Political Influence, Bank Capital, and Credit Allocation

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June 2023

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ABSTRACT

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

I. INTRODUCTION

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

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

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

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[1] See, for example, Boot and Thakor (1993), Kane (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. The need for such regulation may reflect the classic divide between the private optima of banks and the social optimum in credit extension.

[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.

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

This model generates three predictions. First, politically-pressured banks will reduce their capital ratios. Second, banks subject to greater political pressure will make more politically-favored loans. Third, relative to other banks, these banks will exhibit higher lending risk and poorer post-lending performance. That is, although politically-favored loans are positive-NPV investments for banks in our model, they are nonetheless riskier and less profitable.[5]

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

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

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

Although both parties mix politics and banking, Democrats typically attach greater importance than Republicans to the role of the government in addressing perceived distributional inequities through credit allocation (e.g., Dymski, Epstein, and Pollin (2015), Levy (2006), and Sullivan (2009)). In Section II.B, we provide an extensive discussion of the platforms of the two parties. This discussion reveals that the *publicly stated* positions of the two parties reflect precisely the policy differences in the role of the government in bank credit allocation that we model. This implies that state-chartered banks ("state banks" hereinafter) are subject to greater political influence to allocate credit in states following the election of Democrat governors. While federal regulators are the only regulatory and supervisory authority of federally-chartered banks, state and federal regulators work jointly in monitoring state banks, and federal regulators often rely on state regulators for local information (e.g., Agarwal, Lucca, Seru, and Trebbi (2014)). State governors can thus influence state banks (not federally-chartered banks) through their appointments of the state banking department heads and other personnel, as well as by affecting regulatory policymaking.[7]

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 regulatory pressures and examine

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

[7] See Section IV for a more detailed discussion on the potential influence of state governors on state banks.

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the corresponding differing influences on federally-chartered banks versus state banks. Our baseline analysis relies on a difference-in-difference regression of bank behavior and performance across banks in Democrat versus Republican states in a time window from three years prior to gubernatorial elections to three years after gubernatorial elections.[8] To account for the impact of any time-invariant bank-specific factors and unobserved heterogeneities across elections, we include bank and election fixed effects in all regressions wherever appropriate, in addition to time fixed effects to capture any time trend in bank behavior/performance.

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

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

We also provide additional evidence that the increased lending is indeed more *politically favored*: (i) We show that the higher lending addresses household consumption needs – ostensibly a political goal. Specifically, bank loans to individuals increase in states following the election of Democrat governors. (ii) State banks increase branches in low-income counties following the election of Democrat governors, consistent with the role of branch networks in facilitating credit access for disadvantaged communities. (iii) Finally, CRA (Community Reinvestment Act) ratings improve for these banks, consistent with their lending and branching serving socioeconomic goals. All these results are consistent with the notion that politicians care about income inequality and address it by helping to increase household consumption via an increased supply of bank credit, especially to low-income households. This is further confirmed when we examine transaction-level data on mortgage lending – we find that mortgage lending to low-income households increases significantly following the election of Democrat governors.

Third, with higher politically-favored lending, state banks in Democrat states exhibit a decline in operating performance after gubernatorial elections, relative to state banks in Republican states. Our model implies that this performance decline is not something that banks seek (for example, to

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[8] 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.

achieve an intertemporal tradeoff between lower earnings now and higher earnings in the future). This speaks to the issue of banks' *attitudes* toward credit-allocation influence, something that is hard to establish empirically, but we provide some evidence in support.

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

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

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

Second, we conduct a falsification test and exploit differences among banks based on whether they have federal or state charters, and the corresponding differences in regulatory pressure on them by state regulators. According to our theory, state-level political influence on federally chartered banks should be insignificant. However, if unobserved economic factors are driving our findings, we should expect the documented effect of state-level political influence to also be significant for federal banks in the same state. We thus repeat all the benchmark empirical analyses for federal banks and find that the impact of the gubernatorial election outcomes is insignificant in most cases.

