



Political bargaining and multinational bank bailouts

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Abstract

This article examines the role of political bargaining and state institutions in explaining variation in state support to multinational banks (MNBs). International business theory predicts that multinational enterprises will engage in political activities to gain a competitive advantage over rivals. I hypothesize that MNBs with greater bargaining power and favorable institutions received state capital injections on more attractive terms than foreign rivals. I test this hypothesis by studying the October 2008 state recapitalizations of MNBs by the UK, France, Germany, the United States, and Switzerland. I measure the relative attractiveness of state bailouts by comparing the bank stock price reactions when the bailouts were announced. The stock prices of MNBs receiving more favorable state support outperformed foreign rivals, reflecting the competitive advantage gained. States imposed more punitive terms on banks when political and legal institutions were more favorable and MNBs were unable to form a coalition. States that are highly dependent on banks and where state bailouts were large relative to GDP were also more punitive. These findings highlight the importance of political behavior as a tool of strategy, and the need for coordination on banking policy across states to reduce moral hazard.

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INTRODUCTION

Multinational banks (MNBs) have been relatively understudied in the international business (IB) literature, yet their strategies and behavior have a direct impact on the performance of multinational enterprises (MNEs) and states. This relationship became all too apparent during the 2007–2009 global financial crisis when the distress of US and European MNBs was cited as the cause of the global decline in bank lending (Ivashina & Scharfstein, 2010), corporate investment (Campello & Graham, 2010), foreign trade (Chor & Manova, 2012), and economic growth (Reinhart & Rogoff, 2009). Crises, however, provide insights by providing a dynamic context for IB researchers to study the interactions between states, MNEs, and institutions (Allen, Chakraborty, & Watanabe, 2011; Chung, Lee, Beamish, & Isobe, 2010). The 2008 financial crisis provides a natural experiment to examine the impact of political bargaining between states and MNBs on outcomes. Boddewyn (1988) theorized that MNEs engage in

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political activities to gain a competitive advantage over rivals. While earlier research portrayed political bargaining as a two-player game between states and MNEs, Nebus and Rufin (2010) expand the traditional bargaining model to capture a network of actors. They argue that the power, motivations, and constraints differ across domestic and international sub-state actors, which generates different predictions for the outcome of MNE–state bargaining.

This article studies the state bailouts of MNBs in five countries that provided capital injections directly to banks: the United Kingdom (UK), France, Germany, the United States (US) and Switzerland. The bailouts were announced in October 2008 following the September bankruptcy of Lehman Brothers – a shock that threatened to bring down the world's biggest banks (Brunnermeier, 2009; King, 2009). Initial efforts by policymakers to restore market confidence by rescuing individual banks were unsuccessful. On 8 October 2008 the UK's Labour government announced a comprehensive rescue package for all eligible UK banks. Within two weeks, ten other countries had announced similar bank bailouts. The taxpayer funds committed by these countries to rescuing banks totaled 18.8% of their combined GDP (Panetta et al., 2009).¹ What is surprising is how much the cost and terms of state capital injections varied across these five countries. Some countries provided support to their largest banks at relatively low cost and in a form that did not dilute bank shareholders. Other countries diluted existing shareholders and imposed severe restrictions on management. This study examines why some states adopted a highly punitive approach *vis-à-vis* MNBs, such as the UK, vs a more favorable approach, such as the US. A case study of the UK vs US illustrates the importance of political and legal institutions, and of coalitions of actors when negotiating with states.

The October 2008 bailouts provide a natural experiment to study political bargaining between states and MNBs. Negotiations on the terms of state bailouts took place simultaneously over a short period of time in five high-income economies featuring similar levels of financial development but variation in key political institutions. I use bargaining power to explain the variation in the cost and terms of capital injections, which are observable and can be measured relative to each other. I hypothesize that MNBs with greater bargaining power and favorable institutions received state capital injections on more attractive terms than foreign rivals. I measure the relative attractiveness of bargaining outcomes using the stock market reactions that followed the

announcement of state bailouts.² When evaluating bargaining power, I consider the features highlighted in Nebus and Rufin's (2010) network bargaining power (NBP) model, namely the role of coalitions of actors and institutions.

I find that the US bailouts were the most favorable, and the UK bailouts the most punitive, for MNBs in these states. The nine US banks receiving state capital outperformed the stock market by 14.7% on the announcement, while the three UK banks underperformed by –27.5%. The reactions relative to foreign rivals are even larger, consistent with the state bailouts changing the competitive position within this global industry. Comparing the size of state capital injections, states that committed the most funds as a share of GDP imposed the most punitive terms on banks. In terms of political variables, right-of-center parties offered the most favorable terms, while states featuring fewer political constraints and veto-players imposed more punitive conditions. I also find that states where the banking sector is more important for the economy – whether measured by the size of bank assets to GDP, the size of bank credit to GDP, or the concentration of the banking section – charged more for state support.

A case study comparing the US and the UK bailouts illustrates the importance of coalitions of actors, and the constraints posed by political and legal institutions, for influencing the state's bargaining power vs MNBs. The US Treasury Secretary faced a number of political veto players that weakened his bargaining position, as well as legal restrictions on his ability to force bank recapitalizations. Faced with a strong coalition of banks, the US provided capital on terms so attractive that the banks would be unwise to refuse it. The UK Chancellor, by contrast, had a strong bargaining position *vis-à-vis* the banks. He faced few political constraints due to the concentration of power in the UK political system. Legal restrictions on the Chancellor's ability to act had been identified and removed. The UK banks were not united, with some desperate for capital, preventing any coalition from forming. The UK Chancellor could therefore impose punitive conditions on the banks. These outcomes are consistent with predictions of the NBP model.

This study makes several contributions to the IB literature. First, a study of the 2008 bailouts of MNBs improves our understanding of Boddewyn's (1988) theory of MNE political behavior. In testing Boddewyn's theory, I incorporate insights from Nebus and Rufin's (2010) NBP model. Second, this study highlights the impact of institutions for influencing

outcomes, particularly political and legal institutions (Henisz & Zelner, 2005; Jackson & Deeg, 2008). Third, this study addresses the question of “who benefits?” from state interventions. It illustrates the international political economy dimension of these bailouts and the relative power between MNEs and states (Agmon, 2003; Strange, 1996). Finally, this study brings insights from a financial theory (Lang & Stulz, 1992) to the study of an IB question, as advocated by Agmon (2006), and uses stock prices to measure the outcome of political activity, as advocated by Hillman, Keim, and Schuler (2004). IB researchers can use the contagion–competition theory and stock price reactions to study MNEs in any global industry, not just banking.

One implication of this study is that MNEs should view political activity as a tool of strategy. State intervention shifts the playing field among MNEs, conferring a competitive advantage on some vs others. In this study, US and German MNBs appear to have gained an advantage over their UK and French rivals through state support. This study also illustrates the moral hazard problem in banking. Moral hazard describes a situation where an actor who is protected when taking a risk has an incentive to take more risk. If state support protects MNB's management and shareholders when taking risks, MNBs are likely to increase risk-taking even when this outcome is costly for society.

