

# Political Influence, Bank Capital, and Credit Allocation

Finance Working Paper N° 864/2022 December 2022 Sheng Huang China Europe International Business School

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We thank Victoria Ivashina, Sumit Agarwal (discussant), Nataliya Gerasimova (discussant), Marco Pagano (discussant), and participants in the 2017 Conference on "Banks, Systemic Risk, Measurement and Mitigation" and the 2017 China International Conference in Finance, the 2018 Financial Intermediation Research Society Annual Conference as well as seminar participants at the Bank of Canada, Northeastern University, Singapore Management University, The Reserve Bank of India, Rutgers University, The Frankfurt Business School, University of Miami, and The Federal Reserve Bank of Philadelphia for helpful discussions and comments. We also thank Meng Gao, Yuan Meng, Evelyn Toh, Huilin Yang, and Gaole Zhang for excellent research assistance.

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#### Abstract

Political influence on bank credit allocation is often viewed as being necessary to address social problems like income inequality. We hypothesize that such influence affects bank governance and elicits bank capital responses. Our hypothesis yields three testable predictions, for which we find supporting evidence. First, when banks observe election outcomes that suggest greater impending political credit-allocation influence, they reduce capital to increase fragility and deter political influence. Second, banks subject to greater political influence nonetheless increase lending that politicians favor, and household consumption consequently increases. Third, these banks exhibit poorer post-lending performance. Our study has implications for the interaction between politics, household consumption and bank governance and risk through a specific channel – the interplay between credit-allocation regulation and bank capital structure.

Keywords: Politics, bank regulation, capital requirements

JEL Classifications: G21, G28

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### Political Influence, Bank Capital, and Credit Allocation

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### Political Influence, Bank Capital, and Credit Allocation

#### ABSTRACT

Political influence on bank credit allocation is often viewed as being necessary to address social problems like income inequality. We hypothesize that such influence affects bank governance and elicits bank capital responses. Our hypothesis yields three testable predictions, for which we find supporting evidence. First, when banks observe election outcomes that suggest greater impending political credit-allocation influence, they reduce capital to increase fragility and deter political influence. Second, banks subject to greater political influence nonetheless increase lending that politicians favor, and household consumption consequently increases. Third, these banks exhibit poorer post-lending performance. Our study has implications for the interaction between politics, household consumption and bank governance and risk through a specific channel – the interplay between credit-allocation regulation and bank capital structure.

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#### I. INTRODUCTION

**Motivation, Theory and Research Question:** It is well known that politicians influence economic outcomes (e.g. Cohen, Coval, and Malloy (2011), Lindbeck and Weibull (1987), Nordhaus (1975), and Rogoff (1990)). Nowhere is this more evident than in banking (e.g., Brown and Dinc (2005)), and political desire to influence the credit market is not a radical idea. Politics has influenced banking for centuries, and many have written about how politics and career concerns shape the actions of legislators and bank regulators.<sup>1</sup> In their book, Calomiris and Haber (2014) make a powerful case that politics has always been front and center stage in banking.

In banking, politics often influences credit allocation. Because the profit-maximizing lending decision of banks may not maximize social welfare, laws may be enacted to require banks to make loans they otherwise may not make.<sup>2</sup> This has become an increasingly pressing issue in light of growing income inequality that has been the subject of much public debate. As politicians grapple with how to deal with the social problems it creates, there is also research evidence that an increase in bank credit supply helps to reduce income inequality (e.g. Brei, Ferri and Gambacorta (2018)). So politicians may wish to enact regulations that encourage banks to increase lending, especially to disadvantaged groups. In some instances, credit allocation regulation may also serve political goals, so the motives for political influence may transcend at least the conventional notion of social welfare (see Calomiris and Haber (2014)). Safety-net protected banks may be willing to accept such credit allocation directives as part of the "Game of Bank Bargains" discussed by Calomiris and Haber (2014).

Politicians also care about the safety and soundness of banking. If credit allocation directives expose banks to greater risk, politicians face a tradeoff between the benefits of increasing bank credit supply and the cost of higher bank risk, so they may choose not to require banks to make politically-favored loans. Of course, bank risk is also affected by the bank's capital. For any (risky) lending, the risk of failure is higher the lower the bank's capital. This will affect the bank's capital choice.<sup>3</sup> The above discussion leads to our research question: How does political influence on credit allocation

<sup>&</sup>lt;sup>1</sup> See, for example, Boot and Thakor (1993), Kane (forthcoming), Johnson and Kwak (2010), Lo (2012), Rajan (2010), Song and Thakor (2012), and Stiglitz (2010).

<sup>&</sup>lt;sup>2</sup> An example is the Community Reinvestment Act (CRA) in the U.S. Many other countries (e.g., India) have requirements that banks lend to under-represented minorities and historically-disadvantaged groups. The need for such regulation may reflect the classic divide between the private optima of banks and the social optimum in credit extension.

<sup>&</sup>lt;sup>3</sup> This may also be an attempt by the bank to transfer more of the perceived losses from unprofitable loans from its shareholders to its insured and uninsured creditors.

affect the capital structure and lending decisions of value-maximizing banks (those whose governance seeks to maximize shareholder value)?

We address this question by capturing the tradeoffs discussed above in a simple model of bank capital structure with political influence on credit allocation. The bank makes its capital structure decision after it knows the outcome of a political (state governor) election. The outcome reveals to the bank whether it is likely to be subject to some pressure to lend to politically-favored groups. This revelation may be through a formal legislative change, but it need not be. Possibly more often, it could be either informal communication, or simply greater regulatory influence on banks to make certain types of loans (say, inferred from pronouncements of winning politicians). It may not even be actual political pressure, but simply political preferences *perceived* by banks – perhaps due to subtle cues or public announcements by politicians – without politicians explicitly asking banks to do anything.<sup>4</sup> Our analysis and conclusions do not depend on the specific manner in which political influence (real or perceived) manifests itself. Once the bank learns about whether there is political pressure to engage in some types of lending, it chooses its capital structure to balance the value of deposit financing against the increased moral hazard from lowering capital. At the next date, the politician observes the bank's capital structure and the political or social-welfare benefit of exerting credit-allocation influence, and decides whether to exert the influence. Lending then occurs. What we show is that the ex ante probability that the politician will influence future credit allocation is increasing in the bank's capital ratio. Recognizing this, the bank chooses a lower capital ratio ex ante than it would in the absence of perceiving such political influence. Nonetheless, in equilibrium the probability of creditallocation influence remains positive, so the bank does make politically-favored, riskier loans in some states of the world.

This model generates three predictions. First, a bank that perceives political pressure on credit allocation will reduce its capital ratio. Second, this response notwithstanding, banks subject to greater political pressure will make more politically-favored loans. Third, relative to other banks, these banks will exhibit higher lending risk and poorer post-lending performance. That is, although politically-

<sup>&</sup>lt;sup>4</sup> It is thus impossible for us as econometricians to directly observe or document political pressure, which, by its very nature, is something that neither banks nor their regulators (or politicians) would record in traceable form. Moreover, such informal or subtle pressure can be broadly perceived by all banks and not just be limited to any specific bank. Examples are statements like: "banks should make more loans to underserved communities" or "banks should not make loans to smoke-stack companies". Such pronouncements are very commonly observed. In Section IV.A, we provide a more detailed discussion of this.

favored loans are positive-NPV investments for banks in our model, they are nonetheless riskier and less profitable.<sup>5</sup>

What This Paper Does – Empirical Analysis: Our theoretical analysis assumes that political parties are different in the emphasis they put on influencing bank credit allocation. In the tradition of empirical tests of theoretical models, we do not test this assumption, but rather its predictions. Political influence, by its very nature, is not possible to measure directly because it is typically informally communicated and not documented. Moreover, to the extent that it may not even be informally communicated but simply perceived by banks based on their assessment of the preferences of those in power, its direct measurement becomes additionally elusive. Thus, a standard approach in papers that examine the interaction of politics and banking is to focus on the implications of this political influence—based on a theory or hypothesis-- rather than attempt to directly document the influence.<sup>6</sup> This is one reason why we instrument for potential political influence by using the political ideology of the party to which the winner in state gubernatorial elections in the U.S. belongs.

Although both parties mix politics and banking, Democrats typically attach greater importance than Republicans do to the role of the government in addressing perceived distributional inequities like income inequality—through credit allocation (e.g., Dymski, Epstein, and Pollin (2015), Levy (2006), and Sullivan (2009)). In Section II.B, we provide an extensive discussion of the platforms of the two parties. This discussion reveals that the *publicly stated* positions of the two parties reflect precisely the policy differences in the role of the government in bank credit allocation that we model. This implies that state-chartered banks ("state banks" hereinafter) are subject to greater political influence to allocate credit in states following the election of Democrat governors. While federal regulators are the only regulatory and supervisory authority of federally-chartered banks, state and federal regulators work jointly in monitoring state banks, and federal regulators often rely on state regulators for local information, which allows state regulators to influence state banks (e.g., Agarwal, Lucca, Seru, and Trebbi (2014)). State governors can thus influence state banks (not federallychartered banks (not federally-

<sup>&</sup>lt;sup>5</sup> While the politically-favored loans are positive-NPV investments for banks in our model, our argument also extends to these loans not being positive-NPV. If these (positive-NPV) loans were not riskier and less profitable, there would be no reason for political influence in the first place. That is, there may be a set of loans that unconstrained banks prefer and so do politicians. These loans would be chosen by banks independently of political pressure, and are not the subject of our analysis.

<sup>&</sup>lt;sup>6</sup> For example, in Kostovetsky (2015), the hypothesis is that banks' political connections to politicians with oversight powers over banks affect the risk exposure of banks. This hypothesis is based on the assumption that the "oversight powers provide [connected] committee members [of the U.S. Senate Banking Committee] with a great deal of leverage to influence government decisions that affect the financial industry, including bailout decisions" (page 148). This is, of course, is an assumption. Kostovetsky (2015) does not provide any direct evidence that connected members of the U. S, Senate Banking Committee actually influence government decisions that affect the financial services industry.

chartered banks) through their appointments of the state banking department heads and other personnel, as well as by affecting regulatory policymaking.<sup>7</sup>

Our empirical analysis uses all gubernatorial elections during 1990-2012 and focuses on statechartered commercial banks in all states of the U.S. While focusing on state banks, as part of our identification strategy, we also exploit the within-state differences in regulatory pressures and examine the corresponding differing influences on federally-chartered banks versus state banks. Our baseline analysis relies on a difference-in-difference regression of bank behavior and performance across banks in Democrat versus Republican states in a time window from three years prior to gubernatorial elections to three years after gubernatorial elections.<sup>8</sup> To account for the impact of any time-invariant bank-specific factors, we include bank fixed effects in all regressions wherever appropriate, in addition to time fixed effects to capture any time trend in bank behavior/performance.

**Main Results:** The empirical analysis provides strong evidence in support of our predictions. First, relative to state banks in Republican states, state banks in Democrat states reduce capital post-election. We also document that this decline in capital is through higher dividend payments and stock repurchases.

Second, we find that political pressure significantly affects bank lending. Relative to state banks in Republican states, state banks in Democrat states exhibit an increase in politically-favored lending post-election. Banks view such lending as riskier *ex ante* – we document greater expected losses, as reflected in a significant increase in the loan loss allowances that the banks allocate.

We also provide several pieces of evidence that the increased lending is indeed more *politically favored*: (i) We show that the higher lending addresses household consumption needs – ostensibly a political goal. Specifically, household consumption expenditures increase in states following the election of Democrat governors. (ii) State banks increase branches in low-income counties following the election of Democrat governors, consistent with the role of branch networks in facilitating credit access for disadvantaged communities. (iii) Finally, CRA (Community Reinvestment Act) ratings improve for these banks, consistent with their lending and branching serving socioeconomic goals. All these results are consistent with the notion that politicians care about addressing the consequences of income inequality and do this by helping to increase household consumption via an increased supply

<sup>&</sup>lt;sup>7</sup> See Section IV for a more detailed discussion on the potential influence of state governors on state banks.

<sup>&</sup>lt;sup>8</sup> The use of this long examination window is to better capture the impact of political influence that may take time to materialize. Our main finding is robust to a shorter post-election window of one year or two years after gubernatorial elections. In particular, consistent with banks responding to the election outcome, we find that banks exhibit a decline in their capital ratios even in the first year following the election of a Democrat governor.

of bank credit, especially to low-income households. This is further confirmed when we examine transaction-level data on mortgage lending; specifically, we find that mortgage lending to low-income households increases significantly following the election of Democrat governors.

Third, with higher politically-favored lending, state banks in Democrat states exhibit a decline in operating performance after gubernatorial elections, relative to state banks in Republican states. Our model implies that this performance decline is not something that banks seek (for example, to achieve an intertemporal tradeoff between lower earnings now and higher earnings in the future). This speaks to the issue of banks' *attitudes* toward credit-allocation influence, something that is hard to establish empirically, but we provide some evidence in support.

We show that the above results hold for banks with within-state operations only (single-state banks), but not for banks with out-of-state operations (multi-state banks). This is likely because single-state banks possess less bargaining power to push back against political influence. The finding hence provides further support for our hypothesis.

Lastly, we document that state banks are more likely to switch to a national charter following the election of Democrat governors. Agarwal, Lucca, Seru, and Trebbi (2014) show that state regulators are more lenient with banks than federal regulators, so banks should prefer state regulators to federal regulators *ceteris paribus*. They call for future research to better understand why some banks switch to a national charter despite this. Our finding suggests a possible reason – the *ceteris paribus* condition does not hold because there is greater political pressure on state banks under Democrat governors, pressure that federally-chartered banks do not face.

It is important to note that these results do not permit welfare statements. Political influence on credit allocation boosts household consumption, so it could be welfare-enhancing despite its effect on bank risk. That is, the analysis implies a tradeoff between higher welfare due to higher household consumption and the lower welfare due to reduced safety and soundness.

**Identification Strategies:** One might be concerned that unobserved economic factors may be driving both the gubernatorial election outcomes and bank decisions, and thus any causal inferences may be subject to an omitted variable bias. We employ three identification strategies to address this. First, we use a regression discontinuity (RD) design in exploiting the discontinuity in election outcomes at the winning vote threshold and testing for discontinuities in banks' decisions and performance around this threshold. We confirm that all of our results remain significant with this RD estimation.

Second, we conduct a falsification test and exploit differences among banks based on whether

they have federal or state charters, and the corresponding differences in regulatory pressure on them by state regulators. According to our theory, state-level political influence on federally chartered banks should be insignificant. However, if unobserved economic factors are driving our findings, we should expect the documented effect of state-level political influence to also be significant for federally chartered banks in the same state. We thus repeat all the benchmark empirical analyses for the sample of federally chartered banks, and find that the impact of the gubernatorial election outcomes is not significant in most cases.

Third, we focus our analyses on a subsample of state banks operating exclusively in counties that are geographically close to either side of a state border. The idea is that geographically-proximate counties located on two different sides of a state border are more similar to each other in their macroeconomic environments than to counties far away from the border. Therefore, our estimate of the impact of political influence is less likely to be confounded by any unobservable differences in macroeconomic environments across states. Our findings generally hold for this restricted subsample. **Alternative Explanations and Additional Robustness Checks:** We then proceed to examine the merits of some alternative explanations for our main finding through additional robustness checks. In the first robustness check, we address the concern that the decline in bank equity under Democrat governors might be due to changes in banks' investment opportunities. However, we do not find that the elections of Democrat versus Republican governors are associated with any differences in factors like GDP growth, house price, and income inequality.

In the second robustness check we address the concern that the party affiliation of the elected governor may affect post-election tax rates and that this may cause changes in bank capital structure that differ across Democrat and Republican governors. The literature has used the state income tax rate as an instrument for bank capital (e.g., Ashcraft (2008), Berger and Bouwman (2009, 2013)). Equity is less preferred when the state income tax rate is higher because it increases the tax disadvantage of dividends relative to debt interest. As such, banks in states with higher state income tax rates are expected to have lower equity ratios *ceteris paribus*, suggesting that the decline in bank equity in Democrat states may be due to higher post-election tax rates. But we find that Democrat victories were *not* followed by higher state income tax rates.

In the third robustness check, we examine whether possible differences in regulatory forbearance across Democrat and Republican governors may explain our results. Democrats may be more likely than Republicans to practice regulatory forbearance to bail out insolvent banks, especially those considered "too big to fail" (TBTF). This would generate moral hazard, leading to lower capital

and riskier lending. However, it should be less of a concern here because state banks are not likely to be TBTF. Moreover, this hypothesis suggests that our results should be stronger for larger banks that are systemically more important. However, we find that the documented effects are concentrated in *smaller* banks. Our findings seem consistent with the greater influence of state governors on smaller banks who possess less bargaining power *vis a vis* state regulators, e.g., due to a lower capability and opportunity of having out-of-state operations.

In the last robustness check, we study whether banks' political connections can affect political influence on banks' behavior. One might argue that banks' attitudes towards political pressure may be affected by whether or not they are politically connected. Using a measure of banks' political connection following Kostovetsky (2015), we find that our results remain robust after controlling for it.

**Intended Marginal Contribution Relative to the Literature:** Most relevant is the empirical literature on the influence of politics on bank lending (e.g., Brown and Dinc (2005), and Khwaja and Mian (2005)). We discuss this in more detail in the next section.

One marginal contribution of our paper is documenting a link between government influence on bank credit allocation and the bank's response to this – lowering its capital ratio. Moreover, our analysis also illuminates how political influence induces changes in bank lending and affects bank performance. Since bank capital and lending play key roles in determining safety and soundness, our analysis sheds light on how the interplay between politics and banking—which may be engendered by the desire to use banks to address important social problems— has potential ramifications for banking risk through the credit-allocation channel.

As mentioned earlier, this result notwithstanding, we cannot make welfare statements, since we do not know what motivates politicians to influence credit allocation. It could well enhance social welfare, say due to enhanced consumption, which we document, or the potential welfare gains from reducing distributional inequalities in bank credit. That is, we cannot view bank performance and risk as the sole determinants of social welfare, especially in light of the earlier-mentioned evidence on the role of expanded bank credit in reducing income inequality. On the other hand, it is also possible that political motives may be driven more by the self-interest of politicians than by social welfare.

The rest is organized as follows. Section II reviews the literature on political influence, lending, and bank capital. The testable hypotheses are developed in Section III; a theoretical model that generates these hypotheses is presented in the online Appendix I. Section IV describes the data, presents summary statistics, and provides details of the empirical design. Sections V and VI contain

the empirical analyses. Section V documents that political pressure induces banks to lower their capital, and Section VI documents that banks that are subject to greater political influence exhibit an increase in politically-favored lending and worse operating performance, connoting higher banking fragility. Section VII presents robustness checks and discussions. Section VIII concludes.

#### **II. THE RELATED LITERATURE**

#### A. The Influence of Politics on Banking

It is well known that politicians try to influence economic outcomes – like employment, bank bailouts, etc. – for political gain (e.g., Nordhaus (1975), Lindbeck and Weibull (1987), Rogoff (1990), and Faccio, Masulis, and McConnell (2006)). Cohen, Coval, and Malloy (2011) provide evidence that federal funds allocated to sates have a "crowding out" effect, causally diminishing corporate investments and reducing overall employment.

The point that politicians may attempt to influence the credit allocation decisions of banks is even more compelling. See, for example, Pagano and Volpin (2001) and Brown and Dinc (2005). Becker and Ivashina (2018) show that European governments can pressure domestic banks to buy local sovereign debt through direct government ownership and government influence on banks' boards of directors. Such holdings of domestic government debt crowd out corporate lending by these banks. Braun and Raddatz (2010) examine international data to examine how frequently former highranking politicians become bank directors. At the country level, they show that this connectedness is strongly negatively related to economic development, which is difficult to reconcile with a benign public-interest view of bank regulation. Related to this, numerous papers have documented that politicians in emerging markets use state-owned banks to achieve political goals, and this imposes costs on the economy. See, for example, Khwaja and Mian (2005) and Cole (2009).

This problem is *not* limited to government-owned banks or banks in emerging markets. Kane (forthcoming) and Rajan (2010) have highlighted the role of politics in U.S. banking regulation. Agarwal, Lucca, Seru, and Trebbi (2014) document that state and federal regulators in the U.S. implement identical rules differently and suggest (but do not test) that this may be explained by different degrees of political pressure on regulators. Liu and Ngo (2014) provide evidence suggesting strategic political manipulation of U.S. bank closures. Peek and Rosengren (2005) argue that the misallocation of credit in Japan during its economic crisis was due to the perverse incentive of a government faced with a growing budget deficit. Dinc (2005) examines banking data in many emerging markets *and* developed economies and finds strong evidence of political influence on bank lending.

Iannotta, Nocera, and Sironi (2013) use cross-country data on large European banks to show that government-owned banks have higher operating risk than private banks and that this risk increases in election years; see Anginer, Demirguc-Kunt, and Zhu (2014) for similar results. Agarwal, Benmelech, Bergman, and Seru (2012) provide evidence that the Community Reinvestment Act (CRA) led to riskier lending by U.S. banks. Shen and Lin (2012) provide evidence that sheds light on *how* politics affects bank performance and *why* government-owned banks underperform. <sup>9</sup> Their analysis shows that governments have numerous levers that they can pull to try and influence the lending policies of banks, so the credit-allocation decision analyzed in this paper is only one of those levers.

Perhaps the most extensive and historically-compelling account of the manner in which politics affects the design of banking systems and the regulation of banks has been provided by Calomiris and Haber (2014). They study centuries of bank regulation in many countries, most notably the U.S. and Canada, and argue that politics is an integral part of banking in all countries and it determines whether societies suffer repeated banking crises repeatedly (as in Argentina and the U.S.) or never (as in Canada). Their book provides a rich set of institutional facts that are consistent with and further illuminate the empirical evidence cited above<sup>10</sup>.

The existing literature thus provides empirical support and motivation for the assumption underlying our theory that the regulator may adopt formal regulations or less-formal regulatory practices—including jawboning—that pressure banks to make politically-favored loans, which are riskier with lower expected payoffs. Such regulations are typically presented as seeking to correct distributional inequities due to credit-market frictions, or simply to serve the broad political objective of expanded credit access. The recent research of Brei, Frerri and Gambacorta (2018) supports the idea that politicians who wish to address income inequality may be interested in providing inducements to banks to expand credit supply to households. Moreover, these papers also provide evidence supporting our premise that state governors significantly influence banking outcomes (e.g., Liu and Ngo (2014)).<sup>11</sup>

<sup>&</sup>lt;sup>9</sup> Several other papers have offered explanations for the underperformance of government-owned banks, including the view that such banks provide individual politicians with an opportunity to pursue political goals. See Beim and Calomiris (2000) and Sapienza (2004).

<sup>&</sup>lt;sup>10</sup> Consistent with these institutional facts, Thakor (forthcoming) develops a normative theory of political influence on bank capital and lending, which has implications for prudential bank regulation when there is political influence on credit allocation.

<sup>&</sup>lt;sup>11</sup> While not focusing on state banks, Do, Lee, and Nguyen (2017) find that local firms that are connected with state governors are more likely to receive state subsidies, loans, and tax credits, and they also obtain better access to bank loans, borrow more, and pay lower interest. Do, Lee, and Nguyen (2014) suggest that state governors are less likely to be scrutinized as intensely as federal politicians, and thus can enjoy more leeway in policymaking.

#### **B.** Politics and Banking: Democrats Versus Republicans

Although politics and banking are mixed by both parties, Democrats typically emphasize more the government's role in addressing distributional inequities through credit allocation. Dymski, Epstein, and Pollin (2015), who represent the views of liberal economists aligned with labor unions and Democrats, view government influence over bank credit allocation as desirable, and advocate how to do it. Both Levy (2006) and Sullivan (2006) point out the greater emphasis Democrats put on social and economic equality, with government-assisted expansion of credit availability to low-income and minority groups.

Perhaps the contrast between Republicans and Democrats on this issue is most starkly expressed in the debate over a bill proposed in 1975 by Representative Henry Reuss (D-WI) that would have required the 200 largest US banks to report to Congress how they were allocating credit. The bill was defeated in the House and Rep. Chalmers Wylie (R-OH) said: "A rose by any name would smell just as sweet. This is a disguise for the beginning of a credit allocation system." Another important example is the Community Reinvestment Act that was signed into law by President Carter (D) and strengthened substantially in 1995 during President Clinton's (D) term, although it had bipartisan support; see Calomiris and Haber (2014) for more on this. Further, in the aftermath of the 2007-09 financial crisis, not only were banks that were accused of misdeeds required to pay fines by the Obama administration, but they were also required to invest billions of dollars in new loans to low-income and minority neighborhoods. Republicans strongly disagreed with the notion that banks were to blame for the crisis and needed to be thus "punished".<sup>12</sup>

Getting banks to increase consumer credit is an important mechanism by which politicians can elevate wealth accumulation and household consumption in underserved groups, and doing this helps politicians address income and consumption inequality concerns. Empirical evidence that increased borrowing facilitates greater household consumption is provided by Jagannathan, Kapoor, and Schaumburg (2013) who document that per capita household consumption in the U.S. grew at a dramatically higher rate during 2001-2007, and was financed substantially by borrowing against home equity (see also Mian and Sufi (2014)). Republicans and Democrats are divided on the government's role in this. Democrats have long advocated aggressive government intervention in the housing market to expand opportunities for minorities and low-income residents.<sup>13</sup> The architect of the 1992 bill that created "affordable housing" requirements on Fannie Mae and Freddie Mac was Congressman Barney

<sup>&</sup>lt;sup>12</sup> See Wallison (2011).

