POLITICAL INFLUENCE ON BANK CREDIT ALLOCATION: BANK CAPITAL RESPONSES, CONSUMPTION AND SYSTEMIC RISK

Sheng Huang* **Anjan V. Thakor****

April 2017

ABSTRACT

We develop a model in which political influence on credit allocation elicits bank capital responses. The model generates three hypotheses that we test empirically. 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 politically-favored lending, and household consumption consequently increases. Third, these banks exhibit poorer post-lending performance. Our study has implications for the interaction between politics, consumption, systemic risk, and financial stability through a specific channel—the interplay between credit-allocation regulation and bank capital structure.

JEL Classification Numbers: G21, G28

Key Words: Politics, bank regulation, capital requirements

---

* Assistant Professor of Finance, Lee Kong Chian School of Business, Singapore Management University, 50 Stamford Road, Singapore 178899. Tel: (+65) 68280252. Email: shenghuang@smu.edu.sg

** Corresponding author: ECGI, and John E. Simon Professor of Finance, Director of Doctoral Programs, and Director of the WFA Center for Finance and Accounting Research, Olin School of Business, Washington University in St. Louis, One Brookings Drive, St. Louis, MO 63130-4899. Tel: (314) 935-7197. Email: thakor@wustl.edu

We thank Marco Pagano and participants in the 2017 Conference on "Banks, Systemic Risk, Measurement and Mitigation", as well as seminar participants at the Bank of Canada and Northeastern University for helpful discussions and comments. We also thank Meng Gao and Evelyn Toh for excellent research assistance.

I. INTRODUCTION

Motivation, Theory and Research Question: It is well known that politicians try to influence economic outcomes for political gain (see, for example, Lindbeck and Weibull (1987), Nordhaus (1975), and Rogoff (1990)). Nowhere is this more evident than in banking (e.g., Brown and Dinc (2005)). The desire of politicians to be involved in the functioning of the credit market is not a radical idea. Politics has influenced banking for centuries, and many have written about how factors like politics and career concerns shape the actions of legislators and bank regulators.[1] In their recent book, Calomiris and Haber (2014) make a powerful case that politics has always been front and center stage in banking (p.13):

"The fact that the property-rights system underpinning banking system is an outcome of political deal making means that there are no fully "private" banking systems; rather, modern banking is best thought of as a partnership between the government and a group of bankers, a partnership that is shaped by the institutions that govern the distribution of powers in the political system…Banks are regulated and supervised according to technical criteria, and banking contracts are enforced according to abstruse laws, but these criteria and laws are not created and enforced by robots programmed to maximize social welfare; they are the outcomes of a political process – a game, as it were – whose stakes are wealth and power."

One area of political influence on banking is in credit allocation. Because the profit-maximizing lending decision of banks may not coincide with what politicians view as social-welfare maximizing, laws may be enacted to require banks to make loans that banks may otherwise not make.[2] In some instances, such regulatory mandates may serve political goals that may include the desire to influence election outcomes by making credit available to certain groups, so the motives for political influence may transcend at least the conventional notion of social welfare, as indicated in the Calomiris and Haber (2014) quote above. Banks, which are the recipients of government safety

[1] See, for example, Boot and Thakor (1993), Kane (1990, forthcoming), Johnson and Kwak (2010), Lo (2012), Rajan (2010), Song and Thakor (2012), and Stiglitz (2010).

[2] 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.

nets, may be willing to accept such credit allocation directives as part of the "Game of Bank Bargains" that Calomiris and Haber (2014) discuss in their book.

Politicians also care about the safety and soundness of banking. To the extent that politically-motivated credit allocation directives expose banks to greater risk, the legislative proclivity to require banks to make politically-favored loans will be tempered by the desire to not expose banks to excessive risk. Of course, bank risk will also be affected by the capital it keeps. For any kind of (risky) lending, the risk of failure is higher the lower the bank's capital. This will affect the bank's capital choice.[3]

We capture these tradeoffs 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 a directive to lend to politically-favored groups; this need not be a formal legislative change, but can simply be greater regulatory pressure on banks to make certain types of loans. It then chooses its capital structure to balance the value of deposit financing against 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 issuing a credit-allocation directive. The politician then decides whether to constrain the bank with such a directive. Lending then occurs. What we show is that the *ex ante* probability that the politician will issue a future credit-allocation directive 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 a credit-allocation directive remains positive, so the bank does make politically-favored, riskier loans in some states of the world.

[3] 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.

This simple model leads to three testable predictions. First, when the bank perceives political pressure on credit allocation, it will reduce its capital ratio. Second, this capital structure response notwithstanding, banks subject to greater political pressure will make more politically-favored loans. Third, these banks will exhibit higher lending risk and poorer post-lending performance.

Our main goal is to confront these predictions with the data. The null hypothesis is that potential political influence on credit allocation is not significant enough to affect banks' capital structure decisions. In this case, politics will play no discernable role in the choices banks make with respect to capital. Which of these hypotheses finds support in the data? This is the first research question we address.

The second research question is whether our second and third predictions are supported by the data. The null hypothesis here is that political influence is simply not significant enough to sway banks' lending decisions and affect their performance, given the capital structure and other adjustments banks can make.

What This Paper Does – Empirical Analysis: 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 politics and banking are mixed by both parties, the Democratic party typically attaches greater importance to the role of the government in addressing perceived distributional inequities through credit allocation; see, for example, Dymski, Epstein, and Pollin (2015), Levy (2006), and Sullivan (2009).[4] This implies that state-chartered banks ("state banks"

[4] Dymski et al. (2015), who represent the views of liberal economists aligned with labor unions and the Democratic Party, view government influence over bank credit allocation as desirable and advocate means by which this can be done more efficiently. Both Levy (2006) and Sullivan (2006) point out the greater emphasis Democrats put on social and economic equality, with credit availability to low-income and minority groups playing a key role in achieving this. 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". See *CQ Almanac* 1975. The Community Reinvestment Act 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

hereinafter) are subject to greater political influence in states following the election of Democratic governors. While federal regulators are the only regulatory and supervisory authority of federally chartered banks, state banking departments and federal regulators work jointly in monitoring state banks, and federal regulators often rely on state regulators for local information – which leaves room for state regulators to play a significant role in regulation and hence affect the behavior of state banks. State governors can thus have a potentially substantial influence on state banks (not on federally-chartered banks) through their appointments of the state banking department heads and other critical personnel as well as their influence on regulatory policymaking.[5]

Our empirical analysis uses all gubernatorial elections during 1990-2012 and focuses on state-chartered 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 regulation 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 Democratic versus non-Democratic states in a time window from three years prior to gubernatorial elections to three years after gubernatorial elections.[6] 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 that are to capture any time trend in bank behavior/performance.

(2014) for more on this. 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. The literature on non-financial firms and investments (e.g. Di Giuli and Kostovetsky (2014) and Hong and Kostovetsky (2012)) has also made a similar observation about the greater importance attached by Democrats than Republicans to issues of social equality. We discuss this more in Section IV.

[5] See Section IV for a more detailed discussion on the potential influence that state governors may have on state banks.

[6] 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 Democratic governor.

The empirical examinations provide strong evidence for our predictions. First, banks reduce capital following the victories of Democratic candidates in gubernatorial elections, when their credit allocation is likely to be subject to greater political influence. We also document that this decline in capital is through dividend payments and stock repurchases, but not mechanically due to increased borrowing. In contrast, banks increase capital following the victories of Republicans and Independent candidates.

Second, we find that political pressure does have a significant impact on bank lending behavior. In particular, state banks exhibit higher growth in politically-favored lending following the election of Democratic governors. Banks view such lending as riskier *ex ante* – we document greater losses, as reflected in a significant increase in the loan loss allowances that the banks allocate. We also provide two pieces of evidence that the increased lending is indeed in the form of more politically-favored loans: (i) we document improved CRA (Community Reinvestment Act) ratings for these banks, consistent with the higher lending serving socioeconomic goals, and (ii) we show that the higher lending seems to be addressing household consumption needs – ostensibly the political goal. Specifically, we find that household consumption expenditures increase in states following the election of Democratic governors.

Third, with the increased riskier politically-favored lending, state banks exhibit a decline in operating performance after gubernatorial elections in Democratic states.

One might be concerned that unobserved economic factors may be driving both the gubernatorial election outcomes and bank decisions, and thus any causal inferences drawn on the relation between them may be subject to an omitted variable bias. We employ two identification strategies to address this. First, we conduct the empirical analysis using a regression discontinuity design (RDD) with a subsample of close elections. In such elections, the assignment of an individual state to be treated is assumed to be random, and thus RDD allows an estimation of the average

treatment effect of Democratic states versus non-Democratic states that is free of any omitted variable bias and other possible endogeneity concerns. We confirm that the impact of Democratic victories on bank capital structure decisions, lending behavior, and performance remains significant for this subsample.

Second, we exploit differences among banks based on whether they have federal or state charters, and the corresponding differences in regulation pressures on them by state regulators. Under the premise of our theory, state-level political influence on the decisions of federally chartered banks should be insignificant. However, if unobserved economic factors are driving our findings, we should expect the state-level political influence to also be significant on 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. This helps to rule out the possibility that some unobserved economic factors underlying the gubernatorial election outcomes may have caused banks to make the decisions we document.

Lastly, 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 interest on debt. As such, banks in states with higher state income tax rates are expected to have lower equity ratios, *ceteris paribus*. One may thus be concerned that the decline in bank equity in Democratic states may be due to increased state income tax rates after the elections. To check this, we examine post-election changes in state income tax rates. Based on this, we conclude that this alternative explanation can be ruled out.

Relation to the Literature and Intended Marginal Contribution: Our paper is most closely related to the literature on the influence of politics on bank lending, a topic on which there is a

substantial empirical literature (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 relative to the literature is documenting a link between government influence on bank credit allocation and the manifestation of the bank's response to this in the form of lowering its capital ratio. Moreover, our analysis also illuminates how political influence induces higher bank loan growth and impinges on bank performance. Since bank capital and loan growth play key roles in determining the safety and soundness of banks, our analysis sheds light on how the interplay between politics and banking has ramifications for systemic risk and banking stability through the credit-allocation channel.

Our analysis does not permit welfare statements. We cannot determine what motivates politicians to favor credit extension to certain groups. It could well enhance social welfare (say due to enhanced consumption, which we document), in which case welfare would be positively impacted by such lending even though it makes bank performance worse. On the other hand, political motives may be driven more by the self-interest of politicians than by social welfare.

The rest of the paper is organized as follows. Section II reviews the literature on political influence, lending, and bank capital. The theoretical model is developed in Section III, with proofs in the 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 higher growth 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

It is well known that politicians try to influence economic outcomes for political gain. Nordhaus (1975) discusses "political business cycles" and observes that politicians may boost short-term employment before elections at the cost of greater subsequent inflation. Lindbeck and Weibull (1987) note that politicians, motivated by the goal of winning elections, have stronger incentives to manipulate economic variables when elections are more competitive. This is consistent with Rogoff's (1990) conclusion that politicians manipulate variables around elections to signal ability and get voter support. Politics also plays a role during times of distress. Faccio, Masulis, and McConnell (2006) document that politically-connected firms are more likely to be bailed out than other firms.

In banking, the point that politicians may attempt to influence the credit allocation decisions of banks is even more compelling. Pagano and Volpin (2001) discuss the political economy of banking and point out that regulation and its enforcement strike a balance between social and economic constituencies. Brown and Dinc (2005) document that the design of bank regulation is politically-driven. This evidence provides support for Kane's (forthcoming) hypothesis that, for political reasons, most countries (including the U.S.) establish a regulatory culture that involves politically-directed subsidies to select bank borrowers. He goes on to argue that this is accompanied by politically-motivated design of bank regulation that undermines the quality of bank supervision and produces financial crises. Braun and Raddatz (2010) examine data for a large number of countries to examine how frequently former high-ranking politicians become bank directors. At the country level, they show that this connectedness is strongly negatively related to economic development. They argue that the patterns they document in the data are difficult to reconcile with a benign public-interest view of bank regulation.

A number of empirical papers have documented that in emerging markets politicians often use state-owned banks as vehicles for the achievement of political goals. Khwaja and Mian (2005)

use loan-level data pertaining to more than 90,000 firms that represent the universe of corporate lending in Pakistan between 1996 and 2002, and show that "politically-connected" firms—those whose directors participate in elections—borrow 45 percent more and have 50 percent higher default rates than other firms. They find that such preferential treatment occurs exclusively in government banks. They document that firms with stronger politicians as directors are able to garner higher political rents, and that this kind of lending is not socially-motivated lending by government-owned banks to politicians. Moreover, *there are costs to the economy due to such lending.* Cole (2009) examines the impact of state elections on agricultural lending in India and finds that lending by government-owned banks increases in election years, while lending by privately-owned banks appears to be unaffected.

