Journal of Financial Stability 19 (2015) 83–104

Contents lists available at ScienceDirect

Journal of Financial Stability

journal homepage: www.elsevier.com/locate/jfstabil

Political connections, bank deposits, and formal deposit insurance

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ARTICLE INFO

Article history:
Received 21 March 2014
Received in revised form 24 October 2014
Accepted 16 January 2015
Available online 24 January 2015

JEL classification:
G28

Keywords:
Banking
Political connections
Bank deposits
Funds
Deposit insurance system
Indonesia

ABSTRACT

This paper investigates the impact of banks' political connections on their ability to collect deposits under two different deposit insurance regimes (blanket guarantee and limited guarantee). We use a unique hand-collected dataset that identifies the political connections of Indonesian commercial banks, from Q1:2002 to Q2:2008. We find that, regardless of their type (state-owned or private entities), politically connected banks are able to attract deposits more easily than their non-connected counterparts. We also show that this effect is more pronounced after the implementation of formal deposit insurance with limited coverage. Our findings have various policy implications. Formal deposit insurance might have improved market discipline, as highlighted by earlier studies, but it has also exacerbated the issue of political connections in the banking sector.

1. Introduction

Worldwide, politics remarkably influences business, particularly in countries with high level of corruption, weak legal systems, and poor governance (Faccio, 2006). Three main channels of political influence on business have been outlined in the literature. Firstly, the grabbing hand theory (Shleifer and Vishny, 1994, 1998) states that public firms are exploited to fulfill the interests of politicians and bureaucrats under their control. Secondly, the rent seeking theory posits that bureaucrats rent their position by providing privileges to businessmen in exchange for bribes (Krueger, 1974). Finally, the last channel concerns politically connected firms, those with political figures on their boards or those which have close relationships with those who possess political power.

Studies on politically connected firms show political linkages can affect firms both positively and negatively. On the one hand, some empirical studies find several benefits of political connections, including, (i) easier access to financial resources, such as bank loans and others funds, at more convenient conditions (Charumilind et al., 2006; Claessens et al., 2008; Fraser et al., 2006; Khwaja and Mian, 2005; Li et al., 2008); (ii) increased confidence in the legal system (Li et al., 2008); (iii) improved performance (Johnson and Mitton, 2003); (iv) a higher probability of bail-out (Faccio et al., 2006); (v) an increase in firm value through, for example, increased stock value (Goldman et al., 2009); and (vi) lower-cost equity capital (Boubakri et al., 2012). On the other hand, some studies find that political connections negatively impact firms. These negative impacts include: (i) lesser-quality accounting information (e.g. reported earnings) (Chaney et al., 2011); (ii) appointed managers and directors with lesser qualifications (Boubakri et al., 2012; Leuz and Oberholzer-Gee, 2006); (iii) a decrease in long term performance due to lower managerial incentives and/or inefficiency (Claessens et al., 2008; Fan et al., 2007); and (iv) a higher cost of debt (Bliss and Gul, 2012).

While the political connections of non-financial firms are well documented in the literature, the impact of political connections on banks is less studied. Braun and Raddatz (2010) find that politically connected banks are larger, more profitable, less leveraged, and less risky than non-politically connected banks. Most papers on the role of politics in the banking industry compare the profitability, lending behavior and risk-taking of state-owned (government) banks with those of private banks. Molyneux and Thornton (1992) find government ownership has a positive impact on bank profitability. Sapienza (2004) documents how state-owned banks charge similar or identical firms lower interest rates than do private banks.

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http://dx.doi.org/10.1016/j.jfs.2015.01.004
1572-3089/

Moreover, the lending behavior of state-owned banks is influenced by the electoral performance of the party affiliated with those banks. Dinc (2005) concludes government banks increase their lending in election years relative to private banks, particularly in developing countries. Disli et al. (2013) study political connections and depositor discipline. They show that depositors discipline their banks less when banks' top executives were formerly elected to parliament.

In this paper, we study the role banks' political connections play in attracting deposits, that is how it affects depositors' behavior, and whether the type of deposit insurance in place influences this role. Specifically, we investigate whether formal insurance with limited coverage – which is expected to credibly exclude some creditors – outweighs, to some extent, the benefits of being politically connected or if it provides more value to political connections. Our work is closely related to Disli et al. (2013) who study the effect of a blanket guarantee scheme on market discipline. But our main focus is on whether political connections are not hindering the market discipline benefits of a change in the deposit insurance system (from a blanket guarantee scheme to a limited guarantee regime). It has been indeed shown (Hamada, 2011) that the implementation of limited deposit insurance in Indonesia has successfully improved market discipline in the banking sector. Hence, the aim of this paper is to see whether political connections might have outweighed such benefits and if yes to what extent.

We start by investigating whether banks' political connections effectively impact the supply of funds, i.e. whether these connections facilitate access to deposit funding. The general argument is that banks invest in political connections because the benefits these connections would provide are higher than the cost banks would bear. Particularly in an unsophisticated and turbulent banking environment, political connections could be a valuable resource for banks, enabling them to more easily obtain resources in the form of deposits[1]. Depositors might perceive these banks as less risky because banks' political connections are expected to implicitly guarantee that the government would rescue them[2] in case of distress and depositors could thus more easily recover their funds.