LITERATURE REVIEW AND HYPOTHESES

This section reviews IB theories of MNE political behavior and their connection to firm strategy. It enriches Boddewyn's theory using the NBP model, incorporating multiple actors and institutional constraints. It then reviews a financial theory of stock price reactions that is used to measure the outcomes of state–MNB bargaining over capital injections. It concludes by outlining testable hypotheses.

Political Behavior, Bargaining, and Institutions

Following the pioneering work of Boddewyn (1988), many researchers have theorized that MNEs engage in political activities to gain a competitive advantage over rivals (Boddewyn & Brewer, 1994; Bonardi, Hillman, & Keim, 2005; Chen, Ding, & Kim, 2010; Hillman et al., 2004; Luo, 2006; Rodriguez, Siegel, Hillman, & Eden, 2006; Rugman & Verbeke, 1998; Shaffer, 1995). This literature argues that MNEs seek to shape public policy in their favor, but their ability to bargain is constrained by institutions (Henisz & Zelner, 2005; Jackson & Deeg, 2008).

Boddewyn (1988) argues that the political behavior of MNEs has been ignored or downplayed in dominant economic models of the MNE, with the political landscape treated as given and exogenous. Boddewyn defines political behavior as “particular ways of relating to targets located in the *non-market environment* of firms” (Boddewyn, 1988: 342, original emphasis). The *ways* refers to activities ranging from lobbying to public-relations campaigns to bribery. The *targets* include the state, public opinion, and organized pressure groups. The *non-market environment* refers to political institutions, such as the branches of government, the checks and balances in the political system, international agreements, and other stakeholders. Boddewyn's key insight is that politics and institutions are endogenous factors that MNEs can influence to develop a competitive advantage relative to rivals. Boddewyn and Brewer (1994) are more explicit and treat home and host governments as factors of production that firms must manage to gain a sustainable competitive advantage. State actions create winners and losers in the marketplace. As Shaffer states, “Government intervention may enhance the relative position of one party at the expense of another” (Shaffer, 1995: 503). MNEs must therefore use political behavior to achieve their strategic objectives (Bonardi et al., 2005).

The NBP model of Nebus and Rufin (2010) provides insights for testing Boddewyn's theory of MNE political behavior. The NBP model is an extension of canonical bargaining models that focus on bilateral interactions between MNEs and states, such as Vernon's (1971) obsolescing bargaining model. The NBP model can accommodate multiple numbers and types of actors, as well as formal and informal institutions. Power in this model is issue-dependent and is measured relative to other actors' bases. Using network theory, researchers can map actors' bargaining positions, and trace the *constraints* and *supports* between each of them. An actor's bargaining power is a function of their prominence, reflecting their structural position (or centrality) in the network, and the direct and indirect ties to other actors. The benefit of the NMB model is that it can capture greater complexity, such as the impact of *coalitions* of actors and *indirect* leverage. Coalitions of actors who share common preferences and are motivated to work together can exhibit more power in the network than the sum of their individual power levels. By ignoring coalitions, a canonical model of MNE–state bargaining may generate false predictions. I examine constraints, supports, and



coalitions when evaluating the variation in costs and terms of state capital injections.

Nebus and Rufin (2010) highlight that this model can accommodate political, legal, and sociological institutions. Many researchers argue that formal and informal political institutions constrain state decision-making (Beck, Clarke, Groff, Keefer, & Walsh, 2001; Henisz, 2000; Henisz & Zelner, 2005; Hillman et al., 2004). As one example, differences in the number of checks and balances and the power of veto-players in the political system play a large role in explaining outcomes. Jackson and Deeg (2008) stress that researchers often miss the important ways in which institutions impact on MNEs, shaping their strategies by constraining their options, and advocate a case-based approach. These insights are used to explain the variation in state bailouts across the five countries studied in this article.

Financial Research on Competition Effects

Lang and Stulz (1992) theorize that stock prices can be used to assess the impact of an event on a firm's competitive position. Any material event affecting a firm should also affect the stock prices of industry rivals, with the market reaction depending on how the news affects the industry's prospects.³ If an event reveals industry-wide information that is negative, then the stock prices of industry rivals are expected to fall. These positively correlated stock movements are known as *contagion effects*. But if the news is firm-specific and idiosyncratic, such as a bankruptcy due to mismanagement or fraud, then the disappearance of a competitor will benefit industry rivals. Rivals' stock prices will rise, leading to negatively correlated stock prices reactions known as *competition effects*. Lang and Stulz (1992) test this competition-contagion theory using US bankruptcy announcements and find evidence for both effects.

Flannery (1998) surveys banking studies of contagion and competition effects, which examine events such as bankruptcies, supervisory actions, and dividend cuts. These studies confirm that both effects are typically present, with competition effects dominating for banks that compete directly in the same geographic market or line of business. These studies are all based on US data.

Hypothesis Development

The theoretical literature on political bargaining suggests a number of factors that may affect outcomes. The political economy literature views political parties on the right and the left as pursuing distinctive policies with different preferences towards growth,

employment, and inflation (Alesina, 1989; Hibbs, 1986). Left-wing parties have the support of trade unions and workers, while right-wing parties represent business and wealthy individuals. The ability of politicians to deliver policies that favor their constituents is restricted by the nature of political institutions. Political systems that feature more checks and balances or veto-players are more constraining for political actors. I examine the political orientation of the state, the degree of political polarization, the number of veto-players or constraints in the political system, the size of the ruling political party's majority, and the degree of fractionalization of political parties. I hypothesize that right-wing (left-wing) governments with a greater majority, less fractionalization, and fewer veto-players should be associated with more favorable (less favorable) outcomes to banks.

Politicians and other policymakers may be restricted by budgetary constraints if the outlays from state intervention are large relative to the state's finances. When governments commit more public funds, it should generate more scrutiny from taxpayers and voters. I look at the size of the bailouts relative to GDP. I hypothesize that state support should also be more costly for MNBs when governments commit more resources to bailouts.

The bargaining position of banks depends on their size and importance to the domestic economy. MNBs that are very large relative to home-country GDP are often described as "too big to fail", implying that their collapse would not only dramatically affect the domestic economy but might bankrupt the state.⁴ The literature on financial development and economic growth classifies countries as having either bank-based or market-based financial systems (Demirgüç-Kunt & Levine, 2001). In a bank-based system, the economy is more dependent on bank credit to finance investment, job creation, and economic growth.

I examine the size of bank assets-to-GDP and the size of bank credit-to-GDP. I also measure the degree of banking competition using the share of total bank assets held by the top three banks and a measure of banking sector concentration. I hypothesize that MNBs will have more bargaining power when: MNBs are larger relative to GDP; the economy is more dependent on bank credit; and the banking system is more concentrated. Nebus and Rufin (2010) argue that coalitions of actors have more bargaining power. I hypothesize that the ability to form coalitions and the bargaining power of banks will be greater when there are fewer large banks and they share a common motivation to act. Finally, the

Table 1 Overview of state measures to support banks, September 2008 – January 2009

Measure	United Kingdom	Germany	France	United States	Switzerland
Central bank liquidity operations	Yes	Yes	Yes	Yes	Yes
Short selling restrictions	18 Sep	21 Sep	21 Sep	18 Sep	21 Sep
<i>Ad hoc</i> actions to support specific banks	29 Sep	6 Oct	30 Sep		
Deposit insurance	3 Oct	6 Oct		3 Oct	5 Nov
Bank bailouts	8 Oct	13 Oct	13 Oct	14 Oct	16 Oct
Capital injections	13 Oct	13 Oct	20 Oct	14 Oct	16 Oct
Debt guarantees	8 Oct	13 Oct	13 Oct ^a	14 Oct	
Asset purchases ^b		13 Oct		3 Oct ^c	16 Oct
Asset insurance	19 Jan			23 Nov	
Commitments to bailouts (US dollars in billions) ^d	1476	669	183	2684	42
Commitments as % of 2008 GDP ^e	54.0%	28.1%	18.9%	22.3%	8.9%
Outlays as % of 2008 GDP	44.1%	6.1%	5.3%	7.4%	8.7%
Outlays as % of 2008 banking sector assets	8.8%	1.9%	1.4%	8.4%	1.5%

Sources: Bank for International Settlements; Panetta et al. (2009); IMF; national websites.

