

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

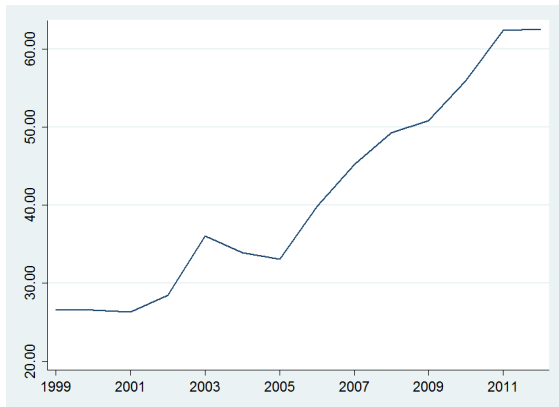
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- ▶ Assignments of CAMELS ratings
- ▶ Regulators may impose informal or formal actions
- ▶ Formal actions include civil money penalties, prohibition and removal orders, formal written agreements, cease and desist orders, prompt corrective action directives, and deposit insurance threats
- ▶ Regulators and their staffs have substantial discretion along the supervisory process
- ▶ Can banks interfere in the supervisory process?

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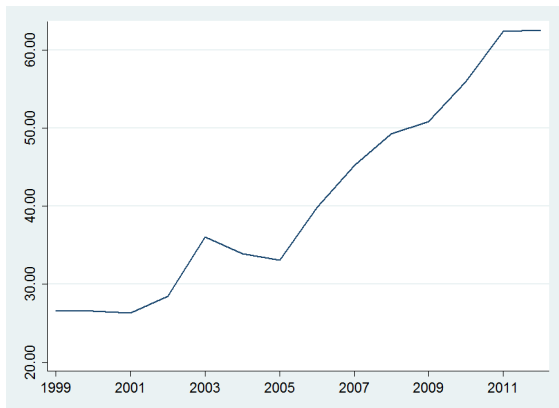
- ▶ Banks' political influence may affect the ability of regulators to design proper rules and **to enforce the rules in place**
- ▶ Lobbying is an important source of rising political influence



- ▶ Little systematic examination of the evidence on the incidence and drivers of lobbying efforts made by the banking industry

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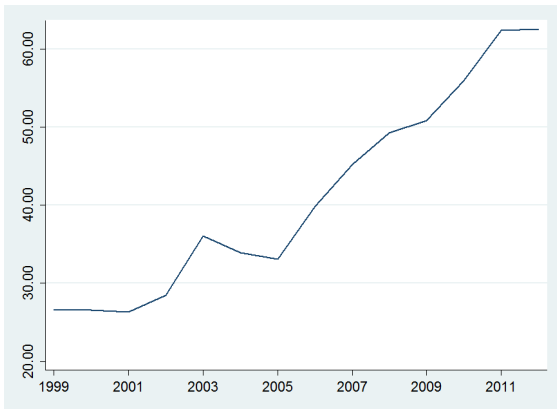
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This Paper

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 (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:

Jayaratne and Strahan (QJE 1996); Kroszner and Strahan (JF 1996); Delis, Staikouras and Tsoumas (MS 2016); Danisewicz, McGowan, Onali and Schaeck, (JFI 2016); Kupiec, Lee and Rosenfeld (JFS 2017)

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 and politicians to provide favorable treatment (Stigler 1971; Peltzman 1976)

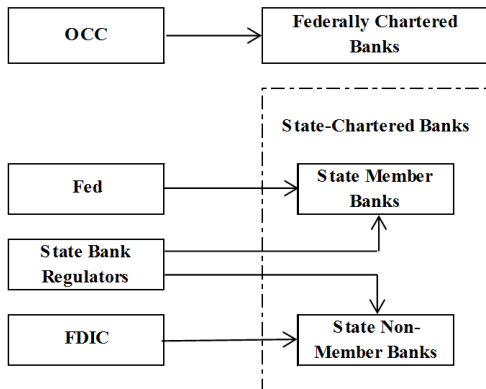
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Dataset

- ▶ 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 |

- ▶ In total: 1,677 severe enforcement actions and 4,494 less severe actions
- ▶ Source: SNL Financial

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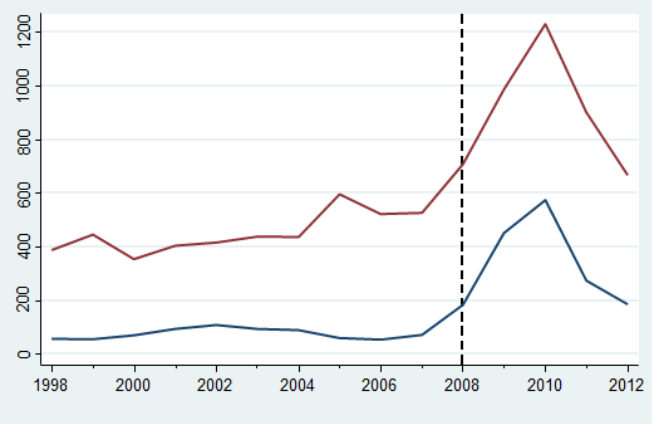
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Enforcement Activity over Time