Third, we examine a subsample of state banks operating exclusively in counties that are geographically close to either side of a state border. The idea is that geographically-proximate counties located on two different sides of a state border have more similar macroeconomic environments than do counties far away from the border. Therefore, our estimate of the impact of political influence is less likely to be confounded by any unobservable differences in macroeconomic environments across

states. Our findings generally hold for this restricted subsample.

Alternative Explanations: We then proceed to examine the merits of some alternative explanations for our main finding. First, the decline in bank equity under Democrat governors might be due to changes in banks' investment opportunities. However, we do not find evidence to support this conjecture. Second, the party affiliation of the elected governor may affect post-election tax rates and this may cause changes in bank capital structure that differ across Democrat and Republican governors. The literature has used the state income tax rate as an instrument for bank capital (e.g., Ashcraft (2008), Berger and Bouwman (2009, 2013)), arguing that higher tax rates favor debt financing. However, we find that Democrat victories were *not* followed by a greater change in state income tax rates. Third, we examine whether possible differences in regulatory forbearance across Democrat and Republican governors may explain our results, if Democrats are more inclined to practice forbearance, especially for banks considered "too big to fail" (TBTF). This would generate moral hazard, leading to lower capital and riskier lending. This hypothesis suggests that our results should be stronger for larger banks that are systemically more important. However, we find that the documented effects are concentrated in *smaller* banks. Our findings seem consistent with the greater influence of state governors on smaller banks who possess less bargaining power *vis a vis* state regulators. Lastly, we study whether banks' political connections can affect political influence on banks' behavior. Using a measure of banks' political connection following Kostovetsky (2015), we find that our results remain robust after controlling for it.

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

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

This result notwithstanding, we cannot make welfare statements, since we do not know what motivates politicians to influence credit allocation. It could well enhance social welfare, say due to enhanced consumption from better access to individual loans, or the potential welfare gains from

reducing distributional inequalities in bank credit[9]. That is, we cannot view bank performance and risk as the sole determinants of social welfare, especially in light of the earlier-mentioned evidence on the role of expanded bank credit in reducing income inequality. On the other hand, it is also possible that political motives may be driven more by the self-interest of politicians than by social welfare. That is, the analysis implies a tradeoff between higher welfare due to higher household consumption and the lower welfare due to reduced safety and soundness.

II. THE RELATED LITERATURE

A. The Influence of Politics on Banking

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

The point that politicians may attempt to influence the credit allocation decisions of banks is even more compelling. See, for example, the theory in Thakor (2021) and the evidence in Chu and Zhang (2022), Lopez and Siegel (2023), Norden, Mequita and Wang (2021), Pagano and Volpin (2001) and Brown and Dinc (2005). Becker and Ivashina (2018) show that European governments can pressure domestic banks to buy local sovereign debt through direct government ownership and government influence on banks' boards of directors. Such holdings of domestic government debt crowd out corporate lending by these banks. Braun and Raddatz (2010) examine international data to examine how frequently former high-ranking politicians become bank directors. At the country level, they show that this connectedness is strongly negatively related to economic development, which is difficult to reconcile with a benign public-interest view of bank regulation. Related to this, numerous papers have documented that politicians in emerging markets use state-owned banks to achieve political goals, and this imposes costs on the economy. See, for example, Khwaja and Mian (2005) and Cole (2009).

This problem is *not* limited to government-owned banks or banks in emerging markets. Kane (forthcoming) and Rajan (2010) have highlighted the role of politics in U.S. banking regulation. Agarwal, Lucca, Seru, and Trebbi (2014) document that state and federal regulators in the U.S.