Notes: This table summarizes state interventions following Lehman’s bankruptcy for the UK, Germany, France, the United States, and Switzerland. The countries are arranged based on the date of the first bailout announcement.

^aVia the Société de financement de l’économie française (SFEF).

^bWhile the US and Germany announced asset purchase plans, only the Swiss had taken action by the end of January 2009.

^cPlans for the Troubled Asset Relief Program (TARP) were made public on 19 September. The TARP was voted down by Congress on 29 September, but approved in revised form on 3 October.

^dIncludes capital injections, asset purchases, and debt guarantees. Excludes deposit insurance.

^eFigures converted to US dollars at average 2009 exchange rates.

financial condition of banks and their access to alternative sources of capital matter. Banks that are in better financial condition, have less need for capital, or have access to private capital should be in a stronger bargaining position with the state.

DESCRIPTION OF SAMPLE AND METHODOLOGY

The main sample is 39 MNBs headquartered in five countries that provided capital injections to banks: the UK, France, Germany, the US, and Switzerland. Of these 39 banks, 30 received capital injections from mid-September 2008 to end-January 2009.⁵ I also examine a control sample of 23 banks in three neighboring countries (Canada, Italy, and Spain) where states did not recapitalize banks. Together these 62 MNBs represent the largest, publicly listed banks in these countries, as reported in Bankscope and national websites. To be included, a bank had to be in existence as of year-end 2008 with a free float greater than 20% of common shares outstanding. My measure of whether state capital injections are more or less favorable to MNBs is the stock market reaction when the capital injections are announced. I compare the average stock price reaction for a given country’s MNBs around the announcement of state capital injections. I benchmark this treatment sample against the stock market reaction for the control sample of Canadian, Italian, and Spanish banks.

Data on individual stock prices, national stock market indices, and equity market volatility is from DataStream. Data on bank total assets is from Bankscope as of year-end 2007. Details on the capital injections are taken from national websites and bank websites. Details on state outlays under the rescue plans are from Panetta et al. (2009). Political variables are from the World Bank Database of Political Institutions (Beck et al., 2001) and from Henisz’s Political Constraint Index Dataset (Henisz, 2000). Banking sector variables are from the World Bank Financial Development and Structure database (Beck, Demirgüç-Kunt, & Levine, 2010).

Details on Capital Injections

Table 1 provides an overview of actions taken by states to restore market confidence between September 2008 and January 2009. US Treasury Secretary Paulson held a press conference on 19 September 2008 to announce plans to purchase distressed bank assets under the \$700 billion Troubled Asset Relief Program (TARP).⁶ European governments intervened in late September to rescue or nationalize distressed banks, such as Fortis in the Benelux countries (29 September), Bradford & Bingley in the UK (29 September), Dexia in France and Belgium (30 September), and Hypo Real Estate Bank in Germany (6 October). Despite these



efforts, the situation continued to deteriorate with stock markets falling, volatility rising.

The failure of efforts to restore market confidence led states to adopt a more pro-active and comprehensive approach. The UK announced a comprehensive rescue plan on 8 October that offered capital injections, debt and deposit guarantees, and later incorporated asset insurance. Politicians in neighboring countries scrambled to provide similar support to their banks. Not all states provided details of state support at the time of the first announcement. While the UK announced its bailout on 8 October, the terms and recipients of state capital injections were only disclosed on 13 October. Similarly France announced its support on 13 October, but only disclosed which banks received support on 20 October. Finally, Germany never disclosed the terms of its support, and only disclosed on 3 November that Commerzbank had required state capital injections.

The most striking feature of the October 2008 bailouts is the variation in instruments used to recapitalize banks, their cost, and the conditions of support. Table 2 compares the instruments and highlights the different coupon rates, redemption rights, dilution of existing shareholders, and other restrictions across countries. The instruments ranged from a combination of common and preferred shares in the UK, to preferred shares in the US, subordinated debt in France, and mandatory convertible notes in Switzerland.⁷ Germany took undisclosed ownership stakes in banks ("silent participations"), but the terms were not made public. All these instruments boosted regulatory capital ratios, although only the common and preferred shares were counted as Tier 1 capital. The cost of these instruments ranged from a low of 5% in the US to a high of 12.5% in Switzerland. In three cases, the cost increased after five years to encourage banks to repay the securities. The dilution of existing shareholders ranged from no impact in France, low dilution in the US from the warrants, modest dilution in Switzerland from the conversion of the notes, and high dilution in the UK due to the use of common equity. State capital injections came with other conditions, such as limits on compensation, representation on the Board of Directors, lending requirements, and restrictions on the payment of dividends.

The variation in timing, choice of instruments, cost and other terms reflected a lack of coordination across countries. It also reflected different approaches to the problem. In the UK, Germany, and Switzerland, state support was voluntary with no requirement that

banks use it. In Switzerland, for example, only UBS accepted state capital, reflecting the high cost and lack of alternatives for the bank. Credit Suisse declined but announced plans to raise CHF10.4 billion of capital through a combination of common equity, mandatory convertible bonds, and other hybrid securities. All the UK banks were offered capital but only three accepted it. A bank's choice to accept state capital in these two countries sent a negative signal about its financial condition. To avoid this stigma, France and the US required all leading banks to accept state capital. Germany's approach was not to disclose the recipients, with only Commerzbank later announcing it had accepted state capital.

The UK was the only country to use common shares when recapitalizing its banks, with existing shareholders diluted by up to 58%.⁸ The UK's preferred shares were among the most expensive, paying a 12% annual dividend for the first five years. The UK banks were also prohibited from paying any common dividends until the state's preferred shares were repaid. The UK put representatives on the Board of Directors, increasing the state's influence over management. Having responded favorably to the initial announcement of state support on 8 October, the disclosure of the cost and terms on 13 October had a very mixed response on UK bank stocks. The three banks accepting state capital – HBOS, Lloyds TSB, and Royal Bank of Scotland (RBS) – saw their shares fall by an average of -17%, while the banks not taking capital – Barclays, HSBC, and Standard Chartered Bank – saw their shares rise by as much as 20%.

Under the Capital Purchase Plan, the US Treasury bought perpetual preferred shares. These preferred shares paid a low initial coupon rate of 5%, rising to 9% after five years to encourage repayment. Banks were allowed to continue paying regular quarterly cash dividends of no more than the amount of the last quarterly cash dividend, but were restricted from buying back shares.⁹ The US Treasury also received warrants, valid for ten years, which allowed the government to buy common shares equal to 15% of the value of the preferred shares. The preferred shares did not dilute existing common shareholders but reduced bank leverage.