The problem of political influence on the credit allocation decisions of banks is *not* limited to government-owned banks or to banks in emerging markets. Kane (1990, forthcoming) and Rajan (2010) have made the point that politics have played an important role in banking regulation in the United States. For example, Agarwal, Lucca, Seru, and Trebbi (2014) document that state and federal regulators in the U.S. implement identical rules differently and indicate (but do not test) that this may in part be explained by different degrees of political pressure on regulators. Liu and Ngo (2014) document that bank failures in a state, which are politically costly to the incumbent governor seeking re-election in that state, are significantly lower in the year leading up to a gubernatorial election in the U.S., suggesting strategic political manipulation of 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 data on banks in a large number of emerging markets *and* developed economies and finds strong evidence of political influence on bank lending. Specifically, government-owned banks increase their lending in election years relative to private banks, and this effect is robust to controlling for country-

specific macroeconomic and institutional factors as well as bank-specific factors. The magnitude of the political effect is striking—the increase in lending is about 11% of a government-owned bank's total loan portfolio or about 0.5% of the median country's GDP per election per government-owned bank. Iannotta, Nocera, and Sironi (2013) use cross-country data on a sample of large European banks to show that government-owned banks have higher operating risk than private banks and that this operating risk tends to increase in election years. Using a sample of 1872 publicly-traded banks in 63 countries over the 1997–2009 time period, Anginer, Demirguc-Kunt, and Zhu (2014) find results that are similar in spirit. They document that correlated risk-taking by banks is higher in countries with greater government ownership of banks. In terms of political influence on banking in the U.S., Agarwal, Benmelech, Bergman, and Seru (2012) provide evidence that the Community Reinvestment Act (CRA) led to riskier lending by banks in the U.S. They find that in the six quarters surrounding the CRA exams, lending increases on average by 5% every quarter, and loans in those quarters default about 15% more often.

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 recently 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 not only is politics an integral part of banking in all countries but that politics also determine whether societies suffer repeated banking crises (as in Argentina and the U.S.) or never suffer banking crises (as in Canada). Their book provides a rich set of institutional facts that are consistent with and further illuminate the empirical evidence cited above[7].

Bank performance is also affected by politics. Shen and Lin (2012) provide evidence that

[7] Consistent with these institutional facts, Thakor (2016) 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.

sheds light on *how* politics affects bank performance and *why* government-owned banks underperform. They argue that political interference by the government, which takes the form of the replacement of government bank executives within 12 months of a major election, results in a decline in the financial performance of the affected bank.[8] They find that political interference is greater in developing countries than in developed countries. 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.

These papers provide empirical support and motivation for the assumption underlying our theory that the regulator may put in place either formal regulations or less-formal regulatory practices—including jawboning—that direct banks to make loans to politically-favored borrower groups. Such regulations are typically presented as initiatives to correct distributional inequities resulting from credit-market frictions, lack of observable attributes signifying creditworthiness for certain borrower groups, or simply as interventions to serve the broad political objectives of expanded credit access. Moreover, these papers also provide evidence supporting our premise that state governors significantly influence banking outcomes (e.g., Liu and Ngo (2014)).[9]

Our paper is also related to how bank capital affects bank risk and value. Holmstrom and Tirole (1997) develop a model in which higher bank capital strengthens bank monitoring incentives and improves loan quality. Mehran and Thakor (2011) develop a dynamic version of that model to show that endogenously-determined higher bank capital improves loan quality, bank performance, and bank value via the borrower monitoring channel, and also provide supporting empirical evidence. Peek and Rosengren (2005) document that (exogenous) negative shocks to capital lead to

[8] 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).

[9] While not focusing on state banks, Do, Lee, and Nguyen (2016) 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.

lower bank lending. Berger and Bouwman (2009) show that large banks with higher capital create more liquidity, whereas Berger and Bouwman (2013) provide empirical evidence that banks with higher capital are more likely to survive financial crises and gain market share during crises. Thakor's (2014) review of the literature concludes that higher bank capital, relative to current levels, will lead to lower systemic risk and greater financial stability.

Our contribution relative to this literature is that we document the influence of politics on bank capital structure, which highlights an additional factor in the bank's capital structure decision that has not been studied before. 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. THE THEORY: MODEL AND HYPOTHESES DEVELOPMENT

In this section, we provide a simple theoretical justification for the main hypotheses we test. We do this by developing a model of political influence on bank credit allocation and how this influences bank capital structure and performance. 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.[10] For each dollar of deposits, depositors enjoy a value of liquidity services of $\gamma \in (0,1)$.[11] Deposits are available in elastic supply at an expected return of zero, including the value of depository services.

The sequence of events is as follows. At $t=0$, an election outcome is observed. The winning governor is either a Democrat, Republican, or Independent. Each bank, after observing the election

[10] Partial deposit insurance, which is the case in practice, leaves the analysis unchanged.
[11] See Song and Thakor (2007) for example.

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 preference for the bank to make a politically-preferred loan, and determines whether to issue a credit allocation directive for the bank to make that loan. This will be made precise shortly.

There are three types of 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. We assume:

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

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:

$$p < q. \tag{3}$$

However, the 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 $1-\delta$ at t=1. That is, the realization of $\tilde{\beta}$ occurs at t=1. 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

$$\pi_h < L\,. \tag{4}$$

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 implements at t=1 the credit-allocation directive issued by the government, if there is any. The bank's choice set for loans is $c_1 \equiv \{G, B\}$ and $c_2 \equiv \{P, B\}$. The regulator can direct the bank to choose c_2—that is what we call a *credit-allocation directive*. However, within a choice set $c_i \left(i \in \{1,2\}\right)$, the bank can choose *B* unobservably, i.e., while the regulator can ensure that the bank lends from c_2, 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 1 goes here]

The *politician's objective function* is:

$$W_i = \begin{cases} \alpha_1 Pr \text{ (bank does not fail at t=2)} \\ +\alpha_2 \text{ Pr (bank makes } P \text{ loan)} \tilde{\beta} \quad \text{if i =Democrat} \\ \\ \text{Pr (bank does not fail at t=2)} \quad \text{if i= Independent or Republican.} \end{cases} \tag{5}$$

where $\alpha_1 > 0$ and $\alpha_2 > 0$ are constants.

We will also assume that:

$$px + \beta_2 < qx, \tag{6}$$

which means that the social efficiency of the *G* loan is higher than that of the *P* loan, including the political benefit of *P*.

The *bank's objective function* is to maximize the net present value (NPV) of its shareholders at t=0 (with its capital structure choice) and to maximize the value of equity at t=1 (with its loan choice).

Results

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

Restriction 1: *The spread between π_h and π_ℓ is greater than the difference in the expected values of G and P (See the Appendix I for the exact mathematical expression).*

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: *The expected value of G is sufficiently higher than π_h (see the Appendix I for the exact expression).*

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: *The regulatory probability of preventing the bank from choosing B when the bank prefers to do so, θ, is small enough (see the Appendix I for the exact expression).*

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 a credit-allocation directive with positive probability. For example, if $\theta = 1$, then all risk-shifting moral hazard vanishes and there would be a credit-allocation directive regardless of bank capital.

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 in the Appendix I.

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.[12]

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 such that:*

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

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

[12] Subsidized deposit insurance or taxes will also lead to the same all-debt capital structure.

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.

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 relatively unattractive for two reasons. First, it requires the bank to keep a higher capital level to persuade depositors that it will not choose *B*. Second, it is less profitable than *G*.

Proposition 3: *(Regulatory Policy) There exists a set* $\left(\underline{\beta}, \overline{\beta}\right)$ *of positive measure such that if* $\beta_1 \in \left(\underline{\beta}, \overline{\beta}\right)$ *and* $\beta_2 > \overline{\beta}$*, then the regulator will direct the bank to invest in loan P at t=1 with probability 1 if* $E \geq \hat{E}_\ell^*$ *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 $E \geq \hat{E}_\ell^*$ at *t*=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 θ, so a credit-allocation directive is attractive if β_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 $E \in [E_\ell^*, \hat{E}_\ell^*)$ then the bank will prefer *G* to *B* if $\tilde{\pi} = \pi_\ell$, so the probability of bank failure is lower *without* a credit-allocation

directive than with such a directive. In this case, if $\tilde{\beta} = \beta_1$ (political benefit of *P* is low), the regulator/politician prefers not to issue a credit-allocation directive, but if the political benefit of *P* is high ($\tilde{\beta} = \beta_2$), the credit-allocation directive is chosen.

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 $E \geq \hat{E}_\ell^*$ will result in a credit-allocation directive 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 asked to choose *P* below 1. Dropping *E* below E_ℓ^* is not optimal for the bank because then there is no cost to the regulator of imposing a credit allocation directive (since the bank prefers *B* in all states regardless of whether it is free to choose *G* or being directed to choose *P*), so a credit-allocation directive will occur with probability 1. Moreover, if θ is low enough, the bank may be unable to raise financing in this case. *Figure 2* presents the probability of a credit-allocation directive as a function of bank capital.

[Figure 2 goes here]

A clear implication of the above analysis is that 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 amount of politically-favored lending in excess of bank value maximization that they will be asked to do.[13] This leads to:

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

[13] As mentioned earlier, there is 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 asked to make politically-favored loans is positive, despite the lower bank capital choice. That is, we would expect growth of politically-favored loans to be higher in the presence of greater political influence.[14] Moreover, to the extent that the 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 exhibit higher growth in politically-favored loans, and states with such banks will experience an increase in household consumption.

However, making these loans means that bank performance should decline. 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, provide the descriptive statistics, and discuss the empirical methodology used. Testing the three predictions discussed above requires finding an empirical proxy for political influence. We use the outcome of state gubernatorial elections for this purpose. 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 interaction between state governors and senators. As discussed in the Introduction, among the two political parties that dominate state governorships, the Democratic Party puts greater emphasis on government

[14] While in our model, a credit-allocation directive does not affect overall bank loan growth, in practice one can imagine that the bank makes politically-favored loans in addition to – rather than in lieu of – the loans it would make otherwise. This would result in an increase in overall household consumption instead of a substitution of consumption between different households.

intervention and regulation in the pursuit of socioeconomic goals, as explained earlier.[15] Therefore, we expect banks to be subjected to greater political influence to allocate credit to politically-favored sectors and bank decisions to be consequently affected more when a Democrat wins the gubernatorial election than when a Republican or an independent does.

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 to have either a federal charter issued by the Office of the Comptroller of the Currency (OCC) or 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).[16] 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[17], in the 1970's the FDIC began the experiment of having these examinations alternate between state banking departments and FDIC examiners. The Fed followed suit in the early 1980's. The exam-alternating

[15] The previous research has documented a similar outcome-relevant impact of the political ideology of executives in non-financial firms and in the investment community. For example, Di Giuli and Kostovetsky (2014) find that Democratic-leaning firms spend significantly more on corporate social responsibility than Republican-leaning firms, and they do not recover these expenditures through increased sales. They identify firms to be Democratic-leaning (Republican-leaning) based on whether they have Democratic (Republican) founders, CEOs, and directors and whether are headquartered in Democratic (Republican) states. Hong and Kostovetsky (2012) show that Democratic managers are more likely to manage "socially-responsible" investing (SRI) funds, and they are less likely to invest in "socially-irresponsible" firms even if they manage non-SRI funds.

[16] See Blair and Kushmeider (2006) for a detailed discussion of the dual banking system in the U.S.

[17] 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.

policies were more standardized in the 1990's (see Agarwal, et al. (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 very significant in the regulation and supervision of state-chartered banks.

This implies that state governors have potentially substantial influence on state-chartered banks through their appointments of the state banking department heads and other critical personnel as well as their influence on regulatory policymaking. The influence of state governors on banking outcomes has been documented in previous research, as discussed earlier in Section II. This influence can have political underpinnings engendered by local interests.[18] The economic significance of such political influence is underscored by the fact that state-chartered 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 and systematic impact on federally-chartered banks because they are regulated by the OCC rather than state agencies, and they enjoy preemption from certain state laws as a special feature that remains in the dual banking system. Therefore, we examine whether state-chartered banks reduce their capital ratios and exhibit higher growth in politically-favored lending and poorer performance in the years that follow the election of a Democrat as governor in that state, relative to the victory of a Republican or an independent.

A. Data and Descriptive Statistics

We start by collecting the results of gubernatorial and senate elections during 1990-2012 from the Federal Election Committee (FEC) website, the National Governors Association (NGA) website,

[18] See, for example, Aggarwal, et al. (2014) for direct evidence that state regulators exhibit less stringent regulatory enforcement than federal regulators due to local interests.

and other media sources like The Washington Post.[19] Bank balance sheet and income statement data are from Reports of Condition and Income (Call Reports). For every gubernatorial election state-year 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. Definitions of all variables in our empirical analyses are in the Appendix II.

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 1st and 99th percentiles. During the sample period of 1990-2012, there is a total of 314 elections, 142 of which were won by Democrats, 166 by Republicans, and 6 by independents.[20] The average (median) vote margin (the difference in the percentage of votes won by the winning candidate and by the losing candidate) is 16.7% (13.4%). Our sample consists of 11,758 state-chartered commercial banks and 41,878 bank-years as of the year prior to gubernatorial elections. 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

[19] Our sample period starts from 1990 when data on election results such as voting margins first became collectively available.
[20] All the empirical results are similar if election-years won by independents are excluded from the sample.

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 9.5%, but a decrease in ROA (*ROA growth*) and earnings (*Earnings growth*) at an annual rate of -6.9% and -3.8%, respectively. 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]

Figure 3 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 Republicans and independents won. For New Hampshire and Vermont, where the governor's term is two years, we limit the examination window to three years [-1, +1].[21] 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 post-election period, the equity ratios of banks in non-Democratic states experience an increase that far exceeds the increase in Democratic 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 3 goes here]

B. Empirical Methodology

[21] The results are not materially affected if we exclude banks chartered in New Hampshire and Vermont from our sample.

