

Lobbying on Regulatory Enforcement Actions: Evidence from US Commercial and Savings Banks

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Regulatory Capture and the Financial Crisis

There are multiple causes of the financial crisis. But we cannot ignore the element of 'capture' in the systemic failures of oversight, regulation, and disclosure in the financial sector.

– Daniel Kaufmann, Forbes on January 27, 2009

Banking Supervision

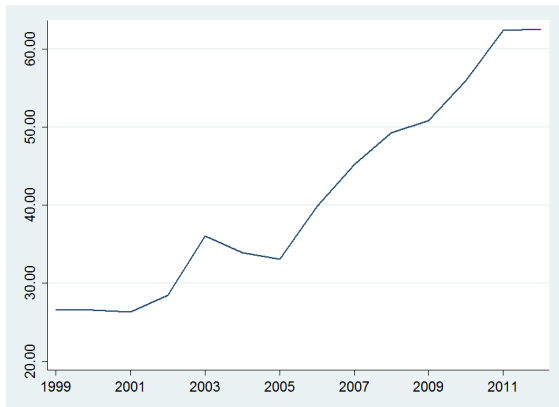
- ▶ The supervisory process entails off-site and on-site examinations
- ▶ Assignments of CAMELS ratings
- ▶ Regulators may impose informal or formal actions
- ▶ Formal actions include civil money penalties, prohibition and removal orders, formal written agreements, cease and desist orders, prompt corrective action directives, and deposit insurance threats
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Bank Lobbying

- ▶ Banks' political influence may affect the ability of regulators to design proper rules and **to enforce the rules in place**
- ▶ Lobbying is an important source of rising political influence



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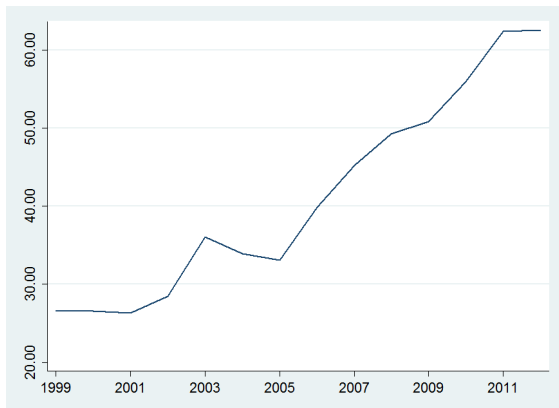
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Goals:

1. Empirical examination of the relationship between bank lobbying and regulatory enforcement outcome
2. Investigation of the transmission mechanism by examining the risk-taking behavior and performance of lobbying banks

Contributions:

1. Use of hand-collected data covering all US commercial and savings banks from 2008 to 2012
2. Evidence identifying that lobbying banks are less likely to be subject to a severe enforcement action
3. Moral hazard problem: By gaining preferential treatment, lobbying banks “safely” pursue riskier strategies

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Related Literature

Capture, regulatory design and capital allocation:

Kroszner and Strahan (QJE 1999); Mian, Sufi and Trebbi (AER 2010); Duchin and Sosyura (JFE 2012); Igan, Mishra and Tressel (NBER 2012)

Moral hazard and bank risk taking:

Duchin and Sosyura (JFE 2014); Black and Hazelwood (JFS 2013); Kostovetsky (JFE 2015)

Special interest politics and regulatory enforcement events:

Agarwal, Lucca, Seru and Trebbi (QJE 2014); Shive and Forster (RoF 2016); Lim, Hagendorff and Armitage (2016)

The real effects of banking regulation and supervision:

Jayarathne and Strahan (QJE 1996); Kroszner and Strahan (JF 1996); Delis, Staikouras and Tsoumas (MS 2016); Danisewicz, McGowan, Onali and Schaeck (JFI 2016)

Main Hypothesis

Lobbying banks are associated with lower probability of receiving a severe enforcement action

- ▶ **Information-based theory:** Banks have better information than regulators and partly reveal their information by endogenously choosing their lobbying effort (Grossman and Helpman 2001)
- ▶ **Capture theory:** Banks lobby to incentivize the regulator to provide favorable treatment (Stigler 1971; Peltzman 1976)