France bought deeply subordinated debt from its banks with a coupon of 8% for five years, and floating thereafter. This debt qualified as Tier 2 capital but did not provide any protection to common shareholders and increased the bank's leverage. Finally, Switzerland bought mandatory convertible notes from UBS with a 12.5% coupon that were

Table 2 Details of state capital injections to banks in October 2008

Country	Type of security (regulatory treatment)	Dividend/Coupon	Redemption/Convertibility	Average dilution of common	Other conditions
United Kingdom	Common shares (Tier 1)	Not reported	Not applicable	48.8% (3 banks)	Same as preferred <i>No common dividends</i> . Limits on compensation. Board appointments. Lending requirement
	Preferred (Tier 1)	12% for 5 years, LIBOR+700 basis points thereafter	Non-callable for 5 years		
United States – Capital Purchase Program ^a	Preferred (Tier 1) with warrants	5% for 5 years, 9% thereafter	Callable at par after 3 years (or earlier using proceeds from qualifying equity offering)	3.4% (initial 9 banks) 4.9% (next 9 banks)	Limits on tax deductibility for compensation. Dividends allowed, but not increases. No share repurchases Limits on compensation. Lending requirement
France	Subordinate debt (Tier 2)	8% for 5 years, floating thereafter	Not reported	0.0% (5 banks)	Limits on compensation. Lending requirement
Germany	Silent partnerships (Tier 1)	Not reported	Not reported	Not available	Limits on compensation and dividends. Lending requirement
Switzerland	Mandatory convertible notes (Tier 2)	12.5% maturing in 30 months	Convertible to common at the issuer's option; converts automatically after 30 months	9.2% (UBS only)	Limits on compensation

Notes: This table provides details on the instruments used to recapitalize banks in October 2008, including the type of security used, the cost, and any stated terms and conditions. Banks in these countries were required to meet regulatory Total capital ratios of 8% of risk-weighted assets, of which at least 50% was Tier 1 and the remainder was Tier 2 capital.

^aThe preferred shares under the Capital Assistant Program, announced 10 February 2009, had a 9% dividend for 7 years, with the preferred convertible to common at the issuer's option. The preferred shares convert automatically after 7 years.

Table 3 Reaction of stock market to bailout announcements

Date	Country event	US (S&P500) (%)	UK (FTSE) (%)	France (CAC) (%)	Germany (DAX) (%)	Switzerland (SMI) (%)	US equity market volatility (VIX) (%)
15 Sep	Lehman bankruptcy	-4.7	-3.9	-3.8	-2.7	-3.8	23.5
19 Sep	TARP announced	4.0	8.8	9.3	5.6	6.1	-3.1
29 Sep	TARP rejected	-8.8	-5.3	-5.0	-4.2	-4.6	34.5
8 Oct	UK package	-1.1	-5.2	-6.3	-5.9	-5.5	7.2
13 Oct	French + German packages	11.6	8.3	11.2	11.4	11.4	-21.4
14 Oct	US package	-0.5	3.2	2.7	2.7	5.1	0.3
16 Oct	Swiss package	4.3	-5.3	-5.9	-4.9	-3.3	-2.4

Notes: This table shows daily movements and pairwise correlations for different market indices around the following events in the fall of 2008: Lehman’s bankruptcy filing on 15 September, the announcement of the Troubled Asset Relief Program (TARP) on 19 September, the initial rejection of the TARP by Congress on 29 September (subsequently approved on 3 October), and the bailout announcements in the UK, France, Germany, the US, and Switzerland. National stock market indices are shown for the US (S&P500), UK (FTSE), France (CAC), Germany (DAX), and Switzerland (SMI). Also shown are changes in US equity market volatility (VIX), based on the volatility of the S&P500 index.

convertible to common at the company’s option or at maturity in 30 months. Switzerland also bought \$60 billion of illiquid mortgage assets, which improved UBS’s capital ratios. No other Swiss banks accepted state capital.

Table 3 provides details on the reaction of stock market indices to these announcements. The UK bailout announcement was accompanied by a fall in equity markets globally, with the biggest declines on European bourses. The French and German announcements saw equity markets rise in Europe and the US, with volatility falling. The US announcement on 14 October drew a modest response, with stock markets higher. Finally the Swiss announcement was accompanied by falling stock markets in Europe but rising stock markets in the US. When evaluating the response of bank stocks, these market movements will be controlled for to identify the impact on banks.

MARKET-BASED MEASURE OF BARGAINING OUTCOMES

This section examines the MNBs’ stock price reactions following the announcement of state capital injections. I use the relative stock price reaction for a country’s banks vs foreign rivals to determine which MNBs gained (or lost) a competitive advantage from this event. The methodology used to measure these reactions is pooled OLS regressions with dummies identifying the different events, interaction terms by country, and other variables that control for market conditions. The regressions are estimated using the full sample with daily data on bank returns from January 2006 to January 2009.

To measure the impact of the bailout announcements, I estimate the following regressions:

$$\begin{aligned}
 R_{STK\ i,t} = & \alpha + \beta_1 R_{MKT\ t} + \beta_2 R_{VOL\ t} \\
 & + \sum_{k=1}^8 \chi_{i,k} D_{k,t} \sum_{m=1}^8 \varphi_{i,k} D_{k,t} Ctry_m \\
 & + \sum_{j=1}^4 \delta_{i,j} S_{j,t} + \varepsilon_i
 \end{aligned} \tag{1}$$

where

- $R_{STK\ i,t}$ is the one-day stock return for bank i on day t ;
- $R_{MKT\ t}$ is the one-day return on the stock market index on day t ;
- $R_{VOL\ t}$ is the one-day percentage change in stock market volatility on day t ;
- $D_{k,t}$ is a dummy variable for event k , equal to one when $t=k$, and zero otherwise;
- $Ctry_m$ is a dummy variable set to one for country m , and zero otherwise;
- $S_{j,t}$ is a dummy variable for event j , equal to one when $t=j$, and zero otherwise.

R_{STK} is the daily total return on a bank’s stock. R_{MKT} is the daily total return on the relevant stock market index by country. R_{VOL} is the one-day percentage change in realized volatility for each country’s stock market index. D is a dummy for the eight events: Lehman’s bankruptcy on 15 September, the first announcement of the TARP on 19 September (TARP_UP), the TARP’s initial rejection by US Congress on 29 September (TARP_DOWN), the UK bailout on 8 October, the French and German bailouts on 13 October, the US bailout

Table 4 Reaction of bank stock returns to state bailouts announcements and capital injections