B.1. Difference-in-difference Regressions (DID)

To formally examine the impact of potential influence under Democratic governors, we first run OLS regressions based on the following difference-in-difference (DID) specification:

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

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.[22] 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 also a dummy that equals one if a Democratic candidate wins the gubernatorial election and zero otherwise. Therefore, the coefficient β_1 captures the average effect of a Democratic governor on Y_{ijt} and β_2 the average effect of a non-Democratic governor on Y_{ijt} in the three years after the election compared with the three years before the election. $\beta_1 - \beta_2$ is thus the DID coefficient that captures the effect of a Democratic governor on Y_{ijt} relative to the effect of a non-Democratic governor. 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.

[22] As noted earlier, for New Hampshire and Vermont where the governor's term is two years, we limit the examination window to three 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 results are robust to a shorter examination window of one year or two years following the election.

One might be concerned that the post-election three-year window [+1, +3] may not be long enough to capture the effect of governors and their political influence. It might take longer for governors to enact regulations that reflect their political interests, and for bank lending decisions to be affected by these regulations. As a result, we may not pick up the relevant changes in loan quality and bank performance within the short measurement window even if these effects exist. While this concern is legitimate, its main impact should be to create a bias against us finding significant results. Moreover, as we discuss later in Section VI.B, 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 a measure of loan quality. This should help to partially alleviate the concern. Lastly, we also note that the decline in bank earnings that we measure could underestimate the actual decline on these regulation-motivated loans.

We include bank-level control variables (X_i) that vary depending on Y_{ijt}. We also add state-level variables (S_j), including *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 (μ_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 (μ_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 (μ_j) instead and find that all results hold. For the interest of brevity, we do not tabulate these results.

B.2. Regression Discontinuity Design (RDD)

One concern with our benchmark DID analysis may be that the assignment to treatment (a Democratic governor being elected) versus control (a non-Democratic governor being elected)

groups is not random. In our regressions, we have controlled for state-level observables that are likely to be related with the election outcome. But unobservables (e.g., economic uncertainty in a state that shifts public opinions) that affect an election outcome may also affect banks' decisions and performance in the state, and our estimates of the impact of a Democratic governor might thus be biased. We employ two identification strategies to address this concern, including the main one discussed below and the other in Section VII.A.

Close elections with a narrow vote winning margin between the winning candidate and the losing candidate provide us with an opportunity to use a regression discontinuity design (RDD) to clearly identify the treatment effect. Specifically, the function that assigns a state to treatment is discontinuous at the vote threshold of 50% in elections. By focusing on a subsample of state-years with close elections, Democratic states and non-Democratic states are effectively "homogenized". That is, a state where a Democrat wins by a narrow vote margin is virtually identical to a state where a Democrat loses by a narrow margin, after controlling for state characteristics. Therefore, the assignment of an individual state to be treated is assumed to be random in close elections (see also Lee (2008)). The RDD thus allows an estimation of the average treatment effect of Democratic states versus non-Democratic states that is free of any omitted variable bias and other possible endogeneity concerns, thereby yielding a clear identification.

Our RDD estimation is based on the following empirical model:

$$Y_{ijt} = \beta_0 + \beta_1 Democrat + \beta_2 X_{it} + \beta_3 S_{jt} + \mu_t + \epsilon_{ijt}, \quad (2)$$

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 explanatory variables X_{it} and S_{jt} are the same as in the model specification (1). We also include calendar year fixed effects (μ_t) in the model specification as before. We choose to not include state or bank fixed effects because of the lack of within-state or within-

bank variations (and thus the lack of statistical power of estimation) in the resulting small subsample of close elections. The parameter of main interest, β_1, captures the average treatment effect, i.e., how elected Democratic governors affect the decisions and performance of banks in their states differently from non-Democratic governors.

We focus on a subset of states where gubernatorial elections had a victory margin of 4% or less. Do, Lee, and Nguyen (2016) examine the impact of firm directors' connection with elected governors on firm value using close gubernatorial elections that had a victory margin of 5% or less, and show that connected firms experience a significant value appreciation around the elections. Our empirical approach is similar to that in Chava and Roberts (2008) who estimate the effect of covenant violations on corporate investment by exploiting the discrete nature of a covenant violation that is determined by whether a borrower's accounting variable goes above or below a given covenant threshold, irrespective of the distance from the threshold. Our results are robust to various victory margins, such as within 3%, 5%, and 7%.

V. THE EFFECT OF POLITICS ON BANK CAPITAL DECISIONS

A. DID Regressions

A.1. Bank capital

Table 2 shows the results that are consistent with *Hypothesis 1* about the impact of political influence on bank capital. There are four scenarios of the election outcomes: "R-D" in which a Democratic candidate wins the election while her predecessor is a Republican (or an Independent); "D-R" in which a Republican (or an Independent) candidate wins the election while her predecessor is a Democrat; "R-R" in which both the winner and the predecessor are Republicans (or Independents); and "D-D" in which both the winner and the predecessor are Democrats.

In Column (1), the four scenarios are pooled and the regression is run on the pooled sample using Specification (1). The coefficient β_1 is negative and the coefficient β_2 is positive, and both are statistically significant. It suggests that banks reduce equity in response to the election of a Democratic governor. In contrast, banks increase capital following the election of a Republican or an Independent governor. The reported diff-in-diff coefficient $\beta_1 - \beta_2$ in the lower part of the table also shows that it is negative and statistically significant, indicating that the reduction of capital in banks in states where Democrats win is significantly more, compared with the change in capital in otherwise comparable banks in non-Democratic states. Economically, the diff-in-diff coefficient is -0.5×10^{-3}. The relative reduction is in contrast to the annual growth in *Book equity* of 0.65×10^{-3} for the median bank in the sample.

We next examine banks' capital responses under each scenario of the four election outcomes separately, based on the following specification:

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

where all variables are defined as in Specification (1). The coefficient β_1 is of main interest, which captures how bank capital changes in response to an election outcome. Take the example of "R-D", β_1 captures the average change in bank capital when the state transitions from a Republican (or an Independent) governor to a Democratic governor. We expect a significantly negative β_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 β_1 in both scenarios due to no change in the political party, or a weakly positive β_1 for "R-R" and a weakly negative β_1 for "D-D" if running another term by the same party reinforces the political influence from the prior term. Conducting analysis separately under the different election scenarios enables us to more clearly identify the direction of the impact of the potential regulation change, but at the cost of a loss of statistical power. This analysis also 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.

The results are reported in Columns (2) – (5). The coefficient β_1 is negative for "R-D" and highly significant, with economic magnitude being larger than that obtained in the pooled regression in Column (1). It suggests that banks reduce capital substantially following the victory of a Democratic candidate when the predecessor is a Republican (or an Independent). And banks increase capital significantly following the victory of a non-Democratic candidate who has a Democratic predecessor, as shown by the positive and statistically significant coefficient β_1 for "D-R". The coefficient β_1 is positive for "R-R" and negative for "D-D", but neither significantly different from 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. Overall, the results suggest that our main finding is driven by the two changing-party cases – "R-D" and "D-R". This finding holds even after controlling for state economic conditions such as GDP, GDP growth, and unemployment rate.

[Table 2 goes here]

In *Table 2*, the bank characteristics that we control for include: 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 (as expected), 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.

A.2. Dividends and share repurchase

We next explore the channels through which banks reduce capital. Our hypothesis is consistent with the notion that the reduction in bank capital is through a payout-induced reduction in the level of capital, and is not achieved via asset expansion financed with additional borrowing. We therefore examine whether banks are more likely to increase dividends and share repurchases following the election of a Democratic governor. We employ the same model specification as in (1) for this purpose, 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 instead. In all regressions, we include state-level variables – GDP, GDP growth, and unemployment rate.

The results reported in *Table 3* show that banks increase dividends and stock repurchases following the election of a Democratic governor. Specifically, in Column (1) on dividends, the positive coefficient β_1 and the negative coefficient β_2 are as expected, and β_1 is statistically significant and β_2 is marginally significant. The diff-in-diff coefficient $\beta_1 - \beta_2$ is also positive and significant. The finding suggests that banks increase (reduce) cash dividends following the election of a Democrat (non-Democrat) as governor. In economic magnitudes, the diff-in-diff coefficient is 0.063×10^{-3}, which amounts to over 2% of the dividends paid by the median bank in the sample 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. In Column (2) on stock

sale, we find that the coefficients β_1, β_2, and $\beta_1 - \beta_2$ all have the expected signs, which suggests that banks are more likely to conduct stock repurchases after a Democratic governor takes office than before, relative to what happens after a Republican or an independent governor takes office. Possibly due to the lack of within-state variation in banks' stock sales, these coefficients are not statistically significant. We also note that data on stock sales are missing for many banks, resulting in the substantial decrease in the number of observations.

[Table 3 goes here]

B. Regression Discontinuity Design

Note that our findings in *Table 2* on bank capital responses to different scenarios of election outcomes suggest that they are less likely to be driven by the omitted variable that drives both election outcomes and bank capital decisions discussed earlier. If adverse economic shocks resulted in a change in the ruling party in gubernatorial elections and the subsequent change in bank capital, the effect on bank capital should be the same for "R-D" and "D-R". However, we find that the effect on bank capital for "R-D" is the *opposite* of that for "D-R"; this (at least) partially alleviates the omitted variable concern, and provides further support for our political influence hypothesis.

Nonetheless, to more formally address the issue of estimation bias in the OLS regressions that arises from the possible endogeneity of election outcomes, we conduct the regression discontinuity design (RDD) estimation described earlier and present the results in *Table 4*. The even-column models include both firm-level and state-level control variables, while the odd-column models do not. Also, 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. The results are broadly consistent with the results of the difference-in-difference analysis in *Tables 2* and *3*. The estimated coefficients β_1 are negative for *Book equity* and *Stock sale* and positive for *Dividend*, and they are all statistically significant.

Based on Model (2), the coefficient β_1 indicates that banks reduce their capital ratio by 0.41×10^{-2} following a Democratic candidate's victory in a close election as compared to a Republican or an Independent candidate's victory. The impact is also economically substantial—the reduction in bank capital amounts to 4.4% of the sample median *Book equity* as of the year prior to election. The larger coefficients in the RDD estimation (in absolute terms) as compared to those in the diff-in-diff estimation indicate that unobserved omitted factors that affect both election outcomes and bank capital decisions may be biasing our diff-in-diff estimates downward.

These results suggest that even in close elections, banks tend to reduce capital by increasing dividends and stock repurchases following a Democratic victory, and confirm that the effect of a Democratic governor is causal. Our RDD estimation results are robust to a range of narrow victory margins in defining close elections. For brevity, we do not tabulate these results, but they are available upon request.

[Table 4 goes here]

C. Alternative explanations

We further test some alternative explanations for the above findings. First, it is possible that the decline in bank equity ratios ($\frac{E}{E+D}$) is due to an increase in the level of bank borrowing (D) in Democratic states. We check this and, in results that are untabulated for brevity, we find that there is no change in the level of bank liability (regardless of whether it is in the form of deposits or subordinate debt) in the post-election period in states with Democratic governors. Thus, the decline in equity capital ratios in those banks is not due to greater bank borrowing. Rather, it is a result of a decrease in the level of equity. Second, is the increase in dividend payment a signal of better bank performance in the future? We show in the next section that there is indeed a decline in operating performance in those banks. Thus, the increase in dividend payment is more consistent with banks

reacting to the (perceived) political influence by reducing capital. We present more evidence later that the decline in bank performance is due to a deterioration in loan quality at those banks.

D. 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 impact of a Democratic governor on bank capital may vary depending on which party holds the majority in the state senate. 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 we expect the senate to be a more stable and significant source of influence.

We divide the sample into two subsamples based on whether the senate has a Democratic majority in a state 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 analysis in *Table 2* on bank capital and in *Table 3* on dividends and stock sales in these two subsamples, respectively. 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. Our conjecture is that the effect of a Democratic governor on bank capital should be more pronounced in states in which the Democrats have a majority in the senate during the governor's tenure.

[Table 5 goes here]

The results reported in *Table 5* are consistent with this conjecture. In Models (1) and (2) on bank equity, we find that the estimated coefficients β_1 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 Democratic. However, the diff-in-diff coefficient $\beta_1 - \beta_2$ in Model (1) is only

marginally significant, while in Model (2) it is more significant both economically and statistically. That is, the reduction in bank capital is more pronounced in states in which there is a Democratic governor *and* a senate with a Democratic 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 β_1 and $\beta_1 - \beta_2$ have consistent signs as in *Table 3* in all models except in Model (5), they are statistically significant only (and also have substantially larger magnitudes compared with those in *Table 3*) in the subsample of states in which there is a Democratic governor *and* a Democratic majority in the senate.

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

In this section, we test *Hypotheses 2* and *3*. Specifically, we find that growth in politically-favored loans is significantly higher in banks in Democratic states than in non-Democratic states. These loans contribute to higher CRA ratings for these banks, consistent with the higher lending serving socioeconomic goals that matter to politicians. However, we find that these loans are riskier and have higher expected losses, and these banks exhibit a decline in operating performance.