<sup>&</sup>lt;sup>13</sup> See Haldane (2016).

Frank (D). Under this law, these government-sponsored enterprises (GSEs) were required to have at least 30% of the loans they purchased to be those made to people at or below the median income in their communities.<sup>14</sup> This requirement was later raised to 50% under President Clinton (D). These legislative initiatives were not intended to increase total mortgage lending *per se.* Rather, they were intended to induce changes in the composition of lender portfolios, so a greater fraction of lending would be to underserved communities. Our study indeed provides important supporting evidence by showing that more mortgage lending by state banks goes to low-income borrowers following elections of Democrats (more details are in Section VI).

This approach to the government's role is also reflected in the 2016 Democrat Party Platform:

"Disparities in wealth cannot be solved by the free market alone, but instead, the federal government must play a role in eliminating systematic barriers to wealth accumulation for different racial groups and improving opportunities for people from all racial and ethnic backgrounds to build wealth."

In sharp contrast, the 2016 Republican Party Platform stated:

"We must scale back the federal role in the housing market.....We will end the government mandates that required Fannie Mae, Freddie Mac, and federally-insured banks to satisfy lending quotas to specific groups."

A noteworthy point is that, while politically-favored loans may be positive-NPV projects for banks, the empirical evidence discussed earlier indicates that they tend to result in poorer loan performance and higher operating risks for banks.<sup>15</sup>

#### C. The Impact of Bank Capital on Bank Risk and Value

Our paper is also related to how bank capital affects bank risk and value. The previous theoretical literature includes Holmstrom and Tirole (1997) and Mehran and Thakor (2011). Peek and Rosengren (2005) provide evidence that (exogenous) negative shocks to capital reduce bank lending. Berger and Bouwman (2009) show that large banks with higher capital create more liquidity, whereas Berger and Bouwman (2013) document that banks with higher capital are more likely to survive financial crises and gain market share. Thakor's (2014) review of the literature concludes that higher bank capital, relative to current levels, will lower systemic risk and improve financial stability.

<sup>&</sup>lt;sup>14</sup> Prior to this, these GSEs were required to buy only prime mortgages.

<sup>&</sup>lt;sup>15</sup> One might ask why banks do not make these loans without political pressure if they are not negative-NPV investments. There may be many reasons, such as informational frictions that result in credit rationing (e.g., Stiglitz and Weiss (1981)), or capacity constraints that limit the bank's ability to make *all* positive-NPV loans, so they prefer to make more profitable loans that are not politically favored. We return to this issue later.

Our contribution to this literature is that we document the influence of politics on bank capital structure, which highlights a previously-unexplored factor in the bank's capital structure decision. Moreover, we also show that this influence leads to effects on bank loan quality and performance that are consistent with the predictions of the theories discussed above.

#### III. HYPOTHESES DEVELOPMENT

To provide a theoretical foundation for the main hypotheses we test, we present a simple model of political influence on bank credit allocation with endogenous bank capital structure. To conserve space, this model is presented in the online Appendix I; we discuss the main intuition here.

Our main hypothesis is that the influence of politics on banks' credit allocation can trigger an optimal response of the banks in their capital decisions. Specifically, politics often influences credit allocation ostensibly to improve social welfare, but this might not be profit-maximizing for banks. Even if the politically-favored loans are positive NPV for banks, if banks view themselves as capacity constrained (i.e., there is some optimal finite size at which the bank chooses to operate), then these loans may not be preferred by the bank because there are other loans that are more profitable and allow the bank to reach its desired asset portfolio size. If credit-allocation pressure exposes banks to greater risk and lower profits, they will have an incentive to reduce the probability of being subjected to such pressure. Banks which recognize that, in addition to their desire to influence bank credit allocation, politicians also care about the safety and soundness of banks, will then want to increase their own fragility in order to make it less attractive for politicians to impose credit-allocation pressure that imperils banks further. One salient way to increase fragility is to reduce the bank's capital ratio. Thus, there will be an incentive for banks to lower their capital levels when they anticipate greater credit-allocation political pressure. By doing this, they hope to limit the likelihood and extent of politically-favored lending that they will be asked to do.<sup>16</sup> This (formally, *Proposition 4* of the model) leads to:

Hypothesis 1: The greater the political pressure banks anticipate to make politically-favored loans, the more they will reduce their capital.

<sup>&</sup>lt;sup>16</sup> There is also a complementary risk-shifting effect that will reinforce the bank's desire to lower its capital ratio in anticipation of political influence on its lending. To the extent that such lending is riskier, the shareholders might prefer that this risk be shifted to the bank's creditors, which would then induce them to ask the bank to pay out dividends to the shareholders prior to engaging in this lending; this will cause the bank's capital ratio to drop.

The null hypothesis is that potential political influence on credit allocation is not significant enough to affect banks' capital structure decisions.

Our theoretical analysis also shows that the probability that banks will be pressured to make politically-favored loans is positive, despite the lower bank capital choice. This happens because there is ex ante uncertainty – at the time the bank chooses it capital ratio – about the value that politicians will assign to politically-favored loans, i.e. the politician's tradeoff between the social/political value of some forms of lending and the cost of increased bank fragility is uncertain ex ante for the bank. This means that when the bank chooses a particular capital ratio, it cannot be certain that it will not be pressured to make a politically-favored loan. Since any choice of capital ratio intended to reduce the likelihood of credit-allocation pressure distorts the bank's choice away from the unconstrained capital structure optimum, the bank trades off this distortion against the probability of being subject to credit-allocation pressure. Consequently, in equilibrium the bank chooses a capital ratio that reduces, but does not eliminate, the probability of credit-allocation pressure. This implies that more politically-favored loans are meant to enable consumption by underserved households, we would expect household consumption to also increase. This leads to:

Hypothesis 2: Banks subject to greater political pressure will make more politically-favored loans, and states with such banks will experience an increase in household consumption.

While the first part of this hypothesis follows from the model, the second part is a logical extrapolation of the model. We do not have household consumption in the model, but the politically-favored loans we have in mind are mostly consumer loans that feed consumption.

However, making these loans will adversely affect bank performance. The reason is that we assume that banks are profit-maximizing and are capacity-constrained, so any pressure to make lower-profitability loans comes at the expense of more profitable loans.<sup>17</sup> This leads to:

Hypothesis 3: Banks subject to greater political pressure will exhibit poorer performance.

#### IV. DATA AND EMPIRICAL METHODLOGY

In this section, we describe the data, the summary statistics, and the empirical methodology used.

<sup>&</sup>lt;sup>17</sup> One might argue that banks might increase overall lending and make both the loans they would have made anyway by simply expanding lending to accommodate the politically-favored loans. While this is possible, it does not change the conclusion that overall bank profitability will decline as long as the politically-favored loans are not as profitable as the loans an unconstrained bank would make.

#### A. Nature of Political Influence and Its Empirical Proxy

Testing the three predictions discussed above requires an empirical proxy for political influence. Our proxy is the outcome of state gubernatorial elections. Specifically, we instrument for the pending political influence on banks in a given state with the political ideology of the party to which the winner in the state gubernatorial election belongs. We focus on state governors because of their greater influence on policy-making and regulations than other state rule-makers, like senators. We also examine the impact of the potential interaction between state governors and senators.

As discussed earlier, since the Democratic Party puts greater emphasis on government regulation in the pursuit of socioeconomic goals, we expect banks to be more likely to allocate credit to politically-favored sectors when a Democrat wins the gubernatorial election than when a Republican does. We note that governors with a given party affiliation may have different views and policies, and hence they may not be monolithic. However, our empirical identifications (explained below) exploit the difference between Democrats and Republicans within a state; this diminishes the concern about potential differences between governors in the same political party for our study. We exclude from our analysis cases where either the predecessor governor or the winning governor (or both) is an Independent, due to the ambiguity about their political ideology.

Our analysis focuses on state-chartered commercial banks in all states of the U.S. Under the dual banking system in the U.S., banks can choose between a federal charter issued by the Office of the Comptroller of the Currency (OCC) and a state charter issued by a state government. The choice of charter determines the supervisor of a bank. For federally chartered banks, OCC is the primary regulatory and supervisory authority. For state-chartered banks, they are regulated and supervised jointly by their state chartering authority and a federal regulator. A state-chartered bank's membership in the Federal Reserve System determines its federal regulator. Specifically, the Fed regulates state member banks (SMBs), and the FDIC regulates nonmember banks (NMBs).<sup>18</sup> While enforcement cooperation between state and federal regulators—depending on interagency agreements—is the norm in monitoring state-chartered banks, federal regulators often rely on information from state regulators, who have a local informational advantage relative to federal regulators, to reduce regulatory and supervisory costs. For example, for the key "safety and soundness" bank examinations that culminate in the assignment of CAMELS ratings<sup>19</sup>, in the 1970's the FDIC began the experiment of

<sup>&</sup>lt;sup>18</sup> See Blair and Kushmeider (2006) for a detailed discussion of the dual banking system in the U.S.

<sup>&</sup>lt;sup>19</sup> A CAMELS rating rates a bank's conditions in each of the following six components: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk.

having these examinations alternate between state banking departments and FDIC examiners. The Fed followed suit in the early 1980's. The exam-alternating policies were more standardized in the 1990's (see Agarwal, Lucca, Seru, and Trebbi (2014) for more details). CAMELS ratings are a key input in many regulatory decisions such as licensing, branching, and merger approvals. State banking departments thus significantly influence federal regulators when it comes to state banks, and are consequently significant in the regulation and supervision of state-chartered banks.<sup>20</sup>

This implies that state governors can influence state-chartered banks through appointments of the state banking department heads and other personnel as well as their influence on regulatory policymaking. More generally, as discussed earlier, while political influence can be exerted formally (e.g., through legislations or direct guidance), it is more often indirect, informal, or implicit. We next present evidence of the various ways in which this influence manifests itself in practice.

#### A.1. Evidence on Personnel Appointments

First, we examine whether Democrat governors have a stronger preference than Republican governors to appoint state banking department heads who share their political ideology. Specifically, for each state, we manually search the personnel information of its banking department from its website. For many states, information of only the current officers is available, but not the historical archives of the past officers. Out of the 304 gubernatorial elections in our sample (to be discussed below in Section IV.A), we were able to find information of banking department heads for 69 Democrat and 76 Republican governors in 21 states during the sample period. The archived information includes the banking department heads' names, titles, dates of appointment, and dates of end of service. There is heterogeneity across states in the names of their banking departments and the titles of their heads. For the sake of convenience, we take the mostly adopted title "Commissioner" for all the heads. During the terms of the 69 Democrat and 76 Republican governors, there were 114 and 140 commissioners, respectively.<sup>21</sup>

We next follow the literature (e.g., Lee, Lee, and Nagarajan, 2014) to identify the commissioners' political orientation using their political campaign donation records from Federal Election Commission (FEC).<sup>22</sup> Among the 73 (90) commissioners under Democrat (Republican)

<sup>&</sup>lt;sup>20</sup> We do not believe that the state-federal regulatory rotation practice significantly affects our findings. This is confirmed by our results shown in *Table I.A.8* of the online Appendix later. Specifically, we do not find that the effect of a Democrat governor is concentrated in any specific year during the post-election period.

<sup>&</sup>lt;sup>21</sup> There can be multiple commissioners appointed during one term of a governor. The tenure of a commissioner varies across states and governors.

<sup>&</sup>lt;sup>22</sup> For individual political donations exceeding \$200, the identities and contributions of donors and information about candidate or committee recipients, including their party affiliations, are all made public by the FEC. In our sample, the

governors, for whom we can find donation records, 50 (47) exhibit Democrat (Republican) orientation. That is, 68.5% of commissioners under Democrat governors are perfectly aligned in political orientation with their governors, while this number is 52.2% for Republican governors. Because the tenure of a commissioner can span multiple governors (that is, a commissioner can be appointed by the predecessor governor and continue her service during the incumbent governors' tenure), we further investigate those commissioners who were appointed by incumbent governors. The finding is even more striking – 78.8% of commissioners appointed by incumbent Democrat governors are Democrats, while only 20% of those appointed by Republican governors are Republicans, with the affiliations inferred from political donations.<sup>23</sup> The evidence appears to be consistent with Democrat governors' stronger preference to influence state banks through appointments of the state banking department heads. Our finding echoes Becker and Ivashina (2018) who find that European governments have pressured banks for politically-motived lending through their influence on banks' boards of directors.

#### A.2. Evidence on State Regulation of Banks

Second, the influence of politics on regulatory policymaking, as documented in previous research (Section II), can be underpinned by local political interests (e.g., as in Agarwal, Lucca, Seru, and Trebbi (2014)). Consistent with this, we find that the laxity of state regulators relative to federal regulators is greater under Democrat governors than Republicans.<sup>24</sup> Specifically, we regress the state-level federal-state spread in CAMELS (reported in Figure IV in Agarwal, Lucca, Seru, and Trebbi (2014)) for the period of 1996-2011 on an indicator of Democrat governors, state characteristics that include GDP, GDP growth, and the unemployment rate, as well as aggregate bank characteristics such as bank equity, loan loss allowance, and non-performance loan ratio.<sup>25</sup> In results tabulated in *Table I.A.1* of the online Appendix, we find that the coefficients on the Democrat indicator are significantly positive in both Columns (1) and (2) for the full sample of all states.

vast majority of commissioners made donations only to one party. In only two cases where commissioners donated to both parties, we measure their political orientation as the party to which they donated more.

<sup>&</sup>lt;sup>23</sup> Among the 33 (40) commissioners appointed by incumbent Democrat (Republican) governors, for whom we can find donation records, 26 (8) exhibit Democratic (Republic) orientation.

<sup>&</sup>lt;sup>24</sup> Because regulators appear to be more lax under Democrat governors, one may argue that banks may take more risks (by decreasing their capital and increasing the proportion of riskier assets) under Democrat governors as hypothesized not because of political pressure, but because of lesser regulatory constraints (or weaker regulatory oversight) under Democrat governors. However, if banks were exploiting this laxity to reduce capital ratios and make riskier loans, it has to be the case that by doing so they made higher profits. But this is not what we find. Rather, our finding is the exact opposite---banks make lower profits under Democrat governors. The combination of higher risk, lower profits, more politicallyfavored lending, and better CRA scores seems more consistent with our theory that banks are responding to political pressure rather than with the alternative story that they are exploiting regulatory laxity to make more money.

<sup>&</sup>lt;sup>25</sup> We thank Amit Seru for providing access to the federal-state spread data through his website.

We note that the state-level federal-state spread is time invariant, but in many states the governorship switched parties during the sample period, which may introduce noise in the estimated effect of Democrat governors. To address this issue, we repeat the regressions in Columns (3) and (4) of *Table I.A.1* for the subsample of states that had not experienced any change in the ruling gubernatorial party throughout the period. The estimated effect of Democrat governors for this subsample cleanly identifies the difference between Democrat and Republican governors in terms of their impact on the laxity of state regulators. Indeed, we find that the effect of Democrat governors is not only statistically significant but also substantially larger in economic magnitude than that estimated from the full sample. The estimated coefficients on the Democrat indicator in Columns (3) and (4) are about five times as large as those in Columns (1) and (2).

The economic significance of such political influence is underscored by the fact that statechartered banks account for 70% of all U.S. commercial banks and over 27% of total commercial bank assets, with state chartering still the most common form of chartering for new banks. Of course, such state-level influence is unlikely to have a material impact on federally-chartered banks because they are regulated by the OCC, and they enjoy preemption from certain state laws as a special feature of the dual banking system. Therefore, we examine whether state-chartered banks reduce their capital ratios and exhibit an increase in politically-favored lending and poorer performance in the years that follow a Democrat being elected governor in that state, relative to the election of a Republican.

#### A.3. Evidence of Other Formal and Informal Political Influence

Lastly, we present evidence of other formal and informal political influence. It can be exerted in three ways: (i) formally in the form of legislations; (ii) non-legislatively through guidance; and (iii) informally through the expression of opinions. For examples of influence through formal legislative changes, see House Bill 5194 signed into law by Governor Pritzker (D) of Illinois in 2022 and a similar program in New York that has been active since 1997, both aiming for the creation of bank branches in underserved communities and the increase of new credit to underserved households, as well as House Bill 132 signed by Governor Grisham (D) of New Mexico that reforms predatory lending.

For examples of non-legislative political influence through guidance, see the guidance to all state banks, announced by Governor Hochul (D) of New York on April 15, 2022, to expand access to low-cost bank accounts for New Yorkers. Governor Hochul also issued guidance on September 26, 2022 to all state banks, calling on them to support residents of Puerto Rico in the aftermath of Hurricane Fiona, including waiving ATM and late fees, increasing ATM withdrawal limits, and facilitating and expediting the transmission of funds. As another example of direct guidance, see also

the PA CARE package launched by Pennsylvania on March 30, 2020, a voluntary consumer-relief initiative urging banks and other lenders to offer additional financial support to people across the Commonwealth.

In addition to this and possibly more frequently, the third form of political influence manifests itself in rather indirect, informal, or implicit ways. By its very nature, neither banks nor their regulators (or politicians) would record it in traceable form. Hence, as acknowledged by Becker and Ivashina (2018), some government pressure "might be too subtle to capture with standard types of data". Nevertheless, we present some anecdotal evidence of the ways in which implicit pressure is exerted on state banks, through either voice or actions, or both.<sup>26</sup>

First, regulators do not have to issue direct guidance to banks, but can just make public announcements and also entertain proposals that reflect dissatisfaction with how banks are lending to minority groups. For example, in a few states, lawmakers, government administrations, and activists have been pushing for establishing state-owned banks because private banks do not sufficiently serve the interest of minorities. These are examples of pressure/implicit threats to banks – banks are basically led to infer that either they lend more to disadvantaged groups or some alternatives will be created to compete with banks. In Democrat-controlled states, such voices are likely to have more credibility with the banks themselves because the Democratic party platform supports these initiatives, as we have discussed earlier.

Second, government officials can attend events that honor some banks for their contribution to the local economy and especially to underserved communities. They can also form a public-private partnership by setting up special funds jointly with some banks, which provide low-interest loans to small businesses and nonprofits, particularly in those low-income communities. Events (and the politicians' remarks during them) and special loan programs of this kind send a powerful message to other banks in the region.

Third, some state politicians may simply express their opinions in social media to promote financial inclusiveness and call for more loan access for minority groups. These will be heard by local banks that are subject to state regulation in the states these politicians operate in.

For brevity, details of the above examples are presented in the online Appendix II with Section A for formal legislations, Section B for direct guidance, and Section C for implicit pressure or informal influence.

<sup>&</sup>lt;sup>26</sup> Implicit pressure on the large banks by the federal government is relatively better known, due possibly to its greater exposure in sources like national media. See Sorkin (2010) for several examples of it.

#### **B.** Data and Descriptive Statistics

Data: We collect the results of gubernatorial and senate elections during 1990-2012 from the Federal Election Committee (FEC) website, the National Governors Association (NGA) website, and other media sources like The Washington Post. Our sample period starts in 1990 because detailed data on election results such as voting margins first became collectively available only then and ends in 2012 to ensure that bank data are available in the post-election three-year period. Bank financial statement data are from Reports of Condition and Income (Call Reports). For every gubernatorial election stateyear during the sample period, we obtain year-end (from December CALL) capital structure, annual cash dividends, net stock sale, loan growth, loan loss allowance, operating income, net income, and other accounting information of all commercial banks chartered in the state for the seven-year window [-3, +3] around the election year 0. We require information on a bank's book value of equity, book value of total assets, operating income, and net income in the year to be available for a bank-year observation to be included in the sample. Data on bank branching are from FDIC. We obtain data on mortgage applications and originations since 1998 from the Home Mortgage Disclosure Act (HMDA) dataset.<sup>27</sup> We focus on conventional loans that banks have the greatest discretions over.<sup>28</sup> We merge the HMDA data with Call Reports using lender identity. Those unmatched banks from the HMDA dataset are manually matched using the bank's name and location. Definitions of all our variables are in the Appendix.

**Summary Statistics**: *Table 1* presents the distribution of gubernatorial elections (Panel A) and summary statistics of bank and state economy characteristics for the sample as of the year prior to gubernatorial elections (Panel B). To reduce the impact of outliers, all bank-level continuous variables, except those for which we take the natural logarithm of the variable, are winsorized at the 1<sup>st</sup> and 99<sup>th</sup> percentiles. As shown in the left part of Panel A, there is a total of 304 elections, 140 of which were won by Democrats and 164 by Republicans during the sample period of 1990-2012.<sup>29</sup> The average

<sup>&</sup>lt;sup>27</sup> Earlier data on mortgages are less complete and thus we follow the literature to start our examination of banks' mortgage lending decisions from 1998.

<sup>&</sup>lt;sup>28</sup> We therefore drop from the raw dataset any non-conventional loan applications (Federal Housing Administrationinsured, Veteran Administration-guaranteed, Farm Service Agency, or Rural Housing Service loans). Loans securitized through GSEs are dropped because they are typically underwritten with GSEs' own standards. We also disregard refinancing loans whose repayment history has been available to banks and thus less discretion is needed. Applications for investment purposes (i.e., not owner-occupied properties), for home improvement purposes, or for unusual products (manufactured houses or multi-family dwellings) are also excluded.

<sup>&</sup>lt;sup>29</sup> As discussed, we exclude from our analysis cases where either the predecessor governor or the winning governor (or both) is an Independent.

(median) vote margin (the difference in the percentage of votes won by the winning candidate and by the losing candidate) is 17% (14.5%).

Our sample consists of 11,709 state-chartered commercial banks and 40,913 bank-years as of the year prior to gubernatorial elections. As presented in Panel B, the average capital ratio (*Book equity*) of sample banks is around 10% while the median is 9.2%. On average, the annual ratio of total cash dividend payment to prior-year-end total assets (*Dividend*) for sample banks is 0.005 while the annual *ROA* and *Earnings* (the ratios of net income and operating income to prior-year-end total assets, respectively) are 0.009 and 0.082, respectively. The average (median) ratios of loan loss allowance and provision to total loans are 0.016 (0.013) and 0.006 (0.003), respectively. Sample banks, on average, have experienced a growth in loans at a rate of 9.6%, but a decrease in ROA (*ROA growth*) and earnings (*Earnings growth*). The amounts of net stock sale in sample banks are skewed and thus an indicator variable (*Stock sale*) is created, with -1 indicating a negative net stock sale (stock repurchase), 1 indicating a positive net stock sale, and 0 otherwise. The positive average *Stock sale* of 0.049 suggests that the average sample bank has a net stock sale. Lastly, the median sample bank is rated as "satisfactory" in the CRA rating (rating = 2).

#### [Table 1 goes here]

**Time Series of Bank Equity**: *Figure 1* plots the time-series behavior of the annual average *Book equity* of sample banks for the seven-year window [-3, +3] around gubernatorial elections in year 0, in which one plot pertains to banks in states in which Democrats won and the other plot pertains to banks in states in which Democrats won and the other plot pertains to banks in states in which Republicans won. For New Hampshire and Vermont, where the governor's term is two years, we limit the examination window to three years [-1, +1].<sup>30</sup> While both groups exhibit slight upward trends in book equity over time that are consistent with the secular upward trend in bank equity ratios during this time, the noteworthy point is that the parallel trends assumption over the [-3, 0] time period is satisfied for the two groups, with a sharp divergence after year 0. In the postelection period, the equity ratios of banks in Republican states experience an increase that far exceeds the increase in Democrat states. We will conduct a more rigorous regression analysis below that accounts for various factors related to bank capital decisions. In all the regressions, we include calendar year fixed effects to control for the secular time trend in bank equity.

[Figure 1 goes here]

#### C. Empirical Methodology

<sup>&</sup>lt;sup>30</sup> The results are not materially affected if we exclude banks chartered in New Hampshire and Vermont from our sample.

#### C.1. Difference-in-difference Regressions (DID)

To formally examine the impact of potential influence under governors of different parties, we first build a panel of bank-years for the six-year window [-3, +3] around each gubernatorial election and run OLS regressions based on the following difference-in-difference (DID) specification:

(1) 
$$Y_{ijt} = \beta_0 + \beta_1 A fter + \beta_2 Democrat + \beta_3 A fter * Democrat + \beta_4 Predecessor + \beta_5 X_{it} + \beta_6 S_{jt} + \mu_i + \mu_t + \epsilon_{ijt},$$

where subscript *i* denotes the state bank, subscript *j* denotes the state where state bank *i* is located, and subscript *t* denotes the year in the six-year window [-3, +3] around gubernatorial elections.<sup>31</sup> To avoid the potential confounding impact of elections, we exclude the election year 0 from the analysis.  $Y_{ijt}$  represents bank capital and lending behavior as well as outcome variables such as banks' CRA ratings and earnings we examine in more detailed analyses that follow. *After* is a dummy that equals one if year *t* is in the post-election year window [+1, +3] and zero if it is in the pre-election year window [-3, -1]. *Democrat* is a dummy that equals one if a Democrat candidate wins the gubernatorial election and zero otherwise. Therefore, the DID coefficient  $\beta_3$  captures the effect of a Democrat governor on  $Y_{ijt}$  relative to the effect of a Republican governor in the three years after the election compared with the three years before the election. We also include an indicator variable, *Predecessor*, which equals one if the predecessor governor is a Democrat and zero otherwise. This should allow us to identify the effect of the potential change in regulation brought by the change in the governor's political party.