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[9] Lo and Thakor (2023) discuss how government influence on bank credit allocation can potentially improve welfare by enhancing investments in biomedical R&D.

implement identical rules differently and suggest (but do not test) that this may be explained by different degrees of political pressure on regulators. Liu and Ngo (2014) provide evidence suggesting strategic political manipulation of U.S. bank closures. Peek and Rosengren (2005) argue that the misallocation of credit in Japan during its economic crisis was due to the perverse incentive of a government faced with a growing budget deficit. Dinc (2005) examines banking data in many emerging markets *and* developed economies and finds strong evidence of political influence on bank lending. Iannotta, Nocera, and Sironi (2013) use cross-country data on large European banks to show that government-owned banks have higher operating risk than private banks and that this risk increases in election years; see Anginer, Demirguc-Kunt, and Zhu (2014) for similar results. Agarwal, Benmelech, Bergman, and Seru (2012) provide evidence that the Community Reinvestment Act (CRA) led to riskier lending by U.S. banks. Shen and Lin (2012) provide evidence that sheds light on *how* politics affects bank performance and *why* government-owned banks underperform. [10] Their analysis shows that governments have numerous levers that they can pull to try and influence the lending policies of banks, so the credit-allocation decision analyzed in this paper is only one of those levers.

Perhaps the most extensive and historically-compelling account of the manner in which politics affects the design of banking systems and the regulation of banks has been provided by Calomiris and Haber (2014). They study centuries of bank regulation in many countries, most notably the U.S. and Canada, and argue that politics is an integral part of banking in all countries and it determines whether societies suffer repeated banking crises repeatedly (as in Argentina and the U.S.) or never (as in Canada). Their book provides a rich set of institutional facts that are consistent with and further illuminate the empirical evidence cited above[11].

The existing literature thus provides empirical support and motivation for the assumption underlying our theory that the regulator may adopt formal regulations or less-formal regulatory practices—including jawboning—that pressure banks to make politically-favored loans, which are riskier with lower expected payoffs. Such regulations are typically presented as seeking to correct distributional inequities due to credit-market frictions, or simply to serve the broad political objective of expanded credit access. The recent research of Brei, Frerri and Gambacorta (2018) supports the

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[10] 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).

[11] Consistent with these institutional facts, Thakor (2021) 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. The theory developed in that paper has a central premise similar to the motivation in this paper.

idea that politicians who wish to address income inequality may be interested in providing inducements to banks to expand credit supply to households. Moreover, these papers also provide evidence supporting our premise that state governors significantly influence banking outcomes (e.g., Liu and Ngo (2014)).[12]

B. Politics and Banking: Democrats Versus Republicans

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

Perhaps the contrast between Republicans and Democrats on this issue is most starkly expressed in the debate over a bill proposed in 1975 by Representative Henry Reuss (D-WI) that would have required the 200 largest US banks to report to Congress how they were allocating credit. The bill was defeated in the House and Rep. Chalmers Wylie (R-OH) said: "A rose by any name would smell just as sweet. This is a disguise for the beginning of a credit allocation system." Another important example is the Community Reinvestment Act that was signed into law by President Carter (D) and strengthened substantially in 1995 during President Clinton's (D) term, although it had bipartisan support; see Calomiris and Haber (2014) for more on this. Further, in the aftermath of the 2007-09 financial crisis, not only were banks that were accused of misdeeds required to pay fines by the Obama administration, but they were also required to invest billions of dollars in new loans to low-income and minority neighborhoods. Republicans strongly disagreed with the notion that banks were to blame for the crisis and needed to be thus "punished".[13]

Getting banks to increase consumer credit is an important mechanism by which politicians can elevate wealth accumulation and household consumption in underserved groups, and doing this helps politicians address income and consumption inequality concerns. Empirical evidence that increased borrowing facilitates greater household consumption is provided by Jagannathan, Kapoor, and Schaumburg (2013) who document that per capita household consumption in the U.S. grew at a

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

[13] See Wallison (2011).

dramatically higher rate during 2001-2007, and was financed substantially by borrowing against home equity (see also Mian and Sufi (2014)). Republicans and Democrats are divided on the government's role in this. Democrats have long advocated aggressive government intervention in the housing market to expand opportunities for minorities and low-income residents.[14] The architect of the 1992 bill that created "affordable housing" requirements on Fannie Mae and Freddie Mac was Congressman Barney Frank (D). Under this law, these government-sponsored enterprises (GSEs) were required to have at least 30% of the loans they purchased to be those made to people at or below the median income in their communities.[15] This requirement was later raised to 50% under President Clinton (D). These legislative initiatives were not intended to increase total mortgage lending *per se*. Rather, they were intended to induce changes in the composition of lender portfolios, so a greater fraction of lending would be to underserved communities. Our study indeed provides important supporting evidence by showing that more mortgage lending by state banks goes to low-income borrowers following elections of Democrats (more details are in Section VI).

