscal cost of resolving of the 1997/1998 banking crisis in Indonesia is the highest among Asian countries amounted to Rp654 trillion or 51% of annual GDP. The majority of the cost (amounted to Rp425 trillion) is for the bank recapitalization program.