One concern is that the three-year post-election window [+1, +3] may not be long enough to fully capture the effect of governors and their political influence. While this concern is legitimate, its main impact should be to create a bias against us finding significant results. Moreover, as discussed in Section VI.D, we use loan loss allowances (a bank's estimate of loan losses expected at the time of loan origination), rather than actual loan charge-offs, as an *ex ante* measure of loan quality. This should partially alleviate the concern. Lastly, note that the decline in bank earnings on these regulation-motivated loans may also be underestimated.

<sup>&</sup>lt;sup>31</sup> As noted earlier, for New Hampshire and Vermont where the governor's term is two years, we limit the examination window to two years [-1, +1]. The results are not affected if we exclude all commercial banks chartered in New Hampshire and Vermont from the sample. Moreover, the main results are robust to a shorter examination window of one year or two years following the election.

We include two sets of time-varying control variables, one at the bank level  $(X_{it})$  and the other at the state level  $(S_{jt})$ . The first, which varies depending on  $Y_{ijt}$ , will be explained in individual regressions later. The latter includes *State GDP* (in natural logarithm), *State GDP growth* rate, and *State unemployment rate* that help to control for differing levels of economic development in different states. In all regressions, we include year fixed effects  $(\mu_t)$  to account for the potential time trend in  $Y_{ijt}$ , and cluster robust standard errors at the bank level. Also, unless otherwise specified, we estimate all regressions with bank fixed effects  $(\mu_i)$  to eliminate the possible impact on  $Y_{ijt}$  of any time-invariant bank-specific characteristics (and state-specific factors too, for the vast majority of cases where banks do not change their state charters). As a robustness check, we conduct all tests with state fixed effects  $(\mu_j)$  instead and cluster standard errors at the state level, and find that all results hold. For the interest of brevity, we do not tabulate these results; they are available upon request.

#### C.2. Regression Discontinuity (RD) Design

The above DID approach may not account for the potential endogeneity of election outcomes, because the assignment to treatment (a Democrat governor being elected) versus control (a Republican governor being elected) groups may not be random. In our regressions, we have controlled for state-level observables that may affect election outcome. But unobservables (e.g., economic uncertainty in a state that shifts public opinion) that affect an election outcome may also affect banks' decisions and performance, causing our estimates to be biased. We address this concern with three identification strategies, the one discussed below and the other two in Section VII.A.

The function that assigns a state to treatment is discontinuous at the winning vote threshold in elections. This allows us to use a regression discontinuity (RD) design to clearly identify the treatment effect. Intuitively, the estimation exploits the discontinuity in election outcomes at the vote threshold and tests for discontinuities in banks' decisions and performance around this threshold. In other words, the assignment of an individual state to be treated is assumed to be random around the winning vote threshold (see also Lee (2008)). The underlying assumption that generates the local random assignment result is that relevant actors do not have precise control over the election results, while imprecise influence is allowed (Lee and Lemieux, 2010). Eggers, Fowler, Hainmueller, Hall, and Snyder (2015) examine a wide variety of electoral settings including statewide elections in the U.S., and conclude that the assumptions behind the RD design are satisfied.

Our RD estimation is based on the following empirical model:

(2) 
$$Y_{ijt} = \beta_0 + \beta_1 Democrat + \sum_{n=1}^N \delta_{nw} (VM)^n + \sum_{n=1}^N \delta_{nl} (-VM)^n + \beta_2 X_{it} + \beta_3 S_{jt} + \mu_t + \epsilon_{ijt},$$

where subscript *i* denotes the state bank, subscript *j* denotes the state where bank *i* is located, and subscript *t* denotes the year in the three-year window [+1, +3] following gubernatorial elections. The dependent variable  $Y_{ijt}$  and *Democrat* as well as other explanatory variables  $X_{it}$  and  $S_{jt}$  are the same as in the model specification (1). We also include calendar year fixed effects ( $\mu_t$ ) as before. We do not include bank fixed effects here, because including individual fixed effects is not necessary for identification in an RD design (Lee and Lemieux, 2010).<sup>32</sup> Instead, following Lee and Lemieux (2010), we account for within-bank correlation of the errors over time using clustered standard errors.

We control for the vote margin of an election (VM) with a high-order polynomial. We also allow for a different polynomial for observations on the winning side (w) and on the losing side (l) for Democratic candidates. As our benchmark, we restrict our sample to elections with a vote margin not greater than 0.2. Note that this sampling choice deals with the classic trade-off between noise and potential bias in fitting observations far from the winning vote threshold while estimating the discontinuities in  $Y_{ijt}$  around the threshold. In later robustness tests, we also show the robustness to varying the size of our sample by increasing vote margins to fit more observations. The parameter of main interest,  $\beta_1$ , is a consistent estimate of the effect of a Democrat governor being elected, i.e., how elected Democrat governors affect the decisions and performance of banks differently from Republic governors.

#### **V. THE EFFECT OF POLITICS ON BANK CAPITAL DECISIONS**

#### A. Bank Capital

**Empirical Support for** *Hypothesis 1*: *Table 2* shows the DID (Panel A) and RD (Panel B) analyses results that are consistent with *Hypothesis 1* about the impact of political influence on bank capital. We start with banks' capital structure decisions and then discuss the channels through which banks change their capital structure. Model (1) of Panel A presents the main result estimated with the DID model using Specification (1) where the dependent variable is *Book equity* (note that the level of it in all regressions throughout the paper is multiplied by 100 to scale up the estimated coefficients on the

<sup>&</sup>lt;sup>32</sup> According to Lee and Lemieux (2010), imposing a specific dynamic structure introduces more restrictions without any gain in identification, because the source of identification is a comparison between those just below and above the threshold, which can be carried out with a single cross-section.

independent variables). The reported DID coefficient  $\beta_3$  is negative and statistically significant. It suggests that banks reduce equity in response to the election of a Democrat governor. In contrast, as indicated by the significantly positive coefficient  $\beta_1$ , banks increase capital following the election of a Republican governor. To gauge the economic magnitudes of these within-bank estimates, it is important to account for the within-bank low variation in its equity level for a bank. Specifically, the relative reduction is about 3.73% of the within-bank standard deviation of bank equity, or in absolute term, amounts to about 86.2% of the annual growth in the level of equity for the median bank in the sample.<sup>33</sup>

Models (1) and (2) of Panel B present the results of the RD estimation for *Book equity* using Specification (2) with the polynomial in the vote margin of order two and three, respectively. They are consistent with the results of the DID analysis in Model (1) of Panel A. Note that in the RD estimation throughout the paper, we include all control variables as in the corresponding DID regressions, but for brevity, we report the estimated coefficient  $\beta_1$  on *Democrat* only. The estimated coefficients  $\beta_1$  are negative and statistically significant in both models, indicating that banks reduce their capital ratio following a Democrat candidate's victory in a close election as compared to a Republican's victory. The impact is also economically substantial—based on Model (2), the reduction in bank capital is over one third of the within-bank standard deviation of bank equity, or in absolute term, amounts to about 8.2 times of the annual growth in the level of equity for the median bank in the sample. Note that the estimated coefficients in the RD estimation (in absolute terms) are much larger than those in the DID estimation. This indicates that unobserved omitted factors that affect both election outcomes and bank capital decisions may be biasing our DID estimates downward, and our RD estimates are more appropriate in gauging the economic magnitudes of political impact.

#### [Table 2 goes here]

In examining banks' capital structure decisions, we control for the following bank characteristics: size (*Asset(log)*), profitability measured by net income (*ROA*), and growth in profitability (*ROA growth*). The results show that *ROA* contributes positively to bank capital, whereas banks with higher *ROA growth* appear to have lower capital. Further, larger banks and banks in states with higher GDP growth have lower capital ratios.

<sup>&</sup>lt;sup>33</sup> The within-bank mean and standard deviation of *Book equity* are 0.097 and 0.015, respectively. The annual growth in the level of equity for the median bank in the sample period is about 0.065%.

Lastly, to see the impact of the anticipated regulation change, we further analyze banks' capital responses separately under four different election scenarios: "R-D" in which a Democrat candidate wins the election while her predecessor is a Republican; "D-R" in which a Republican candidate wins the election while her predecessor is a Democrat; "R-R" in which both the winner and the predecessor are Republicans; and "D-D" in which both the winner and the predecessor are Democrats. In the interest of space, detailed discussions on the tests and results are provided in the online Appendix III. Overall, the results show that our main finding is driven by the two changing-party cases – "R-D" and "D-R". Banks do not seem to change their capital ratios when the election results in no change in the ruling party.

#### B. Capital Reduction Channels: Dividends and Share Repurchase

We next explore the channels through which banks reduce capital. Our hypothesis is consistent with the notion that bank capital is reduced through payouts, and not through asset expansion financed with additional borrowing.<sup>34</sup> We therefore examine whether banks are more likely to increase dividends and share repurchases following a Democrat governor being elected. We employ the same model Specification (1), while changing the dependent variable to *Dividend* and *Stock sale*. When *Dividend* is the dependent variable, we estimate a partial adjustment model of dividends, which includes contemporaneous *Earnings* and one-year lagged *Dividend* as control variables, following Lintner (1956) and more recent studies (e.g., Skinner (2008), and Michaely and Roberts (2012)). When *Stock sale* is the dependent variable, we estimate an ordered logistic model with contemporaneous *Earnings and Earnings growth* as well as one-year lagged *Assets* (in natural logarithm) as control variables. We use *Earnings growth* to proxy for a bank's growth opportunities. Estimation with bank fixed effects in an ordered logistic model is not applicable, and thus we include state fixed effects in this case.

The results reported in the last two models of Panel A (DID) and the last four models in Panel B (RD) in *Table 2* show that banks increase dividends and stock repurchases following the election of a Democrat governor. Specifically, in Model (2) of Panel A on *Dividend* (note that the level of it in all regressions throughout the paper is multiplied by 100 to scale up the estimated coefficients on the independent variables), the DID coefficient  $\beta_3$  is positive and significant. The finding suggests that banks increase dividends following the election of a Democrat as governor. In economic magnitudes, the DID coefficient amounts to over 2.43% of the dividends paid by the median bank in the sample

<sup>&</sup>lt;sup>34</sup> This is consistent with Uluc and Wieladek (2018) who document that banks make capital adjustments primarily through payout adjustments that affect retained earnings.

as of the year prior to election. The within-bank increase in dividends is noteworthy because the median bank experiences no change in annual dividends during the sample period. As shown in Models (3) and (4) of Panel B, the above finding continues to hold in the RD setting and the economic magnitudes of the RD coefficient  $\beta_1$  are much larger as in the case of *Book equity* discussed earlier. For example, in Model (4), the RD coefficient suggests that the increase in dividends by banks following a close election of a Democrat governor amounts to 16% of the prior-year dividends paid by the median bank.

In Model (3) of Panel A (DID) on *Stock sale*, we find that the DID coefficient  $\beta_3$  has the expected negative sign, which suggests that banks are more likely to repurchase stock after a Democrat governor takes office, relative to a Republican governor taking office. Possibly due to little withinstate variation in banks' stock activities, these coefficients are not statistically significant. Further, data on stock sales are missing for many banks, resulting in a substantial reduction in the number of observations. However, in the RD setting as shown in Model (5) of Panel B, the coefficient  $\beta_1$  is negative and statistically significant, indicating that banks are more likely to repurchase stock following a close election of a Democrat governor.

In sum, the above results suggest that banks tend to reduce capital by increasing dividends and stock repurchases following a Democrat victory. And the findings from the RD setting suggest that the effect of a Democrat governor is likely causal.

#### C. The Impact of the State Legislature

In addition to the governor, the state legislature may also influence bank regulation. We now extend our analysis to examine how the gubernatorial impact on bank capital may depend on which party has the state senate majority. We focus on the senate, rather than the house, for two reasons. First, it is empirically difficult to separate the impact of the senate from that of the house when different parities hold the majorities in the two bodies. Second, (house) representatives serve for a much shorter term (two years) than senators (six years), so the senate is a more stable and significant source of influence.

We divide the sample into two subsamples based on whether the senate has a Democrat majority in at least one of the three years following a gubernatorial election, the period in which we examine the impact of the governor on bank capital. We then repeat our benchmark DID analysis in Panel A of *Table 2* on bank capital in these two subsamples. As for bank stock sales decision, we estimate with state fixed effects for bank equity and dividend decisions here too because of insufficient within-bank variations in shorter time series with bank fixed effects in the subsample analyses. We

expect the effect of a Democrat governor on bank capital to be more pronounced in states where the Democrats have a senate majority during the governor's tenure.

#### [Table 3 goes here]

The results reported in *Table 3* are consistent with this. In Models (1) and (2) on bank equity, we find that the estimated DID coefficients  $\beta_3$  are both significantly negative, indicating that banks reduce capital in a state in which a Democrat becomes governor, regardless of whether the senate is also a Democrat. However, it is more significant both economically and statistically in Model (2), so the reduction in bank capital is more pronounced in states with a Democrat governor *and* a senate with a Democrat majority. In Models (3) and (4) we present evidence on dividends, and in Models (5) and (6) we present evidence on stock sales. We find similar results in those cases – although the estimated coefficients  $\beta_3$  have consistent signs as in *Table 2* in all models except in Model (5), they are statistically significant only (and also have substantially larger magnitudes compared with those in *Table 2*) in the subsample of states in which there is a Democrat governor *and* a Democrat majority in the senate.

## VI. THE EFFECT OF POLITICS ON BANK LENDING BEHAVIOR AND PERFORMANCE

We now test *Hypotheses 2* and *3*. Specifically, we find that growth in politically-favored loans, accompanied by bank branching in politically-favored areas, is significantly higher in banks in Democrat states than in Republican states. These loans contribute to higher CRA ratings for these banks, consistent with banks serving socioeconomic goals more effectively. However, we find that banks making these loans experience higher expected losses and poorer operating performance. As further evidence of banks' resistance against (real or perceived) political influence, we show state banks are more likely to switch to a national charter in Democrat states.

#### A. Test of Hypothesis 2: Growth in Politically-favored Loans

Panels A and B of *Table 4* present the DID and RD regression results, respectively, of our main analysis of growth in different types of bank loans – mortgage, real estate, commercial & industrial (C&I), individual, and agricultural. For the convenience of interpretation, we multiply the dependent variable, growth in different types of loans, by 100 and thus it is in percentage. Political pressure based on correcting perceived distributional inequities is likely to be linked to addressing household

consumption needs<sup>35</sup> rather than providing more corporate credit. Our hypothesis thus predicts an increase in individual loans but not in C&I loans in Democrat states.<sup>36</sup>

Consistent with this prediction, following a Democrat governor being elected, loans to individuals (e.g., credit cards) grow significantly as indicated by the positive and statistically significant coefficient  $\beta_3$  in Model (4) of the DID analysis in Panel A. Economically, the DID coefficient suggests that growth in individual loans in banks in Democrat states outpaces banks in Republican states by 0.675%. The same finding holds in the RD setting as shown in Panel B, with a larger economic magnitude related to the impact of Democrat governors. There is also evidence that mortgages increase following a close election of a Democrat governor, as suggested by the significantly positive coefficient  $\beta_1$  in Models (1) and (2) of the RD setting in Panel B (although it is not statistically significant in the DID analysis in Panel A). The DID analysis in Panel A also shows that real estate loans grow significantly in Democrat states, and this finding holds in Model (3) of the RD analysis.

In contrast, banks do not significantly change their commercial and industrial (C&I) loans in either Democrat or Republican states.<sup>37</sup> The difference in the relative change in this type of loans between banks in Democrat states and banks in Republican states is insignificant. Neither the estimated coefficient  $\beta_3$  in Model (3) of Panel A nor the estimated coefficient  $\beta_1$  in both Models (5) and (6) of Panel B is significant. Similar findings can be seen for agricultural loans.

#### [Table 4 goes here]

Overall, our finding is consistent with the evidence on the impact of politics on consumer credit, especially for underserved households (see, for example, Antoniades and Calomiris (2016) and Chavaz and Rose (2019)).<sup>38</sup> In explaining banks' lending decisions, we also control for bank characteristics that include: size (*Asset(log)*), bank capital (*Book equity*), and bank financial health variables, all of which are measured as of the prior year end. Following the literature (e.g., Berger and Udell (2004)), we use the level of reserve allocation for loan losses (Loan loss allowance, or *LLA*) and

<sup>&</sup>lt;sup>35</sup> The loans that most clearly fall in this category are individual loans. Mortgages are both residential and commercial, as is real estate.

<sup>&</sup>lt;sup>36</sup> The predicted effect on agricultural loans is not clearcut. Most farmers have access to alternative funding from the Farm Credit System (FCS), so there is a lesser political need to address that sector. In Section V.C, we will conduct a further examination of whether the increased loans are politically favored.

<sup>&</sup>lt;sup>37</sup> Data on commercial and industrial loans are not available from 2001 and on, which results in a decrease in the number of observations in the regression.

<sup>&</sup>lt;sup>38</sup> In results not tabulated for brevity, we also find a significant increase in the share of individual loans among the banks' loan portfolios following the election of Democrat governors. Our findings are also robust if we focus on a subsample of banks for which information on all types of loans is available.

return on equity (*ROE*) to measure bank financial health. *LLA*, also known as the reserve for loan losses, is a calculated reserve that banks establish to reflect the estimated credit risk associated with their loans. Specifically, it is an estimate of uncollectible amounts used to reduce the book value of loans and leases to the amount that a bank expects to collect. The higher the estimated risk of uncollectable assets in the portfolio, the larger the reserve, and thus the lower the additional lending by the bank to risky borrowers. *Ceteris paribus* it follows that financially-stronger banks with higher capital are more capable of making risky loans. On the other hand, risk-seeking incentives may be stronger among financially-weaker banks due to moral hazard.

Empirically, we find that loan growth is positively related to *Book equity* and negatively related to *LLA* and *Asset(log)* for all types of loans. Similar to the idea that loan demand is higher in larger economies and faster-growing economies, we find that growth in most types of loans is greater in states with higher GDP and higher GDP growth, and is lower in states with higher unemployment.

#### **B.** Impact on Household Consumption

As indicated earlier, if banks are significantly increasing politically-motivated loans without reducing their investments in other loans, then we should expect to see household consumption grow in Democrat states. We empirically test this using the state-level personal consumption expenditure (PCE) data that are available since 1997 from the U.S. Bureau of Economic Analysis. Specifically, we examine how growth in PCE is affected following the election of Democrat governors relative to the election of Republican governors, using Specification (1). The DID analysis allows to purge the effect of any general trend in personal consumption across states. We also control for the state characteristics that are likely to be related with growth in PCE, such as GDP, GDP growth, and unemployment rate. The results are reported in Panel C of *Table 4*. To ease interpretation, we multiply the dependent variable, growth in PCE, by 100 and thus it is in percentage.

Echoing the increase in growth of politically-favored loans in Democrat states in the three years following the gubernatorial elections, there is a corresponding increase in PCE growth during the same period.<sup>39</sup> Specifically, the DID coefficient  $\beta_3$  is positive and significant. The results hold with or without state fixed effects. Economically, as shown in Model (2), relative to that in Republican states, growth in PCE increases significantly by 0.163 percentage in Democrat states following gubernatorial elections, which is over 7% of the average within-state standard deviation of PCE

<sup>&</sup>lt;sup>39</sup> One may argue that we cannot attribute the increase (decrease) in PCE growth solely to the increase (decrease) in politically-favored loan growth by banks chartered in Democrat (Republican) states because national banks operating in these states provide loans too. However, as discussed in Section III, national banks are less likely to be subject to state political pressure. In Section VII.A, we provide a direct test and find evidence supportive of this.

growth rate during the sample period. Consistent with greater consumption expenditures in fastergrowing economies, growth in PCE is higher in states with higher GDP growth and lower unemployment.

Overall, the results are consistent with *Hypothesis 2* that political pressure induces banks to make more politically-favored loans that result in an increase in household consumption.

#### C. Nature of the Elevated Lending

Next we examine whether the increased credit supply is indeed in the form of the kinds of loans that would be politically favored. Our earlier analysis of household consumption indicates an answer in the affirmative, but we provide two further tests here. Both are in line with the idea that politicians will wish to address income inequality issues by having banks expand lending to minority and low-income households.

#### C.1. Test 1: Branching in low-income counties

In association with politically-favored lending, politics may encourage bank branching in politicallyfavored areas. Gilje, Loutskina, and Strahan (2016) demonstrate that banks that are exposed to exogenous liquidity windfalls increase their mortgage lending only in counties where they have branches and only for hard-to-securitize mortgages. They conclude that branch networks continue to be important, despite securitization. We expect that state banks are more likely to expand into underserved areas through branching following the election of Democrats.

Specifically, we examine the change in the proportion of a bank's branches in low-income counties in a state around elections. A county is defined to be low-income in a year if its per capita personal income falls below its median level in the year among all counties in the state. The results, reported in *Table 5*, show that banks increase the proportion of their branches in low-income counties after Democrat governors are elected while decrease it otherwise. The coefficient  $\beta_3$  in the DID analysis (Model (1) of Panel A) is positive and statistically significant. The finding is robust in the RD setting as shown in Models (1) and (2) of Panel B. Economically, the coefficient  $\beta_1$  in Model (2) of Panel B suggests that the proportion of branches in low-income counties increases by 3.25% after a Democrat becomes governor in a close election. Such a change is noteworthy because the median bank experiences no change in this proportion over the sample period.

#### C.2. Test 2: CRA ratings

Because the CRA seeks to address distributional inequities, it fits well our notion of politically-favored lending. Evidence that the CRA ratings of banks improve when they lend more would suggest that

these banks are making more loans that politicians endorse. Compared with our evidence on specific loan types and branching decisions discussed above, it is suggestive of banks' overall behavior.

The CRA, passed by Congress in 1977, encourages financial institutions to meet the credit needs of the communities in which they operate. Federal regulatory agencies conduct periodic onsite examinations of banks' compliance with the CRA, and a composite rating is determined (1 = Outstanding, 2 = Satisfactory, 3 = Needs to Improve, 4 = Substantial Noncompliance). Regulators consider the bank's CRA performance in evaluating its application for various activities, like opening new branches, relocating existing branches, mergers and consolidations, etc.

The CRA rating is based on three performance tests: (i) a lending test; (2) an investment test; and (3) a service test, with the lending test most heavily weighted in the composite rating (about two-thirds). As summarized by Agarwal, Benmelech, Bergman, and Seru (2012), "Among the factors considered are the geographic distribution of lending, the distribution of lending across different borrower income groups, the extent of community development lending, and lending practices to address the credit needs of lower-income geographies (census tracts) or individuals."<sup>40</sup>

Since loans to low- and moderate-income neighborhoods under the CRA standards are also politically favored by Democrat governors, we expect the lending behavior of banks in Democrat states to be more CRA-compliant, with consequently higher CRA ratings (lower rating scores) for banks. This is likely, given our finding that banks in Democrat states increase individual loans and mortgages to low-income households as well as increase branching in low-income counties. Model (2) of Panel A in *Table 5* reports the DID regression results of our direct test of this hypothesis. Consistent with our hypothesis, the CRA ratings of banks improve significantly in states in which Democrat governors are elected relative to those of banks in states in which Republican governors are elected. The coefficient  $\beta_3$  is negative and statistically significant. The RD results presented in Models (3) and (4) of Panel B in *Table 5* confirm the robustness of the finding from the DID analysis, with greater economic magnitudes of the impact of Democrat governors. The coefficient  $\beta_1$  in Model (3) of Panel B is -0.066 and statistically significant, suggesting that the change in the CRA rating following a close election of Democrat governors is noteworthy, given the relatively infrequent CRA

<sup>&</sup>lt;sup>40</sup> The investment test considers a banking institution's qualified investments that benefit the institution's assessment area or a broader statewide or regional area that includes its assessment area. The service test considers the scope of an institution's system for delivering retail-banking services and judges the extent of its community development services and their degree of innovativeness and responsiveness.
examinations.<sup>41</sup> The review cycle for the majority of our sample banks is two years.<sup>42</sup> Note that the sample in this test is relatively small because CRA ratings are only available for banks that are FDIC-insured. We also find that the CRA ratings are higher for larger banks. Moreover, banks in states with lower unemployment rates have better CRA ratings.

# [Table 5 goes here]

To summarize, the findings on CRA ratings echo those on the increase in politically-favored loans made and branches set by banks in Democrat states. Taken together, these findings provide strong evidence supporting *Hypothesis 2* that banks subject to political influence make more politically-favored loans, and these loans enable higher household consumption.

## D. Test of Hypothesis 3: Loan Quality

We now test our hypothesis that the newly-created politically-favored loans are riskier with higher expected losses. Specifically, we examine the effect of a Democrat governor on the change in the bank's loan loss allowance (*LLA*). The change in *LLA* captures changes in loan quality because it "is arguably the best indicator of the status of problems in (a bank's) loan portfolio" (Berger and Udell, 2004), and it is superior to other measures, such as net charge-offs (charge-offs net of recoveries) and ROE/ROA, in capturing estimated credit losses cleanly; Charge-offs typically occur late in the problem-loan resolution process. This issue is particularly relevant in our test, because actual charge-offs can occur well beyond our three-year post-election time window. Moreover, banks also vary in when they write off delinquent loans (see Walter (1991)). Further, ROE/ROA reflects bank profitability not only from lending but also from other activities and transactions.