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

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

In sharp contrast, the *2016 Republican Party Platform* stated:

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

A noteworthy point is that, while politically-favored loans may be positive-NPV projects for banks, the empirical evidence discussed earlier indicates that they tend to result in poorer loan performance and higher operating risks for banks.[16]

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

Our paper is also related to how bank capital affects bank risk and value. The previous

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[14] See Haldane (2016).

[15] Prior to this, these GSEs were required to buy only prime mortgages.

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

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

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

III.   HYPOTHESES DEVELOPMENT

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

Our main hypothesis is that the influence of politics on banks' credit allocation can trigger an optimal response of the banks in their capital decisions. Specifically, politics often influences credit allocation ostensibly to improve social welfare, but this might not be profit-maximizing for banks. Even if the politically-favored loans are positive NPV for banks, if banks view themselves as capacity constrained (i.e., there is some optimal finite size at which the bank chooses to operate), then these loans may not be preferred by the bank because there are other loans that are more profitable and allow the bank to reach its desired asset portfolio size. If credit-allocation pressure exposes banks to greater risk and lower profits, they will have an incentive to reduce the probability of being subjected to such pressure. Banks which recognize that, in addition to their desire to influence bank credit allocation, politicians also care about the safety and soundness of banks, will then want to increase their own fragility in order to make it less attractive for politicians to impose credit-allocation pressure that imperils banks further. One salient way to increase fragility is to reduce the bank's capital ratio. Thus, there will be an incentive for banks to lower their capital levels when they anticipate greater credit-allocation political pressure.[17] This (formally, *Proposition 4* of the model) leads to:

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[17] There is also a complementary risk-shifting effect that will reinforce the bank's desire to lower its capital ratio in anticipation of political influence on its lending. To the extent that such lending is riskier, the shareholders might prefer

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

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

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

Hypothesis 2: Banks subject to greater political pressure will make more politically-favored loans.

However, making these loans will adversely affect bank performance. The reason is that we assume that banks are profit-maximizing and are capacity-constrained, so any pressure to make lower-profitability loans comes at the expense of more profitable loans.[18] This leads to:

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

IV. DATA AND EMPIRICAL METHODLOGY

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

A. Nature of Political Influence and Its Empirical Proxy

Testing the three predictions discussed above requires an empirical proxy for political influence. Our proxy is the outcome of state gubernatorial elections. Specifically, we instrument for the pending

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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.

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

political influence on banks in a given state with the political ideology of the party to which the winner in the state gubernatorial election belongs. We focus on state governors because of their greater influence on policy-making and regulations than other state rule-makers, like senators. We also examine the impact of the potential interaction between state governors and senators.

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

Our analysis focuses on state-chartered commercial banks in all states of the U.S. Under the dual banking system in the U.S., banks can choose between a federal charter issued by the Office of the Comptroller of the Currency (OCC) and a state charter issued by a state government. The choice of charter determines the supervisor of a bank. For federally chartered banks, OCC is the primary regulatory and supervisory authority. For state-chartered banks, they are regulated and supervised jointly by their state chartering authority and a federal regulator. A state-chartered bank's membership in the Federal Reserve System determines its federal regulator. Specifically, the Fed regulates state member banks (SMBs), and the FDIC regulates nonmember banks (NMBs).[19] 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[20], 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 policies were more standardized in the 1990's (see Agarwal, Lucca, Seru, and Trebbi (2014) for more details). CAMELS ratings are a key input

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

[20] 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.

in many regulatory decisions such as licensing, branching, and merger approvals. State banking departments thus significantly influence federal regulators when it comes to state banks, and are consequently significant in the regulation and supervision of state-chartered banks.