We then introduce a change in the regulatory environment and more specifically in the deposit insurance system. We investigate whether this potential added value of being politically connected is identical under a blanket guarantee regime and a limited guarantee system. Looking at both environments will reveal insights into the relative effectiveness of implementing deposit insurance with limited coverage. By credibly excluding some creditors, formal deposit insurance is expected to increase the monitoring efforts of bank creditors and market participants. Several studies examine the effect on market discipline when a blanket guarantee system is replaced with a limited guarantee system. For instance, Imai (2006) finds that the deposit insurance reform in Japan, which shifted the country from a blanket guarantee system to a limited guarantee system, has enhanced market discipline by increasing the sensitivity of deposit interest rates and by increasing the sensitivity of deposit quantity to default risk. However, this paper also concludes that the reform led to more frequent and more generous too big to fail policies. Hadad et al. (2011) obtain mixed results with regard to market discipline while considering regulatory changes in Indonesia after the 1997/1998 financial crisis. Concerning the adoption of a blanket guarantee system and later on by the limited guarantee system, they show that the need for market discipline in the banking industry has been lessened. In the present paper we address the issue of the credibility of the explicit deposit insurance and therefore of the effectiveness of market discipline – i.e. depositors believe that banks might fail – by studying whether the added value of being politically connected is different during the blanket guarantee scheme and the limited guarantee system. If explicit deposit insurance credibly excludes some creditors and insolvent banks do actually fail (no bail-out policy), then political connections will have less value. If however, insolvent banks can still, to some extent, benefit from some sort of support, political connections will have more value.

We study the case of Indonesian banks, which have undergone two regulatory changes related to deposit insurance during the time period we cover. We take advantage of the introduction of a limited guarantee (LG) system to replace a blanket guarantee scheme (BGS) in Indonesian banking. When the 1997/1998 financial crisis was at its height, the Indonesian government closed 16 small banks, which led to bank runs in almost all banks. To prevent the collapse of the overall banking system, the government consequently had to inject a very large amount of last resort loans (Fane and McLeod, 2002; Djiwandono, 2004). Thus, to restore depositors' confidence, a blanket guarantee of all deposits and other liabilities (except equity and subordinated debt) was introduced in January 1998 (Fane and McLeod, 2002; McLeod, 2005; Hadad et al., 2011)[3]. The BGS applied to all commercial banks in Indonesia, except for the branch offices of foreign banks. In other words there was an explicit insurance that all banks would be bailed out, except the foreign ones[4]. Then, after several improvements to the banking system, such as an increase in the minimum capital requirement[5], implementation of related lending limitations[6], Central Bank independence[7], and good governance rules[8], the limited guarantee scheme replaced the blanket guarantee scheme in September 2005. We look in this paper at the impact of banks' political connections within these two different regulatory environments.

For the purpose of our study, we build a dataset that identifies which commercial Indonesian banks are politically connected looking at the names of their bank commissioners, directors and owners checking whether they are current or former political party

[1] Collecting deposits is an important activity for banks. Banks have specific characteristics in how they fund their assets by collecting deposits from the public, and in how they then use these deposits to finance their loans to generate income. Therefore, they need to attract more deposits to support their increased lending activities as deposits are considered cheaper and more stable than other sources of funding.

[2] Faccio et al. (2006) show that politically connected firms are more likely to be bailed out.

[3] Shortly after the crisis, there was lack of confidence in the banking industry, even though the government had introduced the BGS. Moreover, banks were also reluctant to channel loans, which led to a credit crunch on the Indonesian loan market (Trinugroho et al., 2014).

[4] Banks that participate in the BGS have to pay a fixed-rate premium of 0.25% of deposits per year. The Indonesian Bank Restructuring Agency (IBRA) was assigned to manage the BGS (Hadad et al., 2011).

[5] The regulation with regard to capital requirement has changed twice since the 1997/1998 financial crisis. In November 1998, the minimum CAR was temporarily reduced from 8% to 4% of the risk weighted assets; it then returned to 8% in December 2001 (Hadad et al., 2011).

[6] In January 2005, the Central Bank enforced a strict regulation on a bank's lending limitation to its related parties. The maximum related lending is 10% of bank capital. A related party is defined as any natural person or company/entity exercising control over the bank, whether directly or indirectly, through ownership, management, and/or financial links (Hamada and Konishi, 2010).

[7] Central Bank independence was enacted on May 17, 1999 based on Act (UU) No. 23/1999 on Bank Indonesia, and has been amended with Act (UU) No.3/2004 on January 15, 2004. The Act states the status and position of Bank Indonesia as an independent state institution and its freedom from interference by the Government or any other external parties.

[8] The banking authority continuously introduced a number of regulations especially on bank governance to restore confidence in the banking system, which subsequently improved confidence in bank deposits.