Model (1) of Panel A and Models (1) and (2) of Panel B in *Table 6* display the DID and RD regression results, respectively, on the effect of Democrat governors on the change in bank-level *LLA* that strongly support the prediction of our hypothesis (the dependent variable *LLA* is multiplied by 100 and so it is in percentage).<sup>43</sup> Banks allocate more loan loss reserves while increasing politically-favored credit supply following the election of a Democrat governor. The increased loans made by banks in Democrat states thus have higher expected losses. This finding holds after controlling for contemporaneous loan growth (*Loan growtb*), which mitigates the concern that the change in *LLA* is a mechanical result of the change in loan growth. Specifically, in the DID analysis, the estimated

<sup>&</sup>lt;sup>41</sup> Not surprisingly, the median bank in the sample does not experience any change in its annual CRA rating.

 $<sup>^{42}</sup>$  The review cycle for smaller banks – those with less than \$250 million in assets – is five years and for larger banks is two years. In our sample, most banks have assets of over \$250 million.

 $<sup>^{43}</sup>$  The caveat of this analysis is that we do not have data on *LLA* for each individual type of loans and thus cannot examine the riskiness of them separately.

coefficient  $\beta_3$  is positive and statistically significant. In the RD analysis, the estimated coefficient  $\beta_1$  is positive and significant with a much larger economic magnitude than that in the DID analysis. Based on Model (1) of Panel B, it is 0.21% which amounts to over 16% of the median *LLA* in the sample. Such an increase in *LLA* by banks in Democrat states is in sharp contrast to the annual average decrease in *LLA* of 0.0028% by sample banks. Not surprisingly, loan loss provisions (*LLP*) are positively related to *LLA* because they add to *LLA*. State GDP and GDP growth are negatively related to *LLA* and state unemployment rate is positively related to *LLA*, suggesting that banks' loan quality is higher in states with larger, healthier, and faster-growing economies. Overall, the results are consistent with *Hypothesis 2* that the increased politically-favored loans in Democrat states are riskier.

## [Table 6 goes here]

## E. More on Hypothesis 3: Bank Performance

*Hypothesis 3* states that the higher lending resulting from political influence results in poorer bank performance. Because the vast majority of our sample banks are not publicly listed, a market-based valuation is not available. We thus examine how growth in banks' operating income (*Earnings growth*) is affected following the election of a Democrat governor.<sup>44</sup> Model (2) of Panel A and Models (3) and (4) of Panel B in *Table 6* present the DID and RD regression results, respectively. Consistent with our prediction, banks suffer a relative decline in earnings growth following a Democrat governor being elected.

Specifically, in the DID analysis, the coefficient  $\beta_3$  is negative and significant. The finding is robust in the RD analysis. To ease interpretation, the dependent variable is expressed as a percentage. Economically, as shown in Model (4) of Panel B, *Earnings growth* in banks in Democrat states declines by an annual rate of 1.48%. Moreover, *Earnings growth* is positively related to the bank's loan growth and negatively related to the bank's asset size. It is also lower in states with higher GDP and in states with lower GDP growth rates and unemployment.

## F. Further Evidence on Banks' Attitude towards Political Influence: Charter Switching

Our theoretical argument implies that political influence on lending is something that will lower bank profits and hence not sought by banks. While our evidence on banks' profitability and loan risk supports this, we investigate this further by examining how the chartering decisions of banks are related to political influence. Agarwal, Lucca, Seru, and Trebbi (2014) call for future research to better

<sup>&</sup>lt;sup>44</sup> A caveat is that banks' operating income may come not only from loan performance but also from banks' services and financial market operations, with the latter not relevant to their lending decisions. We have also examined banks' operation income, instead of its growth, and find that our results do not change qualitatively.

understand why some state banks switch to a national charter despite more lenient state supervision. As discussed in Section IV, we have tested and found that the laxity of state regulators relative to federal regulators is greater under Democrat governors than under Republican governors. Hence, if state banks are more likely to switch to a national charter following the election of Democrat governors (despite their more lenient supervision), it is strongly suggestive that banks are averse to political influence on their lending. To test this, we pool bank-years of state-chartered banks and federally-chartered banks and examine the impact of the election of Democrat governors on a state bank's decision to switch to a national charter, using Specification (1) for the DID analysis and Specification (2) for the RD analysis. The dependent variable, *Federal charter*, is a dummy that equals one if a bank is federally chartered in a year and zero otherwise. We estimate using a linear probability model in both the DID analysis and the RD analysis; this allows us to apply bank fixed effects in the DID specification.

The results, presented in *Table 7* with Panel A for the DID analysis and Panel B for the RD analysis, are confirmative. Specifically, the DID coefficient  $\beta_3$  and the RD coefficients  $\beta_1$  are all positive across the models and highly significant in both models of Panel B. It suggests that state banks are more likely to switch to a federal charter following the election of Democrat governors. The significantly negative coefficient  $\beta_1$  in the DID analysis in Panel A suggests that state banks are less likely to switch their charters when Republicans win elections. Economically, the coefficient  $\beta_1$  in Model (2) of Panel B suggests that the probability of a state bank switching to a federal charter increases by 0.12% under Democrat governors. The economic impact is substantial, given the unconditional probability of a state bank switching to a federal charter in a given year for our sample is only 0.88%.

## [Table 7 goes here]

Overall, our finding of the higher likelihood of charter switching by state banks under Democrat governors is consistent with state banks shielding themselves against political influence on their lending decisions. It also provides a possible reason for the documented persistence of federal charters noted by Agarwal, Lucca, Seru, and Trebbi (2014) – the greater political pressure on state banks.

# VII. ROBUSTNESS CHECKS AND DISCUSSIONS

In this section, we conduct two additional tests, including a falsification test and a test based on a subsample of geographically-proximate banks across state borders, to address the issue of the confounding effect of economic conditions (especially the unobservables) on both election outcomes and bank capital decisions. We also exploit the heterogeneity in geographic operations among state banks, namely, whether a bank operates in its home state only or its operations span across states, and examine their differing implications for the strength of political influence. We then complement the bank-level analyses of the growth in different types of loans in Section VI.A with showing loan-level evidence of the impact of political influence on bank lending by focusing on a specific type of bank loans – mortgages to households. We further discuss and test several alternative explanations for the decline in bank equity following the election of Democrat governors. Lastly, some additional robustness checks are made.

## A. Falsification Test: Federally-Chartered Banks

In this falsification test, we exploit the within-state differences in regulation pressures on different banks due to their chartering differences. Federally-chartered banks operating in a given state are subject to the same observable and unobservable economic factors as the state banks operating in that state. However, as discussed earlier, federally-chartered banks are supervised and regulated only by federal agencies (precisely, Office of the Comptroller of the Currency), and thus state-level political influence on their decision-making is minimal. Therefore, examining the differential impact of political pressure on federally-chartered banks compared to state-chartered banks operating in that state can help to separate the impact of political pressure from the impact of unobservable economic factors.

We thus repeat the baseline DID regressions on banks' capital structure, loan-making decisions, and performance using the sample of federally-chartered banks only. As *Table 8* shows, the overall impact of the gubernatorial elections on federally-chartered banks in the state is insignificant. Specifically, as shown in Panel A, none of the coefficients  $\beta_3$  is statistically significant in all three models where bank capital, dividends, and stock sales are the dependent variables. That is, federally-chartered banks do not increase dividends and buybacks and reduce capital following the election of Democrat governors.

Panel B presents results on the growth of different types of loans made by federally-chartered banks. There is some evidence that, when Democrats become governors, banks increase real estate and C&I loans that are unlikely to be most politically-favored. In contrast, there is no significant increase in mortgage and household loans. Also, as shown in Panel C on the nature of the increased

lending by federally-chartered banks, there is no evidence that federally-chartered banks increase branches in low-income counties or have their CRA ratings improved after Democrats were elected governor. That is, new loans made by federally-chartered banks do not appear to be politically favored.

Panel D presents results on the riskiness of new loans made by federally-chartered banks and its impact on bank performance. We find that, while the new loans made by these banks in Democrat states tend to be riskier, they do not result in a decline in these banks' earnings growth following the election of Democrat governors, in sharp contrast to the new loans made by state banks.

## [Table 8 goes here]

In sum, these findings help to rule out the possibility that some unobserved state-level economic factors may have led banks to make the capital structure and lending decisions that we have documented. The evidence is consistent with Liu and Ngo (2014) who document a significant impact of state governors on bank failure for state banks, but not for federally-chartered banks.

## **B.** Geographically-Proximate Banks across State Borders

Our second additional test to address the endogeneity issue follows Cheng, Gawande, Ongena, and Qi (2021) by restricting the sample to state banks operating exclusively in counties that are geographically close and lie on either side of a state border.<sup>45</sup> It is based on the rationale that, despite being in two different states, counties that are spatially located close to each other are more similar in their macroeconomic environments to each other than to counties far away from them. Hence, by focusing on the subsample of banks operating in these neighboring counties across state borders, our estimate of the impact of political influence is less likely to be confounded by any unobservable differences in the macroeconomic environments in different states.

Specifically, we obtain each county's distance to a state border from Holmes (1998) and include in the sample only banks that have all of their operations (headquarter and branches) in counties within 50 miles of a state border.<sup>46</sup> The results of the baseline regressions, tabulated in *Table I.A.3* of the online Appendix, continue to hold generally. There are two exceptions – when dividends and branching in low-income counties are the dependent variables, the coefficient  $\beta_3$  has a positive sign as expected but becomes insignificant in both cases (t-statistics = 1.139 and 1.068, respectively); see Panels A and C. The latter case is expected because we restrict the sample to banks operating close to a state border, whose branching decisions are likely to be constrained even without political

<sup>&</sup>lt;sup>45</sup> A related identification strategy is used by Mian, Sufi, and Trebbi (2015).

<sup>&</sup>lt;sup>46</sup> There are many banks operating in counties that are within 50 miles of multiple border lines, especially those in smaller states. Our findings also hold if we exclude these banks.

influence. Overall, the finding for this subsample of banks helps to further alleviate the endogeneity concern.

### C. Heterogeneity in Geographic Operations among State Banks

We then examine how our findings differ across state banks that operate in their home states only ("single-state" banks) and state banks with cross-state operations in a year ("multi-state" banks). Intuitively, according to our hypothesis, single-state banks should be more susceptible to political influence than multi-state banks because the latter can hedge with out-of-state operations and hence have more bargaining power. Hence, the impact of the gubernatorial elections should be greater for single-state banks.

The results in *Table 9*, where we repeat the baseline regressions for the subsample of singlestate banks in the odd columns and the subsample of multi-state banks in the even columns, confirm this. We note that most banks have their operations in their chartering states only. In the table, we only tabulate the coefficients  $\beta_1$  through  $\beta_3$  but not others for brevity, while other control variables are included in the regressions.<sup>47</sup> The coefficients  $\beta_3$  in Panels A through D are consistent with their counterparts in *Tables 2, 4, 5* and 6 for the subsample of single-state banks, both economically and statistically. In contrast, the coefficients  $\beta_3$  for the subsample of multi-state banks are mostly insignificant or in the opposite signs when CRA ranking and earnings growth are the dependent variables. These findings thus provide further support for our hypothesis.

## [Table 9 goes here]

## D. Loan-level Evidence of Political Influence: Mortgage Lending to Low-income Borrowers

We next provide some loan-level evidence of the impact of political influence on bank lending by exploiting transaction-level data of mortgage lending to households. These data are more granular, with borrower characteristics that allow us to examine more closely whether politically-influenced bank lending may be targeting a specific and politically favored group of borrowers. Access to mortgage credit is vital to home ownership for underserved households. Such lending thus helps to narrow the wealth accumulation gap between the haves and the have-nots and has frequently been mentioned by politicians. Our hypothesis, in light of the greater emphasis on equity and socioeconomic issues by Democrats, predicts that state banks increase mortgage lending to underserved households more following the election of Democrats than the election of Republicans as governors.

<sup>&</sup>lt;sup>47</sup> The estimation does not somehow converge in the regression of stock sale for the subsample of multi-state banks and hence no results are reported in Panel A in that case.

Specifically, we aggregate the individual mortgage originations to the bank-state-year level. We then examine whether proportionally more low-income households apply for mortgages and whether banks allocate a greater share of their mortgage lending to low-income households following the election of Democrat governors. We do this by investigating changes in the following variables around elections: (i) The proportion of mortgage applications to a bank from low-income households among all applicants of the bank (labeled as *Mortgage application*); and (ii) the size of a bank's mortgage lending to low-income households relative to its total mortgage asset origination (*Mortgage size*) in the year. An applicant is classified as low-income if his/her income provided in the application is below the state per capita personal income in the year.

The results are tabulated in *Table I.A.4* of the online Appendix for brevity, where Panel A is for the Differences-in-differences specification (DID) and Panel B the Regression Discontinuity (RD) design. The results from both the DID and RD settings show that the proportion of mortgage applications from low-income households increases significantly following the election of Democrat governors. Moreover, the share to low-income households in banks' overall mortgage lending increases following a close election of Democrats as governor; the coefficient on *Democrat* is significantly positive in the RD setting when the polynomial order is three. The estimated coefficient on the key variable of interest, *After\*Democrat*, in the DID analysis (Panel A) of *Mortgage size* has the expected sign but is statistically insignificant. When *Mortgage size* is the dependent variable, we control for the corresponding ratio of the accepted low-income applicants' income to all accepted applicants' income on loan size.

Overall, our finding is consistent with a noteworthy role of political influence on the mortgage market that has received increasing attention (see, for example, Agarwal, Amromin, Ben-David, and Dinc (2018), Chavaz and Rose (2019), and Chu and Zhang (2022)).

## E. Tests and Discussions of Alternative Interpretations

We further discuss and test a few potential alternative interpretations for the documented banks' capital response to political influence.

## E.1. Change in investment opportunities?

Is the decrease in bank equity after the election of Democrat governors due to a decline in investment opportunities for banks? In our baseline analysis, we have controlled for a set of state-year variables that are intended to capture the change in state economic conditions. Nonetheless, we conduct a further check of several factors that might reflect banks' investment opportunities, including GDP

growth, house prices, and income inequality, all at the state-year level. We, however, do not find any significant differences in them under Democrat governors (results tabulated in *Table I.A.5* of the online Appendix).

# E.2. Change in state income tax?

Democrats and Republicans differ on tax policy, with Democrats generally favoring higher taxes. The literature has used the state income tax rate as an instrument for bank capital (e.g., Ashcraft (2008), Berger and Bouwman (2009, 2013)), arguing that a higher tax rate means lower capital.<sup>48</sup> So if a Democrat governor increases the state tax rate, banks would reduce capital. However, we do not find any evidence that state tax rates are higher under Democrat governors (results tabulated in *Table I.A.6* of the online Appendix).

# E.3. Difference in regulatory forbearance?

One may argue that Democrats are more likely to exercise regulatory forbearance, with a greater propensity to bail out failing banks. This engenders moral hazard – banks thus respond with lower capital ratios and greater risk taking. However, we are not aware of any evidence that one party has been more inclined to bail out failed banks than the other.<sup>49</sup> Also, state banks are unlikely to be too big to fail. Furthermore, even if Democrats have a great proclivity for bailouts due to TBTF concerns, it should be more evident for larger banks. This means that the effects we document should be stronger for larger banks. The results, presented in *Table I.A.7* of the online Appendix, are the opposite of what this alternative story predicts. In particular, our main finding holds only for the subsample of small banks. As discussed in the case of single-state banks above, the evidence is more consistent with small banks being more susceptible to political influence than large banks, possibly due to their lower bargaining power.

# E.4. Impact of political connection?

Banks' responses to political pressure may depend on whether they are politically connected. The literature has provided some evidence on the impact of political connection on bank behavior. For instance, using a bank's headquarter in a state with a senator sitting on the influential Senate Committee on Banking, Housing, and Urban Affairs as an indicator of the bank's political connection,

<sup>&</sup>lt;sup>48</sup> The idea is that a higher tax rate increases the value of the debt tax shield and encourages banks to keep lower equity capital.

<sup>&</sup>lt;sup>49</sup> Indeed, both parties supported providing massive taxpayer funds for bailouts of various financial institutions during the 2007-2009 crisis, and TARP was approved while President Bush (R) was in office. Ronald Reagan (R) was the President during the 1980s when numerous S&Ls were bailed out. Faced with the financial stresses associated with bank failures, bailouts appear to have bipartisan support.

Kostovetsky (2015) shows that political connection increases banks' appetite for risk taking. Using the same measure of political connection, Cheng, Gawande, Ongena, and Qi (2021) find that while banks are more cautious when facing policy uncertainty, they are less so if they are politically connected. To check whether our findings are affected by whether a bank is politically connected, we follow Kostovetsky (2015) to create a dummy variable *Senate banking committee* for each bank-year that equals one if the state bank is headquartered in a state with a senator sitting on the Senate Committee on Banking, Housing, and Urban Affairs in the year and zero otherwise. We then augment the baseline DID specification of the regressions by including it as an additional control variable. The results, tabulated in *Table I.A.8* of the online Appendix, show that our main findings remain almost intact.

To sum up, while it is impossible to completely rule out all alternative explanations for our results, we believe the decline in bank equity following the election of Democrat governors is less likely due to factors other than a rational response by banks to (real or perceived) political influence. In the interest of space, detailed discussions on the tests of the first three alternative explanations above are in the online Appendix III.

## F. Other Miscellaneous Robustness Checks

#### F.1. The parallel trend assumption in the DID analysis

Although Figure 1 shows parallel trends in bank equity prior to elections won by Democrats and Republicans, we conduct a regression analysis to verify that the key parallel trend assumption of DID estimation is satisfied. Specifically, we modify the After dummy in equation (1) with three time indicators for the examination window [-3, +3]: Before-1 for the year immediately prior to the election year (Year -1), After+1 for the year immediately after the election year (Year 1), and After+2&3 for the two years after Year 1 (Years 2&3). The original interaction term After\*Democrat is replaced by each of their interactions with Democrat accordingly. The two years prior to Before-1 (Years -2&-3) is thus the benchmark years. The results of regressions for bank capital decisions with this modified specification are reported in Panel A of Table I.A.9 of the online Appendix. The coefficient on Democrat\*Before-1 captures how the change in the dependent variable – bank equity, dividends, and stock sale, respectively - from Years -2&-3 to Year -1 differs between banks in states where Democrats and Republicans win later. None of them is statistically significant for each of the bank capital decisions, confirming the parallel trends in bank capital prior to elections for the two groups of banks. Instead, the coefficients on *Democrat\*After+1* and *Democrat\*After+2&3* reflect how the relative change of bank capital evolves from Years -2&-3 to Year 1 and to Years 2&3, respectively. The results in Model (1) show that both coefficients are negative and statistically significant. Thus, the relative

decrease in equity by banks in Democratic states occurs in the year right after the election and continues for the next two years. The relative increase in dividends paid by banks in Democratic states occurs in Years 2 and 3, while stock sale does not differ significantly from the past in any of the postelection years, which is consistent with the finding in the DID estimation.

We have also conducted the same parallel trend verification tests for all other main bank decision and outcome variables involving DID estimation and found the assumption is generally satisfied. The results are presented in the rest of panels in *Table I.A.9* of the online Appendix.

## F.2. Vote margins in the RD analysis

Lastly, we examine the robustness of our results to the selection of vote margins in the RD analysis. Specifically, we extend the vote margin to 0.25 and 0.3 and repeat the RD estimation with the polynomial order being two and three, respectively. The results, tabulated in *Table I.A.10* of the online Appendix, continue to hold.

# **VIII. CONCLUSION**

This paper has theoretically and empirically examined the idea that legislators/regulators may be motivated to influence on banks' credit allocation either through informal mechanisms like jawboning or by enacting regulations aimed at influencing bank lending. It may even be the case that banks are merely catering to what they *perveive* to be political pressure based on the stated preferences of the party in power. The political preference for such lending may arise from social efficiency considerations, fairness/equity concerns, the desire to address social problems like income inequality, and/or private benefits for politicians. Anticipation of such political pressure may encourage banks to keep lower levels of capital in order to increase their fragility, which would then dissuade legislators and regulators from putting credit allocation pressure on banks. Nonetheless, political pressure is predicted to induce banks to make more politically-favored loans that are riskier and lead to lower bank performance.

We find strong empirical support for these predictions. We proxy for political influence by linking it to the ideology of each of the two major parties, and propose, based on the previous research, that Democrats are more likely than Republicans to favor political influence on bank credit allocation to address distributional inequities and achieve other social welfare and political goals. Consistent with our theory, we find that when Democrats win gubernatorial elections, banks reduce their capital levels, increase their politically-favored lending, exhibit poorer performance, and have a higher likelihood of switching to a national charter than when Republicans win; this effect is causal. We cannot make welfare statements, however. One reason is that we find that the increased lending also boosts household consumption in the state, so it is possible that welfare is higher under Democrat governors, despite the effect on bank performance. But our results do mean that political influence on bank credit allocation may make banks more fragile and increase systemic risk, calling for a previously-unrecognized offsetting prudential regulation response. In this sense, it confirms the Calomiris and Haber (2014) hypothesis that politics and banking are inextricably linked and that politics influences bank leverage, lending, and risk.

Note that our analysis focuses on the implications of political influence on banks that lies outside of explicit changes in regulation that may result from a change in the party in the governor's mansion. If there was a legislative or regulatory change following the election of a governor from a party other than the predecessor, all banks would have little choice but to respond. But this would not be a change in bank behavior to real or perceived political pressure. Rather, it would be a response to a change in the law itself, with that change potentially attributable to a change in the political ideology of the governor. While that is an interesting topic to study in future research, it is not the goal of this paper. An interesting question on that issue would be to examine whether there was a circumventing of the regulation through the exploitation of loopholes by some banks, but that would be a very different exercise from the one in our paper. Nonetheless, some may find it surprising that there is strong evidence of statistically and economically significant effects of political ideology on bank behavior even in the absence of regulatory changes.

# Appendix: Variable Definitions

Variable	Definitions		
After	A dummy that equals one for the three years following a gubernatorial election and zero for the three years prior to the election.		
Asset (log)	The natural logarithm of book value of total assets.		
Book equity	The ratio of book value of equity to book value of total assets.		
Branch	The proportion of branches in low-income counties for a bank.		
CRA rating	Rating of a bank's CRA (Community Reinvestment Act) performance assigned at the regulator's examination: 1 = Outstanding, 2 = Satisfactory, 3 = Needs to Improve, 4 = Substantial Noncompliance.		
Democrat	A dummy that equals one if a Democrat candidate wins the gubernatorial election in the state and zero otherwise.		
Dividend	The ratio of total cash dividends paid (common dividends and preferred dividends) to book value of total assets as of the prior year end.		
Earnings	The ratio of operating income to book value of total assets as of the prior year end.		
Earnings growth	The difference between the current-year earnings and the lagged one-year earnings, divided by the lagged one-year earnings.		
Federal charter	A dummy that equals one if a bank is federally chartered in a given year and zero otherwise.		
Loan growth	The difference between total loans and the lagged one-year total loans, divided by the lagged one-year total loans.		
Loan loss allowance	The ratio of loan loss allowance to total loans (net of unearned income).		
Loan loss provision	The ratio of loan loss provision to total loans (net of unearned income).		
Mortgage applicant income	The ratio of the accepted low-income mortgage applicants' total income to all accepted mortgage applicants' total income for a bank. An applicant is classified as low-income if his/her income provided in the application is below the state per capita personal income in the year.		
Mortgage application	The proportion of low-income mortgage applicants among all applicants.		
Mortgage size	The size of a bank's mortgage lending to low-income households relative to its total mortgage asset origination.		
Predecessor	A dummy that equals one if the predecessor of a governor is Democrat and zero otherwise.		
ROA	e ratio of current-year net income to book value of total assets as of prior year end.		

ROA growth	The difference between the current year ROA and the lagged one-year ROA, divided by the lagged one-year ROA.
ROE	The ratio of net income to book value of equity as of the prior year end.
State GDP(log)	The natural logarithm of nominal GDP of the state.
State GDP growth	The ratio of the change in the nominal GDP of the state from the prior year to nominal GDP as of the prior year.
State personal income growth (PCE)	The ratio of the change in the personal income per capita of the state from the prior year to personal income per capita as of the prior year.
State unemployment rate	Unemployment rate of the state (in percentage).
Stock sale	An indicator variable that equals -1 (+1) if the bank reports negative (positive) net stock sale and zero otherwise.

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# **Table 1 Summary Statistics**

This table reports descriptive statistics for the sample. Panel A presents the distribution of gubernatorial elections from 1990 to 2012. Panel B presents the summary statistics of the sample state chartered commercial banks in the year end prior to gubernatorial elections. All variables are defined in the Appendix.