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

A.1. Evidence on Personnel Appointments

First, we examine whether Democrat governors have a stronger preference than Republican governors to appoint state banking department heads who share their political ideology. Specifically, for each state, we manually search the personnel information of its banking department from its website. For many states, information of only the current officers is available, with no information of the past officers. Out of the 304 gubernatorial elections in our sample (to be discussed below in Section IV.A), we found information of banking department heads for 69 Democrat and 76 Republican governors in 21 states during the sample period. The archived information includes the banking department heads' names, titles, dates of appointment, and dates of end of service. There is heterogeneity across states in the names of their banking departments and the titles of their heads. For convenience, we take the mostly adopted title "Commissioner" for all the heads. During the terms of the 69 Democrat and 76 Republican governors, there were 114 and 140 commissioners, respectively.[21]

We next follow the literature (e.g., Lee, Lee, and Nagarajan, 2014) to identify the commissioners' political orientation using their political campaign donation records from Federal Election Commission (FEC).[22] Among the 73 (90) commissioners under Democrat (Republican) governors, for whom we can find donation records, 50 (47) exhibit Democrat (Republican) orientation. That is, 68.5% of commissioners under Democrat governors are perfectly aligned in political orientation with their governors, while this number is 52.2% for Republican governors. Because the tenure of a commissioner can span multiple governors, we further investigate those commissioners who were appointed by incumbent governors. The finding is even more striking – 78.8% of

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[21] There can be multiple commissioners appointed during one term of a governor. The tenure of a commissioner varies across states and governors.

[22] For individual political donations exceeding $200, the identities and contributions of donors and information about candidate or committee recipients, including their party affiliations, are all made public by the FEC. In our sample, the vast majority of commissioners made donations only to one party. In only two cases where commissioners donated to both parties, we measure their political orientation as the party to which they donated more.

commissioners appointed by incumbent Democrat governors are Democrats, while only 20% of those appointed by Republican governors are Republicans, with the affiliations inferred from political donations.[23] The evidence appears to be consistent with Democrat governors' stronger preference to influence state banks through appointments of the state banking department heads. Our finding echoes Becker and Ivashina (2018) who find that European governments have pressured banks for politically-motivated lending through their influence on banks' boards of directors.

A.2. Evidence on State Regulation of Banks

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

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

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[23] Among the 33 (40) commissioners appointed by incumbent Democrat (Republican) governors, for whom we can find donation records, 26 (8) exhibit Democratic (Republic) orientation.

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

[25] We thank Amit Seru for providing access to the federal-state spread data through his website.

sample. The estimated coefficients on the Democrat indicator in Columns (3) and (4) are about five times as large as those in Columns (1) and (2).

The economic significance of such political influence is underscored by the fact that 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 impact on federally-chartered banks because they are regulated by the OCC, and they enjoy preemption from certain state laws as a special feature of the dual banking system. Therefore, we examine whether state-chartered banks reduce their capital ratios and exhibit an increase in politically-favored lending and poorer performance in the years that follow a Democrat being elected governor in that state, relative to the election of a Republican.

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

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

For examples of non-legislative political influence through guidance, see the guidance to all state banks, announced by Governor Hochul (D) of New York on April 15, 2022, to expand access to low-cost bank accounts for New Yorkers. Governor Hochul also issued guidance on September 26, 2022 to all state banks, calling on them to support residents of Puerto Rico in the aftermath of Hurricane Fiona, including waiving ATM and late fees, increasing ATM withdrawal limits, and facilitating and expediting the transmission of funds. As another example of direct guidance, see also the PA CARE package launched by Pennsylvania on March 30, 2020, a voluntary consumer-relief initiative urging lenders to offer additional financial support to people across the Commonwealth.

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

on state banks, through either voice or actions, or both.[26]

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

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

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

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

B. Data and Descriptive Statistics

Data: We collect the results of gubernatorial and senate elections during 1990-2012 from the Federal Election Committee (FEC) website, the National Governors Association (NGA) website, and media sources like The Washington Post. Our sample period starts in 1990 because detailed data on election results such as voting margins first became available only then, and ends in 2012 to ensure that bank data are available in the post-election three-year period. Bank financial statement data are from Reports of Condition and Income (Call Reports). For every gubernatorial election 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

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

assets, operating income, and net income in the year to be available for a bank-year observation to be included in the sample. Data on bank branching are from FDIC, and on mortgage applications and originations since 1998 are from the Home Mortgage Disclosure Act (HMDA) dataset.[27] We focus on conventional loans that banks have the greatest discretions over.[28] We merge the HMDA data with Call Reports using lender identity. Those unmatched banks from the HMDA dataset are manually matched using the bank's name and location. All variable definitions are in the Appendix.