A. Growth in Politically-favored Loans and Household Consumption

Panel A of *Table 6* presents the DID regression results of our main analysis of growth in different types of bank loans – mortgage, real estate, commercial & industrial (C&I), individual, and agricultural. Political pressure based on correcting perceived distributional inequities and populist political motivations is more likely to be linked to addressing household consumption needs rather than providing more credit to corporations. Moreover, farmers have access to alternative funding sources within the Farm Credit System, so there is a lesser political need to address that sector. Our

hypothesis thus predicts an increase in mortgage, real estate, and individual loans, but not in C&I or agricultural loans, in Democratic states.[23]

Consistent with this prediction, following a Democratic governor being elected, banks experience a significant increase in the growth of mortgages and other real estate loans, and loans to individuals (such as credit cards). This can be seen from the positive and statistically significant coefficient β_1 in Models (1), (2), and (4). In contrast, as the negative and significant coefficient β_2 suggests in these models, banks reduce their growth in these types of lending in states following a non-Democratic governor being elected. The diff-in-diff coefficients $\beta_1 - \beta_2$ are all positive and statistically significant for the above three types of loans. Economically, the diff-in-diff coefficients suggest that growth in mortgage, real estate, and individual loans in banks in Democratic states outpaces banks in non-Democratic states by 0.4%, 0.9%, and 0.7%, respectively.

In contrast, banks do not significantly change their commercial and industrial (C&I) loans and agricultural loans in either Democratic or non-Democratic states.[24] The differences in the relative changes in these two types of loans between banks in Democratic states and banks in non-Democratic states are insignificant. None of the estimated coefficients β_1, β_2 and $\beta_1 - \beta_2$ in Models (3) and (5) is significant.

Overall, our finding is consistent with the evidence presented in an emerging literature on the impact of politics on consumer credit, especially for underserved households (see, for example, Antoniades and Calomiris (2016) and Chavaz and Rose (2016)). In addition, although our model does not have a prediction about the bank's total loan growth, we have checked it. In results that are not tabulated for brevity, we find that banks experience a significant increase in loan growth following a Democratic governor being elected, and reduce their growth in lending following a non-

[23] In Section V.C., we will conduct a further examination of whether the increased loans are politically favored.
[24] 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.

Democratic governor being elected. It suggests that the growth in politically-favored loans in Democratic states is not at the expense of (growth in) other loans.

[Table 6 goes here]

In explaining bank loan growth, 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 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. *Ceteris paribus*, it follows that financially-stronger banks with higher capital are expected to be able to supply more credit. The reason is that they will face less pressure from regulatory supervisors to buttress their loan loss reserves and increase their capital. Consistent with this, we find that loan growth is positively related to *Book equity* and *ROE* and negatively related to *LLA* for all types of loans. At the state level, in addition to GDP, GDP growth, and unemployment rate, we also control for personal income growth to capture its impact on loan demand. 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 rate. Moreover, loan growth is lower in states with higher personal income growth, indicating an overall substitution between loan demand and household income.

As indicated earlier, if banks are significantly increasing politically-motivated loans (and not doing this by reducing their investments in other loans), then we should expect to see an increase in

the growth of household consumption in Democratic 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.[25] Specifically, we examine how growth in PCE is affected following the election of Democratic governors relative to the election of non-Democratic governors, using Specification (1). The diff-in-diff 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, unemployment rate, and personal income growth. The results are reported in Panel B of *Table 6*. For the convenience of interpretation, we multiply the dependent variable, growth in PCE, by 100 and thus it is in percentage.

Echoing the increase (decrease) in growth of politically-favored loans in Democratic (non-Democratic) states in the three years following the gubernatorial elections, there is a corresponding increase (decrease) in PCE growth during the same period.[26] Specifically, the estimated coefficient β_1 is positive and marginally significant, while β_2 is significantly negative. The diff-in-diff coefficient $\beta_1 - \beta_2$ is positive and significant. The results hold with or without state fixed effects. Economically, relative to that in non-Democratic states, growth in PCE significantly increases by 0.32 percentage in Democratic states following the gubernatorial elections, which amounts to a 7.6% increase from the average PCE growth rate as of the year prior to the election. Consistent with greater consumption expenditures in faster-growing economies, growth in PCE is higher in states with higher GDP growth, higher personal income growth, and lower unemployment rate.

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

[25] We use data on PCE in goods that include households' expenditures on both durable and nondurable goods.

[26] 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 Democratic (non-Democratic) 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.

B. 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 Democratic governor on the change in loan loss allowance (*LLA*) that a bank allocates. We choose to use the change in *LLA* to capture the change in loan quality for reasons as follows. First, it "is arguably the best indicator of the status of problems in (a bank's) loan portfolio" (Berger and Udell, 2004). As discussed above, it reflects estimated credit losses within a bank's portfolio of loans and leases. Second, 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, namely, subsequent to the determination that the problem loans are unlikely to be resolved. This issue is particularly relevant in our test, because actual charge-offs can occur well beyond our examination period of the three years following elections. Moreover, banks also vary in how conservative they are and how they handle loan write-offs. Some banks promptly recognize delinquent loans and write them off, while others carry such loans on their books until supervisors direct them to write off the loans (see Walter (1991)). Further, ROE/ROA reflects bank profitability not only from lending but also from other sources, such as services and capital market products and transactions.

Column (1) of *Table 7* displays the DID regression results on the effect of Democratic governors on the change in bank-level *LLA* that strongly support the prediction of our hypothesis.[27] The estimated coefficient β_1 is positive and β_2 is negative, and both are statistically significant at the 1% level. The diff-in-diff coefficient $\beta_1 - \beta_2$ is positive and highly significant. Therefore, banks allocate more loan loss reserves while increasing politically-favored credit supply following a Democratic governor being elected in their state. The opposite is encountered for banks in non-

[27] 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.

Democratic states. These results indicate that the increased loans made by banks in Democratic states have higher expected losses. This finding holds after controlling for contemporaneous loan growth (*Loan growth*), which mitigates the concern that the change in *LLA* is a mechanical result of the change in loan growth. The diff-in-diff coefficient $\beta_1 - \beta_2$ is 0.32×10^{-3}. The relative increase in *LLA* by banks in Democratic states is in sharp contrast to the annual average decrease in *LLA* of 0.28×10^{-4} by sample banks. That is, while the average bank experiences an annual decrease in *LLA* during the sample period, banks in Democratic states see an increase in *LLA* of a magnitude of 11.4 times the average annual change in *LLA* (in absolute terms). 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 economies and those exhibiting higher growth.

[Table 7 goes here]

C. Nature of the Elevated Lending

Next we examine how the bank's loan portfolio characteristics change when bank lending increases, particularly in terms of the representation of mortgages, real estate loans and individual loans in these portfolios. Are these indeed the kinds of loans that would be politically favored? Our earlier analysis of household consumption indicates an answer in the affirmative, but we provide a further test here. Since we do not have access to detailed information about borrower characteristics, we address these questions by examining changes in banks' Community Reinvestment Act (CRA) ratings. The idea is that the CRA seeks to address distributional inequities, so it fits well into the category of politically-favored lending that our paper focuses on. Evidence that the CRA ratings of banks improve would suggest that these banks are making more loans that politicians endorse.

The CRA, passed by Congress in 1977, encourages financial institutions to help meet credit needs of the entire communities in which they operate and provide retail banking and community development services. In particular, the CRA is intended for banks to provide credits to low- and moderate-income neighborhoods, consistent with "safe and sound" operations. To enforce the statute, 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 take into account the bank's CRA performance in evaluating its application for a variety of activities, such as opening new branches, relocating existing branches, mergers and consolidations, and other corporate activities.

The CRA compliance rating is given based on three specific 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 the use of innovative or flexible lending practices to address the credit needs of lower-income geographies (census tracts) or individuals."[28]

To the extent that loans to low- and moderate-income neighborhoods under the CRA standards are also politically favored by Democratic governors, we expect the lending behavior of banks in Democratic states to be oriented towards greater CRA compliance, with consequently higher CRA ratings (lower rating scores). This is likely, given our finding that banks in Democratic states increase mortgage lending, real estate loans and individual loans, all of which satisfy the requirements of the CRA compliance rating. Column (2) of *Table 7* displays the DID regression

[28] 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.

results related to the impact of Democratic governors on the CRA ratings of the banks in their states. Consistent with our hypothesis, the CRA ratings of banks improve significantly in states in which Democratic governors are elected, and decline significantly in states in which non-Democratic governors are elected. The estimated coefficient β_1 is negative and β_2 is positive, and both are statistically significant. The diff-in-diff coefficient $\beta_1 - \beta_2$ is -0.02 and significantly different from zero. The improvement in the CRA ratings of banks in Democratic states, relative to the decline in the CRA ratings of banks in non-Democratic states, is especially noteworthy, given the relatively infrequent CRA examinations[29]. The review cycle for the majority of our sample banks is two years.[30] 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 rate have better CRA ratings.

To summarize, the findings on CRA ratings echo those on the increase in politically-favored loans made by banks in Democratic states. Taken together, these findings provide strong evidence supporting *Hypothesis 2* that banks subject to political influence make more politically-favored loans that enable higher personal consumption, while these loans are riskier for the banks.

D. Bank Performance

Hypothesis 3 states that the higher lending resulting from political influence results in poorer bank performance. Because the majority of our sample banks are not publicly listed, a market-based valuation is not available. We thus examine how banks' operating income (*Earnings*) is affected following the election of a Democratic governor.[31] As an additional measure, we also look at its growth (*Earnings growth*), but choose to tabulate the results only in this main test in the interest of

[29] Not surprisingly, the median bank in the sample does not experience any change in its annual CRA rating.
[30] 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.
[31] 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.

brevity. Columns (3) and (4) of *Table 7* present the DID regression results for *Earnings* and *Earnings growth*, respectively. Consistent with our prediction, banks suffer a reduction in earnings and a decline in earnings growth in the years following a Democratic governor being elected. In comparison, banks in states with a non-Democratic governor being elected experience an increase in both earnings and the earnings growth rate.

Specifically, in both cases of *Earnings* and *Earnings growth*, the estimated coefficient β_1 is negative and β_2 is positive, and both are statistically significant (except that in the case of *Earnings*, the significance of β_1 is marginal). The diff-in-diff coefficients $\beta_1 - \beta_2$ are both negative and significant. Economically, the diff-in-diff coefficient $\beta_1 - \beta_2$ in the case of *Earnings* is -0.02×10^{-2}. The reduction in *Earnings* for banks in Democratic states, relative to the improvement in *Earnings* for banks in non-Democratic states, amounts to nearly one percent of the standard deviation of *Earnings* as of the year prior to gubernatorial elections. Similarly, the diff-in-diff coefficient $\beta_1 - \beta_2$, -0.36×10^{-2}, implies that *Earnings growth* in banks in Democratic states, relative to that in banks in non-Democratic states, declines by an annual rate of 0.36%. We also find that *Earnings* is negatively related to the loan loss allowance in the prior year. *Earnings* and *Earnings growth* are both positively related to the bank's loan growth and negatively related to the bank's asset size. They are also lower in states with higher GDP. Moreover, *Earnings* is higher in states with higher GDP growth.

E. Results with RDD estimation

Table 8 reports the results of the regression discontinuity design in testing the effect of a Democratic governor on bank lending behavior and performance. Similar to *Table 4*, we report coefficient estimates without (odd columns) and with (even columns) controls for bank and state characteristics. The results confirm those obtained in the DID regressions. Panel A reports results on the growth of different types of loans. In all cases, the estimated coefficients have predicted signs and are statistically significant, and are thus consistent with those in Panel A of *Table 6*. In Panel B, results

on bank loan quality and nature and bank performance are reported. They are consistent with the results in Table 7, except that the estimated coefficient β_1 is not statistically significant in Column (6) where *Earnings* is the dependent variable. Overall, the RDD coefficient estimates are larger in magnitude than the DID estimates. It suggests that the DID estimation may underestimate the impact of political influence on bank lending behavior and performance. Our main finding is nonetheless unlikely to be affected by the possible endogeneity of the state gubernatorial election outcomes.

[Table 8 goes here]

VII. ROBUSTNESS CHECKS AND DISCUSSIONS

In this section, we present an additional approach to the Regression Discontinuity Design to address the issue of the confounding effect of economic conditions (especially the unobservables) on both election outcomes and bank capital decisions. Also, we discuss and test an alternative explanation for the decline in bank equity following the election of Democratic governors.

A. Federally-Chartered Banks

We exploit the within-state differences in regulation pressures on different banks due to their chartering differences. For federally-chartered banks that operate in the same state of state-chartered banks, they are subject to the impact of the same observable and unobservable economic factors as the state banks. 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 expected to be small. Therefore, examining how political pressure may affect federally-chartered banks differently compared to state-chartered banks operating in that state can help to delineate the impact of political pressure from the impact of unobservable economic factors. That is, if unobservable economic factors are driving our findings

related to bank capital, lending and performance, we should expect to observe the same impact on federally-chartered banks operating in the state.