Election Year	#. Elections	#.Elections Democrats Won	Vote Margin (Mean)	Vote Margin (Median)
		Al	l elections	
1990	34	19	0.163	0.140
1991	3	2	0.183	0.223
1992	12	8	0.193	0.173
1993	2	0	0.092	0.092
1994	33	10	0.177	0.146
1995	3	1	0.134	0.111
1996	11	7	0.276	0.177
1997	2	0	0.071	0.071
1998	34	11	0.189	0.163
1999	3	2	0.241	0.326
2000	11	8	0.098	0.101
2001	2	2	0.099	0.099
2002	34	13	0.113	0.080
2003	4	0	0.110	0.101
2004	11	5	0.132	0.077
2005	2	2	0.081	0.081
2006	36	20	0.191	0.164
2007	3	1	0.232	0.174
2008	11	7	0.308	0.329
2009	2	0	0.105	0.105
2010	36	13	0.149	0.123
2011	4	2	0.232	0.212
2012	11	7	0.162	0.121
Total	304	140	0.170	0.145

#### **Panel A: Gubernatorial elections**

	Mean	Median	Std	Ν
Assets (log)	11.26	11.13	1.308	40913
Book equity	0.100	0.092	0.034	40913
Dividend	0.005	0.003	0.006	40332
Stock sale	0.049	0	0.276	22554
ROA	0.009	0.011	0.01	40913
ROA growth	-8.76e-06	2.08e-06	0.008	40913
Earnings	0.082	0.081	0.024	40913
Earnings growth	-0.04	-0.03	0.184	40903
Retained earnings	0.045	0.042	0.043	40869
ROE	0.101	0.111	0.106	40909
Loan loss allowance	0.016	0.013	0.009	40727
Loan loss provision	0.006	0.003	0.01	40719
Loan growth	0.096	0.067	0.182	40728
Branch (%)	35	0	43.40	25920
Application (%)	22.61	20	18.33	7947
Approval (%)	68.80	76.19	30.87	6620
Size (%)	13.99	9.64	15.73	6564
CRA rating	1.888	2	0.416	7268
State GDP(log)	12.04	12.05	1.01	40913
State GDP growth	0.045	0.049	0.033	40913
State unemployment rate	5.64	5.30	1.837	40913

Panel B: State-chartered bank characteristics and state characteristics as of the year prior to gubernatorial elections

## Table 2 The Effect of Democrat Governors on Bank Capital Decisions

This table presents results of regressions that examine the effect of Democrat governors on bank capital. The dependent variables are indicated on the top of each column, and *Book equity* and *Dividend* are both multiplied by 100. In Panel A (DID regressions), the sample includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. In Columns (1) and (2), linear regressions are run, while in Column (3) an ordered logistic regression is run. In Panel B, estimations are done in a regression discontinuity (RD) design for a subsample of banks in states that hold gubernatorial elections during 1990-2012. The first four models are estimated with OLS regressions in which *Book equity* and *Dividend* are the dependent variables, respectively, and the last two with ordered logistic regressions in which *Stock sale* is the dependent variable. In both panels, all variables are defined as in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

1 and 11. Dank capital av	Taner A: Dank capital decisions (DID)						
	(1)	(2)	(3)				
VARIABLES	Book equity	Dividend	Stock sale				
After	0.035***	-0.004**	0.009				
	(3.550)	(-2.297)	(0.469)				
Democrat	-0.005	-0.004	0.044				
	(-0.244)	(-1.286)	(1.215)				
After*Democrat	-0.056***	0.007**	-0.026				
	(-2.632)	(2.093)	(-0.658)				
Predecessor	-0.043*	0.001	-0.011				
	(-1.960)	(0.171)	(-0.331)				
ROA	44.577***						
	(19.806)						
ROA growth	-11.026***						
	(-7.350)						
Asset(log)	-0.891***		0.006				
	(-15.460)		(0.273)				
State GDP(log)	-0.133	0.065**	-0.002				
	(-0.481)	(2.062)	(-0.004)				
State GDP growth	-1.336***	0.112	-0.623				
	(-3.444)	(1.367)	(-0.695)				
State unemployment	-0.011	-0.000	0.028				
	(-0.688)	(-0.053)	(1.184)				
Earnings		0.048***	0.147***				
		(23.571)	(12.276)				
Prior-year dividends		27.096***					
		(42.739)					
Earnings growth			-5.306***				
			(-4.759)				
Observations	230,256	226,888	126,364				
R-squared	0.094	0.125	0.079				
Bank FE	Yes	Yes	No				
State FE	No	No	Yes				
Year FE	Yes	Yes	Yes				

Panel A: Bank capital decisions (DID)

	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	Book equity	Book equity	Dividend	Dividend	Stock sale	Stock sale
Democrat	-0.351***	-0.532***	0.037***	0.048***	-0.352**	-0.046
	(-3.302)	(-3.905)	(3.909)	(3.924)	(-2.453)	(-0.251)
Observations	81,014	81,014	80,018	80,018	35,926	35,926
R-squared	0.099	0.099	0.364	0.364	0.046	0.047
Vote margin	0.2	0.2	0.2	0.2	0.2	0.2
Polynomial order	2	3	2	3	2	3
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes

Panel B: Bank capital decisions (RD)

# Table 3 The Effect of Democrat Governors on Bank Capital Decisions in States with/without Democrat Senates

This table presents results of regressions that examine the effect of Democrat governors on bank capital decisions in two subsamples of states with/without Democrat senates. The overall sample includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. The subsample of states with Democrat senates (*Dem Senate*) is defined as those states in the sample that have Democrat senates in at least one of the three years following the gubernatorial elections, and the other subsample (*Non-Dem Senate*) is defined as the subsample of states without Democrat senates. OLS regressions are run in Models (1) to (4) with the dependent variable being *Book equity* in the first two models and *Dividend* in the last two models. Both *Book equity* and *Dividend* are both multiplied by 100. Ordered logistic regressions are run in Models (5) and (6) with the dependent variable being *Stock sale*. Other bank-level and state-level control variables are also included as in Tables 2, although their estimated coefficients are not reported. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	Non-Dem		Non-Dem		Non-Dem	
	Senate	Dem Senate	Senate	Dem Senate	Senate	Dem Senate
VARIABLES	Book equity	Book equity	Dividend	Dividend	Stock sale	Stock sale
After	0.012	0.045**	-0.005*	-0.004	-0.037	0.073**
	(0.554)	(2.386)	(-1.731)	(-1.608)	(-0.919)	(2.520)
Democrat	0.091**	0.005	-0.006	-0.013***	0.030	0.072
	(2.455)	(0.119)	(-1.308)	(-3.210)	(0.566)	(1.209)
After*Democrat	-0.087**	-0.118***	0.006	0.012***	0.055	-0.190***
	(-2.070)	(-3.826)	(1.114)	(3.153)	(0.728)	(-3.546)
Observations	102,951	127,305	100,428	126,460	54,344	72,020
R-squared	0.158	0.133	0.337	0.369	0.069	0.089
State FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes

# Table 4 The Effect of Democrat Governors on Bank Loan Growth and Household Consumption Growth

Panels A (Diff-in-diff) and B (Regression discontinuity design) present results of regressions that examine the effect of Democrat governors on bank loan growth. The sample in Panel A includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. Panel B is for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years subsequent to those elections during 1990-2012. In both panels, growth in loans of different types (mortgage, real estate, commercial & industrial, individual, and agriculture), indicated at the top, is in percentage and regressed in different columns, respectively. For each type of loans, growth in loans is measured as the difference between current-year loans and the lagged one-year loans, divided by the lagged one-year loans. All other variables are defined in the Appendix. Panel C present results of OLS regressions that examine the effect of Democrat governors on the growth in Panels A and B and at the state level in Panel C, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Growth in	n different types	of bank loans (D	<b>(D</b> )		
	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
After	-0.167	-0.472***	0.032	-0.293**	0.241
	(-1.445)	(-5.507)	(0.150)	(-2.348)	(0.718)
Democrat	-0.552**	-0.769***	-0.413	-0.350	0.530
	(-2.515)	(-4.549)	(-1.023)	(-1.562)	(0.894)
After*Democrat	0.348	0.908***	0.144	0.675**	-0.589
	(1.380)	(4.868)	(0.316)	(2.484)	(-0.813)
Predecessor	-0.381**	0.086	-0.147	0.541***	0.120
	(-2.133)	(0.612)	(-0.426)	(2.926)	(0.255)
Asset(log)	-11.128***	-11.092***	-18.380***	-11.571***	-14.864***
	(-23.543)	(-28.505)	(-12.125)	(-21.359)	(-11.826)
Loan loss					
allowance	-231.357***	-278.278***	-80.669*	-189.528***	-257.985***
	(-10.760)	(-16.839)	(-1.911)	(-8.549)	(-5.110)
Book equity	120.054***	104.554***	117.521***	99.823***	41.568**
	(14.879)	(16.671)	(6.236)	(11.454)	(2.202)
ROE	1.365	4.075***	20.586***	7.758***	8.851
	(0.780)	(3.051)	(6.301)	(4.153)	(1.609)
State GDP(log)	16.025***	12.750***	18.690***	1.865	-7.702
	(6.600)	(6.577)	(3.644)	(0.923)	(-1.366)
State GDP growth	-10.439**	7.974**	22.846**	18.858***	-15.828
	(-1.970)	(2.070)	(2.027)	(3.598)	(-1.027)
State					
unemployment	-2.342***	-2.059***	-1.614***	-1.705***	-0.198
	(-14.599)	(-17.252)	(-4.644)	(-10.790)	(-0.387)
Observations	224,560	225,840	122,904	225,311	161,651
R-squared	0.056	0.092	0.026	0.051	0.006
Bank FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

I uner Di Growe	n m uniei ent	types of built								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
			Real	Real	Commercial	Commercial				
VARIABLES	Mortgage	Mortgage	Estate	Estate	& Industrial	& Industrial	Individual	Individual	Agriculture	Agriculture
Democrat	2.849***	2.381***	3.156***	0.325	0.372	2.062	3.097***	2.438**	2.178	2.455
	(3.999)	(2.622)	(5.616)	(0.450)	(0.236)	(0.939)	(4.165)	(2.503)	(0.983)	(0.834)
Observations	79,805	79,805	80,180	80,180	35,351	35,351	79,964	79,964	55,975	55,975
R-squared	0.030	0.030	0.056	0.057	0.028	0.029	0.030	0.030	0.005	0.005
Vote margin	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Polynomial										
order	2	3	2	3	2	3	2	3	2	3
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

## Panel B: Growth in different types of bank loans (RD)

	(1)	(2)
VARIABLES	State PCE Growth	State PCE Growth
After	-0.092*	-0.086**
	(-1.976)	(-2.027)
Democrat	-0.219	-0.166*
	(-1.652)	(-1.682)
After*Democrat	0.174*	0.163*
	(1.717)	(1.678)
Predecessor	0.047	0.019
	(0.635)	(0.229)
State GDP(log)	0.018	-0.562
	(0.300)	(-0.429)
State GDP growth	24.111***	20.973***
	(6.867)	(7.328)
State unemployment	-0.216***	-0.482***
	(-4.395)	(-5.336)
Observations	1,076	1,076
R-squared	0.867	0.895
State FE	No	Yes
Year FE	Yes	Yes

Panel C: State-level personal consumption expenditure growth

## Table 5 The Effect of Democrat Governors on the Nature of Bank Lending

Panels A (Diff-in-diff) and B (Regression discontinuity design) present results of regressions that examine the effect of Democrat governors on the nature of bank lending. The sample in Panel A includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. Panel B is for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years subsequent to those elections during 1990-2012. The dependent variables in each column are indicated at the top, where *Branching* is the proportion of branches in low-income counties for a bank in the year and *CRA Rating* is rating of a bank's CRA (Community Reinvestment Act) performance assigned at the regulator's examination: 1 =Outstanding, 2 =Satisfactory, 3 =Needs to Improve, 4 =Substantial Noncompliance. All other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Nature of lending (DID)					
	(1)	(2)			
VARIABLES	Branching	CRA Rating			
After	-0.270**	0.007***			
	(-2.278)	(2.770)			
Democrat	0.067	0.002			
	(0.269)	(0.410)			
After*Democrat	0.596**	-0.018***			
	(2.274)	(-3.010)			
Predecessor	0.538**	-0.013***			
	(2.143)	(-2.682)			
ROA	-39.698**	-1.324***			
	(-2.455)	(-2.793)			
ROA growth	-16.110	0.977**			
	(-1.421)	(2.298)			
Asset(log)	-1.220**	-0.018**			
	(-2.539)	(-1.963)			
State GDP(log)	5.873	0.044			
	(1.479)	(0.718)			
State GDP growth	11.859**	-0.135			
	(2.289)	(-0.938)			
State unemployment	-0.064	0.017***			
	(-0.285)	(4.038)			
Observations	167,011	47,084			
R-squared	0.002	0.059			
Bank FE	Yes	Yes			
Year FE	Yes	Yes			

# Panel A: Nature of lending (DID)

### Panel B: Nature of lending (RD)

	(1)	(2)	(3)	(4)
VARIABLES	Branching	Branching	CRA Rating	CRA Rating
Democrat	-0.364	3.245*	-0.066***	-0.025*
	(-0.242)	(1.719)	(-3.535)	(-1.675)
Observations	64,665	64,665	17,686	17,686
R-squared	0.052	0.053	0.067	0.068
Vote margin	0.2	0.2	0.2	0.2
Polynomial order	2	3	2	3
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

## Table 6 The Effect of Democrat Governors on Loan Quality and Bank Performance

Panels A (Diff-in-diff) and B (Regression discontinuity design) present results of regressions that examine the effect of Democrat governors on bank loan loss allowance and performance. The dependent variables in each column are indicated at the top, where *LLA* is the ratio of loan loss allowance to total loans (net of uncarned income) and *Earnings growth* is the growth in earnings which is defined as the ratio of operating income to book value of total assets as of the prior year end. Both *LLA* and *Earnings growth* are multiplied by 100. The sample in Panel A includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. Panel B is for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years subsequent to those elections during 1990-2012. All other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Loan quality and bank performance (DID)			
	(1)	(2)	
VARIABLES	LLA	Earnings Growth	
After	-0.018***	0.205***	
	(-6.152)	(4.250)	
Democrat	-0.000	0.315***	
	(-0.051)	(3.610)	
After*Democrat	0.036***	-0.383***	
	(5.766)	(-3.656)	
Predecessor	0.017***	-0.179**	
	(2.785)	(-2.506)	
Asset(log)	-0.078***	-3.588***	
	(-6.444)	(-18.065)	
Loan growth	-0.887***	31.062***	
	(-47.699)	(57.367)	
State GDP(log)	-0.099	-2.884***	
	(-1.492)	(-3.101)	
State GDP growth	-0.632***	4.040*	
	(-5.458)	(1.653)	
State unemployment	0.047***	0.585***	
	(10.914)	(8.785)	
Loan loss provision	30.713***		
	(57.560)		
Loan loss allowance		41.342***	
		(4.484)	
Observations	229,009	227,111	
R-squared	0.253	0.258	
Bank FE	Yes	Yes	
Year FE	Yes	Yes	

	(1)	(2)	(3)	(4)
			Earnings	Earnings
VARIABLES	LLA	LLA	Growth	Growth
Democrat	0.210***	0.104***	-1.265***	-1.478***
	(8.329)	(3.248)	(-4.255)	(-3.741)
Observations	80,595	80,595	80,610	80,610
R-squared	0.266	0.266	0.203	0.203
Vote margin	0.2	0.2	0.2	0.2
Polynomial order	2	3	2	3
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

Panel B: Loan quality and bank performance (RD)

## Table 7 The Effect of Democrat Governors on Charter Switching by Banks

Panels A (Diff-in-diff) and B (Regression discontinuity design) present results of regressions that examine the effect of Democrat governors on banks' chartering decisions. The dependent variable is *Federal charter*, a dummy that equals one if a bank is federally chartered in a year and zero otherwise. The sample in Panel A includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. Panel B is for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years subsequent to those elections during 1990-2012. In both panels, all other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Switching to Federal Charter (DID)			
	(1)		
VARIABLES	Federal charter		
After	-0.001*		
	(-1.686)		
Democrat	-0.000		
	(-0.371)		
After*Democrat	0.001		
	(1.078)		
Predecessor	-0.001		
	(-0.921)		
ROA	-0.325***		
	(-3.878)		
ROA growth	0.042		
	(0.878)		
Asset(log)	-0.005*		
	(-1.839)		
State GDP(log)	-0.020		
	(-1.236)		
State GDP growth	0.001		
	(0.037)		
State unemployment	0.002**		
	(2.120)		
Observations	313,846		
R-squared	0.010		
Bank FE	Yes		
Year FE	Yes		

## Panel B: Switching to Federal Charter (RD)

	(1)	(2)
VARIABLES	Federal charter	Federal charter
Democrat	0.094***	0.116***
	(8.607)	(8.332)
Observations	224,247	224,247
R-squared	0.040	0.040
Vote margin	0.2	0.2
Polynomial order	2	3
Controls	Yes	Yes
Year FE	Yes	Yes

## Table 8 The Effect of Democrat Governors: Evidence from Federally Chartered Banks

This table presents results of the diff-in-diff (DID) regressions that examine the effect of Democrat governors on various bank decisions in different panels for the sample of all federally chartered commercial banks that operate in the states of the sample state banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. In Panel A, bank equity, dividends, and stock sale are the dependent variables as in Table 2. In Panel B, growth in loans of different types (mortgage, real estate, commercial & industrial, individual, and agriculture), indicated at the top, is regressed in different columns as in Table 4, respectively. In Panel C, bank branching decisions and CRA ratings are examined as in Table 5. In Panel D, bank loan loss allowance and earnings growth are the dependent variables as in Table 6, respectively. All other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Bank capital de	ecisions (DID)		
	(1)	(2)	(3)
VARIABLES	Book equity	Dividend	Stock sale
After	0.054*	-0.003	-0.040
	(1.828)	(-0.783)	(-1.128)
Democrat	-0.075	-0.008	0.055
	(-1.178)	(-1.190)	(0.896)
After*Democrat	-0.090	0.008	0.032
	(-1.452)	(0.963)	(0.438)
Predecessor	-0.073	-0.013*	0.147**
	(-1.125)	(-1.929)	(2.463)
ROA	69.506***		
	(6.598)		
ROA growth	-31.712***		
	(-4.408)		
Asset(log)	-2.039***		0.028
	(-7.372)		(0.944)
State GDP(log)	-0.307	0.082**	-0.903
	(-0.361)	(2.056)	(-1.181)
State GDP growth	-5.073***	0.141	-1.563
	(-4.099)	(0.839)	(-1.034)
State unemployment	0.072	-0.013***	-0.027
	(1.443)	(-2.634)	(-0.656)
Earnings		0.043***	0.022***
		(14.315)	(4.282)
Prior-year dividends		15.103***	
		(13.973)	
Earnings growth			1.048
			(0.934)
Observations	83,590	81,454	52,217
R-squared	0.093	0.086	0.047
Bank FE	Yes	Yes	No
State FE	No	No	Yes
Year FE	Yes	Yes	Yes

	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
After	-0.205	-0.257	-0.462	-0.345*	-0.894
	(-0.950)	(-1.639)	(-1.397)	(-1.771)	(-1.343)
Democrat	-0.503	-0.675**	-1.387**	-0.066	-0.615
	(-1.252)	(-2.187)	(-2.546)	(-0.164)	(-0.496)
After*Democrat	0.532	0.673*	1.202*	0.671	2.337
	(1.099)	(1.874)	(1.758)	(1.490)	(1.485)
Predecessor	-0.595*	-0.243	0.405	1.110***	0.798
	(-1.698)	(-0.954)	(0.792)	(3.415)	(0.833)
Asset(log)	-13.009***	-12.003***	-15.359***	-12.457***	-24.566***
	(-13.945)	(-16.726)	(-10.896)	(-15.253)	(-9.646)
Loan loss	-	-		-	
allowance	171.629***	223.709***	-30.098	115.312***	-63.874
	(-4.969)	(-8.134)	(-0.648)	(-3.469)	(-0.611)
Book equity	70.832***	57.247***	63.517***	51.531***	4.348
	(4.540)	(4.660)	(2.849)	(3.444)	(0.093)
ROE	5.020*	5.199**	18.105***	7.204***	7.702
	(1.797)	(2.490)	(5.702)	(2.605)	(0.777)
State GDP(log)	2.590	2.009	7.528	-0.153	-1.672
	(1.280)	(1.264)	(1.558)	(-0.051)	(-0.313)
State GDP growth	19.197**	28.357***	30.837**	50.496***	24.468
	(2.139)	(4.085)	(2.012)	(5.555)	(0.728)
State					
unemployment	-3.194***	-2.563***	-1.743***	-1.214***	1.262
	(-10.837)	(-11.480)	(-4.047)	(-4.477)	(1.308)
Observations	80,178	80,408	52,104	80,769	59,159
R-squared	0.045	0.067	0.039	0.053	0.008
Bank FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

\_\_\_\_

# Panel B: Growth in different types of bank loans (DID)

# Panel C: Nature of lending (DID)

	(1)	(2)
VARIABLES	Branching	CRA Rating
After	0.125	-0.009
	(0.601)	(-1.438)
Democrat	-0.129	-0.001
	(-0.296)	(-0.104)
After*Democrat	-0.483	0.014
	(-0.966)	(0.981)
Predecessor	-0.560	0.014
	(-1.345)	(1.177)
ROA	7.002	-3.177**
	(0.264)	(-2.546)

ROA growth	-16.393	2.554**
	(-1.041)	(2.455)
Asset(log)	-1.631**	-0.003
	(-2.068)	(-0.138)
State GDP(log)	-2.428	0.072
	(-0.840)	(1.205)
State GDP growth	11.156	-0.203
	(1.358)	(-0.519)
State unemployment	0.174	0.006
	(0.482)	(0.568)
Observations	53,374	7,389
R-squared	0.003	0.051
Bank FE	Yes	Yes
Year FE	Yes	Yes

# Panel D: Loan quality and bank Performance (DID)

	(1)	(2)
		Earnings
VARIABLES	LLA	growth
After	-0.029***	0.024
	(-5.041)	(1.501)
Democrat	0.007	0.019
	(0.588)	(0.516)
After*Democrat	0.059***	-0.044
	(4.713)	(-1.244)
Predecessor	0.040***	-0.027
	(3.582)	(-0.891)
Asset(log)	-0.092***	-0.679***
	(-3.521)	(-5.106)
Loan growth	-0.845***	5.070***
	(-25.420)	(25.985)
State GDP(log)	-0.076	-0.774
	(-1.101)	(-1.317)
State GDP growth	-0.803***	1.217
	(-3.729)	(1.542)
State unemployment	0.066***	0.052*
	(8.051)	(1.908)
Loan loss provision	30.910***	
	(30.307)	
Loan loss allowance		-10.595**
		(-2.560)
Observations	81,436	81,523
R-squared	0.267	0.391
Bank FE	Yes	Yes
Year FE	Yes	Yes

## Table 9 The Effect of Democrat Governors: Single- vs. Multi-state banks

This table presents results of the diff-in-diff (DID) regressions that examine the effect of Democrat governors on various bank decisions in different panels in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012 for the subsamples of state banks that operate only in their home states (single-state, in the odd columns) and state banks that have cross-state operations in a year (multi-state banks, in the even columns). In Panel A, bank equity, dividends, and stock sale are the dependent variables as in Table 2. In Panel B, growth in loans of different types (mortgage, real estate, commercial & industrial, individual, and agriculture), indicated at the top, is regressed in different columns as in Table 4, respectively. In Panel C, bank branching decisions and CRA ratings are examined as in Table 5. In Panel D, bank loan loss allowance and earnings growth are the dependent variables as in Table 6, respectively. All other control variables are included but not tabulated. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

1 aner 11. Dank capital av					
	(1)	(2)	(3)	(4)	(5)
VARIABLES	Book equity	Book equity	Dividend	Dividend	Stock sale
Bank operation	Single-state	Multi-state	Single-state	Multi-state	Single-state
After	0.039***	-0.008	-0.004**	0.006	-0.001
	(3.908)	(-0.123)	(-2.269)	(0.539)	(-0.042)
Democrat	0.002	0.005	-0.004	0.005	0.029
	(0.085)	(0.052)	(-1.035)	(0.268)	(0.783)
After*Democrat	-0.065***	0.021	0.007**	-0.014	-0.003
	(-3.055)	(0.147)	(2.040)	(-0.562)	(-0.073)
Other controls	Yes	Yes	Yes	Yes	Yes
Observations	221,223	9,033	218,126	8,762	122,308
R-squared	0.099	0.127	0.123	0.116	0.083
Bank FE	Yes	Yes	Yes	Yes	No
State FE	No	No	No	No	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

Panel A:	Bank (	canital	decisions	(DID)
I and A.	Dank	capitai	uccisions	$(\nu I \nu)$

Tanci D. Olowu	Taner D. Growth in different types of bank loans (DID)									
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
					Commercial	Commercial				
VARIABLES	Mortgage	Mortgage	Real Estate	Real Estate	& Industrial	& Industrial	Individual	Individual	Agriculture	Agriculture
							Single-	Multi-		
Bank operation	Single-state	Multi-state	Single-state	Multi-state	Single-state	Multi-state	state	state	Single-state	Multi-state
After	-0.210*	0.847	-0.481***	-0.075	-0.011	-1.069	-0.320**	0.029	0.277	-3.634
	(-1.789)	(1.200)	(-5.562)	(-0.150)	(-0.049)	(-0.900)	(-2.519)	(0.038)	(0.822)	(-1.375)
Democrat	-0.573**	-0.496	-0.781***	-0.936	-0.563	-0.747	-0.342	-0.878	0.660	-7.271*
	(-2.565)	(-0.433)	(-4.527)	(-1.117)	(-1.381)	(-0.329)	(-1.511)	(-0.636)	(1.112)	(-1.719)
After*Democrat	0.445*	-1.893	0.936***	0.137	0.265	1.767	0.723***	-0.067	-0.625	7.498
	(1.746)	(-1.154)	(4.979)	(0.118)	(0.573)	(0.634)	(2.625)	(-0.039)	(-0.862)	(1.228)
Other controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	216,167	8,393	217,322	8,518	119,223	3,681	216,778	8,533	155,681	5,970
R-squared	0.056	0.124	0.092	0.159	0.027	0.038	0.052	0.071	0.006	0.032
Bank FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

## Panel B: Growth in different types of bank loans (DID)

	(1)	(2)	(3)	(4)	
VARIABLES	Branching	Branching	CRA Rating	CRA Rating	
Bank operation	Single-state	Multi-state	Single-state	Multi-state	
After	-0.248**	-0.327	0.009***	-0.026**	
	(-2.014)	(-0.830)	(3.144)	(-2.140)	
Democrat	0.161	-1.276*	0.004	-0.032	
	(0.623)	(-1.701)	(0.742)	(-1.144)	
After*Democrat	0.555**	0.805	-0.020***	0.057**	
	(2.046)	(0.837)	(-3.366)	(2.036)	
Other controls	Yes	Yes	Yes	Yes	
Observations	159,568	7,443	45,062	2,022	
R-squared	0.002	0.021	0.061	0.093	
Bank FE	Yes	Yes	Yes	Yes	
Year FE	Yes	Yes	Yes	Yes	

# Panel C: Nature of lending (DID)

# Panel D: Bank Performance (DID)

	(1)	(2)	(3)	(4)	
VARIABLES	LLA	LLA	Earnings	Earnings	
Bank operation	Single-state	Multi-state	Single-state	Multi-state	
After	-0.018***	-0.012	0.015***	-0.106***	
	(-6.125)	(-0.925)	(2.827)	(-2.730)	
Democrat	0.001	-0.029	0.008	-0.078	
	(0.204)	(-1.108)	(0.787)	(-1.280)	
After*Democrat	0.037***	0.023	-0.026**	0.248***	
	(5.761)	(0.817)	(-2.337)	(2.807)	
Other controls	Yes	Yes	Yes	Yes	
Observations	220,218	8,791	220,309	8,801	
R-squared	0.248	0.403	0.624	0.583	
Bank FE	Yes	Yes	Yes	Yes	
Year FE	Yes	Yes	Yes	Yes	

**Figure 1:** Yearly Plot of Average Equity Ratios of State Chartered Banks in Democrat States vs. Republican States around Gubernatorial Elections.