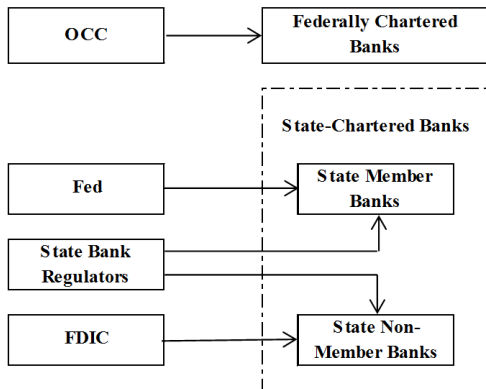
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Dataset

- ▶ Supervision of commercial and savings banks:



- ▶ Banks supervised by federal agencies: OCC, FDIC, or Fed
- ▶ 7,698 banks over the 2008–2012 period
- ▶ 34,952 bank-year observations

Enforcement Actions Data

- ▶ “Severe” actions issued against troubled institutions in 2008-2012

Year	Formal written agreements	Cease and desist orders	Prompt corrective action directives	Deposit insurance threats
2008	85	99	2	0
2009	142	293	18	0
2010	170	370	34	1
2011	54	195	25	2
2012	35	134	18	0
All years	486	1,091	97	3

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Bank Lobbying Activities in the US Political System

- ▶ Lobbyists (hired by banks) attempt to sway the influence of regulators on specific issues, using a combination of contacts, expertise, persuasion and public relation skills
- ▶ LDA of 1995 imposes strict disclosure rules for every individual and firm lobbying the Congress and federal agencies
- ▶ Lobbying disclosure filings indicate the amounts received by clients, the issue areas and agencies lobbied
- ▶ Lobbying sample:
 - ▶ 668 lobbying bank-year observations (about 2% of sample)
 - ▶ Average (median) lobbying expenditures per year: \$1,498,464 (\$403,800).
- ▶ Main measures: (1) lobbying status; (2) lobbying experience

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Severe Enforcement Actions and Bank Lobbying

Probit model: $\text{Prob}(Y_{it} | \mathbf{X}_{it}) = F(\alpha + \mathbf{X}_{it}\beta)$

	(1)	(2)	(3)	(4)
	2008-12 Sample		1998-2012 Sample	
Lobbying	-0.021*** (0.007)		-0.007*** (0.003)	
Lobbying experience		-0.008** (0.003)		-0.003* (0.002)
Capital adequacy	-0.116*** (0.034)	-0.116*** (0.034)	-0.060*** (0.007)	-0.060*** (0.007)
Asset quality	-1.738*** (0.102)	-1.737*** (0.102)	0.073*** (0.023)	0.072*** (0.023)
Management quality	-0.003 (0.010)	-0.003 (0.010)	-0.019*** (0.003)	-0.019*** (0.003)
Earnings	-0.838*** (0.080)	-0.838*** (0.080)	-0.717*** (0.019)	-0.717*** (0.019)
Liquidity	0.035*** (0.011)	0.035*** (0.011)	0.019*** (0.005)	0.019*** (0.005)
Sensitivity to market risk	-0.008 (0.008)	-0.008 (0.008)	-0.017*** (0.003)	-0.017*** (0.003)
Deposit-to-asset ratio	0.001 (0.017)	0.001 (0.017)	0.030*** (0.006)	0.031*** (0.006)
Leverage	0.005*** (0.001)	0.005*** (0.001)	0.002*** (0.000)	0.002*** (0.000)
Total core deposits	-0.000 (0.002)	-0.000 (0.002)	-0.003*** (0.001)	-0.003*** (0.001)
Size	0.002 (0.002)	0.001 (0.002)	0.003*** (0.001)	0.003*** (0.001)
Age	-0.000*** (0.000)	-0.000*** (0.000)	-0.000*** (0.000)	-0.000*** (0.000)
Personal income growth	0.001 (0.000)	0.000 (0.000)	0.000 (0.001)	0.000 (0.000)
Regulator, Year & State FE	Yes	Yes	Yes	Yes
Pseudo R^2	0.273	0.273	0.252	0.252

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Economic Magnitudes

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- ▶ A one additional year of experience in lobbying decreases the probability of a severe enforcement action by 2.5%

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Lobbying Expenditures, Revolving Door Lobbyists and Direct Lobbying on Regulators