We thus repeat the baseline DID regressions on banks' capital structure, loan-making decisions, and performance using the sample of federally-chartered banks only. The results, reported in *Table 9*, show that the overall impact of the gubernatorial election outcomes on federally-chartered banks operating in the state is not significant. Specifically, as shown in Panel A, neither the estimated coefficient β_1 nor the diff-in-diff coefficient $\beta_1 - \beta_2$ is statistically significant in all three models where bank capital, dividends, and stock sales are the dependent variables, respectively. That is, federally-chartered banks do not reduce capital following the elections of Democratic governors. They do not increase dividends or net equity buyback either.

Panel B presents results on the growth of different types of loans made by federally-chartered banks. There is some evidence that, following the election of Democratic governors, they increase real estate, commercial & industrial, and agricultural loans that are not likely to be most politically-favored as discussed earlier except real estate loans. In comparison, there is no significant increase in mortgage and individual loans that are arguably more politically-favored. We complement this finding with results presented in Panel C on the nature of the increased loan making by federally-chartered banks. We find that, while the newly-created loans made by these banks in Democratic states tend to be riskier, they do not result in an improvement in their CRA ratings, in sharp contrast to the new loans made by state-chartered banks. That is, these newly-created loans by federally-chartered banks do not appear to be politically favored. Moreover, we find no evidence that federally-chartered banks experience a decline in performance following the election of Democratic governors.

[Table 9 goes here]

In sum, these findings help to rule out the possibility that some unobserved economic factors underlying the gubernatorial election outcomes 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 for federally-chartered banks.

B. Change in State Income Tax?

The literature has used the state income tax rate as an instrument for bank capital (e.g., Ashcraft (2008), Berger and Bouwman (2009, 2013)), as explained earlier. So if a Democratic governor increases the state income tax rate, banks would reduce capital for a reason that is different from that in our theory.

We examine whether this is the case by testing how state income tax rates change during the six-year window around gubernatorial elections. We use the same benchmark DID regressions of Specification (1) as in our tests of bank decisions. We take the maximum state income tax rates provided by NBER as the dependent variable, which are calculated from a run of the TAXSIM model.[32] State-level characteristic variables such as GDP, GDP growth, and unemployment rate are included as controls. We find that state income tax rates increase following the election of Democratic governors (positive β_1) and decrease following the election of non-Democratic governors (negative β_2), but neither β_1 nor β_2 is statistically significant. Moreover, the diff-in-diff coefficient $\beta_1 - \beta_2$ is not significant either. The results, not tabulated for brevity, are robust to whether state fixed effects are included in the regression in addition to year fixed effects. It suggests that our main finding is unlikely to be driven by a significant difference in fiscal policy changes such as income tax rate changes following elections.

[32] 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 http://users.nber.org/~taxsim/ for more on the TAXSIM model.

VIII. CONCLUSION

This paper has theoretically and empirically examined the idea that legislators/regulators may be politically motivated and may exert influence on banks' credit allocation either through jawboning or by enacting regulations aimed at influencing bank lending. The political preference for such lending may arise from social efficiency considerations, fairness/equity concerns, 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 diminish 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, and exhibit poorer performance than when either independents or Republicans win; this effect is causal. The increased lending also boosts household consumption in the state. Thus, we cannot make welfare statements. 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.

APPENDIX I

A. PARAMETRIC RESTRICTIONS:

Restriction 1: $\pi_h - \pi_\ell > x[q-p]$ (A-7)

Restriction 2: $qx\xi[1-\theta][\xi\theta+1-\xi]^{-1} > \pi_h$ (A-8)

Restriction 3: $\theta < \min\{\theta^0, \hat{\theta}\}$ (A-9)

where θ^0 is the solution to

$$\theta[1-\xi^2\theta-2\xi[1-\xi]]-[1-\xi]^2=0 \quad \text{(A-10)}$$

and

$$\hat{\theta} \equiv \{1+2\xi[1-\xi]\}[2\xi^2]^{-1}. \quad \text{(A-11)}$$

Note that if $\theta < \hat{\theta}$, then the derivative of the left-hand side of (A-10) with respect to θ is increasing in θ.

B. PROOFS:

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

$$q[x-D_R]-E \quad \text{(A-12)}$$

where the repayment obligation on deposits, D_R, solves:

$$q[D_R+\gamma D]=D$$

yielding

$$D_R = D[1-\gamma q][q]^{-1}. \quad \text{(A-13)}$$

Substituting (A-13) back in (A-12) gives us:

$$q[x-D[1-\gamma q]][q]^{-1}-E \quad \text{(A-14)}$$

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

$$qx-L[1-\gamma q]-E\gamma q \quad \text{(A-15)}$$

which is strictly decreasing in *E*. Thus, if the bank intends to choose *G* at *t*=1, it will choose to be all-debt 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 (4), which implies

$$\xi\pi + [1-\xi]\pi_\ell < L\,.$$

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

$$px - L[1-\gamma q] - E\gamma q \tag{A-16}$$

which is less than the expression in (A-15). ■

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 π is:

$$q[x - D_r] \geq \pi_h\,. \tag{A-17}$$

Since this constraint will bind in equilibrium, we can solve for (A-17) as an equality and derive:

$$E_h^* = \frac{\pi_h - qx + L[1-\gamma q]}{1-\gamma q}\,. \tag{A-18}$$

Proceeding similarly, we can derive:

$$\hat{E}_h^* = \frac{\pi_h - px + L[1-\gamma q]}{1-\gamma q}\,. \tag{A-19}$$

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:

$$p[x - D_R] \geq \pi_\ell \tag{A-20}$$

where D_R solves

$$\{\xi\theta + 1 - \xi\}\, p[D_R + \gamma D] = D \tag{A-21}$$

where we recognize that if π_h occurs (probability ξ), then the bank will choose *G* only when the regulator can prevent the choice of *B* (probability θ). Thus,

$$D_R = DB_1 p^{-1} \tag{A-22}$$

where

$$B_1 \equiv \frac{1-\gamma p\{\xi\theta + 1 - \xi\}}{\xi\theta + 1 - \xi}\,. \tag{A-23}$$

Substituting for D_R in (A-20) and solving it as an equality yields:

$$\hat{E}_\ell^* = \frac{\pi_\ell - px + LB_1}{B_1}. \tag{A-24}$$

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

$$E_\ell^* \equiv \frac{\pi_\ell - qx + LA_1}{A_1} \tag{A-25}$$

where

$$A_1 \equiv \frac{1 - \gamma q\{\xi\theta + 1 - \xi\}}{\xi\theta + 1 - \xi}\ . \tag{A-26}$$

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

$$\frac{\pi_h - qx + L[1 - rq]}{1 - \gamma q} > \frac{\pi_\ell - px + LB_1}{B_1} \tag{A-27}$$

with some algebra, it can be shown that (A-27) is satisfied because (A-7) 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:

$$qx - L[1 - \gamma q] - E_h^* rq. \tag{A-28}$$

Substituting for E_h^* from (A-18) and simplifying, we get:

$$\frac{q[x - \gamma\pi_h]}{1 - \gamma q} - L. \tag{A-29}$$

Now suppose the bank chose E_ℓ^* at *t*=0 and then *G* at *t*=1. Then the NPV to its shareholders at *t*=1 is:

$$[\xi\theta + 1 - \xi]\left[qx - A_1 L + A_1 E_\ell^* - E_\ell^*\right] + \xi[1 - \theta]\left[\pi_h - E_\ell^*\right] \tag{A-30}$$

where A_1 is defined in (A-26) and we recognize that the bank will choose *B* with probability $\xi[1 - \theta]$. Substituting for E_ℓ^* from (A-25) and simplifying (A-30) yields:

$$\frac{qx}{A_1} + \xi[1 - \theta]\pi_h - L - \pi_\ell[\xi\theta + 1 - \xi]\left\{\frac{\gamma q[\xi\theta + 1 - \xi]}{1 - \gamma q[\xi\theta + 1 - \xi]}\right\}. \tag{A-31}$$

Tedious algebra shows that (A-8) is a sufficient (not necessary) condition for the expression in (A-29) to be strictly greater than the expression in (A-31).

So we have proved that the bank prefers *G* with E_h^* to *G* with E_ℓ^*. 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_ℓ^*, 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 θ low enough. ■

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

Now,

$$\Pr(\text{bank will not fail}) = p. \tag{A-32}$$

Using (5) we can write (using "d" for "Democrat"):

$$W_d = \alpha_1 p + \alpha_2 \tilde{\beta} \tag{A-33}$$

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

$$\Pr(\text{bank will not fail}) = q$$

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

$$W_d = \alpha_1 q. \tag{A-34}$$

For the politician to prefer to issue a credit-allocation directive, we need

$$\alpha_2 \beta_1 > \alpha_1 [q - p]. \tag{A-35}$$

Case 2: $E = E_h^*$

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

$$\Pr(\text{bank will not fail}) = \xi\theta p + [1-\xi] p \tag{A-36}$$

and

$$W_d = \alpha_1 \{\xi\theta p + [1-\xi] p\} + \alpha_2 [\xi\theta + 1 - \xi] \tilde{\beta}. \tag{A-37}$$

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

$$\Pr(\text{bank will not fail}) = q \tag{A-38}$$

and

$$W_d = \alpha_1 q\,. \tag{A-39}$$

For the politician to prefer to issue a credit-allocation directive, we need the expression in (A-37) to exceed that in (A-39). This will happen if:

$$\beta_1 > \frac{\alpha_1\left[q - \theta\xi p - \left[1-\xi\right]p\right]}{\xi\theta + 1 - \xi}. \tag{A-40}$$

Now since

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

we can say that if (A-40) holds, so will (A-35). So (A-35) is redundant.

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

If the choice of *P* is forced:

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

$$W_d = \alpha_1\left\{\xi\theta p + \left[1-\xi\right]p\right\} + \alpha_2\left[\xi\theta + 1 - \xi\right]\tilde{\beta}\,. \tag{A-42}$$

If the choice of *P* is not forced:

$$\Pr(\text{bank will not fail}) = \theta\xi q + \left[1-\xi\right]q \tag{A-43}$$

$$W_d = \alpha_1\left\{\theta\xi q + \left[1-\xi\right]q\right\}. \tag{A-44}$$

For the politician to prefer to dictate credit allocation with *P*, we need the expression in (A-42) to exceed that in (A-44). This will be true if

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

which obviously holds given (A-40).

Case 4: $E = E_\ell^*$

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

$$\Pr(\text{bank will not fail}) = \theta p \tag{A-45}$$

and

$$W_d = \alpha_1\theta p + \alpha_2\theta\tilde{\beta}\,. \tag{A-46}$$

If the choice of *P* is not forced:

$$\Pr(\text{bank will not fail}) = \xi\theta q + \left[1-\xi\right]q \tag{A-47}$$

and

$$W_d = \alpha_1\left[\xi\theta q + \{1-\xi\}q\right]. \tag{A-48}$$

For the politician to prefer to dictate credit allocation with *P*, we need the expression in (A-46) to exceed that in (A-48) for $\beta = \beta_2$ and for the expression in (A-48) to exceed that in (A-46) for $\tilde{\beta} = \beta_1$. This will happen if

$$\beta_2 > \frac{\alpha_1\left[\xi\theta q + \left[1-\xi\right]q - \theta p\right]}{\alpha_2\theta} \tag{A-49}$$

and

$$\beta_1 < \frac{\alpha_1\left[\xi\theta q + \left[1-\xi\right]q - \theta p\right]}{\alpha_2\theta}. \tag{A-50}$$

To ensure that (A-40) and (A-50) can be simultaneously satisfied, we need:

$$\frac{\xi\theta q + \left[1-\xi\right]q - \theta p}{\theta} > \frac{q - \xi\theta p - \left[1-\xi\right]p}{\xi\theta + 1 - \xi}. \tag{A-51}$$

Simplifying, we see that this requires that

$$\theta\left\{1-\xi^2\theta - 2\xi\left(1-\xi\right)\right\} - \left[1-\xi\right]^2 < 0. \tag{A-52}$$

Now as long as $\theta < \hat{\theta}$, we can show that the left-hand side of (A-52) is strictly increasing in θ. Let θ^0 be the solution to (A-10). Then, we know that if $\theta < \hat{\theta}$ and $\theta < \theta^0$, (A-52) will hold. Thus, (A-9) guarantees that (A-51) holds. Given this, define

$$\underline{\beta} \equiv \frac{\alpha_1\left[q - \xi\theta p - \left[1-\xi\right]p\right]}{\xi\theta + 1 - \xi}, \tag{A-53}$$

$$\overline{\beta} \equiv \frac{\alpha_1\left[\xi\theta q + \left[1-\xi\right]q - \theta p\right]}{\xi\theta + 1 - \xi} \tag{A-54}$$

and we know that when (A-51) holds, $\left(\underline{\beta}, \overline{\beta}\right)$ has positive measure.

Thus, if $\beta_1 \in \left(\underline{\beta}, \overline{\beta}\right)$ and $\beta_2 > \overline{\beta}$, then the politician will force a choice of *P* with probability one in Cases 1, 2 and 3 (i.e., for $E \geq \hat{E}_\ell^*$), and will force 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 $E \geq \hat{E}_{\ell}^{*}$, the politician always chooses to dictate a choice of *P*. Given this, we know that $\hat{E}_{\ell}^{*}$ dominates either or E_h^* or $\hat{E}_h^*$ since $\hat{E}_{\ell}^{*} < E_h^* < \hat{E}_h^*$. . So we just need to compare E_{ℓ}^{*} and $\hat{E}_{\ell}^{*}$.