Summary Statistics: *Table 1* presents the distribution of gubernatorial elections (Panel A) and summary statistics of bank and state characteristics 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. As shown in the left part of Panel A, there are totally 304 elections, 140 won by Democrats and 164 by Republicans during 1990-2012.[29] The average (median) vote margin (the difference in the percentage of votes won by the winning candidate and by the losing candidate) is 17% (14.5%).

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

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[27] Earlier data on mortgages are less complete and thus we follow the literature to start our examination of banks' mortgage lending decisions from 1998.

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

[29] As discussed, we exclude from our analysis cases where either the predecessor governor or the winning governor (or both) is an Independent.

that the average sample bank has a net stock sale. Lastly, the median sample bank is rated as "satisfactory" in the CRA rating (rating = 2).

[Table 1 goes here]

Time Series of Bank Equity: *Figure 1* plots the time-series behavior of the annual average *Book equity* of sample banks for the seven-year window [-3, +3] around gubernatorial elections in year 0, in which one plot pertains to banks in states in which Democrats won and the other plot pertains to banks in states in which Republicans won. For New Hampshire and Vermont, where the governor's term is two years, we limit the examination window to three years [-1, +1].[30] 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 Republican states experience an increase that far exceeds the increase in Democrat states. We will conduct a more rigorous regression analysis below that accounts for various factors related to bank capital decisions. In all the regressions, we include calendar year fixed effects to control for the secular time trend in bank equity.

[Figure 1 goes here]

C. Empirical Methodology

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

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

(1) $$Y_{iet} = \beta_0 + \beta_1 After_{et} + \beta_2 After_{et} * Democrat_e + \beta_3 X_{it-1} + \beta_4 S_{jt-1} + \mu_i + \mu_e + \mu_t + \epsilon_{iet},$$

where subscript *i* denotes the state bank, subscript *e* denotes the election in state *j* where state bank *i* is located, and subscript *t* denotes the year in the six-year window [-3, +3] around gubernatorial election *e*.[31] To avoid the potential confounding impact of elections, we exclude the election year 0 from the analysis. Y_{iet} represents bank capital and lending behavior as well as outcome variables such

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

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

as banks' CRA ratings and earnings we examine in more detailed analyses that follow. $After_{et}$ is a dummy that equals one if year t is in the post-election-e year window $[+1, +3]$ and zero if it is in the pre-election-e year window $[-3, -1]$. $Democrat_e$ is a dummy that equals one if a Democrat candidate wins gubernatorial election e and zero otherwise. We estimate the regressions with bank (μ_i) and election (μ_e) fixed effects to eliminate the possible impact on Y_{iet} of any time-invariant bank-specific characteristics and unobserved heterogeneities across elections, respectively. In addition, we include year fixed effects (μ_t) to account for the potential time trend in Y_{iet}, and cluster robust standard errors at the bank level. Therefore, the DID coefficient β_2 captures the effect of a Democrat governor on Y_{iet} relative to the effect of a Republican governor in the three years after the election compared with the three years before the election.[32]

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

We include two sets of time-varying control variables, one at the bank level (X_{it-1}) and the other at the state level (S_{jt-1}). The first, which varies depending on Y_{iet}, will be explained in individual regressions later. The latter includes *State GDP* (in natural logarithm), *State GDP growth* rate, and *State unemployment rate* that help to control for differing levels of economic development in different states.