Event	(1) Oct 8 UK bailout	(2) Oct 13 France, Germany bailout	(3) Oct 13 UK banks receiving capital	(4) Oct 14 US bailout	(5) Oct 14 US banks receiving capital	(6) Oct 16 Swiss bailout	(7) Oct 16 Swiss bank receiving capital (UBS)	(8) Oct 20 French announce terms	(9) Oct 20 French banks receiving capital
<i>Panel A: Average bank excess returns by country</i>									
UK banks	6.9%***	-0.3%	-27.5%***	-1.9%***		1.8%***		1.2%**	
FR banks	1.1%**	-10.9%***		-5.5%***		1.4%***		-8.4%***	-6.1%***
DE banks	5.6%***	10.2%***		-2.5%***		7.3%***		-1.9%***	
US banks	-0.3%**	-2.5%***		15.6%***	14.7%***	-3.6%***		-4.2%***	
CH banks	1.0%**	-0.3%		2.0%***		1.1%***	-0.7%***	-1.3%***	
IT banks	2.1%***	-5.2%***		0.0%		5.2%***		-2.1%***	
ES banks	2.0%***	-5.1%***		-1.7%***		3.7%***		-2.6%***	
CA banks	-1.9%***	0.1%		-1.0%		1.0%***		-4.8%***	
<i>Panel B: Average out(under)performance of banks relative to banks in country announcing bailouts on a given day</i>									
UK banks	Base	-10.5%***	-37.7%***	-17.5%***		0.7%*		9.6%***	
FR banks	-5.8%***	-21.1%***		-21.1%***		0.3%*		Base	2.3%***
DE banks	-1.3%**	Base		-18.1%***		6.2%***		6.5%***	
US banks	-7.2%***	-12.7%***		Base	-0.9%	-4.7%***		4.2%***	
CH banks	-5.9%***	-10.5%***		-13.6%***		Base	-1.8%***	7.1%***	
IT banks	-4.8%***	-15.4%***		-15.6%***		4.1%***		6.3%***	
ES banks	-4.9%***	-15.3%***		-17.3%***		2.6%***		5.8%***	
CA banks	-8.8%***	-10.1%***		-16.6%***		-0.1%		3.6%***	

Notes: This table reports the excess reaction of bank stock returns by country in response to the announcement of state bailouts and capital injections in the UK, France (FR), Germany (DE), the US, and Switzerland (CH). The regressions are estimated by pooled OLS across the full sample using daily data from January 2006 to December 2008. Controls for market indices and equity volatility are included but not shown. Standard errors are double-clustered by bank and date (Petersen, 2009). Panel A shows the average bank excess return by country on a given day. The bold values show the excess stock price reaction for banks receiving state capital. Panel B shows the average outperformance (or underperformance) between a country's banks and the banks in the state announcing a bailout. For example, on October 8 the average French bank underperformed the average UK bank by $-5.8\% = 1.1\% - 6.9\%$. On 13 October, all countries are compared against the German banks. Statistical significance is based on joint coefficient tests. The superscripts ***, **, and * indicate significance at the 1, 5, and 10% levels.

on 14 October, and the Swiss bailout on 16 October. To capture the average reaction for each country's banks, I include an interaction term between these event dummies and country dummies (Ctry), with the US as the base (or reference) case. Given that not all banks in a country announcing a bailout accepted capital, I also include four dummy variables identifying the banks that received state support on a given day: UK banks on 13 October, US banks on 14 October, Swiss banks on 16 October, and French banks on 20 October.

Table 4 presents the summary results of these regressions, with the full regressions included in Appendix A. I show the results using pooled OLS regressions with standard errors clustered by bank and date (column 2). Panel A of Table 4 shows the average bank excess returns by country, which are measured after controlling for movements in a country's stock market and changes in equity market volatility. To calculate the outperformance for UK banks on 8 October, for example, I sum the

coefficients for Oct 8 + Oct 8 × UK ($-0.003 + 0.072 = 0.069$, or 6.9%), and test that the sum is statistically different from zero. Panel B shows the average out(under)performance of a country's banks relative to the banks in a country announcing a bailout. The out(under)performance is the difference between two countries, and measures the competition effects in response to an event. For example, on 8 October French banks underperformed UK banks by $-5.8\% = 1.1\% - 6.9\%$. The statistical significance is based on a test of the difference in coefficients.

I briefly review the absolute stock price reactions in Panel A of Table 4 before focusing on the relative stock price reactions in Panel B. Column (1) of Panel A shows that the average UK bank outperformed the UK stock market by 6.9% on 8 October when the UK announced its bailout. Recall that the terms and recipients of UK state capital injections were not disclosed until later. Column (2) shows that the French and German announcements on 13 October had mixed effects, with French banks



underperforming by -10.9% , while German banks outperformed by 10.2% . The UK announced the terms and recipients of state capital on this day, with column (3) showing that the three banks accepting capital underperformed by -27.5% . The US announcement on 14 October was accompanied by an outperformance of 15.6% for the US banks (column 4), and a similar outperformance of 14.7% for the nine US banks receiving state capital (column 5). The Swiss bailout had a slightly positive effect for the three Swiss banks that did not accept capital (column 6) and a slightly negative effect for UBS, which was the sole Swiss bank accepting capital (column 7). On 20 October the French government disclosed the terms and recipients of state capital. The five French banks accepting capital fell by -6.1% (column 9). All these reactions are statistically significant and economically important.

Panel B highlights the bank shareholders perceptions of the winners and losers from these state bailouts. On 8 October, column (1) shows that the UK banks outperformed banks in the other seven countries by 1.3 to 8.8% . All of these differences are statistically significant. But when the punitive cost and terms of their state's capital injections was disclosed on 13 October, the UK banks underperformed by -10% relative to the German banks (column 2), with the three banks accepting capital underperforming by 37.7% on a single day (column 3).

Market participants clearly judged the German bailout as attractive for its banks, as they outperformed foreign rivals by 10–20% on 13 October (column 2). The biggest outperformance of 21.1% was against the French banks, even though the French government announced its intention to support its banks on the same day. Unlike the German announcement, the 13 October French announcement contained no details of capital injections, made no mention of asset purchases, and offered a more expensive and cumbersome debt guarantee scheme than other countries. The French banks also underperformed banks in the remaining countries.

The US announcement on 14 October provided similar evidence of competition effects (column 4). When the US government announced its bailout and state capital injection for its nine largest US banks, the average US bank outperformed by 13.6 to 21.1% – an enormous margin for a single day. The response to the Swiss bailout of UBS on 16 October was mixed, with the Swiss banks underperforming banks in Germany (-6.2%), Italy (-4.1%), and Spain (-2.6%), but outperforming the US banks (4.7%). Finally the disclosure of the terms of the French

capital injections saw their banks significantly underperform banks in the other seven countries.

Summarizing, Table 4 provides evidence of statistically significant and economically important competition effects associated with state capital injections. The average market reactions of banks receiving state capital injections (where identified) or state support (when not) were as follows: US banks $+14.7\%$ (14 October), Germany 10.2% (13 October), Switzerland -1.8% (16 October), France -6.1% (20 October), and UK -27.5% (13 October). This ordering suggests the most favorable capital injections were in the US and Germany and the most punitive in the UK and France. This ordering is very close to the per annum cost associated with state capital injections, with the US the cheapest at 5.0% and the UK more than twice as expensive at 12.0% . Clearly, the US MNBs received more favorable state support than UK MNBs.