Bank Lobbying Activities in the US Political System

- ▶ Lobbying is the strategic transmission of information in private meetings and venues between interest groups and politicians, their staffs, and agents
- ▶ Lobbying Disclosure Act of 1995 imposes strict disclosure rules for every individual and firm lobbying the Congress and federal agencies
- ▶ Lobbyists have to file registration and periodic reports indicating 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

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

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| | (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 |

IV Results

| Second-Stage Results | | | | |
|----------------------|----------------------|---------------------|--------------------|---------------------|
| | (1) | (2) | (3) | (4) |
| Bank Lobbying | | | | |
| Lobbying | -0.048*** (0.016) | -0.219** (0.101) | | |
| Lobbying experience | | | -0.581* (0.337) | -0.083** (0.038) |
| Controls | Yes | Yes | Yes | Yes |
| Regulator FE | Yes | Yes | Yes | Yes |
| Year FE | Yes | Yes | Yes | Yes |
| State FE | Yes | Yes | Yes | Yes |
| Method of Estimation | biprobit | 2SLS | ivprobit | 2SLS |
| R^2 | - | 0.189 | - | 0.1906 |

| First-Stage Results | | | | |
|-------------------------------------|---------------------|---------------------|---------------------|---------------------|
| | (1) | (2) | (3) | (4) |
| Instruments | | | | |
| Distance to DC | -0.002** (0.001) | -0.001* (0.000) | -0.003** (0.002) | -0.001* (0.000) |
| Initial market size | 3.007*** (0.712) | 0.675*** (0.084) | 1.820*** (0.064) | 1.811*** (0.208) |
| Controls | Yes | Yes | Yes | Yes |
| Regulator FE | Yes | Yes | Yes | Yes |
| Year FE | Yes | Yes | Yes | Yes |
| State FE | Yes | Yes | Yes | Yes |
| F test of excluded instruments | - | 32.608 | - | 37.956 |
| Hansen J -statistic (p -value) | - | 0.289 | - | 0.322 |
| Wald test of $\rho=0$ (p -value) | 0.126 | - | 0.165 | - |

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| Distance to DC | -0.002** (0.001) | -0.001* (0.000) | -0.003** (0.002) | -0.001* (0.000) |
| Initial market size | 3.007*** (0.712) | 0.675*** (0.084) | 1.820*** (0.064) | 1.811*** (0.208) |
| Controls | Yes | Yes | Yes | Yes |
| Regulator FE | Yes | Yes | Yes | Yes |
| Year FE | Yes | Yes | Yes | Yes |
| State FE | Yes | Yes | Yes | Yes |
| <i>F</i> test of excluded instruments | - | 32.608 | - | 37.956 |
| Hansen <i>J</i> -statistic (p -value) | - | 0.289 | - | 0.322 |
| Wald test of $\rho=0$ (p -value) | 0.126 | - | 0.165 | - |

Robustness and Alternative Explanations

- ▶ Subsample analyses for each supervisor
- ▶ Linear probability model with bank fixed effects
- ▶ Lobbying bank sample only
- ▶ Alternative control variable definitions
- ▶ Exclude top 25% Capital adequacy
- ▶ Exclude bottom 25% Capital adequacy
- ▶ Exclude New York City and Washington, D.C.
- ▶ Exclude Top 10% Size
- ▶ Higher-order powers of Size
- ▶ Construction of matched subsamples of lobbying (treatment group) and non-lobbying banks (control group) using propensity score matching

Risk Taking in Lobbying Banks

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

| | (1) | (2) |
|---------------------|---------------------|--------------------|
| 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
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Performance of Lobbying Banks

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

| | (1) | (2) |
|---------------------|--------------------|---------------------|
| 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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| Lobbying | -0.002* (0.001) | |
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| Controls | 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

Robustness

- ▶ Graphical analysis based on a difference-in-differences regression model
- ▶ Short-term and long-term performance of lobbying banks exposed to uncertainty shocks
- ▶ Other checks:
 - ▶ Exclude top 25% Capital adequacy
 - ▶ Exclude bottom 25% Capital adequacy
 - ▶ Exclude New York City and Washington, DC
 - ▶ Exclude Top 10% Size
 - ▶ Higher-order powers of Size
 - ▶ 2SLS regressions (Distance to DC and Initial market size)

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, especially in the European Union
 2. Regulations governing lobbying activities

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Thank You!