C.2. Regression Discontinuity (RD) Design

Election outcomes are not exogenous as the assignment to treatment (a Democrat governor being elected) versus control (a Republican governor being elected) groups may not be random. Unobservables (e.g., economic uncertainty in a state that shifts public opinion) that affect an election outcome may also affect banks' decisions and performance, causing our estimates to be biased. The inclusion of election fixed effects can mitigate this issue if the unobservables are time invariant throughout the six-year window around an election. We further address this concern with three identification strategies, the one discussed below and the other two in Section VII.

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[32] The single term $Democrat_e$ is omitted in the specification due to the application of election fixed effects. Also, we have tested the parallel trend assumption of the DID approach and found it is satisfied.

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

Our RD estimation is based on the following empirical model:

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

where subscript i denotes the state bank, subscript e denotes the election in state j where state bank i is located, and subscript t denotes the year in the three-year window [+1, +3] following gubernatorial election e. The dependent variable Y_{iet} and $Democrat_e$ as well as other explanatory variables X_{it-1} and S_{jt-1} are the same as in the model specification (1). In addition, we include an indicator variable, $Predecessor_e$, which equals one if the predecessor governor for election e 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. We also include calendar year fixed effects (μ_t) as before. We do not include bank fixed effects here, because including individual fixed effects is not necessary for identification in an RD design (Lee and Lemieux, 2010).[33] Instead, following Lee and Lemieux (2010), we account for within-bank correlation of the errors over time using clustered standard errors.

We control for the vote margin of an election (VM_e) with a high-order polynomial. We also allow for a different polynomial for observations on the winning side (w) and on the losing side (l) for Democratic candidates. As our benchmark, we restrict our sample to elections with a vote margin not greater than 0.2. Note that this sampling choice deals with the classic tradeoff between noise and potential bias in fitting observations far from the winning vote threshold while estimating the

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

discontinuities in Y_{iet} around the threshold. We also show the robustness to varying the size of our sample by increasing vote margins to fit more observations (results not tabulated for brevity). The parameter of main interest, β_1, is a consistent estimate of the effect of a Democrat governor being elected, i.e., how elected Democrat governors affect banks differently from Republic governors.

V. THE EFFECT OF POLITICS ON BANK CAPITAL DECISIONS

A. Bank Capital

Empirical Support for *Hypothesis 1*: *Table 2* shows the DID (Panel A) and RD (Panel B) analyses results that are consistent with *Hypothesis 1* about the impact of political influence on bank capital. We start with banks' capital structure decisions and then discuss the channels through which banks change their capital structure. Model (1) of Panel A presents the main result estimated with the DID model using Specification (1) where the dependent variable is *Book equity* (note that the level of it in all regressions throughout the paper is multiplied by 100 to scale up the estimated coefficients on the independent variables). The reported DID coefficient β_2 is negative and statistically significant. It suggests that banks reduce equity in response to the election of a Democrat governor. To gauge the economic magnitudes of these within-bank estimates, it is important to account for the within-bank low variation in its equity level for a bank. Specifically, the relative reduction is about 3.07% of the within-bank standard deviation of bank equity, or in absolute term, amounts to about 70.8% of the annual growth in the level of equity for the median bank.[34]

Models (1) and (2) of Panel B present the results of the RD estimation for *Book equity* using Specification (2) with the polynomial in the vote margin of order two and three, respectively. They are consistent with the results of the DID analysis in Model (1) of Panel A. Note that in the RD estimation throughout the paper, we include all control variables as in the corresponding DID regressions, but for brevity, we report the estimated coefficient β_1 on $Democrat_e$ only. The estimated coefficients β_1 are negative and statistically significant in both models, indicating that banks reduce their capital ratio following a Democrat candidate's victory in a close election as compared to a Republican's victory. The impact is also economically substantial—based on Model (2), the reduction in bank capital is over one third of the within-bank standard deviation of bank equity, or in absolute term, amounts to about 8.2 times of the annual growth in the level of equity for the median bank in the sample. Note

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[34] The within-bank mean and standard deviation of *Book equity* are 0.097 and 0.015, respectively. The annual growth in the level of equity for the median bank in the sample period is about 0.065%.

that the estimated coefficients in the RD estimation (in absolute terms) are much larger than those in the DID estimation. This indicates that unobserved omitted factors that affect both election outcomes and bank capital decisions may be biasing our DID estimates downward, and our RD estimates are more appropriate in gauging the economic magnitudes of political impact.