Insights from the NBP Model

Appendix B provides a qualitative case study of the US vs UK bank bailouts. The case study illustrates the complex nature of the bargaining over state capital injections to MNBs. The US decision to support the banks was made by a former banker, a bureaucrat appointed by an unpopular Republican President. Treasury Secretary Paulson, who negotiated on behalf of the President and the state, was intellectually opposed to state intervention (Paulson, 2010). He was in a weak bargaining position *vis-à-vis* the US MNBs. He had to collaborate with several government agencies and gain the approval of an antagonistic Democratic Congress to get approval for any rescue plan. With the election only a month away, the Republicans were on the defensive. The US banks represented a powerful coalition, increasing their bargaining power. They were active political lobbyists, with connections to influential members of Congress, who had the potential to block unfavorable proposals. The banks were powerful economic players, responsible for much of bank lending, with implications for US job creation and growth. Several of the US MNBs were well capitalized and did not require government assistance. Paulson needed all nine banks to voluntarily take capital to avoid a stigma for any one of them. But he had no legal power to force banks to raise capital. With few supports, many constraints, and a coalition that was supported by both political and legal institutions, Paulson's bargaining power was weak as predicted by the NBP model. He proposed a plan that was too good to be turned down and gave the US MNBs a

Table 5 Comparison of state capital injections, state commitments, political variables, and banking sector characteristics

Country	United States	Germany	Switzerland	France	UK
<i>Excess stock price reaction for banks receiving capital</i>	14.7%	10.2%	-0.7%	-6.1%	-27.5%
<i>Details on capital injections:</i>					
Voluntary participation	No	Yes	Yes	No	Yes
Use of common shares	No	No	No	No	Yes
Dilution of common shareholders	3.4%	Not disclosed	9.3%	0.0%	48.8%
Annual cost of capital (preferred or debt)	5.0%	Not disclosed	12.5%	8.0%	12.0%
<i>Size of state bailouts:</i>					
State outlays to GDP (%)	7.4%	6.1%	8.7%	5.3%	44.1%
State outlays to banking sector assets (%)	8.4%	1.9%	1.5%	1.4%	8.8%
<i>Political variables:</i>					
Government political orientation	Right	Right	Centre	Right	Left
Index of political constraints	39%	47%	41%	56%	39%
Number of veto players	4	4	3	5	3
Margin of majority (fraction of seats held by government)	54%	58%	84%	73%	55%
Fractionalization index	50%	60%	80%	71%	59%
<i>Banking sector characteristics:</i>					
Banking sector assets to GDP (%)	0.8	2.7	9.7	2.9	3.1
Bank credit to GDP (%)	60	104	174	104	187
Stock market+bond market capitalization to GDP (%)	307	135	336	204	189
Banking sector concentration (%)	34	71	92	62	59
Top 3 market share of bank assets (%)	39%	31%	81%	70%	64%

Notes: This table compares details on the state capital injections, the size of state commitments under the rescue plans, political variables, and banking characteristics. Countries are ordered left to right from most favorable to most punitive terms and conditions, as measured by the excess stock market reaction for banks accepting capital from Table 4. Details on state outlays under the rescue plans are from Panetta et al. (2009). Political variables are from the World Bank Database of Political Institutions (Beck et al., 2001) and from Henisz's Political Constraint Index Dataset (Henisz, 2000). Banking sector characteristics are from the World Bank Financial Development and Structure database (Beck et al., 2010) and Bankscope.

competitive advantage relative to their foreign rivals. Investors recognized this fact with the average US bank stock prices outperforming foreign rivals by 15–20% when the deal was announced.

UK Chancellor Darling was a Labour politician who had considerable autonomy due to his party's majority in Parliament, with few checks and balances in the political system. Darling owed no allegiance to the banks, either politically or intellectually. While the Chancellor had to work with counterparts at the central bank and bank regulator, Darling had personally appointed both to their positions. The only binding constraints on the Chancellor were legal restrictions on the nationalization of banks, which were identified and removed through an act of Parliament. The UK banks were enormous relative to the country's economy, and the funds committed to capital injections represented one-tenth of the government's annual budget. Not surprisingly, the Labour government wanted to show voters that it was spending taxpayers' funds wisely. The banks were in very

different positions and were not a coalition. Two of them – HSBC and Standard Chartered – were British in name only and well capitalized (Darling, 2011). Barclays had access to private capital with fewer conditions attached. The remaining three banks – RBS, Lloyds TSB, and HBOS – were near collapse. They accepted the Chancellor's costly terms even though one CEO was fired, bonuses to board members were cut, and dividends to shareholders were eliminated. The Chancellor had strong supports, few constraints, and did not face a coalition. As predicted by the NBP model, he held all the bargaining power *vis-à-vis* the weaker banks and imposed a punitive deal. Investors recognized this, with stock prices of the three banks receiving capital underperforming foreign bank stocks by more than -35%.

Comparison of State Capital Injections and Political Institutions

This final section briefly compares the political institutions and banking sector characteristics across the five states that injected capital in their banks.



Table 5 provides details on the capital injections, the size of state bailouts, political variables, and banking sector characteristics. Countries are ordered from left to right from most favorable to most punitive terms and conditions, as measured by the excess stock price reaction for banks receiving capital.

When looking at the details on capital injections, the most favorable had the lowest dilution of common shareholders (US 3.4%) and the lowest annual cost of capital (US dividend of 5.0% per annum), but bank participation was not voluntary. The most punitive had the greatest dilution (UK 49%) and a higher cost for the capital (UK 12.0%), but bank participation was voluntary. The decision to accept state capital signaled the weak financial condition of a bank.

In terms of the size of state bailouts, the state that committed the most funds as a share of GDP – the UK at 44% of GDP – imposed the most punitive terms. The magnitude of state outlays relative to banking sector assets shows a concave U-shape, high for the extremes (US, UK) but lower in the middle (Germany, Switzerland, France). In terms of political variables, the UK's Labour government was the sole left-of-center party and imposed the most punitive conditions. The index of political constraints shows a concave shape, with states at the extremes exhibiting the lowest scores on this dimension. The number of veto players shows little variation, but suggests fewer veto players are associated with more punitive terms. Both the margin of majority, as measured by the fraction of seats held by the ruling party, and the fractionalization index, based on the probability that two deputies picked at random from the legislature will come from different parties, show a convex shape. Low ratios are found to the left and the right, with a hump shape in the middle.

Finally, states where the banking sector is more important for the economy charged more for state support. Countries such as the UK, France, and Switzerland featured higher banking sector assets to GDP, higher bank credit to GDP, a greater dependence on bank credit relative to equity and bond markets, and a greater concentration of banks assets in the top three banks. This pattern suggests that states that are highly dependent on banks were more punitive.

CONCLUSION

This study seeks to explain the cross-country variation in the terms of state capital injections to MNBs in October 2008. This event highlights the importance of political bargaining and institutions for

constraining actors and determining the outcomes of state–MNE bargaining. Boddewyn (1988) and Boddewyn and Brewer (1994) theorize that MNEs engage in political activities to gain a competitive advantage over rivals. Because state actions create winners and losers in the marketplace, MNEs should treat home and host governments as factors of production that firms must manage to gain a sustainable competitive advantage. MNEs must therefore use political behavior to achieve their strategic objectives. The NBP model of Nebus and Rufin (2010) argues that bargaining power is influenced by the network of state and MNE actors, and the constraints and supports between them. Political institutions and the nature of coalitions are particularly important for determining outcomes.