This figure plots the time-series of the annual average *Book equity* of sample banks for the sevenyear window [-3, +3] around gubernatorial elections in year 0. One plot pertains to banks in states in which Democrats won and the other plot pertains to banks in states in which Republicans won.
## Political Influence, Bank Capital, and Credit Allocation

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Anjan V. Thakor

December 2022

Online Appendix

#### Political Influence, Bank Capital, and Credit Allocation

#### **ONLINE APPENDIX I: The Model**

Consider an economy with three dates: t = 0, 1, 2. All agents are risk neutral and the riskless interest rate is zero. The main agents are banks, depositors, borrowers, and legislators/regulators. For simplicity, deposits are uninsured and available in elastic supply at an expected return of zero.<sup>50</sup> For each dollar of deposits, depositors enjoy a value of liquidity services of  $\gamma \in (0,1)$ .<sup>51</sup>

The sequence of events is as follows. At t=0, an election outcome is observed. The winning governor is either a Democrat or a Republican.<sup>52</sup> Each bank, after observing the election outcome, determines its capital structure and raises D in deposits/debt financing and E in equity such that:

$$D + E = L \tag{1}$$

where *L* is the size of the loan to be made at t=1.

At t=1, the winning governor observes the bank's capital, experiences the random realization of a strength of personal preference for the bank to make a politically-preferred loan, and determines whether to exert credit-allocation influence on the bank. This will be made precise shortly.

There are three types of (pairwise mutually exclusive) loans in the feasible set:  $\{G, P, B\}$ . A *G* loan is a socially-efficient loan that pays off x > 0 with probability  $q \in (0,1)$  at t=2 and zero with probability 1-*q*. If the loan pays off zero, then we view it as a loan default that leads to bank failure. *P* is the politically-preferred loan. It confers political benefits on the winning party. It pays off x with probability  $p \in (0,1)$  at t=2 and zero with probability 1-p. We assume:

$$qx > px > L. \tag{2}$$

This means that both G and P are positive-NPV loans for the bank, but G is more profitable than  $P^{53}$  However, the P loan also produces political benefits  $\tilde{\beta} \in \{\beta_1, \beta_2\}$  with  $0 < \beta_1 < \beta_2 < \infty$ . At t=0, it is common knowledge that  $\tilde{\beta} = \beta_1$  with probability  $\delta \in (0,1)$  and  $\tilde{\beta} = \beta_2$  with probability

<sup>&</sup>lt;sup>50</sup> Partial deposit insurance, which is the case in practice, leaves the analysis unchanged.

<sup>&</sup>lt;sup>51</sup> See Song and Thakor (2007) for example.

<sup>&</sup>lt;sup>52</sup> For clearer identification, we exclude Independents from the analysis. See Section IV for more discussions on this.

<sup>&</sup>lt;sup>53</sup> See the earlier discussion in Section II.B of the empirical evidence supporting the assumption that politicallypreferred loans tend to be riskier and less profitable for banks than other loans.

 $1-\delta$  at t=1. That is, the realization of i occurs at t=1. Consistent with our previous discussion, we assume that the political benefit is enjoyed only by Democrat governors and not Republican governors. In general, we just need i to be higher for Democrats.

The *B* loan is one that produces no contractible payoff at t=2, but yields the manager a random private benefit  $\tilde{\pi} \in \{\tilde{\pi}_{\ell}, \tilde{\pi}_{h}\}$  with  $0 < \pi_{\ell} < \pi_{h} < \infty$ , and  $\pi_{h} < L$ .

That is, *B* is socially inefficient. Viewed at t=0,  $Pr(\tilde{\pi} = \pi_h) = \xi$  and  $Pr(\tilde{\pi} = \pi_\ell) = 1-\xi$ . The bank's loan choice is made after it *privately* observes the realized  $\tilde{\pi}$ .

The bank regulator exerted at t=1 the credit-allocation influence favored by the government, if there is any. The bank's choice set for loans is  $c_1 = \{G, B\}$  and  $c_2 = \{P, B\}$ . The regulator can pressure the bank to choose  $c_2$  — that is what we call *credit-allocation pressure*. However, within a choice set  $c_i (i \in \{1, 2\})$ , the bank can choose *B* unobservably, i.e., while the regulator can ensure that the bank lends from  $c_1$ , it cannot ensure with probability one that the bank will not choose *B*. The probability that regulatory supervision can prevent the bank from choosing *B* when it would like to is  $\theta \in (0,1)$ .

At t=2, the loan payoff is realized and depositors are paid off by the bank if its contractible cash flow (x) permits it. If the bank fails (contractible payoff of zero), depositors receive nothing. While realized payoffs on P and B are commonly observed at t=2, the realization of  $\tilde{\pi}$  is privately observed by the bank and the realization of  $\tilde{\beta}$  is privately observed by the politician (governor or state bank regulator appointed by the governor). The probability distributions of  $\tilde{\beta}$  and  $\tilde{\pi}$  are common knowledge. Figure 1 summarizes the sequence of events.

[Figure I.A.1 goes here]

The politician's objective function is:

$$W_{i} = \begin{cases} \alpha_{1}Pr \text{ (bank does not fail at t=2)} \\ +\alpha_{2}Pr \text{ (bank makes } P \text{ loan)}\beta & \text{if } i = \text{Democrat} \\ Pr \text{ (bank does not fail at t=2)} & \text{if } i = \text{Republican.} \end{cases}$$
(3)

where  $\alpha_1 > 0$  and  $\alpha_2 > 0$  are constants. We will also assume that:

$$px + \beta_2 < qx, \tag{4}$$

so G loan has a higher social efficiency than the P loan, including its political benefit.54

The *bank insider's objective function* is to maximize the sum of the private benefit from the loan and the net present value (NPV) of the bank's shareholders at t=0 (with its capital structure choice) and to maximizes the sum of the private benefit from the loan and the value of equity at t=1 (with the loan choice). The assumption is that *G* and *P* are mutually exclusive, and *B* is mutually exclusive with *G* as well as *P*. Thus, we are assuming that the bank has a capacity constraint and cannot make all loans that may be profitable.<sup>55</sup> This capacity constraint may either be justified based on incentive problems that generate an optimal finite size (as in Millon and Thakor (1985)) or limited bank equity capital in a general equilibrium setting (as in Allen, Carletti, and Marquez (2015)). <sup>56</sup> That is, we take bank size as fixed and then examine its loan portfolio and capital structure decisions, as in previous capital structure theories of banks and non-banks. Alternatively, *P* may have a negative NPV for the bank, with the regulator's political or social welfare benefit from *P* being large enough to override the bank's loss from the loan. Our analysis goes through with either specification.

In reality, banks make both the loans they prefer to make and the loans they make with regulatory nudging. Our set-up readily accommodates this. To see this, suppose that a regulatory mandate to invest in *P* takes the form of the bank investing in a fraction  $\lambda \in (0,1)$  of its portfolio in *P* loans and the rest in either *P* or *G* (the bank clearly prefers *G*). Assume that the bank's loan portfolio payoffs are linear in the investment made in the loan for all types of loans, and that the probability of success of *P* is  $\hat{p} < p$ , with  $\lambda \hat{p} + [1 - \lambda]q \equiv p$ . Thus, the expected payoff to the bank on a *loan portfolio* consisting of both *P* and *G* is px, which satisfies (2) and (3), while its expected payoff when it faces no credit-allocation pressure and chooses *G* is qx. The analysis that follows is entirely consistent with this specification.<sup>57</sup> Thus, our maintained assumption throughout the analysis is that both *G* and *P* are positive-NPV loans for the bank, but *G* is more profitable.

<sup>&</sup>lt;sup>54</sup> This assumption is not crucial to the analysis in the following sense. Suppose px < qx but  $px + \beta_2 > qx$ . Then, taking into account political benefits, *P* has higher social efficiency than *G* when  $\tilde{\beta} = \beta_2$ . In this case, the political creditallocation pressure is also welfare enhancing. None of our results is affected by this change. With (4), our analysis implies that politics will influence bank lending even when it is not welfare enhancing.

<sup>&</sup>lt;sup>55</sup> Such mutual exclusivity is standard in models in which bank capital acts as an incentive device for prudent lending, e.g., Holmstrom and Tirole (1997) and Mehran and Thakor (2011).

<sup>&</sup>lt;sup>56</sup> Thus, in our model, credit-allocation pressure induces changes in bank lending at the intensive margin, not the extensive margin. In addition to capacity constraints, bank managers may have incentives to avoid *P* because these loans are less profitable and lead to lower ROE, reducing executive bonus.

<sup>&</sup>lt;sup>57</sup> This specification is an example of a more general setting in which we can think of the payoffs on P and G as the overall payoffs on the bank's asset portfolio when it invests in P and G respectively. That is, these payoffs would also include income from other sources like fee income and returns on security investments. The bank would then make a loss on P and yet be profitable on the portfolio that contains P. if having a license to operate necessitates investing in P, the

#### Results

Throughout the analysis, we will impose the following restrictions on the deep parameters.

**Restriction 1:** 
$$\pi_h - \pi_\ell > x[q-p]$$
 (A-5)

#### That is, the spread between $\pi_h$ and $\pi_\ell$ is greater than the difference in the expected values of G and P.

This restriction simply means that the high private benefit associated with B is higher than the sum of the low private benefit and the expected value difference between the G and P loans. This ensures that higher (equity) capital is needed to induce the bank to choose G when B has a high private benefit than to choose P when B has a low private benefit.

**Restriction 2:** 
$$qx\xi[1-\theta][\xi\theta+1-\xi]^{-1} > \pi_h$$
 (A-6)

#### That is, the expected value of G sufficiently exceeds $\pi_h$ .

This restriction is sufficient to ensure that when there is no political influence on credit allocation, the bank will prefer G in all states of the world in the second best.

**Restriction 3:** 
$$\theta < \min\{\theta^0, \hat{\theta}\}$$
 (A-7)

where  $\theta^0$  is the solution to

$$\theta \left[ 1 - \xi^2 \theta - 2\xi [1 - \xi] \right] - \left[ 1 - \xi \right]^2 = 0 \tag{A-8}$$

and

$$\hat{\theta} = \{1 + 2\xi [1 - \xi]\} [2\xi^2]^{-1}.$$
(A-9)

Note that if  $\theta < \hat{\theta}$ , then the derivative of the left-hand side of (A-8) with respect to  $\theta$  is increasing in  $\theta$ .

That is, the regulatory probability of preventing the bank from choosing B when the bank prefers to do so,  $\theta$ , is small enough.

The purpose of this restriction is to ensure that the politician/regulator is sufficiently concerned about risk shifting by the bank that low bank capital will deter credit-allocation pressure with positive probability. For example, if  $\theta = 1$ , then all risk-shifting moral hazard vanishes and there would be credit-allocation pressure regardless of bank capital.

bank's participation constraint for operating will be satisfied even with P because the bank is profitable overall, even though it has a lower profitability with P than with G. Of course, P could just as well be a positive-NPV loan in this case.

We now begin by stating the bank's capital structure choice in the first best case in which the bank's loan choice is observable and the socially-efficient loan G is chosen. For expositional continuity, all proofs are placed right after the model.

*Lemma 1:* The first best involves the bank choosing an all-deposit capital structure at t=0 and investing in G at t=1.

The intuition is straightforward. Since G has the highest value among all three loans, it is chosen by the bank at t=1. Deposits have associated with them liquidity services that depositors value, which reduces the interest rate banks have to pay on deposits. This makes deposits preferred over equity, leading to an all-debt capital structure at t=1.<sup>58</sup>

We now turn to the second best and analyze how the bank's preferences for the different types of loans change with its capital level.

**Proposition 1:** There exist four bank capital levels in the second best  $\hat{E}_h^* > E_h^* > \hat{E}_\ell^* > E_\ell^* > 0$  chosen at t=0:

(i) If  $\tilde{\pi} = \pi_h$ , then the bank prefers P to B if  $E \ge \hat{E}_h^*$ , and B to P if  $E < \hat{E}_h^*$ . It prefers G to B if  $E \ge E_h^*$ , and B to G if  $E < E_h^*$ .

(ii) If 
$$\tilde{\pi} = \pi_{\ell}$$
, then the bank prefers P to B if  $E \ge \hat{E}_{\ell}^*$ , and B to P if  $E < \hat{E}_{\ell}^*$ . It prefers G to B if  $E \ge E_{\ell}^*$ , and B to G if  $E < E_{\ell}^*$ .

To see the intuition, note first that equity capital is needed in the second-best case to give the bank skin-in-the-game to make prudent loan choices. Consider the bank's private benefit realization  $\tilde{\pi} = \pi_h$ . In this case, the temptation to choose *B* is the greatest. So the highest amount of capital is needed to deter the bank from doing so. This is  $\hat{E}_h^*$  if the bank's choice set is  $\{P, B\}$ , and it is  $E_h^*$  if the bank's choice set is  $\{P, B\}$ , and it is  $E_h^*$  if the bank's choice set is  $\{G, B\}$ . The reason why  $\hat{E}_h^* > E_h^*$  is that *G* is a higher-valued loan than *P*, so the moral hazard in the bank being tempted to choose *B* is greater with *P* than with *G*.

When the bank's private benefit realization is  $\tilde{\pi} = \pi_{\ell}$ , the moral hazard of the bank choosing *B* is smaller. Thus,  $\hat{E}_{\ell}^* < \hat{E}_{h}^*$  and  $E_{\ell}^* < E_{h}^*$ . The reason why  $E_{\ell}^* < \hat{E}_{\ell}^*$  is the same as the reason why  $E_{h}^* < \hat{E}_{h}^*$ . The reason why  $E_{h}^* > \hat{E}_{\ell}^*$  is Restriction 1.

<sup>&</sup>lt;sup>58</sup> Subsidized deposit insurance or taxes will also lead to the same all-debt capital structure.

**Proposition 2:** In the second best, if the bank is free to choose its lending from either  $c_1$  or  $c_2$ , it will choose a capital structure with  $E = E_h^*$  and make the G loan.

The intuition is that G has the highest expected value and in equilibrium this loan surplus accrues to the bank, so G is chosen. Choosing P is dominated for two reasons: (i) It requires the bank to keep higher capital to persuade depositors that it will not choose B; (ii) it is less profitable.

**Proposition 3:** (Regulatory Policy) There exists a set  $(\underline{\beta}, \overline{\beta})$  of positive measure such that if  $\beta_1 \in (\underline{\beta}, \overline{\beta})$  and  $\beta_2 > \overline{\beta}$ , then the regulator will pressure the bank to invest in loan P at t=1 with probability 1 if  $E \ge \hat{E}_{\ell}^*$  was chosen at t=0, and with positive probability less than 1 if  $E \in [E_{\ell}^*, \hat{E}_{\ell}^*)$  was chosen at t=0.

The intuition is as follows. When the bank chooses  $E \ge \hat{E}_{\ell}^*$  at  $\ell=0$ , the regulator knows that the bank will prefer *P* to *B* if  $\tilde{\pi} = \pi_{\ell}$ . If  $\tilde{\pi} = \pi_h$ , the bank will prefer *B*, but the regulator can prevent this choice with probability  $\theta$ , so credit-allocation pressure is attractive if  $\beta_2$  is large enough. When  $E < \hat{E}_{\ell}^*$ , the regulator knows that the bank will always prefer *B* to *P*, so it must rely exclusively on its own auditing to prevent *B* from being chosen. However, if  $E \in [E_{\ell}^*, \hat{E}_{\ell}^*]$ , the bank will prefer *G* to *B* if  $\tilde{\pi} = \pi_{\ell}$ , so the probability of bank failure is lower *without* credit-allocation pressure than with such pressure. In this case, if  $\tilde{\beta} = \beta_1$ , the regulator prefers not to impose credit-allocation pressure, but if the political benefit of *P* is high ( $\tilde{\beta} = \beta_2$ ), the credit-allocation pressure is imposed.

# **Proposition 4:** (Bank's Capital Structure) In a Nash equilibrium, given the regulator's behavior, the bank chooses $E = E_{\ell}^*$ at t=0.

This is our central result. The bank knows that any  $E \ge \hat{E}_{\ell}^*$  will result in credit-allocation pressure with probability one. If  $E \in [E_{\ell}^*, \hat{E}_{\ell}^*)$ , then we know from our earlier analysis that  $E_{\ell} = E_{\ell}^*$  is the best choice for the bank in this set. By choosing  $E = E_{\ell}^*$ , the bank reduces the probability of being pressured to choose *P* below 1. Dropping *E* below  $E_{\ell}^*$  is not optimal for the bank because then there is no cost to the regulator of imposing credit-allocation pressure (since the bank prefers *B* in all states regardless of whether it is free to choose *G* or being pressured to choose *P*), so credit-allocation pressure will occur with probability 1. Moreover, if  $\theta$  is low enough, the bank may be unable to raise financing in this case. Figure 2 presents the probability of credit-allocation pressure as a function of bank capital.

[Figure I.A.2 goes here]

#### **PROOFS OF THE MODEL:**

**Proof of Lemma 1**: The NPV of G to insiders at t=0 is:

$$q[x-D_R]-E \tag{A-10}$$

where the repayment obligation on deposits,  $D_R$ , solves:

$$q[D_{R} + \gamma D] = D$$
  
yielding  
$$D_{R} = D[1 - \gamma q][q]^{-1}.$$
 (A-11)

Substituting (A-11) back in (A-10) gives us:

$$q\left[x - D\left[1 - \gamma q\right]\right] \left[q\right]^{-1} - E \tag{A-12}$$

which upon simplification (recognizing that D + E = L) yields:

$$qx - L[1 - \gamma q] - E\gamma q \tag{A-13}$$

which is strictly decreasing in *E*. Thus, if the bank intends to choose *G* at t=1, it will choose to be alldebt financed at t=0.

Next, *B* can never be chosen when depositors can observe the bank's loan choice because they receive no repayment. The insiders will not self-finance because of the negative NPV of B, which implies

$$\xi \pi_h + [1 - \xi] \pi_\ell < L$$

The NPV of *P* to insiders at t=0 is

$$px - L[1 - \gamma q] - E\gamma q \tag{A-14}$$

which is positive but less than the expression in (A-13).

**Proof of Proposition 1:** We will solve for the capital cutoffs that ensure that the bank will prefer not to invest in *B*.

First, the incentive compatibility condition for the bank to prefer *G* to *B* at t=1 for any realization of  $\pi$  is:

$$q[x-D_r] \ge \pi_h \tag{A-15}$$

Since this constraint will bind in equilibrium, we can solve for (A-15) as an equality and derive:

$$E_{h}^{*} = \frac{\pi_{h} - qx + L[1 - \gamma q]}{1 - \gamma q}.$$
 (A-16)

Proceeding similarly, we can derive:

$$\hat{E}_h^* = \frac{\pi_h - px + L[1 - \gamma q]}{1 - \gamma q} \quad . \tag{A-17}$$

Now suppose we want the bank's incentive compatibility (IC) condition to only be satisfied when  $\tilde{\pi} = \pi_{\ell}$ . Then the IC constraint for the bank to prefer *P* to *B* is:

$$p[x-D_R] \ge \pi_\ell \tag{A-18}$$

where  $D_R$  solves

$$\left\{\xi\theta + 1 - \xi\right\} p \left[D_R + \gamma D\right] = D \tag{A-19}$$

where we recognize that if  $\pi_h$  occurs (probability  $\xi$ ), then the bank will choose G only when the regulator can prevent the choice of B (probability  $\theta$ ). Thus,

$$D_{R} = DB_{1}p^{-1} \tag{A-20}$$

where

$$B_1 \equiv \frac{1 - \gamma p \left\{ \xi \theta + 1 - \xi \right\}}{\xi \theta + 1 - \xi} \,. \tag{A-21}$$

Substituting for  $D_R$  in (A-18) and solving it as an equality yields:

$$\hat{E}_{\ell}^{*} = \frac{\pi_{\ell} - px + LB_{1}}{B_{1}}.$$
(A-22)

Similarly, the IC constraint for the bank to prefer G to B when  $\tilde{\pi} = \pi_{\ell}$  yields:

$$E_{\ell}^* \equiv \frac{\pi_{\ell} - qx + LA_1}{A_1} \tag{A-23}$$

where

$$A_{\rm I} = \frac{1 - \gamma q \left\{ \xi \theta + 1 - \xi \right\}}{\xi \theta + 1 - \xi} \quad . \tag{A-24}$$

By inspection, it is obvious that  $\hat{E}_{h}^{*} > E_{h}^{*}$ ,  $\hat{E}_{h}^{*} > \hat{E}_{\ell}^{*}$ ,  $\hat{E}_{\ell}^{*} > E_{\ell}^{*}$ , and  $E_{h}^{*} > E_{\ell}^{*}$ . This is because  $B_{1} > 1 - \gamma p$  and  $A_{1} > 1 - \gamma q$ . What remains to be proved is that  $E_{h}^{*} > \hat{E}_{\ell}^{*}$ . This requires showing

$$\frac{\pi_h - qx + L[1 - rq]}{1 - \gamma q} > \frac{\pi_\ell - px + LB_1}{B_1} \tag{A-25}$$

with some algebra, it can be shown that (A-25) is satisfied because (A-5) holds.

**Proof of Proposition 2:** Suppose the bank chooses G at t=1 and  $E_h^*$  at t=0. Then the NPV of its shareholders at t=0 is:

$$qx - L[1 - \gamma q] - E_h^* rq \,. \tag{A-26}$$

Substituting for  $E_h^*$  from (A-16) and simplifying, we get:

$$\frac{q\left[x-\gamma\pi_{h}\right]}{1-\gamma q}-L.$$
(A-27)

Now suppose the bank chose  $E_{\ell}^{*}$  at t=0 and then G at t=1. Then the NPV to its shareholders at t=1 is:

$$\left[\xi\theta + 1 - \xi\right]\left[qx - A_{\mathrm{I}}L + A_{\mathrm{I}}E_{\ell}^{*} - E_{\ell}^{*}\right] + \xi\left[1 - \theta\right]\left[\pi_{h} - E_{\ell}^{*}\right]$$
(A-28)

where  $A_1$  is defined in (A-24) and we recognize that the bank will choose *B* with probability  $\xi[1-\theta]$ . Substituting for  $E_{\ell}^*$  from (A-23) and simplifying (A-28) yields:

$$\frac{qx}{A_{l}} + \xi [1-\theta]\pi_{h} - L - \pi_{\ell} [\xi\theta + 1 - \xi] \left\{ \frac{\gamma q [\xi\theta + 1 - \xi]}{1 - \gamma q [\xi\theta + 1 - \xi]} \right\}$$
(A-29)

Tedious algebra shows that (A-6) is a sufficient (not necessary) condition for the expression in (A-27) to be strictly greater than the expression in (A-29).

So we have proved that the bank prefers G with  $E_h^*$  to G with  $E_\ell^*$ . It is obvious that the bank prefers G with  $E_h^*$  to P with  $\hat{E}_h^*$  (since  $\hat{E}_h^* > E_h^*$ ). Moreover, given that G with  $E_h^*$  dominates G with  $E_\ell^*$ , it also follows that G with  $E_h^*$  dominates P with  $\hat{E}_\ell^*$ . Note that B is not an option. If  $E < E_\ell^*$ , no financing is available for  $\theta$  low enough.