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

$$q\left[x - D_R^0\right]\left[\xi\theta + 1 - \xi\right] + \xi\left[1-\theta\right]\pi_h - E_{\ell}^{*} \tag{A-55}$$

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

$$p\left[x - \hat{D}_R\right]\left[\xi\theta + 1 - \xi\right] + \xi\left[1-\theta\right]\pi_h - \hat{E}_{\ell}^{*} \tag{A-56}$$

where

$$D_R^0 = DA_1 q^{-1} \tag{A-57}$$

and $\hat{D}_R$ is given by (A-22), 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-51) exceeds that in (A-52) ■

Appendix II: 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.
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 Democratic 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.
Loan growth	The difference between total loans and the lagged one-year total loans, divided by the lagged one-year total loans.
LLA	Loan loss allowance – the ratio of loan loss allowance to total loans (net of unearned income).
LLP	Loan loss provision – the ratio of loan loss provision to total loans (net of unearned income).
Predecessor	A dummy that equals one if the predecessor of a governor is Democratic and zero otherwise.
ROA	The ratio of current-year net income to book value of total assets as of the 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	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.

REFERENCES

Agarwal, Sumit, Efraim Benmelech, Nittai Bergman, and Amit Seru, "Did the Community Reinvestment Act (CRA) Lead to Risky Lending?" NBER Working Paper No. 18609, December 2012.

Agarwal, Sumit, David Lucca, Amit Seru, and Francesco Trebbi, "Inconsistent Regulators: Evidence from Banking", *Quarterly Journal of Economics* 129(2), 2014, pp.889-938.

Anginer, Deniz, Asli Demirguc-Kunt and Min Zhu, "How Does Competition Affect Bank Systemic Risk?", *Journal of Financial Intermediation,* 23(1), January 2014, pp. 1–26.

Antoniades, Alexis and Charles Calomiris, "Mortgage Market Credit Conditions and U.S. Presidential Elections," 2016, Columbia working paper.

Ashcraft, Adam B., Does the market discipline banks? New evidence from the regulatory capital mix. *Journal of Financial Intermediation* 17, 2008, pp. 787-821.

Beim, David and Charles Calomiris. *Emerging Financial Markets*. McGraw-Hill/Irwin, New York, 2000.

Berger, Allen N. and Christa H. Bouwman, "Bank Liquidity Creation", *Review of Financial Studies* 22(9), 2009, pp. 3779–3837.

Berger, Allen N. and Christa H. Bouwman, "How Does Capital Affect Bank Performance During Financial Crises?", *Journal of Financial Economics* 109(1), 2013, pp. 146–176.

Berger, Allen N. and Gregory F. Udell, "The Institutional Memory Hypothesis and the Procyclicality of Bank Lending Behavior", *Journal of Financial Intermediation* 13, 2004, pp. 458-495.

Blair, Christine E. and Rose M. Kushmeider, "Challenges to the Dual Banking System: The Funding of Bank Supervision," *FDIC Banking Review* 18, 2006, pp. 1–20.

Boot, Arnoud, and Anjan V. Thakor, "Self-Interested Bank Regulation", *American Economic Review* 83(2), 1993, pp. 206–212.

Braun, Matias and Claudio Raddatz, "Banking on Politics: When Former High-Ranking Politicians Become Bank Directors", *World Bank Economic Review* 24(2), 2010, pp. 234–279.

Brown, Craig O. and I Serdar Dinc, "The Politics of Bank Failures: Evidence From Emerging Markets", *The Quarterly Journal of Economics*, 120(4), 2005, pp. 1413–1444.

Calomiris, Charles W., and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton University Press, 2014.

Chava, Sudheer, and Michael Roberts, "How Does Financing Impact Investment? The Role of Debt Covenants", *Journal of Finance* 63, 2008, pp. 2085-2121.

Chavaz, Matthieu and Andrew Rose, "Political Borders and Bank Lending in Post-Crisis America," 2016, Berkeley working paper.

Cole, Shawn, "Fixing Market Failures or Fixing Elections? Agricultural Credit in India", *American Economic Journal: Applied Economics*, 1(1), 2009, pp. 219–250.

Di Giuli, Alberta, and Leonard Kostovetsky, "Are Red or Blue Companies More Likely to Go Green? Politics and Corporate Social Responsibility", *Journal of Financial Economics* 111(1), 2014, pp. 158–180.

Dinc, Serdar, I., "Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets", *Journal of Financial Economics* 77, 2005, pp. 453–479.

Do, Quoc-Anh, Yen-Teik Lee, and Bang Dang Nguyen, "Out of Sight, Out of Mind: The Value of Political Connections in Social Networks", 2014, working paper.

Do, Quoc-Anh, Yen-Teik Lee, and Bang Dang Nguyen, "Directors as Connectors: The Impact of the External Networks of Directors on Firms", 2016, working paper.

Dymski, Gary, Gerald Epstein, and Robert Pollin (eds), *Transforming the US Financial System: Equity and Efficiency in the 21st Century,* Routledge, New York, NY, 2015.

Faccio, Mara, Ronald Masulis, and John McConnell, "Political Connections and Corporate Bailouts," *Journal of Finance* 61, 2006, pp. 2597–2635.

Feenberg, Daniel Richard, and Elizabeth Coutts, "An Introduction to the TAXSIM Model", *Journal of Policy Analysis and Management* 12(1), 1993, pp. 189-194.

Holmstrom, Bengt and Jean Tirole, "Financial Intermediation, Loanable Funds, and the Real Sector", *Quarterly Journal of Economics* 112(3), 1997, pp.663-691.

Hong, Harrison, and Leonard Kostovetsky, "Red and Blue Investing: Values and Finance", *Journal of Financial Economics*, 103(1), 2012, pp.1–19.

Iannotta, Giuliano, Giacomo Nocera and Andrea Sironi., "The Impact of Government Ownership on Bank Risk." *Journal of Financial Intermediation,* 22(2), April 2013, pp. 152–176.

Johnson, Simon, and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, New York: Random House, Pantheon Books, 2010.

Kane, Edward, "Principal-Agent Problems in S&L Salvage," *Journal of Finance* 45(3), July 1990, pp. 755–764.

Kane, Edward, "Regulation and Supervision: An Ethical Perspective", Chapter 12 in *Oxford Handbook on Banking* (eds: A. Berger, P. Molyneaux, and J. Wilson), London, *Oxford University Press*, 2nd Edition, forthcoming.

Khwaja, Asim Ijaz and Atif Mian, "Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market", *Quarterly Journal of Economics*, 120(4), 2005, pp. 1371–1411.

Lee, David, S, "Randomized experiments from non-random selection in U.S. House elections". *Journal of Econometrics* 142(2), 2008, pp. 675-697.

Levy, Jonah, *The State after Statism: New State Activities in the Age of Liberalization*, Florence: Harvard University Press, 2006.

Lindbeck, Assar and Jörgen W. Weibull, "Balanced-Budget Redistribution as the Outcome of Political Competition", *Public Choice* 52(3), 1987, pp. 273–297.

Lintner, John, "Distribution of incomes of corporations among dividends, retained earnings, and taxes", *American Economic Review* 46, 1956, pp. 97–113.

Liu, Wai-Man and Phong T. H. Ngo, "Elections, Political competition and Bank failure", *Journal of Financial Economics* 112(2), 2014, pp. 251-268.

Lo, Andrew W., "Reading about the Financial Crisis: A Twenty-One Book Review", *Journal of Economic Literature* 50(1), 2012, pp. 151–178.

Mehran, Hamid and Anjan V. Thakor, "Bank Capital and Value in the Cross-Section", *Review of Financial Studies* 24(4), 2011, pp. 1019–1067.

Michaely, Roni, and Michael Roberts, "Corporate Dividend Policies: Lessons from Private Firms", *Review of Financial Studies* 25, 2012, pp. 711–746.

Nordhaus, William D., "The Political Business: Cycle 12", *The Review of Economic Studies* 42(2), 1975, pp. 169–190.

Pagano, Marco, and Paolo Volpin, "The Political Economy of Finance", *Oxford Review of Economic Policy* 17-4, 2001, pp. 502-519.

Peek, Joe, and Eric S. Rosengren, "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan", *American Economic Review* 95(4), 2005, pp. 1144–1166.

Rajan, Raghuram G., *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010.

Rogoff, Kenneth, "Equilibrium Political Budget Cycles", *The American Economic Review*, 80(1), 1990, pp. 21–36.

Sapienza, Paola, "The Effects of Government Ownership on Bank Lending", *Journal of Financial Economics,* 72(2), 2004, pp. 357–384.

Shen, Chung-Hua and Chih-Yung Lin, "Why Government Banks Underperform: A Political Interference View", *Journal of Financial Intermediation*, 21(2), April 2012, pp. 181–202.

Skinner, Douglas, J., "The Evolving Relation between Earnings, Dividends, and Stock Repurchases", *Journal of Financial Economics,* 87(3), 2008, pp. 582–609.

Song, Fenghua, and Anjan V. Thakor, "Relationship Banking, Fragility and the Asset-Liability Matching Problem", *Review of Financial Studies* 20(6), 2007, pp. 2129–2177.

Song, Fenghua, and Anjan V. Thakor, "Financial System Development and Political Intervention", *World Bank Economic Review* 26(1), 2012, pp. 1–36.

Stiglitz, Joseph E., *Free Fall*, W.W. *Norton and Company*, New York, 2010.

Sullivan, Larry, E. *The SAGE Glossary of Social and Behavioral Sciences,* SAGE Publications, 2009.

Thakor, Anjan, V., "Bank Capital and Financial Stability: An Economic Tradeoff or a Faustian Bargain?" *Annual Review of Financial Economics* 6*,* 2014, 185-223.

Thakor, Anjan, V. "Politics, Regulatory Mistrust and Bank Capital", Working Paper, Washington University in St. Louis, June 2016.

Walter, John, "Loan Loss Reserves," *Economic Review*, July/August 1991, 20-30.

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 II.

Panel A: Gubernatorial elections

Election Year	#. Elections	#.Elections Democrats Won	#.Elections Republican Won	Vote Margin (Mean)	Vote Margin (Median)
1990	36	19	15	0.157	0.122
1991	3	2	1	0.183	0.223
1992	12	8	4	0.193	0.173
1993	2	0	2	0.092	0.092
1994	36	11	24	0.163	0.106
1995	3	1	2	0.134	0.111
1996	11	7	4	0.276	0.177
1997	2	0	2	0.071	0.071
1998	36	11	23	0.19	0.163
1999	3	2	1	0.241	0.326
2000	11	8	3	0.098	0.101
2001	2	2	0	0.099	0.099
2002	36	14	22	0.11	0.078
2003	4	0	4	0.11	0.101
2004	11	5	6	0.132	0.077
2005	2	2	0	0.081	0.081
2006	36	20	16	0.191	0.164
2007	3	1	2	0.232	0.174
2008	11	7	4	0.308	0.329
2009	2	0	2	0.105	0.105
2010	37	13	23	0.145	0.119
2011	4	2	2	0.232	0.212
2012	11	7	4	0.162	0.121
Overall	314	142	166	0.167	0.134

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

	Mean	Median	Std	N
Assets (log)	11.251	11.12	1.305	41878
Book equity	0.104	0.093	0.034	41878
Dividend	0.005	0.003	0.006	41287
Stock sale	0.049	0	0.276	23124
ROA	0.009	0.011	0.01	41878
ROA growth	-0.069	-0.026	1.405	41837
Earnings	0.082	0.081	0.024	41878
Earnings growth	-0.038	-0.028	0.183	41868
ROE	0.101	0.111	0.106	41874
Loan loss allowance	0.016	0.013	0.009	41686
Loan loss provision	0.006	0.003	0.01	41677
Loan growth	0.095	0.067	0.181	41687
CRA rating	1.885	2	0.417	7411
State GDP(log)	11.55	11.569	1.114	314
State GDP growth	0.045	0.048	0.038	314
State unemployment rate	5.615	5.2	1.921	314
State personal income growth	0.036	0.040	0.035	314