In October 2008, the UK, France, Germany, the United States, and Switzerland provided state capital to home-country MNBs at varying costs and using different instruments. I measure the relative attractiveness of state bailouts by comparing the reaction of bank stock prices when the bailouts were announced. MNBs receiving more favorable state support outperformed foreign rivals, reflecting the competitive advantage gained from this support. States with more favorable political and legal institutions that faced weaker coalitions of banks had greater bargaining power and imposed more punitive terms on banks.

This study has several important policy implications. First, the study highlights that states should coordinate their actions *vis-à-vis* MNBs to promote a level playing field. Only a time-consistent policy that punishes excessive risk-taking can promote a stable financial system that benefits the global economy. The Financial Stability Board provides an international forum for this coordination. Second, states need to remove legal restrictions on their ability to act. The US Treasury's bargaining position was severely limited by a lack of legal authority to force recapitalizations on banks. The UK Chancellor identified and removed this legal constraint, thus strengthening his bargaining position. Finally, states may wish to consider institutional reforms to depoliticize banking policy. One parallel is the institutional reforms made to monetary policy during the 1990s, which provided central banks with operational independence in the pursuit of price stability but political accountability over the goals. A similar institutional reform to depoliticize banking policy may be warranted. The European Union has taken steps in this direction with the 2011 creation of the European Banking Authority. By comparison, the

US's Financial Stability Oversight Council increases the number of veto-players and the barriers to action, rather than reducing them.

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NOTES

¹Support was announced by Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Switzerland, the UK, and the US.

²Veronesi and Zingales (2010) employ a similar strategy to identify which of the initial nine US banks benefited most from the US bailout.

³Underlying this theory is a view that stock markets are efficient and prices reflect relevant information about a firm and its future prospects. While there are many critics of stock market efficiency, particularly in its strong-form efficiency, the consensus in finance is that weak-form efficiency does hold (Stein, 2009).

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Appendix A

Regressions on Bank Stock Returns by Country

This appendix reports regressions of individual bank stock returns around key events in the fall of 2008. The regressions are estimated by regressing individual bank stock returns on a set of independent variables:

$$\begin{aligned}
 R_{STK\ i,t} = & \alpha + \beta_1 R_{MKT\ t} + \beta_2 R_{VOL\ t} \\
 & + \sum_{k=1}^8 \chi_{i,k} D_{k,t} \sum_{k=1}^8 \varphi_{i,k} D_{k,t} C_{try\ m} \\
 & + \sum_{j=1}^4 \delta_{i,j} S_{j,t} + \varepsilon_i
 \end{aligned} \quad (A.1)$$

R_{MKT} is the daily total return on the relevant stock market index by country. R_{VOL} is the one-day percentage change in realized volatility for each country's stock market index. D is a dummy for the eight events: Lehman's bankruptcy on 15 September, the first announcement of the TARP on

19 September (TARP_UP), the TARP's initial rejection by US Congress on 29 September (TARP_DOWN), the UK bailout on 8 October, the French and German bailouts on 13 October, the US bailout on 14 October, and the Swiss bailout on 16 October. C_{try} is a dummy variable for each country. S is a dummy for banks receiving direct state support on the following days: UK banks receiving capital (Oct 13 support UK), US banks receiving capital (Oct 14 support US), Swiss banks receiving capital (Oct 16 support CH), and French banks receiving capital (Oct 20 support FR). The regressions are estimated using daily data from January 2006 to December 2008 using three separate methods. Column (1) shows the results when using pooled OLS with standard errors clustered by bank. Column (2) shows pooled OLS with standard errors double-clustered by bank and day, using the Stata code from Petersen (2009). Column (3) shows panel regressions with firm fixed effects. The superscripts ***, **, and * indicate significance at the 1%, 5%, and 10% level.

Table A1 Regressions on bank stock returns by country

Specification	(1) OLS, clustered by bank	(2) OLS, clustered by bank and date	(3) Panel with bank fixed effects
Constant	-0.000**	0.000	-0.000*
Index return	1.279***	1.279***	1.279***
Equity volatility change	0.018***	0.018*	0.017***
Sep 15 Lehman	-0.012*	-0.012	-0.012***
Sep 19 TARP_UP	0.049***	0.049	0.049***
Sep 29 TARP_DOWN	-0.066***	-0.066	-0.066***
Oct 8	-0.003	-0.003**	-0.004
Oct 8×UK	0.072	0.072***	0.074***
Oct 8×FR	0.014	0.014***	0.015
Oct 8×DE	0.059**	0.059***	0.061***
Oct 8×CH	0.013	0.013**	0.014
Oct 8×IT	0.024	0.024***	0.024*
Oct 8×ES	0.023	0.023***	0.023*
Oct 8×CA	-0.016	-0.016***	-0.016
Oct 13	-0.025	-0.025***	-0.026***
Oct 13 support UK	-0.272***	-0.272***	-0.271***
Oct 13×UK	0.022	0.022***	0.022
Oct 13×FR	-0.084*	-0.084***	-0.083***
Oct 13×DE	0.127	0.127***	0.130***
Oct 13×CH	0.022	0.022***	0.023
Oct 13×IT	-0.027	-0.027***	-0.027**
Oct 13×ES	-0.026	-0.026***	-0.026**
Oct 13×CA	0.026	0.026***	0.026*
Oct 14	0.156***	0.156***	0.155***
Oct 14 support US	-0.009	-0.009	-0.008
Oct 14×UK	-0.175***	-0.175***	-0.173***
Oct 14×FR	-0.211***	-0.211***	-0.209***
Oct 14×DE	-0.181***	-0.181***	-0.178***
Oct 14×CH	-0.136**	-0.136***	-0.135***
Oct 14×IT	-0.156***	-0.156***	-0.155***
Oct 14×ES	-0.173***	-0.173***	-0.173***
Oct 14×CA	-0.166***	-0.166***	-0.166***
Oct 16	-0.036***	-0.036***	-0.036***
Oct 16 support CH	-0.018	-0.018***	-0.018
Oct 16×UK	0.054**	0.054***	0.056***
Oct 16×FR	0.050***	0.050***	0.052***
Oct 16×DE	0.109***	0.109***	0.112***
Oct 16×CH	0.047**	0.047***	0.047**
Oct 16 x IT	0.088***	0.088***	0.088***
Oct 16×ES	0.073***	0.073***	0.073***
Oct 16×CA	0.046***	0.046***	0.046***
Oct 20	-0.042***	-0.042***	-0.042***
Oct 20 support FR	0.023***	0.023***	0.022
Oct 20×UK	0.054*	0.054***	0.056***
Oct 20×FR	-0.042***	-0.042***	-0.04
Oct 20×DE	0.023*	0.023***	0.026
Oct 20×CH	0.029**	0.029***	0.030*
Oct 20×IT	0.021**	0.021***	0.021*
Oct 20×ES	0.016**	0.016***	0.016
Oct 20×CA	-0.006	-0.006***	-0.005
Obs	25,332	25,332	25,332
Adj. R-squared (or within)	0.439	0.439	0.439



Appendix B

Case Study of US vs UK Bailouts

This appendix provides brief case studies of the bank bailouts in the US and the UK. Both cases highlight the large number of actors involved, the importance of political and legal institutions, and the role of political power for explaining outcomes. At first glance, it is not obvious that these two countries would treat their banks differently. Economically, both are wealthy economies featuring market-based financial systems dominated by a few large MNBs that actively lobby politicians and policymakers (Duchin & Sosyura, 2012). Both countries negotiated and announced their bank capital injections at the same time. But the terms and conditions of state capital injections were very different. The UK capital was expensive (12.0% dividend), dilutive to bank shareholders (average of 49%), and included onerous conditions. The US capital was inexpensive (5.0% dividend), modestly dilutive (average of 3.4%), and came with few strings attached. In the UK, all banks were offered capital but only three accepted it. In the US, the nine largest banks accepted state capital under moral suasion from the US Treasury Secretary. What explains the difference in outcomes?