## **Proof of Proposition 3: Case 1:** First consider $\hat{E}_h^*$ .

Now,

$$\Pr(\text{bank will not fail}) = p. \tag{A-30}$$

Using (3) we can write (using "d" for "Democrat"):

$$W_d = \alpha_1 p + \alpha_2 \tilde{\beta} \tag{A-31}$$

as the value of the politician's objective function if choice of *P* is forced. If the bank is free to choose its loan, then

Pr(bank will not fail) = q

since the bank will choose G (given that  $\hat{E}_h^* > E_h^*$ ), and

$$W_d = \alpha_1 q \,. \tag{A-32}$$

For the politician to prefer to impose credit-allocation pressure, we need

$$\alpha_2 \beta_1 > \alpha_1 [q - p]. \tag{A-33}$$

#### *Case 2:* $E = E_h^*$

If the choice of *P* is forced, then:

$$Pr(bank will not fail) = \xi \theta p + [1 - \xi] p$$
(A-34)

and

$$W_d = \alpha_1 \left\{ \xi \theta \, p + \left[ 1 - \xi \right] \, p \right\} + \alpha_2 \left[ \xi \theta + 1 - \xi \right] \tilde{\beta} \,. \tag{A-35}$$

If the choice of *P* is not forced, then:

$$Pr(bank will not fail) = q \tag{A-36}$$

and

$$W_d = \alpha_1 q \,. \tag{A-37}$$

For the politician to prefer to impose credit-allocation pressure, we need the expression in (A-35) to exceed that in (A-37). This will happen if:

$$\beta_1 > \frac{\alpha_1 \left[ q - \theta \xi p - [1 - \xi] p \right]}{\xi \theta + 1 - \xi}.$$
(A-38)

Now since

$$\frac{q-\xi\theta p-[1-\xi]p}{\xi\theta+1-\xi} > q-p,$$

we can say that if (A-38) holds, so will (A-33). So (A-33) is redundant.

## *Case 3:* $E = \hat{E}_{\ell}^{*}$

If the choice of *P* is forced:

$$Pr(bank will not fail) = \xi \theta p + [1 - \xi] p$$
(A-39)

$$W_{d} = \alpha_{1} \left\{ \xi \theta p + \left[ 1 - \xi \right] p \right\} + \alpha_{2} \left[ \xi \theta + 1 - \xi \right] \tilde{\beta} .$$
(A-40)

If the choice of *P* is not forced:

 $\Pr(\text{bank will not fail}) = \theta \xi q + [1 - \xi] q \tag{A-41}$ 

$$W_d = \alpha_1 \left\{ \theta \xi q + [1 - \xi] q \right\}. \tag{A-42}$$

For the politician to prefer to pressure credit allocation with P, we need the expression in (A-40) to exceed that in (A-42). This will be true if

 $\alpha_2 \beta_1 > \alpha_1 [q-p]$ 

which obviously holds given (A-38).

#### *Case 4:* $E = E_{\ell}^{*}$

If the politician forces a choice of P, the bank always prefers B. So:

$$Pr(bank will not fail) = \theta p \tag{A-43}$$

and

$$W_d = \alpha_1 \theta \, p + \alpha_2 \theta \tilde{\beta} \,. \tag{A-44}$$

If the choice of *P* is not forced:

$$\Pr(\text{bank will not fail}) = \xi \theta q + [1 - \xi] q \tag{A-45}$$

and

$$W_d = \alpha_1 \Big[ \xi \theta q + \{1 - \xi\} q \Big]. \tag{A-46}$$

For the politician to prefer to pressure credit allocation with P, we need the expression in (A-44) to exceed that in (A-46) for  $\beta = \beta_2$  and for the expression in (A-46) to exceed that in (A-44) for  $\tilde{\beta} = \beta_1$ . This will happen if

$$\beta_2 > \frac{\alpha_1 \left[ \xi \theta q + \left[ 1 - \xi \right] q - \theta p \right]}{\alpha_2 \theta} \tag{A-47}$$

and

$$\beta_1 < \frac{\alpha_1 \left[ \xi \theta q + \left[ 1 - \xi \right] q - \theta p \right]}{\alpha_2 \theta}.$$
(A-48)

To ensure that (A-38) and (A-48) can be simultaneously satisfied, we need:

$$\frac{\xi\theta q + [1-\xi]q - \theta p}{\theta} > \frac{q - \xi\theta p - [1-\xi]p}{\xi\theta + 1 - \xi}.$$
(A-49)

Simplifying, we see that this requires that

$$\theta \{ 1 - \xi^2 \theta - 2\xi (1 - \xi) \} - [1 - \xi]^2 < 0.$$
(A-50)

Now as long as  $\theta < \hat{\theta}$ , we can show that the left-hand side of (A-50) is strictly increasing in  $\theta$ . Let  $\theta^0$  be the solution to . Then, we know that if  $\theta < \hat{\theta}$  and  $\theta < \theta^0$ , (A-50) will hold. Thus, (A-7) guarantees that (A-49) holds. Given this, define

$$\underline{\beta} \equiv \frac{\alpha_1 \left[ q - \xi \theta p - [1 - \xi] p \right]}{\xi \theta + 1 - \xi},\tag{A-51}$$

$$\overline{\beta} \equiv \frac{\alpha_1 \left[ \xi \theta q + [1 - \xi] q - \theta p \right]}{\xi \theta + 1 - \xi} \tag{A-52}$$

and we know that when (A-49) holds,  $(\underline{\beta}, \overline{\beta})$  has positive measure.

Thus, if  $\beta_1 \in (\underline{\beta}, \overline{\beta})$  and  $\beta_2 > \overline{\beta}$ , then the politician will impose a choice of P with probability one in Cases 1, 2 and 3 (i.e., for  $E \ge \hat{E}_{\ell}^*$ ), and will impose a choice of P with  $E = E_{\ell}^*$  only when  $\tilde{\beta} = \beta_2$  (probability  $1 - \delta \in (0, 1)$ ).

#### Proof of Proposition 4:

For any  $E \ge \hat{E}_{\ell}^*$ , the politician always chooses to impose a choice of *P*. Given this, we know that  $\hat{E}_{\ell}^*$  dominates either or  $E_h^*$  or  $\hat{E}_h^*$  since  $\hat{E}_{\ell}^* < \hat{E}_h^*$ . So we just need to compare  $E_{\ell}^*$  and  $\hat{E}_{\ell}^*$ .

The bank's NPV at t=0 with  $E_{\ell}^*$  is:

$$q\left[x-D_{R}^{0}\right]\left[\xi\theta+1-\xi\right]+\xi\left[1-\theta\right]\pi_{h}-E_{\ell}^{*}$$
(A-53)

and with  $\hat{E}^{*}_{\ell}$  it is

$$p\left[x-\hat{D}_{R}\right]\left[\xi\theta+1-\xi\right]+\xi\left[1-\theta\right]\pi_{h}-\hat{E}_{\ell}^{*}$$
(A-54)

where

$$D_{R}^{0} = DA_{1}q^{-1} \tag{A-55}$$

and  $\hat{D}_R$  is given by (A-20), i.e.,  $\hat{D}_R = DB_1 p^{-1}$ . Thus,  $D_R^0 < \hat{D}_R$ . Since  $E_\ell^* < \hat{E}_\ell^*$ , it follows that the expression in (A-49) exceeds that in (A-50)

Figure I.A.1: Sequence of Events

t=0	I	t=1	t=2
• Election outco	me is revealed.	Winning politician observes	• All payoffs realized and
• Banks choose	capital structure	realized value of $\dot{i}$ , observes	depositors and bank
and raise debt	(deposits) and	bank capital structure and	shareholders paid off.
equity financin	g.	decides whether to impose	
		credit-allocation pressure.	
		• Bank chooses loan from $l_1$ or	
		$C_2$ after receiving (real or	
		perceived) regulatory pressure.	
		• Regulator is able to prevent	
		choice of $B$ with probability $\theta$ in	
		states in which bank prefers B.	

Figure I.A.2. Probability of Credit-allocation Pressure as a Function of Bank Capital



## ONLINE APPENDIX II: Examples of Formal and Informal Political Influence on Banks Exerted by Democratic Politicians

#### A. Examples of Formal Legislations

According to the release of The Illinois Department of Financial and Professional Regulation on May 19, 2022, Governor Pritzker (D) signed House Bill 5194, the Illinois Banking Development Districts Act, into law. This legislation creates a new incentive program for the creation of bank branches in underserved communities. The program uses public linked deposits and Community Reinvestment Act (CRA) examination standards to attract bank branches to underserved communities, similar to a program in New York. Like the New York program, banks and local governments in Illinois will jointly create a plan for a new banking development district in an area of need. The Illinois Department of Financial and Professional Regulation will evaluate these plans in consultation with the Illinois State Treasurer and approve plans that create consumer friendly bank options in underserved areas. The New York Banking Development Districts program has been active since 1997 and has led to over 30 new banking development districts, over 60,000 new banking accounts, and generated over \$500 million in new credit to underserved households.

See also the press release of The Office of the Governor of New Mexicans on March 1, 2022 that Governor Grisham (D) signed House Bill 132, reforming predatory lending practices by lowering the cap on small loan interest rates from 175% to 36%. "As we continue to grow our economy and create quality jobs for New Mexicans across the state, protecting New Mexico consumers remains critically important," said Governor Grisham, "After many years of effort by advocates and legislators, I am glad to finally sign this legislation into law and deliver common-sense protections to vulnerable New Mexicans in rural and urban communities statewide."

#### **B.** Examples of Direct Guidance

Example 1: New York Governor Hochul (D) announced on April 15, 2022 that she was issuing guidance to expand access to low-cost bank accounts for New Yorkers in recognition of National Financial Literacy Month. The new DFS (Department of Financial Services) guidance encourages state-regulated banks to offer "Bank On" certified accounts to fulfill the state's affordable banking requirements. Bank On accounts eliminate overdraft fees and are critical to attracting individuals from underserved communities into the banking system. These reforms are critical to help low-income New Yorkers access affordable, FDIC-insured banking options that protect and grow hard-earned savings.

This builds on the Governor's financial inclusion agenda that includes tackling debt and surprise billing, helping families and those with student loans, strong consumer protection and transparency requirements for financial products and other recent actions to help New Yorkers gain financial security. "Financial literacy is an essential life skill for everyone's financial wellbeing, and that is why New York State continues to take bold steps to increase access to affordable banking services," Governor Hochul said. Superintendent of Financial Services Adrienne A. Harris said, "The ability to have a bank account is fundamental to the idea of financial health. Through both Bank On and Basic Banking accounts, more New Yorkers can have access to safe, affordable banking services that eliminate a number of fees, including overdraft, inactivity and low balance fees."

Example 2: New York Governor Hochul (D) announced actions on September 26, 2022 to engage New York's financial services industry to support the residents of Puerto Rico in the aftermath of Hurricane Fiona. The Department of Financial Services issued guidance calling on New York statechartered banks to take all reasonable steps to assist consumers and businesses affected by the hurricane, including waiving ATM and late fees, increasing ATM withdrawal limits, and facilitating and expediting the transmission of funds. "These actions will help ease financial burdens for the many New Yorkers seeking to support family and friends in Puerto Rico, as well as anyone in Puerto Rico with New York bank accounts," Governor Hochul said.

Example 3: The PA CARE Package launched by Pennsylvania Attorney General Josh Shapiro on March 30, 2020, a voluntary consumer-relief initiative asking banks and other lenders to offer additional financial support to people across the Commonwealth. Lenders that joined the PA CARE Package initiative pledged to offer consumers relief that went beyond the protections required by the federal CARES Act.

#### C. Examples of Implicit Pressure or Informal Influence

### C.1. Examples of lawmakers, government administrations, and activists pushing for a stateowned bank

Example 1: According to the report titled "N.J. considers setting up nation's second public bank" by Associate Press on November 13, 2019, "New Jersey would become the second state with a publicly run bank — after North Dakota and its century-old institution — under the aims of an executive order Democratic Gov. Phil Murphy signed on Wednesday. Murphy campaigned on creating a state-run bank that uses some state deposits for projects considered worthwhile, like low-income housing

and student loans...... The idea is that state deposits currently sitting in large international banking institutions would instead go into the public bank, which could then provide what Murphy described as 'below market rate capital' to 'creditworthy and socially beneficial projects,' like infrastructure and small business lending, along with affordable housing and higher education loans. Murphy said any state deposits already in community banks could stay there."

Example 2: In support of House Bill 41 – Maryland State Bank Task Force – Establishment that established the Maryland State Bank Task Force to review and evaluate the creation of a Maryland State Bank, Peter Franchot, Comptroller of Maryland, stated in his testimony on March 23, 2021 that "Most of our tax dollars are held in banks that are not focused on our communities. A state bank could hold tax dollars focused on investing in projects that benefit low income, underbanked Marylanders that are commonly overlooked. Exploring this idea, at the very least, is good government and just common sense."

Example 3: According to a media article titled "Activists, lawmakers say Massachusetts public bank is solution to lending disparities" by Sam Turken on February 3, 2022, "As recently as 2011, after the Great Recession, Massachusetts lawmakers created a commission to consider the feasibility of setting up a public bank to help people access credit. The commission ultimately argued against the idea, and support fizzled out after a report from the Federal Reserve Bank of Boston said it would cost \$3.6 billion for Massachusetts to create a public bank similar in size to North Dakota's bank. The idea has become popular again as the COVID-19 pandemic has highlighted gaps in affordable financing. This public bank will make sure that the resources are available not only to the community, but also to financial institutions for partnership and to make sure that they can provide the services to the community members that they are trying to integrate into the broader economy and financial system in Massachusetts,' state Rep. Nika Elugardo said during a recent press conference...... 'We're seeing in the state [a] climate crisis, housing crisis,' said state Sen. Jamie Eldridge, who backs the public bank legislation. This bill would really provide a boost of support for a lot of important projects that would help the commonwealth as a whole.' The State House and Senate's Joint Committee on Financial Services is currently considering the proposal. Supporters want the state to fund the bank with \$50 million annually for four years with federal pandemic relief money. Then, the bank would become self-sufficient, like a private bank."

#### C.2. Examples of events that honor some banks for making loans to underserved communities

#### and special loan programs for minority groups

Example 1: Oregon Governor Brown (D) lauded Wells Fargo's investment of \$5.4 million worth of grants aimed at helping Oregon's minority-owned small businesses. The bank awarded grants to two Community Development Financial Institutions and a chamber of commerce. The money came through Wells' Open for Business Fund, a broader \$420 million initiative the bank says is meant to help small businesses recover. "This \$5.4 million investment in our state will help local CDFIs and nonprofits provide much needed access to capital, as well as technical assistance and experts who can help Black, Indigenous, Latino, Latina, Latinx, Asian, Pacific Islander and Native American entrepreneurs adapt and sustain their business," Brown is quoted as saying in a statement. "I appreciate Wells Fargo's efforts and am proud to support its commitment to Oregon's small businesses."

Example 2: Oregon Governor Brown (D) proclaimed October 17-22 of 2022 as "Community Bank Week". The week honored local banks and their employees for their economic and civic contributions in communities across the state. Oregon's community banks, most of which are chartered by the Division of Financial Regulation, play an essential role in promoting the economic health and prosperity of the state. In some communities, they are the sole provider of banking products and services and sometimes the largest employer. Community banks donate millions of dollars each year to nonprofits and local organizations. "Our state banks continue to support small businesses and agriculture in Oregon, as well as provide banking services and create thousands of jobs," said TK Keen, administrator for the Oregon Division of Financial Regulation. "State banks are also invested in their communities through their 64,000 volunteer hours each year and the millions of dollars they have pledged to support nonprofits and other endeavors throughout the state."

Example 3: In November 2020, Washington Governor Inslee (D) approved a foundational investment of \$30 million for the state Department of Commerce to create a recovery loan program. Commerce is partnering with several financial institutions and community-based organizations to lend \$100 million or more to small businesses and nonprofits with fewer than 50 employees and annual revenues of less than \$3 million. Small business owners and nonprofits across Washington can apply for low interest loans of up to \$150,000 in 60- or 72-month loan terms through the newly-launched Small Business Flex Fund. The Fund is a public-private partnership aimed at helping small businesses and nonprofits – particularly those in low-income communities – recover and grows as communities across the state reopen for business. "Reopening our economy is an incredible milestone and we want

to ensure that our smallest businesses and nonprofits have equitable access to flexible financial support to get back on their feet," said Inslee. "The Small Business Flex Fund will not only aid in our businesses' recovery from the pandemic, but it will allow them to plan ahead, grow and thrive. And this is a tool that will remain available over many years, to bolster our smallest businesses and nonprofit organizations in times of economic hardship."

Example 4: We now provide an example of a Democrat mayor celebrating a bank making more minority loans. According to a news report titled "TCF announces \$1 billion investment in loans for minority-owned businesses" reported in Bridge Michigan on July 24, 2020: : "TCF Bank and Detroit Mayor Mike Duggan announced Thursday that the bank will try to address long-standing racial discrimination in lending by making it possible for more people of color to receive financing. TCF is creating a \$1 billion loan program for minority and women-owned businesses in Detroit and several other cities. Start-ups and existing businesses can apply for loans as small as \$10,000 and up to \$1 million. Duggan said he asked business leaders in Detroit to do something major to help fight systemic racism in the city and in the country. 'For a corporate leader, many of whom are running publicly traded corporations, it's a lot easier to write a check than to make a clear moral statement at a time of political tension, yet every one of them did it,' Duggan said. Duggan believes drastic steps — which include putting up a billion dollars in loan funds — is the best way for Black Detroiters to gain the capital they have been denied for decades."

#### C.3. Opinions of state politicians in social media

Example: Here is a quote from Oregon Governor Brown's Facebook post on March 19, 2020: "Every Oregonian should have access to loans that can keep their small business afloat through this storm – but research shows that nationally, women- and minority-owned businesses are getting less aid."

## ONLINE APPENDIX III: Bank Capital Responses by Election Outcomes and Tests of Alternative Explanations

#### A. Bank Capital Responses by Election Outcomes

To see the impact of the anticipated regulation change, we analyze banks' capital responses separately under four different election scenarios: "R-D" in which a Democrat candidate wins the election while her predecessor is a Republican; "D-R" in which a Republican candidate wins the election while her predecessor is a Democrat; "R-R" in which both the winner and the predecessor are Republicans; and "D-D" in which both the winner and the predecessor are Democrats. We thus examine banks' capital structure decisions under each scenario of the four election outcomes separately, based on the following specification:

$$Y_{ijt} = \beta_0 + \beta_1 A f ter + \beta_2 X_{it} + \beta_3 S_{jt} + \mu_t + \mu_i + \epsilon_{ijt},$$

where all variables are defined as in Specification (1).<sup>59</sup> Of central interest is  $\beta_1$ , which captures how bank capital responds to an election outcome. For "R-D",  $\beta_1$  captures the average change in bank capital when the state transitions from a Republican governor to a Democrat governor. We expect a negative  $\beta_1$  in the case of "R-D", and the opposite in the case of "D-R". In the cases of "R-R" and "D-D", we expect either an insignificant  $\beta_1$  in both scenarios due to no change in the political party, or a weakly positive  $\beta_1$  for "R-R" and a weakly negative  $\beta_1$  for "D-D" if running another term by the same party reinforces the political influence from the prior term.

The results obtained from linear regressions under the four scenarios separately discussed above are reported in *Table I.A.2* of this online Appendix. The coefficient  $\beta_1$  is negative for "R-D" and highly significant, with economic magnitude being larger than that obtained in the pooled regression in Model (1) of Panel A in *Table 2*. It suggests that banks reduce capital substantially following the victory of a Democrat candidate when the predecessor is a Republican. And banks increase capital significantly following the victory of a Republican candidate who has a Democrat predecessor, as shown by the positive and statistically significant coefficient  $\beta_1$  for "D-R". The coefficient  $\beta_1$  is positive for "R-R" and negative for "D-D", but neither significantly different from

<sup>&</sup>lt;sup>59</sup> We note that this analysis is also subject to the endogeneity of the election outcomes; and it imposes the assumption that bank capital decisions are responding differently to other economic factors in the four different election scenarios (i.e., different coefficients on the same economic variables in different scenarios), which seems to not be realistic. Thus, we use this analysis as a robustness check only and focus primarily on the pooled sample while controlling for the party of the elected governor's predecessor.

zero, economically or statistically. Thus, banks do not seem to change their capital ratios when the election results in no change in the ruling party.

#### **B.** Alternative Explanation 1: Change in Investment Opportunities?

To see whether the documented decline in bank equity is due to changes in banks' investment opportunities, we check whether such changes occur during the six-year window around gubernatorial elections. Specifically, we use a state's GDP growth, housing price, and income inequality in a given year to measure investment opportunities in the state-year. For housing price, we take the FHFA (Federal Housing Finance Agency) House Price Index (HPI), a broad measure of the movement of single-family house prices. For income inequality, we use the Gini coefficient from U.S. State-level Income Inequality Data provided by Mark W. Frank on his website.<sup>60</sup> We then run the DID regressions of Specification (1) with the dependent variables being the three measures. The results are presented in *Table I.A.5* of this online Appendix. We find that none of the DID coefficients  $\beta_3$  is statistically significant across all measures with or without state fixed effects applied in the regressions. Hence, our finding is unlikely due to changes in banks' investment opportunities.

#### C. Alternative Explanation 2: Change in State Income Tax?

To see whether our finding is due to changes in state tax, we examine how the changes, if any, varies during the six-year window around gubernatorial elections. We take the maximum state income tax rates provided by the NBER; these are calculated from a run of the TAXSIM model.<sup>61</sup> For any given year for a state, we categorize it into one of the following three groups and assign to it a value of 1 (-1) if there is an increase (decrease) in the state income tax rate from the prior year and 0 if there is no change. We then run an ordered logit regression using the same benchmark DID regressions of Specification (1) as in our tests of bank decisions with the dependent variable being the category variable just defined. State-level characteristic variables such as GDP, GDP growth, and unemployment rate are included as controls, together with both state and year fixed effects. If the state income tax rate is more likely to increase under a Democrat governor, we would expect a positive coefficients  $\beta_3$  are not significant, regardless of whether state fixed effects are applied or not. That is, there is no significant difference in the change in state income taxes across different election

<sup>&</sup>lt;sup>60</sup> https://www.shsu.edu/eco\_mwf/inequality.html

<sup>&</sup>lt;sup>61</sup> Here is the website for the data: http://users.nber.org/~taxsim/state-rates/. For more details, see Feenberg and Coutts (1993) and the website <u>http://users.nber.org/~taxsim/</u> for more on the TAXSIM model.

scenarios. It suggests that our main finding is unlikely to be driven by a significant difference in income tax rate changes following elections.

#### D. Alternative explanation 3: Difference in Regulatory Forbearance?

This alternative explanation for our findings that Democrats are more likely to exercise regulatory forbearance which engenders moral hazard runs into two difficulties. First, Republicans are considered more business-friendly than Democrats,<sup>62</sup> so they may actually be viewed as being more likely to bail out failing banks, implying that the issue of which party is more prone to bailouts is theoretically somewhat unclear. There is no empirical evidence that one party has been more inclined to bail out failed banks than the other.

Second, state banks, the focus of our study, are unlikely to be TBTF. Third, even if Democrats have a great proclivity for bailout due to TBTF concerns, the effects should be more evident for larger banks. We conduct a test of this prediction by regressing bank capital based on Specification (1) in the two subsamples of large vs. small banks, respectively. Specifically, we classify a bank as a small bank if its asset size is below the yearly sample median, and as a large bank otherwise.

The results, presented in *Table I.A.7* in this online Appendix, show that our main finding holds only for the subsample of small banks. Therefore, this further evidence suggests that the regulatory forbearance explanation is unlikely to account for our main finding. Instead, the evidence is more consistent with small banks being more susceptible to political influence possibly due to their lower bargaining power. For instance, small banks are more likely to have their business concentrated within a state, while large banks can have more cross-border business (or more credibly threat to expand beyond state borders).

<sup>&</sup>lt;sup>62</sup> For example, see the 2016 Republican and Democratic Party Platforms discussed earlier.