Probit model: $\text{Prob}(Y_{it} | \mathbf{X}_{it}) = F(\alpha + \mathbf{X}_{it}\beta)$

	(1)	(2)	(3)	(4)	(5)	(6)
	All Banks			Lobbying Banks		
Bank Lobbying						
Lobbying expenditures	-0.002** (0.001)			-0.002 (0.005)		
Revolving door lobbyists		-0.026*** (0.006)			-0.072* (0.040)	
Direct lobbying on regulators			-0.007* (0.004)			-0.013** (0.006)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Regulator FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.273	0.273	0.272	0.161	0.190	0.342

Robustness and Alternative Explanations

- ▶ Subsamples:
 - ▶ Each supervisor taken separately
 - ▶ Lobbying bank sample only
 - ▶ Exclude top 25% Capital adequacy
 - ▶ Exclude bottom 25% Capital adequacy
 - ▶ Exclude New York City and Washington, DC
 - ▶ Exclude Top 10% Size
- ▶ Estimations:
 - ▶ Linear probability model with bank fixed effects
 - ▶ Alternative control variable definitions
 - ▶ Instrumental variables methods (IV: Distance to DC and Initial market size)
 - ▶ Matching methods

Risk Taking in Lobbying Banks

$$\ln(\text{Z-score})_{it} = \alpha + \beta L_{it} + X_{it}\gamma + \epsilon_{it}$$

	(1)	(2)
Bank Lobbying		
Lobbying	-0.120** (0.061)	
Lobbying experience		-0.083* (0.049)
Controls	Yes	Yes
Year FE	Yes	Yes
Bank FE	Yes	Yes
Within R^2	0.155	0.156

- ▶ Model (1): banks that engage in lobbying show a decrease of 12% in their Z-score

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Risk Taking in Lobbying Banks

- ▶ Liquidity risk: lobbying banks increase their exposure to unused commitments (held off the balance sheet) during the years preceding the financial crisis
- ▶ Credit risk: lobbying banks expand more aggressively in the run-up to the financial crisis, but end up with severe problems of bad loans following it

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Performance of Lobbying Banks

$$ROA_{it} = \alpha + \beta L_{it} + X_{it}\gamma + \epsilon_{it}$$

	(1)	(2)
Bank Lobbying		
Lobbying	-0.002* (0.001)	
Lobbying experience		-0.006** (0.003)
Controls	Yes	Yes
Year FE	Yes	Yes
Bank FE	Yes	Yes
Within R^2	0.157	0.147

- ▶ Model (1): Banks show a decline in their ROA of 0.2 pp following their lobbying activities, which represents a decline of almost 50% of its mean value of 0.43 percent

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Year FE	Yes	Yes
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- ▶ **Model (1):** Banks show a decline in their ROA of 0.2 pp following their lobbying activities, which represents a decline of almost 50% of its mean value of 0.43 percent

Performance and Uncertainty Exposure

$$ROA_{it(+3)} = \alpha + \beta L_{it} + X_{it}\gamma + \epsilon_{it}$$

	(1)	(2)	(3)	(4)
Variables of Interest				
Lobbying	-0.002* (0.001)		-0.001* (0.001)	
Lobbying experience		-0.002 (0.004)		-0.001 (0.001)
Lobbying × Uncertainty exposure	-0.001** (0.000)		-0.001* (0.001)	
Lobbying experience × Uncertainty exp.		-0.001* (0.000)		-0.001* (0.001)
Uncertainty exposure	-0.000 (0.000)	-0.000 (0.000)	0.000 (0.000)	-0.000 (0.001)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes
Within R^2	0.173	0.173	0.058	0.079

Summing up

- ▶ Lobbying banks, which are less likely to be subject to severe action, tend to engage in additional risk taking
- ▶ These results appear consistent with the theory of regulatory capture à la Stigler (1971) and Peltzman (1976)
- ▶ The results on bank performance rule out an explanation echoing the informational lobbying literature à la Grossman and Helpman (2001)

Takeaways

- ▶ Findings:
 1. The supervisory process is not immune to the political influence of banks
 2. The supervisory distortions induced by lobbying outweigh the welfare-enhancing role of the lobbying process in terms of information transmission
- ▶ Policy implications:
 1. Redesign of banking regulation in the United States and in other part of the world
 2. Regulations governing (bank) lobbying activities

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Thank You!