Table 2 The Effect of Democratic Governors on Bank Capital

This table presents results of OLS regressions that examine the effect of Democratic governors on bank capital. 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 elections: "R-D" in which a Democratic candidate wins the election while her predecessor is a Republican (or an Independent); "D-R" in which a Republican (or an Independent) candidate wins the election while her predecessor is a Democrat; "R-R" in which both the winner and the predecessor are Republicans (or Independents); and "D-D" in which both the winner and the predecessor are Democrats. In Column (1), the four scenarios are pooled in the regressions. In Columns (2) to (5), regressions are run on each of the individual scenarios separately. In both panels, the dependent variable, *Book equity*, is the ratio of book value of equity to book value of total assets. It is multiplied by 1000 to scale up the estimated coefficients of the independent variables. All control variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)	(5)
Scenarios	All	R-D	D-R	R-R	D-D
Dependent Variable	Book Equity	Book Equity	Book Equity	Book Equity	Book Equity
After*Democrat (β_1)	-0.216*				
	(0.068)				
After*(1-Democrat) (β_2)	0.284***				
	(0.003)				
Democrat	-0.049				
	(0.824)				
Predecessor	-0.472**				
	(0.031)				
After		-2.450***	0.911**	0.017	-0.017
		(0.000)	(0.032)	(0.890)	(0.930)
ROA	450.067***	413.966***	523.800***	363.169***	503.109***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ROA growth	-114.296***	-93.771***	-181.660***	-55.117**	-152.074***
	(0.000)	(0.001)	(0.000)	(0.014)	(0.000)
Asset(log)	-8.877***	-11.267***	-8.904***	-8.308***	-10.114***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
State GDP(log)	-1.734	14.696**	1.260	7.161	-8.326*
	(0.526)	(0.044)	(0.879)	(0.160)	(0.088)
State GDP growth	-12.266***	-0.432	5.525	-35.474***	-4.538
	(0.001)	(0.961)	(0.317)	(0.000)	(0.417)
State unemployment rate	-0.144	0.161	0.117	-0.504**	0.134
	(0.355)	(0.658)	(0.697)	(0.017)	(0.586)
$\beta_1 - \beta_2$	-0.500**				
	(0.016)				
Year FE	Yes	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes	Yes
Observations	236,087	35,412	46,061	89,277	65,337
R-squared	0.094	0.094	0.113	0.081	0.109

Table 3 The Effect of Democratic Governors on Dividends and Net Stock Sale

This table presents results of OLS regressions (Column (1)) and ordered logistic regressions (Column (2)) that examine the effect of Democratic governors on banks' dividend payment and net stock sale decisions, respectively. The 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 dependent variable in Column (1), *Dividend*, is the ratio of total cash dividends paid (common dividends and preferred dividends) to book value of total assets as of the prior year end. It is multiplied by 1000 to scale up the estimated coefficients of the independent variables. The dependent variable in Column (2), *Stock sale*, is an indicator variable that equals -1 (+1) if the bank reports negative (positive) net stock sale and zero otherwise. *Prior-year dividend* is *Dividend* as of the prior year. All other control variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)
Dependent Variable	Dividend	Stock Sale
After*Democrat (β_1)	0.040**	-0.017
	(0.044)	(0.435)
After*(1-Democrat) (β_2)	-0.023	0.015
	(0.123)	(0.424)
Democrat	-0.049	0.044
	(0.155)	(0.224)
Predecessor	0.005	-0.015
	(0.863)	(0.665)
State GDP(log)	0.729**	-0.064
	(0.020)	(0.892)
State GDP growth	1.125	-0.479
	(0.162)	(0.584)
State unemployment rate	0.003	0.027
	(0.874)	(0.248)
Earnings	48.287***	14.912***
	(0.000)	(0.000)
Prior-year dividend	273.145***	
	(0.000)	
Earnings growth		-5.078***
		(0.000)
Assets (log)		0.008
		(0.708)
$\beta_1 - \beta_2$	0.063*	-0.032
	(0.066)	(0.418)
Year FE	Yes	Yes
State FE	No	Yes
Bank FE	Yes	No
Observations	232,639	130,231
(Pseudo) R-squared	0.127	0.080

Table 4 The Effect of Democratic Governors on Bank Capital, Dividend, and Net Stock Sale in a Regression Discontinuity Design

This table presents results of regressions that examine the effect of Democratic governors on bank capital, dividend, and net stock sale in a regression discontinuity design for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 4%. The sample includes all state commercial banks in the three years subsequent to those close elections during 1990-2012. 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 of which are multiplied by 100 to scale up the estimated coefficients of the independent variables. Ordered logistic regressions are run in Models (5) and (6) with the dependent variable being *Stock sale*. *Prior-year dividend* is *Dividend* as of the prior year. All other variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable	Book equity	Book equity	Dividend	Dividend	Stock Sale	Stock Sale
Subsample	Vote margin<=4%	Vote margin<=4%	Vote margin<=4%	Vote margin<=4%	Vote margin<=4%	Vote margin<=4%
Democrat	-0.312***	-0.414***	0.108***	0.037***	-0.294***	-0.240**
	(0.000)	(0.000)	(0.000)	(0.000)	(0.003)	(0.015)
Predecessor	0.023	0.023	0.010	-0.003	-0.303***	-0.016
	(0.740)	(0.743)	(0.404)	(0.615)	(0.002)	(0.869)
State GDP(log)		-0.136**		-0.012**		0.383***
		(0.020)		(0.012)		(0.000)
State GDP growth		-6.758***		1.329***		-12.246***
		(0.000)		(0.000)		(0.000)
State unemployment rate		0.078**		-0.011***		-0.057*
		(0.030)		(0.000)		(0.078)
Assets (log)		-0.537***				0.221***
		(0.000)				(0.000)
ROA		87.319***				
		(0.000)				
ROA growth		-32.352***				
		(0.000)				
Prior-year dividends				59.979***		
				(0.000)		
Earnings				2.930***		14.274***
				(0.000)		(0.000)
Earnings growth						-5.904***
						(0.007)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	27,425	27,425	27,052	27,052	15,363	15,363
R-squared	0.082	0.131	0.035	0.390	0.012	0.048

Table 5 The Effect of Democratic Governors on Bank Capital, Dividend, and Net Stock Sale in States with/without Democratic Senates

This table presents results of regressions that examine the effect of Democratic governors on bank capital, dividend, and net stock sale in two subsamples of states with/without Democratic 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 Democratic senates is defined as those states in the sample that have Democratic senates in at least one of the three years following the gubernatorial elections, and the other subsample is defined as the subsample of states without Democratic 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. 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 and 3, although their estimated coefficients are not reported. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable	Book equity	Book equity	Dividend	Dividend	Stock Sale	Stock Sale
Subsample	Non-Democratic Senate	Democratic Senate	Non-Democratic Senate	Democratic Senate	Non-Democratic Senate	Democratic Senate
After*Democrat (β_1)	-0.791***	-0.760***	0.015	0.090***	0.014	-0.114***
	(0.005)	(0.000)	(0.693)	(0.000)	(0.779)	(0.004)
After*(1-Democrat) (β_2)	-0.081	0.350*	-0.024	-0.021	-0.058	0.083***
	(0.704)	(0.054)	(0.372)	(0.319)	(0.148)	(0.003)
Democrat	0.872**	0.017	-0.051	-0.123***	0.024	0.074
	(0.018)	(0.966)	(0.251)	(0.002)	(0.647)	(0.215)
Predecessor	-1.034***	-0.485	0.024	-0.000	0.063	-0.111**
	(0.002)	(0.168)	(0.500)	(0.999)	(0.193)	(0.043)
$\beta_1 - \beta_2$	-0.710*	-1.110***	0.039	0.111***	0.072	-0.197***
	(0.085)	(0.000)	(0.475)	(0.004)	(0.335)	(0.000)
Bank and State Characteristics	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	105,831	130,256	103,247	129,392	55,667	74,564
R-squared	0.158	0.134	0.342	0.372	0.069	0.089

Table 6 The Effect of Democratic Governors on Bank Loan Growth and Household Consumption Growth

Panels A presents results of OLS regressions that examine the effect of Democratic governors on bank loan growth. The 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. Growth in loans of different types (mortgage, real estate, commercial & industrial, individual, and agriculture), indicated at the top, is 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 II. All bank characteristics variables, *Assets (log), LLA, Book equity,* and *ROE*, are as of the prior year end. Panel B present results of OLS regressions that examine the effect of Democratic governors on the growth in personal consumption expenditure at the state level. Robust standard errors are clustered at the bank level in Panels A and at the state level in Panel B, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Growth in different types of bank loans

Loan growth (Types of loans)	(1) Mortgage	(2) Real Estate	(3) Commercial & Industrial	(4) Individual	(5) Agriculture
After*Democrat (β_1)	0.002*	0.005***	0.002	0.004**	-0.003
	(0.100)	(0.000)	(0.464)	(0.011)	(0.486)
After*(1-Democrat) (β_2)	-0.002	-0.004***	0.001	-0.003**	0.002
	(0.126)	(0.000)	(0.725)	(0.016)	(0.596)
Democrat	-0.006***	-0.008***	-0.004	-0.003	0.004
	(0.004)	(0.000)	(0.325)	(0.132)	(0.517)
Predecessor	-0.003*	0.001	-0.001	0.005***	0.002
	(0.052)	(0.372)	(0.843)	(0.005)	(0.636)
Asset(log)	-0.111***	-0.111***	-0.182***	-0.116***	-0.148***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LLA	-2.316***	-2.775***	-0.732*	-1.862***	-2.583***
	(0.000)	(0.000)	(0.075)	(0.000)	(0.000)
Book equity	1.189***	1.036***	1.200***	1.004***	0.410**
	(0.000)	(0.000)	(0.000)	(0.000)	(0.025)
ROE	0.015	0.041***	0.208***	0.080***	0.087
	(0.391)	(0.002)	(0.000)	(0.000)	(0.101)
State GDP(log)	0.163***	0.129***	0.178***	0.017	-0.080
	(0.000)	(0.000)	(0.000)	(0.396)	(0.150)
State GDP growth	-0.031	0.120***	0.411***	0.217***	0.030
	(0.618)	(0.008)	(0.002)	(0.000)	(0.870)
State unemployment rate	-0.023***	-0.021***	-0.018***	-0.017***	-0.002
	(0.000)	(0.000)	(0.000)	(0.000)	(0.646)
State personal income growth	-0.137*	-0.097*	-0.390**	-0.017	-0.396*
	(0.072)	(0.072)	(0.029)	(0.827)	(0.064)
$\beta_1 - \beta_2$	0.004*	0.009***	0.001	0.007**	-0.005
	(0.100)	(0.000)	(0.791)	(0.011)	(0.526)
Year FE	Yes	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes	Yes
Observations	230,360	231,641	126,729	231,110	165,719
R-squared	0.056	0.092	0.027	0.052	0.006

Panel B: State-level personal consumption expenditure growth

VARIABLES	(1) State PCE Growth	(2) State PCE Growth
After*Democrat (β_1)	0.151	0.158
	(0.145)	(0.146)
After*(1-Democrat) (β_2)	-0.170*	-0.166*
	(0.065)	(0.065)
Democrat	-0.375**	-0.283**
	(0.030)	(0.047)
Predecessor	0.035	0.091
	(0.707)	(0.482)
State GDP(log)	-0.021	-1.053
	(0.741)	(0.523)
State GDP growth	15.115***	15.728***
	(0.004)	(0.003)
State unemployment rate	-0.136**	-0.379***
	(0.047)	(0.000)
State personal income growth	39.133***	34.371***
	(0.000)	(0.000)
$\beta_1 - \beta_2$	0.321*	0.324*
	(0.091)	(0.094)
Year FE	Yes	Yes
State FE	No	Yes
Observations	1,076	1,076
R-squared	0.871	0.886

Table 7 The Effect of Democratic Governors on Bank Loan Loss Allowance, CRA Rating, and Performance

This table presents results of OLS regressions that examine the effect of Democratic governors on bank loan loss allowance, CRA rating, and performance. The 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 dependent variable in Column (1), *LLA*, is the ratio of loan loss allowance to total loans (net of unearned income). The dependent variable in Column (2), *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. The dependent variables in Columns (3) and (4), *Earnings* and *Earnings growth*, are the ratio of operating income to book value of total assets as of the prior year end and the difference between the current-year *Earnings* and the lagged one-year *Earnings*, divided by the lagged one-year *Earnings*, respectively. All dependent variables except in Column (2) are multiplied by 100 to scale up the estimated coefficients of the independent variables. All other variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

VARIABLES	(1) LLA	(2) CRA Rating	(3) Earnings	(4) Earnings Growth
After*Democrat (β_1)	0.017***	-0.011***	-0.009	-0.173***
	(0.000)	(0.001)	(0.155)	(0.004)
After*(1-Democrat) (β_2)	-0.015***	0.009***	0.011**	0.182***
	(0.000)	(0.000)	(0.028)	(0.000)
Democrat	0.002	0.003	0.005	0.294***
	(0.718)	(0.534)	(0.597)	(0.001)
Predecessor	0.015**	-0.013***	0.014	-0.166**
	(0.011)	(0.006)	(0.108)	(0.020)
Asset(log)	-0.078***	-0.018*	-0.248***	-3.601***
	(0.000)	(0.063)	(0.000)	(0.000)
Loan growth	-0.888***	0.011	3.498***	31.136***
	(0.000)	(0.568)	(0.000)	(0.000)
State GDP(log)	-0.118*	0.029	-0.560***	-2.925***
	(0.072)	(0.627)	(0.000)	(0.002)
State GDP growth	-0.593***	-0.146	0.412*	3.660
	(0.000)	(0.304)	(0.057)	(0.132)
State unemployment rate	0.047***	0.017***	0.006	0.582***
	(0.000)	(0.000)	(0.417)	(0.000)
LLP	30.659***			
	(0.000)			
LLA			-17.126***	41.638***
			(0.000)	(0.000)
$\beta_1 - \beta_2$	0.032***	-0.020***	-0.020*	-0.355***
	(0.000)	(0.001)	(0.072)	(0.001)
Year FE	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes
Observations	234,811	48,052	234,914	232,915
R-squared	0.252	0.060	0.621	0.258