Paulson's Gift to the US Banks

US bank capital injections were coordinated by US Treasury Secretary Hank Paulson, a former CEO of investment bank Goldman Sachs, who by nature was opposed to government intervention in markets (Paulson, 2010). Paulson was appointed by Republican President Bush in July 2006. By October 2008, a presidential election was scheduled for November and the opposition Democrats controlled the US Congress, making President Bush a lame duck. Paulson had to negotiate with both politicians and bureaucrats when deciding policy towards the banks. On budgetary matters, Paulson was answerable to the Senate Banking Committee and the House Financial Services Committee. In terms of banking regulation, the Treasury had to coordinate with the Federal Reserve Board (the "Fed"), the Securities and Exchange Commission, and other bodies. These constraints restricted Paulson's bargaining power with the banks.

With respect to political institutions, Treasury Secretary Paulson had no ability to take unilateral action, and faced numerous political veto players. Any financial support for the US banks required the explicit endorsement of US politicians. For example, the US Congress initially rejected the \$700 billion

TARP on 29 September and only approved a modified proposal on 3 October. Both Paulson (2010) and Swagel (2009) stress that Paulson would never have gotten legislative authority at this time to inject capital into banks.

In terms of legal institutions, the March 2008 collapse of Bear Stearns had exposed the limits on the Treasury's authority. Paulson learnt that the US Treasury had no legal authority to force banks to accept capital. Any capital injections would have to be negotiated with the bank CEOs, who formed a powerful coalition. In particular JPMorgan's CEO Jamie Dimon was a vocal opponent of government restrictions on bank activities (Paulson, 2010). Some of the banks had access to alternative sources of capital. In late September 2008, for example, Goldman Sachs raised capital by selling \$10 billion of perpetual preferred shares to Warren Buffett's Berkshire Hathaway. These preferred shares paid an annual dividend of 10%, twice the cost imposed by the US Treasury for state capital injections two weeks later. Other US banks such as Morgan Stanley were negotiating with sovereign wealth funds or foreign partners to raise capital.

The US Treasury began internal discussions on bank bailouts including capital injections after the UK announced its rescue plan on 8 October (Paulson, 2010). Paulson met with hostile Congressional leaders and requested approval to use \$250 billion of TARP funds to buy US bank equity. Faced with the potential failure of several large MNBs, Congress relented. Paulson instructed his staff to offer terms that would be attractive to the US banks. As Swagel (2009: 39) explains, "In order to ensure that the capital injection was widely and rapidly accepted, the terms had to be attractive, not punitive ... a deal so attractive that banks would be unwise to refuse it". The preferred shares would be non-voting, banks would be allowed to continue paying dividends (but not to increase them), and there was no outright ban on bonuses or severance pay.

Paulson met with the nine bank CEOs on the afternoon of 13 October. That morning, the UK had announced the terms of its bailout, with "much greater government control and stiffer terms than [the US]" (Paulson, 2010: 360). Paulson wanted all the banks to accept the capital to reassure markets and to avoid a stigma for the weaker banks. When JP Morgan's CEO Jamie Dimon heard the details, he called it "cheap capital" (*New York Times*, 2008; Paulson, 2010: 365). All nine banks signed up. The deal, announced on 14 October, was so attractive that Veronesi and Zingales (2010) called it "Paulson's gift".

Darling's Once-and-for-all Solution

The UK situation bears some similarity to the US, but with some striking institutional differences. Unlike the US where the capital injections were coordinated by bureaucrats, the UK decision to invest taxpayers' capital was made by Chancellor Alistair Darling and Prime Minister Gordon Brown, both Labour politicians. Labour had a majority government and controlled the UK Parliament. The UK political system concentrates power in the hands of the Prime Minister and his cabinet, with fewer veto players than the US political system. Opposition politicians have no ability to block a majority UK government from taking actions. UK Chancellors therefore have greater autonomy than their US counterparts. Darling notes: "I was also struck by the fact that the US president, although frequently described as the most powerful man in the world, cannot automatically get what he wants at home. He has to horse-trade. In contrast, when I effectively wrote a cheque to buy £50 billion of bank shares in the UK, I did not even have to get specific parliamentary authority to do so" (Darling, 2011: 118).

Similar to the US, UK banks were supervised under a tripartite agreement between the Treasury, the Bank of England, and the Financial Services Authority (FSA). As fate would have it, Darling had reappointed Bank of England Governor Mervyn King in June 2008, and appointed FSA Chairman Adair Turner in September 2008. Both men owed their jobs to Darling. Together they represented a strong coalition with the same interests and motivation to act.

In terms of legal institutions, the UK Chancellor faced fewer restrictions on his ability to act. During the September 2007 bank run on Northern Rock, Darling discovered that the UK government did not have the legal authority to resolve a failing bank. If the Chancellor tried to nationalize a bank, the government could be sued by the bank's shareholders. Darling therefore pushed through a new law in February 2008 known as the Banking (Special Provisions) Act, which gave the Chancellor legal authority. The Chancellor used this new power to nationalize Northern Rock, wiping out its shareholders, and used it again in September 2008 to nationalize the British bank Bradford & Bingley (Darling, 2011).

On 7 October, the Chancellor decided to act when RBS's share price collapsed (Darling, 2011). Having received the go-ahead from the Prime Minister, Darling called the bank CEOs to a meeting at the Treasury and outlined the government's rescue plan. The £50 billion proposed for capital injections was a significant sum, equivalent to 10% of the government's annual budget. The rescue package announced the next morning did not include details on the cost or the recipients. But the press statement did make clear that there would be limits on executive pay and dividends (Her Majesty's Treasury, 2008a).

On Sunday 12 October, the Chancellor met again with the bank CEOs who had consulted with their boards about the offer of government capital. The UK bank CEOs were divided. HSBC and Standard Chartered did not need funds, and Barclays preferred to raise equity privately and avoid public scrutiny of its salaries (Darling, 2011). Lloyds and HBOS, who had agreed to merge, had no access to private capital and were desperate. They requested £17 billion of government capital in the form of £13 billion of common shares and £4 billion in preferred shares, representing a 44% voting stake in the combined entity. RBS was also desperate and required £20 billion of government capital, consisting of £15 billion of common shares and £5 billion of preferred shares, representing a 63% voting stake. As a condition for the state capital injection, the Chancellor fired RBS's CEO and Chairman of the Board, appointed independent directors to both banks, and suspended bonuses for existing board members. The banks also committed to maintain lending at 2007 levels (Her Majesty's Treasury, 2008b). When the capital injections were disclosed on October 13, the share prices of these three UK banks fell by -27.5% on average.

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