#### Table I.A.1 The Effect of Democrat Governors on Federal-state Spread in CAMELS

This table presents results of OLS regressions that examine the effect of Democrat governors on the state-level federalstate spread in CAMELS (reported in Figure IV in Agarwal, Lucca, Seru, and Trebbi (2014)), labeled as *State lenience*. Columns (1) and (2) are for the full sample, while Columns (3) and (4) are for the subsample of states that did not experience any change in the ruling gubernatorial party during 1996-2011. *Democrat* is an indicator for a Democrat governor in the state-year. For each variable starting with "Bank", it is the median of the respective measure of all sample banks in the state-year. For instance, *Bank equity* is the median *Book equity* of banks in the state-year, where *Book equity* is defined in the Appendix. All other variables are defined in the Appendix. Robust standard errors are clustered at the calendar year level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
	State	State	State	State
VARIABLES	lenience	lenience	lenience	lenience
Democrat	0.021***	0.021***	0.104***	0.096***
	(3.569)	(3.881)	(16.569)	(11.641)
State GDP(log)	0.007***	0.005***	0.013***	-0.004
	(8.836)	(7.179)	(5.429)	(-1.464)
State GDP growth	0.055	-0.019	0.071	0.124
	(0.700)	(-0.234)	(0.355)	(1.217)
State unemployment	0.006***	0.004***	-0.002	0.011***
	(5.764)	(3.206)	(-0.441)	(3.773)
Bank equity		-1.663***		-0.116
		(-5.048)		(-0.228)
Bank loan loss allowance		-2.658***		-5.289
		(-3.263)		(-1.446)
Bank ROA		1.187***		-3.198***
		(3.411)		(-7.241)
Bank non-performing loans		0.810*		-1.678
		(2.045)		(-1.503)
Observations	658	656	137	137
R-squared	0.057	0.107	0.513	0.794
Year FE	Yes	Yes	Yes	Yes

#### Table I.A.2 The Effect of Gubernatorial Election Outcome on Bank Equity

This table presents results of regressions that examine the effect of gubernatorial election on bank capital. The dependent variable is *Book equity*, the ratio of book value of equity to book value of total assets. It is multiplied by 100 to scale up the coefficients on independent variables. The sample includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. There are four scenarios of the election outcomes, each indicated at the top of each column: "R-D" in which a Democratic candidate wins the election while her predecessor is a Republican; "D-R" in which a Republican candidate wins the election while her predecessor are Democrats. *After* is a dummy that equals one for the three years following a gubernatorial election and zero for the three years prior to the election. All other variables are defined as in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
VARIABLES	R-D	D-R	R-R	D-D
After	-0.239***	0.093**	0.011	-0.002
	(-4.572)	(2.192)	(0.794)	(-0.081)
ROA	41.125***	50.884***	36.219***	49.987***
	(8.886)	(12.796)	(9.808)	(15.990)
ROA growth	-9.239***	-17.248***	-5.099**	-15.090***
	(-3.153)	(-6.791)	(-2.203)	(-7.318)
Asset(log)	-1.127***	-0.880***	-0.846***	-1.015***
	(-9.392)	(-9.179)	(-10.371)	(-9.844)
State GDP(log)	1.533**	0.054	0.954*	-0.832*
	(2.065)	(0.064)	(1.821)	(-1.705)
State GDP growth	-0.286	0.630	-4.013***	-0.455
	(-0.313)	(1.148)	(-6.117)	(-0.811)
State unemployment	0.014	0.022	-0.045**	0.014
	(0.387)	(0.733)	(-2.101)	(0.550)
Observations	35,231	45,668	84,020	65,337
R-squared	0.094	0.111	0.082	0.109
Bank FE	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

#### Table I.A.3 The Effect of Democrat Governors: Evidence from Geographically Close Banks across State Borders

This table presents results of the diff-in-diff (DID) regressions that examine the effect of Democrat governors on various bank decisions in different panels for the sample of state commercial banks that operate exclusively within 50 miles of their state borders in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. In Panel A, bank equity, dividends, and stock sale are the dependent variables as in Table 2. In Panel B, growth in loans of different types (mortgage, real estate, commercial & industrial, individual, and agriculture), indicated at the top, is regressed in different columns as in Table 4, respectively. In Panel C, bank branching decisions and CRA ratings are examined as in Table 5. In Panel D, bank loan loss allowance and earnings growth are the dependent variables as in Table 6, respectively. All other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

I uner m Dunn cupitur ue			
	(1)	(2)	(3)
VARIABLES	Book equity	Dividend	Stock sale
After	0.037**	-0.003	-0.020
	(2.413)	(-1.103)	(-0.619)
Democrat	-0.008	-0.004	0.005
	(-0.246)	(-0.792)	(0.084)
After*Democrat	-0.059*	0.006	0.010
	(-1.857)	(1.139)	(0.157)
Other control variables	Yes	Yes	Yes
Observations	86,686	86,048	45,492
R-squared	0.111	0.134	0.067
Bank FE	Yes	Yes	No
State FE	No	No	Yes
Year FE	Yes	Yes	Yes

#### Panel A: Bank capital decisions (DID)

#### Panel B: Growth in different types of bank loans (DID)

	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
After	-0.174	-0.390***	-0.100	-0.623***	-0.508
	(-1.023)	(-2.970)	(-0.287)	(-3.294)	(-0.944)
Democrat	-0.044	-0.264	-0.867	-0.513	-0.026
	(-0.140)	(-1.061)	(-1.355)	(-1.587)	(-0.028)
After*Democrat	0.208	0.635**	0.416	1.324***	0.633
	(0.572)	(2.249)	(0.555)	(3.303)	(0.564)
Other control					
variables	Yes	Yes	Yes	Yes	Yes
Observations	83,996	84,664	43,236	84,532	59,975
R-squared	0.059	0.089	0.030	0.054	0.006
Bank FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

Taner C: Mature of fending (DID)				
	(1)	(2)		
		CRA		
VARIABLES	Branching	Rating		
After	-0.177	0.006		
	(-0.866)	(1.418)		
Democrat	0.280	0.008		
	(0.685)	(1.089)		
After*Democrat	0.474	-0.016*		
	(1.068)	(-1.801)		
Other control variables	Yes	Yes		
Observations	65,490	20,666		
R-squared	0.003	0.060		
Bank FE	Yes	Yes		
Year FE	Yes	Yes		

#### Panel C: Nature of lending (DID)

#### Panel D: Loan quality and bank Performance (DID)

	(1)	(2)
		Earnings
VARIABLES	LLA	Growth
After	-0.009**	0.178**
	(-1.975)	(2.558)
Democrat	0.006	0.242**
	(0.542)	(1.987)
After*Democrat	0.020**	-0.349**
	(2.019)	(-2.346)
Other control		
variables	Yes	Yes
Observations	86,193	85,443
R-squared	0.242	0.281
Bank FE	Yes	Yes
Year FE	Yes	Yes

#### Table I.A.4 The Effect of Democrat Governors on Mortgage Decisions by State Banks

Panels A (Diff-in-diff) and B (Regression discontinuity design) present results of regressions that examine the effect of Democrat governors on banks' mortgage decisions. The dependent variables in each column are indicated at the top, where Mortgage application is the proportion of low-income mortgage applicants among all applicants and Mortgage size is the size of a bank's mortgage lending to low-income households relative to its total mortgage asset origination in the year. An applicant is classified as low-income if his/her income provided in the application is below the state per capita personal income in the year. The sample in Panel A includes all state commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1998-2012. Bank and year fixed effects are included in all columns of Panel A. Panel B is for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years subsequent to those elections during 1998-2012. Year fixed effects are included in all columns of Panel B. In both panels, all other variables are defined in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Mortgage lending decisions (DID)				
	(1)	(2)		
	Mortgage	Mortgage		
VARIABLES	application	size		
After	-0.246*	-0.026		
	(-1.874)	(-0.428)		
Democrat	-0.507**	-0.019		
	(-2.561)	(-0.218)		
After*Democrat	0.621**	0.028		
	(2.250)	(0.221)		
Predecessor	0.627***	0.058		
	(3.206)	(0.693)		
ROA	-2.266	-5.193		
	(-0.122)	(-0.607)		
ROA growth	11.264	-1.606		
	(0.707)	(-0.196)		
Asset(log)	-1.125**	-0.414**		
	(-2.450)	(-2.283)		
State GDP(log)	-3.469	1.116		
	(-0.954)	(1.144)		
State GDP growth	25.899***	2.716		
	(5.011)	(1.093)		
State unemployment	0.194	-0.027		
	(0.962)	(-0.339)		
Applicant income		1.000***		
		(123.162)		
Observations	51,438	42,729		
R-squared	0.019	0.751		
Bank FE	Yes	Yes		
Year FE	Yes	Yes		

	(1)	(2)	(3)	(4)
	Mortgage	Mortgage	Mortgage	Mortgage
VARIABLES	application	application	size	size
Democrat	1.782**	3.500***	0.177	0.785*
	(2.044)	(3.102)	(0.496)	(1.672)
Observations	22,373	22,373	18,340	18,340
R-squared	0.061	0.062	0.808	0.808
Vote margin	0.2	0.2	0.2	0.2
Polynomial order	2	3	2	3
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

#### Panel B: Mortgage lending decisions (RD)

#### Table I.A.5 The Effect of Democrat Governors on State GDP Growth, Housing Price, and Income Inequality

This table presents results of regressions that examine the effect of Democrat governors on state GDP growth, housing price, and income inequality. The sample includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. All other variables are defined as in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

State-level GDP growth, housing price, and income inequality						
	(1)	(2)	(3)	(4)	(5)	(6)
	State GDP	State GDP	Home price	Home price		
VARIABLES	growth	growth	index	index	Gini index	Gini index
After	0.001	0.038	7.821**	5.894	-0.116	-0.141
	(0.008)	(0.435)	(2.084)	(1.345)	(-0.622)	(-0.838)
Democrat	-0.173	0.028	37.419*	7.667	-0.920**	-0.200
	(-0.630)	(0.117)	(1.964)	(0.902)	(-2.047)	(-0.667)
After*Democrat	-0.052	-0.093	-11.446	-8.785	0.221	0.303
	(-0.269)	(-0.483)	(-1.435)	(-1.018)	(0.601)	(0.828)
Predecessor	-0.080	0.055	-8.848	-1.681	-0.947***	0.044
	(-0.509)	(0.301)	(-0.607)	(-0.200)	(-3.059)	(0.214)
State GDP(log)	-0.089	5.075*	33.911	205.725***	0.582	-3.570**
	(-0.546)	(1.798)	(1.588)	(3.396)	(1.560)	(-2.112)
State GDP growth			7.304	-371.963***	17.251***	6.491*
			(0.032)	(-3.790)	(3.053)	(1.945)
State						
unemployment	-0.462***	-0.497**	-9.420	-14.395***	0.400**	0.211
	(-3.233)	(-2.129)	(-1.036)	(-2.699)	(2.159)	(1.418)
Observations	1,172	1,172	1,172	1,172	1,172	1,172
R-squared	0.504	0.543	0.333	0.723	0.359	0.532
State FE	No	Yes	No	Yes	No	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes

#### Table I.A.6 The Effect of Democrat Governors on State Income Tax

This table presents results of regressions that examine the effect of Democrat governors on state income tax. An ordered logit regression is run where the dependent variable is 1 (-1) when a state experiences an increase (decrease) in state income tax in a year from the prior year, and 0 when the state income tax does not change from the prior year. All other variables are defined in the Appendix. Robust standard errors are clustered at the state level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)
VARIABLES	Change in state income tax	Change in state income tax
After	-0.005	0.004
	(-0.046)	(0.033)
Democrat	0.233	0.264
	(1.474)	(1.464)
After*Democrat	0.006	-0.007
	(0.027)	(-0.029)
Predecessor	-0.005	0.085
	(-0.039)	(0.520)
State GDP(log)	-0.012	-0.892
	(-0.205)	(-0.648)
State GDP growth	-0.472	-0.628
	(-0.150)	(-0.191)
State unemployment	0.084	0.173
	(1.476)	(1.603)
Observations	1,706	1,706
State FE	No	Yes
Year FE	Yes	Yes

#### Table I.A.7 The Effect of Democrat Governors on Bank Capital: Subsamples Based on Bank Size

This table presents results of the Diff-in-diff (DID) regressions that examine the effect of Democrat governors on bank capital in two subsamples of small and large banks. The whole sample, which includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012, is divided into two subsamples – small vs. large banks. Large banks are defined as banks with their total assets being greater than (or equal to) the yearly sample median, and small banks are defined otherwise. The dependent variable, *Book equity*, is the ratio of book value of equity to book value of total assets. It is multiplied by 100 to scale up the estimated coefficients of the independent variables. All control variables are defined in the Appendix. Both bank and year fixed effects are included in the regressions. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)
VARIABLES	Small banks	Large banks
After	0.049***	0.017
	(3.522)	(1.330)
Democrat	-0.028	-0.001
	(-0.856)	(-0.035)
After*Democrat	-0.092***	-0.020
	(-3.070)	(-0.737)
Predecessor	-0.060*	-0.018
	(-1.867)	(-0.661)
ROA	45.377***	58.491***
	(13.414)	(19.755)
ROA growth	-11.193***	-22.618***
	(-5.085)	(-11.179)
Asset(log)	-1.839***	-0.370***
	(-15.069)	(-4.410)
State GDP(log)	-0.354	0.643*
	(-0.830)	(1.938)
State GDP growth	-2.100***	-0.263
	(-3.766)	(-0.522)
State unemployment	-0.021	0.010
	(-0.832)	(0.516)
Observations	114,278	115,978
R-squared	0.105	0.114
Bank FE	Yes	Yes
Year FE	Yes	Yes

#### Table I.A.8 The Effect of Democrat Governors on Bank Capital, Loan Making and Performance: Controlling for Political Connection

This table presents results of the Diff-in-diff (DID) regressions that examine the effect of Democrat governors on bank capital in two subsamples of small and large banks. The whole sample, which includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012, is divided into two subsamples – small vs. large banks. Large banks are defined as banks with their total assets being greater than (or equal to) the yearly sample median, and small banks are defined otherwise. The dependent variable, *Book equity*, is the ratio of book value of equity to book value of total assets. It is multiplied by 100 to scale up the estimated coefficients of the independent variables. All control variables are defined in the Appendix. Both bank and year fixed effects are included in the regressions. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

	(212)		
	(1)	(2)	(3)
VARIABLES	Book equity	Dividend	Stock sale
After	0.035***	-0.004**	0.011
	(3.535)	(-2.277)	(0.549)
Democrat	-0.007	-0.004	0.035
	(-0.330)	(-1.209)	(1.000)
After*Democrat	-0.054***	0.007**	-0.026
	(-2.580)	(2.035)	(-0.651)
Senate banking committee	-0.021	0.003	-0.061
	(-0.984)	(0.800)	(-1.611)
Other control variables	Yes	Yes	Yes
Observations	230,256	226,888	126,364
R-squared	0.094	0.125	0.080
Bank FE	Yes	Yes	No
State FE	No	No	Yes
Year FE	Yes	Yes	Yes

#### Panel A: Bank capital decisions (DID)

#### Panel B: Growth in different types of bank loans (DID)

	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
After	-0.170	-0.476***	0.047	-0.297**	0.231
	(-1.468)	(-5.554)	(0.219)	(-2.378)	(0.689)
Democrat	-0.580***	-0.813***	-0.453	-0.393*	0.463
	(-2.640)	(-4.804)	(-1.115)	(-1.748)	(0.778)
After*Democrat	0.369	0.939***	0.144	0.706***	-0.536
	(1.458)	(5.024)	(0.317)	(2.589)	(-0.740)
Senate banking committee	-0.313	-0.488***	-0.432	-0.476*	-0.740
	(-1.254)	(-2.595)	(-0.861)	(-1.756)	(-0.989)
Other control variables	Yes	Yes	Yes	Yes	Yes
Observations	224,560	225,840	122,904	225,311	161,651
R-squared	0.056	0.092	0.026	0.051	0.006
Bank FE	Yes	Yes	Yes	Yes	Yes

#### Year FE

#### Yes

Yes

Yes

#### Panel C: Nature of lending (DID)

	(1)	(2)
		CRA
VARIABLES	Branching	Rating
After	-0.268**	0.007***
	(-2.266)	(2.754)
Democrat	0.058	0.003
	(0.233)	(0.485)
After*Democrat	0.613**	-0.018***
	(2.341)	(-3.043)
Senate banking committee	-0.405	0.009
	(-1.484)	(1.461)
Other control variables	Yes	Yes
Observations	167,011	47,084
R-squared	0.002	0.059
Bank FE	Yes	Yes
Year FE	Yes	Yes

#### Panel D: Loan quality and bank Performance (DID)

I and D. Loan quanty and D.	ank i ci ioi mane	(DID)
	(1)	(2)
		Earnings
VARIABLES	LLA	Growth
After	-0.018***	0.205***
	(-6.271)	(4.245)
Democrat	-0.003	0.313***
	(-0.558)	(3.578)
After*Democrat	0.038***	-0.382***
	(6.127)	(-3.642)
Senate banking committee	-0.034***	-0.018
	(-5.734)	(-0.161)
Other control variables	Yes	Yes
Observations	229,009	227,111
R-squared	0.253	0.258
Bank FE	Yes	Yes
Year FE	Yes	Yes

## Table I.A.9 Tests of the Parallel Trend Assumption in the DID Estimation of Tables 2 and4-6

This table presents results of regressions that examine the effect of Democrat governors on bank capital, lending decisions, and performance. The dependent variables are indicated on the top of each column. The sample includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years subsequent to gubernatorial elections during 1990-2012. *Before-1*, *After+1*, and *After+2&3* are indicators for the year immediately prior to the election year (Year -1), the year immediately after the election year (Year 1), and the two years after Year 1, respectively. All other variables are defined as in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Fallel A: Dalik Capital C	iecisions		
	(1)	(2)	(3)
	Book		
VARIABLES	equity	Dividend	Stock sale
Democrat*Before-1	-0.007	-0.002	-0.048
	(-0.427)	(-0.332)	(-0.944)
Democrat*After+1	-0.058**	-0.008	-0.022
	(-2.501)	(-1.503)	(-0.425)
Democrat*After+2&3	-0.058**	0.015***	-0.055
	(-2.243)	(3.020)	(-1.059)
Before-1	0.003	-0.002	-0.024
	(0.267)	(-0.449)	(-0.697)
After+1	0.034***	0.002	0.031
	(2.891)	(0.719)	(1.187)
After+2&3	0.038***	-0.008***	-0.014
	(2.821)	(-2.681)	(-0.472)
Democrat	-0.003	-0.004	0.058
	(-0.128)	(-0.953)	(1.502)
Predecessor	-0.043*	0.001	-0.011
	(-1.957)	(0.192)	(-0.325)
Observations	220.250	226.000	126.264
Observations	230,256	226,888	126,364
R-squared	0.094	0.125	0.079
Controls	Yes	Yes	Yes
Bank FE	Yes	Yes	No
State FE	No	No	Yes
Year FE	Yes	Yes	Yes

#### Panel A: Bank capital decisions

#### Panel B: Growth in different types of bank loans

	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
Democrat*Before-1	-0.107	0.411	-0.956	1.112	0.751
	(-0.278)	(1.488)	(-1.164)	(1.469)	(0.572)
Democrat*After+1	0.372	0.981***	-1.050	0.653*	0.441

	(1.037)	(3.822)	(-1.427)	(1.677)	(0.393)
Democrat*After+2&3	0.279	1.099***	0.335	1.301***	-0.715
	(0.853)	(4.545)	(0.515)	(3.674)	(-0.731)
Before-1	0.135	0.004	-0.143	-0.536*	0.615
	(0.536)	(0.022)	(-0.267)	(-1.943)	(0.710)
After+1	-0.249	-0.506***	0.288	-0.183	-0.930
	(-1.347)	(-3.818)	(0.801)	(-0.899)	(-1.543)
After+2&3	-0.051	-0.453***	-0.142	-0.642***	1.207**
	(-0.266)	(-3.264)	(-0.369)	(-3.110)	(2.038)
Democrat	-0.516**	-0.919***	-0.141	-0.747***	0.242
	(-1.993)	(-4.783)	(-0.301)	(-2.806)	(0.328)
Predecessor	-0.381**	0.090	-0.170	0.547***	0.131
	(-2.129)	(0.641)	(-0.487)	(2.960)	(0.279)
Observations	224,560	225,840	122,904	225,311	161,651
R-squared	0.056	0.092	0.026	0.051	0.006
Controls	Yes	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

#### Panel C: Nature of lending

	(1)	(2)
		CRA
VARIABLES	Branching	Rating
Democrat*Before-1	0.211	-0.006
	(0.805)	(-0.587)
Democrat*After+1	0.273	-0.025***
	(0.921)	(-2.910)
Democrat*After+2&3	0.874***	-0.017**
	(2.710)	(-2.138)
Before-1	-0.280	-0.000
	(-1.510)	(-0.034)
After+1	-0.013	0.012***
	(-0.088)	(2.811)
After+2&3	-0.553***	0.005
	(-3.356)	(1.025)
Democrat	0.000	0.004
	(0.001)	(0.660)
Predecessor	0.540**	-0.013***
	(2.142)	(-2.684)
Observations	167,011	47,084
R-squared	0.002	0.059
Controls	Yes	Yes
Bank FE	Yes	Yes
Year FE	Yes	Yes
	(1)	(2)
--------------------	-----------	-----------------
VARIABLES	LLA	Earnings Growth
Democrat*Before-1	0.022***	0.310
	(4.201)	(1.621)
Democrat*After+1	0.053***	-0.383**
	(7.685)	(-2.230)
Democrat*After+2&3	0.038***	-0.213
	(5.087)	(-1.469)
Before-1	-0.010***	-0.195
	(-3.143)	(-1.493)
After+1	-0.024***	0.229**
	(-7.060)	(2.502)
After+2&3	-0.020***	0.088
	(-5.284)	(0.948)
Democrat	-0.008	0.205*
	(-1.234)	(1.891)
Predecessor	0.017***	-0.178**
	(2.781)	(-2.485)
Observations	229,009	227,111
R-squared	0.253	0.258
Controls	Yes	Yes
Bank FE	Yes	Yes
Year FE	Yes	Yes

Panel D: Loan quality and bank performance

#### Table I.A.10 The Effect of Democrat Governors: Robustness Tests of the **Regression Discontinuity Design**

This table presents results of the Regression Discontinuity (RD) Design regressions that examine the effect of Democrat governors on bank capital, lending decisions, and performance. The tests are done for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within either 25% or 30%, which includes all state commercial banks in the three years subsequent to those elections during 1990-2012, respectively. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. \*, \*\*, and \*\*\* indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Bank capital decisions (RD)									
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Book	Book	Book	Book					Stock
VARIABLES	equity	equity	equity	equity	Dividend	Dividend	Dividend	Dividend	sale
Democrat	-0.197**	-0.456***	-0.442**	-0.465***	0.025***	0.042***	0.024***	0.037***	0.093
	(-2.123)	(-3.706)	(-2.492)	(-4.136)	(2.953)	(3.805)	(3.082)	(3.705)	(0.747
Observations	89,302	89,302	97,297	97,297	88,218	88,218	96,003	96,003	40,88
R-squared	0.099	0.099	0.096	0.096	0.360	0.360	0.354	0.354	0.045
Vote margin	0.25	0.25	0.3	0.3	0.25	0.25	0.3	0.3	0.25
Polynomial									
order	2	3	2	3	2	3	2	3	2
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Panel	A:	Bank	capital	decisions	(RD
I and	11.	Dams	Capital	uccisions	1 ILL



					Real	Real	Real	Real	Comm
VARIABLES	Mortgage	Mortgage	Mortgage	Mortgage	Estate	Estate	Estate	Estate	Indu
Democrat	2.086***	2.806***	1.922***	2.192***	1.704**	** 2.475***	* 1.387***	2.177***	-0.
	(3.328)	(3.418)	(3.435)	(2.888)	(3.433)	) (3.761)	(3.158)	(3.632)	(-0.
Observations	88,000	88,000	95,864	95,864	88,421	88,421	96,304	96,304	40,
R-squared	0.030	0.030	0.028	0.028	0.054	0.054	0.051	0.051	0.0
Bandwidth	0.25	0.25	0.3	0.3	0.25	0.25	0.3	0.3	0.
Polynomial									
order	2	3	2	3	2	3	2	3	
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Y
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Y
Panel B									
continued									
(11)	(12)	(13)	(14	.)	(15)	(16)	(17)	(18)	(1
Commercial	Commercial								
& Industrial	& Industrial	Individua	l Indivi	dual Ind	ividual	Individual	Agriculture	Agriculture	Agrice
-0.276	1.052	2.668***	* 2.907	*** 2.5	00***	2.989***	3.498*	2.391	3.47
(-0.231)	(0.613)	(4.048)	(3.35	55) (4	.213)	(3.735)	(1.845)	(0.922)	(2.0
46,770	46,770	88,169	88,1	69 9	5,024	96,024	62,225	62,225	67,7
0.026	0.026	0.029	0.02	29 0	.029	0.030	0.005	0.005	0.0
0.3	0.3	0.25	0.2	5	0.3	0.3	0.25	0.25	0.
2	3	2	3		2	3	2	3	2
Yes	Yes	Yes	Ye	S	Yes	Yes	Yes	Yes	Y
Yes	Yes	Yes	Ye	S	Yes	Yes	Yes	Yes	Ye

Panel C: Nature of	f lending (RD)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
					CRA	CRA	CRA
VARIABLES	Branching	Branching	Branching	Branching	Rating	Rating	Rating
Democrat	1.281*	1.173	1.275*	1.103	-0.082***	-0.046**	-0.088***
	(1.986)	(0.669)	(1.719)	(0.724)	(-4.671)	(-2.130)	(-5.463)
Observations	69,792	69,792	76,472	76,472	19,657	19,657	21,524

R-squared	0.051	0.051	0.053	0.053	0.069	0.069	0.068
Bandwidth	0.25	0.25	0.3	0.3	0.25	0.25	0.3
Polynomial order	2	3	2	3	2	3	2
Controls	Yes						
Year FE	Yes						

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
					Earnings	Earnings	Earni
VARIABLES	LLA	LLA	LLA	LLA	Growth	Growth	Grov
Democrat	0.229***	0.172***	0.183***	0.209***	-1.038***	-1.217***	-1.113
	(10.246)	(5.831)	(9.057)	(7.719)	(-3.979)	(-3.459)	(-4.7
Observations	88,854	88,854	96,755	96,755	88,874	88,874	96,7
R-squared	0.260	0.260	0.252	0.253	0.199	0.199	0.20
Bandwidth	0.25	0.25	0.3	0.3	0.25	0.25	0.3
Polynomial order	2	3	2	3	2	3	2
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Ye
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Ye

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