Table 8 The Effect of Democratic Governors on Bank Loan Growth, Loan Loss Allowance, CRA Rating, and Performance in a Regression Discontinuity Design

This table presents results of regressions that examine the effect of Democratic governors on growth of different types of bank loans, loan loss allowance, CRA rating, and earnings in a regression discontinuity design for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 4%. The sample includes all state commercial banks in the three years subsequent to those close elections during 1990-2012. Dependent variables are indicated at the top of each column. *LLA* and *Earnings* are multiplied by 100 to scale up the estimated coefficients of the independent variables. All other variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Panel A Growth in different types of bank loans

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
VARIABLES	Mortgage	Mortgage	Real Estate	Real Estate	Commercial & Industrial	Commercial & Industrial	Individual	Individual	Agriculture	Agriculture
Democrat	0.017***	0.011**	0.015***	0.008**	0.015	0.002	0.022***	0.009*	0.012	0.028
	(0.001)	(0.031)	(0.000)	(0.044)	(0.141)	(0.826)	(0.000)	(0.093)	(0.465)	(0.105)
Predecessor	-0.007	-0.008*	0.004	0.004	0.001	-0.007	-0.003	-0.004	0.023	0.020
	(0.150)	(0.099)	(0.237)	(0.346)	(0.905)	(0.559)	(0.576)	(0.429)	(0.135)	(0.187)
Asset(log)		-0.001		-0.003**		-0.008**		-0.005**		0.020***
		(0.503)		(0.034)		(0.026)		(0.012)		(0.003)
Loan loss allowance		-1.867***		-2.156***		-2.488***		-0.958***		-2.146***
		(0.000)		(0.000)		(0.000)		(0.003)		(0.009)
Book equity		0.497***		0.396***		0.763***		0.508***		-0.136
		(0.000)		(0.000)		(0.000)		(0.000)		(0.497)
ROE		0.006		0.066***		0.087**		0.071**		0.058
		(0.826)		(0.001)		(0.049)		(0.012)		(0.567)
State GDP(log)		0.009**		0.004		0.006		0.006*		-0.012
		(0.010)		(0.117)		(0.353)		(0.099)		(0.394)
State GDP growth		1.087***		1.045***		0.199		0.864***		-0.027
		(0.000)		(0.000)		(0.609)		(0.000)		(0.964)
State unemployment rate		-0.007***		-0.006***		-0.014***		-0.009***		0.012*
		(0.002)		(0.001)		(0.001)		(0.000)		(0.094)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	27,097	27,096	27,187	27,186	14,902	14,902	27,141	27,140	17,701	17,700
R-squared	0.018	0.026	0.032	0.049	0.028	0.037	0.022	0.029	0.004	0.006

Panel B Bank loan loss allowance, CRA rating, and performance

VARIABLES	(1) LLA	(2) LLA	(3) CRA Rating	(4) CRA Rating	(5) Earnings	(6) Earnings
Democrat	0.155***	0.141***	-0.045***	-0.061***	-0.077*	-0.018
	(0.000)	(0.000)	(0.002)	(0.000)	(0.087)	(0.706)
Predecessor	0.045**	0.041**	-0.024*	-0.007	-0.009	-0.037
	(0.017)	(0.013)	(0.072)	(0.570)	(0.873)	(0.462)
Asset(log)		-0.022***		-0.043***		0.092***
		(0.003)		(0.000)		(0.000)
Loan growth		-1.017***		0.054		4.232***
		(0.000)		(0.143)		(0.000)
State GDP(log)		0.001		0.024**		-0.229***
		(0.957)		(0.023)		(0.000)
State GDP growth		2.266***		-0.397		11.918***
		(0.000)		(0.369)		(0.000)
State unemployment rate		-0.032***		0.014**		0.068***
		(0.000)		(0.033)		(0.001)
LLP		43.587***				
		(0.000)				
LLA						-8.182***
						(0.001)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	27,293	27,290	5,950	5,945	27,297	27,421
R-squared	0.073	0.264	0.038	0.057	0.537	0.643

Table 9 The Effect of Democratic Governors: Evidence from Federally Chartered Banks

This table presents results of regressions that examine the effect of Democratic governors 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 Tables 2 and 3, respectively. 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 Panel A of Table 6, respectively. In Panel C, bank loan loss allowance, CRA rating, and earnings are the dependent variables as in Table 7, respectively. All other variables are defined in the Appendix II. Robust standard errors are clustered at the bank level, and p-values are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Effect on equity, dividend, and stock sales

	(1)	(2)	(3)
Dependent Variable	Book Equity	Dividend	Stock Sale
After*Democrat (β_1)	-0.351	0.042	-0.007
	(0.321)	(0.361)	(0.865)
After*(1-Democrat) (β_2)	0.511*	-0.004	-0.039
	(0.074)	(0.903)	(0.260)
Democrat	-0.717	-0.072	0.055
	(0.263)	(0.310)	(0.371)
Predecessor	-0.680	-0.127*	0.136**
	(0.291)	(0.052)	(0.022)
ROA	697.429***		
	(0.000)		
ROA growth	-318.095***		
	(0.000)		
Asset(log)	-21.162***		0.027
	(0.000)		(0.349)
State GDP(log)	-3.918	0.813**	-0.629
	(0.636)	(0.039)	(0.427)
State GDP growth	-49.488***	0.822	-1.436
	(0.000)	(0.625)	(0.335)
State unemployment rate	0.631	-0.142***	-0.022
	(0.208)	(0.005)	(0.576)
Earnings		43.614***	2.334***
		(0.000)	(0.000)
Prior-year dividend		152.478***	
		(0.000)	
Earnings growth			1.489
			(0.192)
$\beta_1 - \beta_2$	-0.862	0.046	0.032
	(0.160)	(0.550)	(0.652)
Year FE	Yes	Yes	Yes
State FE	No	No	Yes

Bank FE	Yes	Yes	No
Observations	85,371	83,203	53,337
(Pseudo) R-squared	0.096	0.086	0.046

Panel B: Effect on growth in different types of bank loans

Loan growth (Types of loans)	(1) Mortgage	(2) Real Estate	(3) Commercial & Industrial	(4) Individual	(5) Agriculture
After*Democrat (β_1)	0.004	0.004*	0.007*	0.003	0.016*
	(0.219)	(0.051)	(0.062)	(0.229)	(0.091)
After*(1-Democrat) (β_2)	-0.002	-0.002	-0.005	-0.003*	-0.011*
	(0.282)	(0.128)	(0.144)	(0.064)	(0.076)
Democrat	-0.005	-0.007**	-0.014**	-0.000	-0.007
	(0.191)	(0.032)	(0.012)	(0.902)	(0.566)
Predecessor	-0.005	-0.002	0.004	0.012***	0.008
	(0.129)	(0.390)	(0.478)	(0.000)	(0.434)
Asset(log)	-0.134***	-0.123***	-0.156***	-0.126***	-0.254***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LLA	-1.707***	-2.275***	-0.377	-1.133***	-0.902
	(0.000)	(0.000)	(0.412)	(0.001)	(0.388)
Book equity	0.698***	0.561***	0.592***	0.502***	0.048
	(0.000)	(0.000)	(0.007)	(0.001)	(0.918)
ROE	0.051*	0.051**	0.180***	0.074***	0.074
	(0.067)	(0.013)	(0.000)	(0.007)	(0.454)
State GDP(log)	0.033	0.022	0.069	0.001	-0.028
	(0.109)	(0.149)	(0.139)	(0.968)	(0.588)
State GDP growth	0.483***	0.412***	0.305*	0.588***	0.572
	(0.000)	(0.000)	(0.089)	(0.000)	(0.189)
State unemployment rate	-0.033***	-0.026***	-0.017***	-0.012***	0.012
	(0.000)	(0.000)	(0.000)	(0.000)	(0.198)
State personal income growth	-0.661***	-0.313***	0.039	-0.167	-0.621
	(0.000)	(0.003)	(0.881)	(0.249)	(0.208)
$\beta_1 - \beta_2$	0.006	0.006*	0.012*	0.006	0.027*
	(0.231)	(0.069)	(0.073)	(0.130)	(0.080)
Year FE	Yes	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes	Yes
Observations	81,917	82,147	53,234	82,503	60,451
R-squared	0.047	0.069	0.039	0.054	0.008

Panel C: Effect on bank loan loss allowance, CRA rating, and performance

VARIABLES	(1) LLA	(2) CRA Rating	(3) Earnings
After*Democrat (β_1)	0.030***	0.007	-0.017
	(0.000)	(0.457)	(0.404)
After*(1-Democrat) (β_2)	-0.028***	-0.006	0.016
	(0.000)	(0.313)	(0.277)
Democrat	0.006	-0.001	0.014
	(0.625)	(0.943)	(0.689)
Predecessor	0.040***	0.011	-0.023
	(0.000)	(0.336)	(0.435)
Asset(log)	-0.094***	-0.003	-0.687***
	(0.000)	(0.900)	(0.000)
Loan growth	-0.839***	0.091**	5.100***
	(0.000)	(0.018)	(0.000)
State GDP(log)	-0.065	0.055	-0.749
	(0.329)	(0.325)	(0.182)
State GDP growth	-0.824***	-0.256	1.172
	(0.000)	(0.515)	(0.130)
State unemployment rate	0.067***	0.009	0.048*
	(0.000)	(0.372)	(0.071)
LLP	31.095***		
	(0.000)		
LLA			-10.797***
			(0.008)
$\beta_1 - \beta_2$	0.058***	0.013	-0.033
	(0.000)	(0.387)	(0.330)
Year FE	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes
Observations	83,185	7,490	83,273
R-squared	0.267	0.050	0.394

Figure 1: Sequence of Events

t=0	t=1	t=2
• Election outcome is revealed. • Banks choose capital structure and raise debt (deposits) and equity financing.	• Winning politician observes realized value of $\tilde{\beta}$, observes bank capital structure and decides whether to issue credit allocation directive. • Bank chooses loan from C_1 or C_2 after receiving regulatory directive. • Regulator is able to prevent choice of *B* with probability θ in states in which bank prefers *B*.	• All payoffs realized and depositors and bank shareholders paid off.

Figure 2. Probability of a Credit-allocation Directive as a Function of Bank Capital

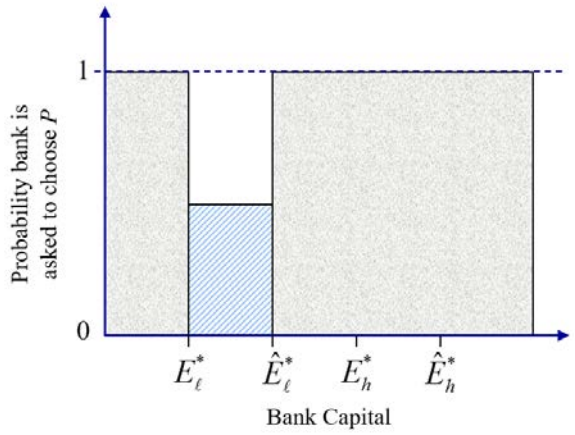
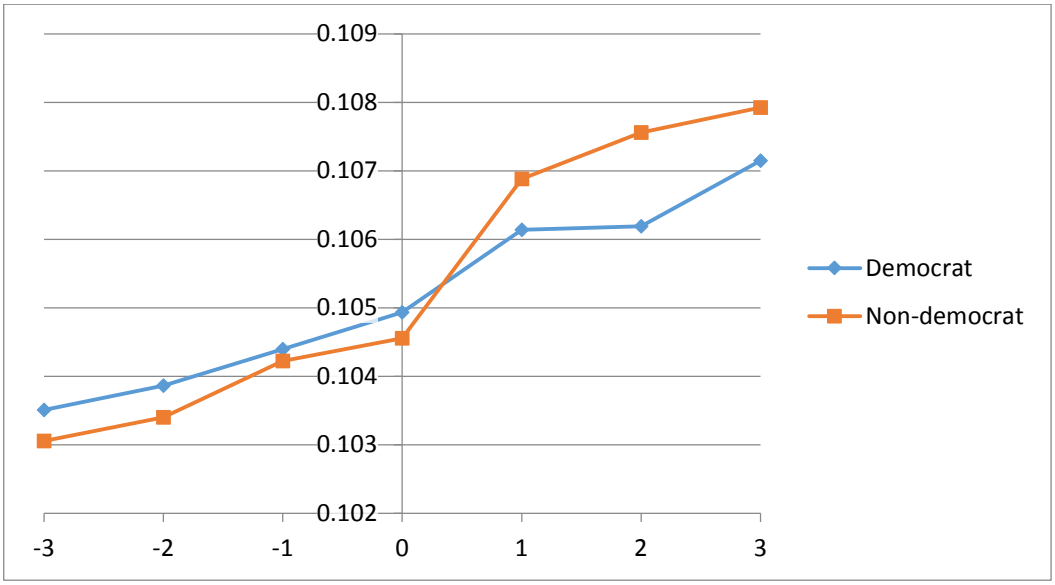


Figure 3: Yearly Plot of Average Equity Ratios of State Chartered Banks in Democratic States vs. Non-Democratic States around Gubernatorial Elections.



This figure plots the time-series of the annual average *Book equity* of sample banks for the seven-year 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 and independents won.