[Table 2 goes here]

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

B. Capital Reduction Channels: Dividends and Share Repurchase

We next explore the channels through which banks reduce capital. Our hypothesis is that bank capital is reduced through payouts, and not through asset expansion financed with additional borrowing.[35] We therefore examine whether banks are more likely to increase dividends and share repurchases following a Democrat governor being elected. We employ the same model Specification (1), while changing the dependent variable to *Dividend* and *Stock sale*. When *Dividend* is the dependent variable, we estimate a partial adjustment model of dividends, which includes contemporaneous *Earnings* and one-year lagged *Dividend* as control variables, following Lintner (1956) and more recent studies (e.g., Skinner (2008), and Michaely and Roberts (2012)). When *Stock sale* is the dependent variable, we estimate an ordered logistic model with contemporaneous *Earnings* and *Earnings growth* as well as one-year lagged *Assets* (in natural logarithm) as control variables. We use *Earnings growth* to proxy for a bank's growth opportunities. Estimation with bank fixed effects in an ordered logistic model is not applicable, and thus we include state fixed effects in this case.

The results reported in the last two models of Panel A (DID) and the last four models in Panel B (RD) in *Table 2* show that banks increase dividends and stock repurchases following the election of a Democrat governor. Specifically, in Model (2) of Panel A on *Dividend* (note that the level of it in all regressions throughout the paper is multiplied by 100 to scale up the estimated coefficients on the independent variables), the DID coefficient β_2 is positive and significant. The finding suggests that banks increase dividends following the election of a Democrat governor. In economic magnitudes, the DID coefficient is 3% of the dividends paid by the median bank as of the year prior to election.

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[35] This is consistent with Uluc and Wieladek (2018) who document that banks make capital adjustments primarily through payout adjustments that affect retained earnings.

The within-bank increase in dividends is noteworthy because the median bank experiences no change in annual dividends during the sample period. As shown in Models (3) and (4) of Panel B, the above finding continues to hold in the RD setting and the economic magnitudes of the RD coefficient β_1 are much larger as in the case of *Book equity* discussed earlier. For example, in Model (4), the RD coefficient suggests that the dividend increase by banks following a close election of a Democrat governor is 16% of the prior-year dividend paid by the median bank.

In Model (3) of Panel A (DID) on *Stock sale*, we find that the DID coefficient β_2 has the expected negative sign, which suggests that banks are more likely to repurchase stock after a Democrat governor takes office, relative to a Republican governor taking office. Possibly due to little within-election variation in banks' stock activities, the coefficient is not statistically significant. Further, data on stock sales are missing for many banks, resulting in a substantial reduction in the number of observations. However, in the RD setting as shown in Model (5) of Panel B, the coefficient β_1 is negative and statistically significant, indicating that banks are more likely to repurchase stock following a close election of a Democrat governor.

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

C. The Impact of the State Legislature

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

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

[Table 3 goes here]

The results in *Table 3* are consistent with this. In Models (1) and (2) on bank equity, the estimated DID coefficients β_2 are both significantly negative, indicating that banks reduce capital in a state in which a Democrat becomes governor, regardless of whether the senate is also a Democrat. However, it is more significant both economically and statistically in Model (2), so the reduction in bank capital is more pronounced in states with a Democrat governor *and* a senate with a Democrat majority. In Models (3) and (4) we present evidence on dividends, and in Models (5) and (6) we present evidence on stock sales. We find the estimated coefficients β_2 have consistent signs and are statistically significant (and also have substantially larger magnitudes compared with those in *Table 2*) only in the subsample of states in which there is a Democrat governor *and* a Democrat majority in the senate.

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

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

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

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

consumption needs[36] rather than providing more corporate credit. Our hypothesis thus predicts an increase in individual loans but not in C&I loans in Democrat states.[37]

Consistent with this prediction, following a Democrat governor being elected, loans to individuals (e.g., credit cards) grow significantly as indicated by the positive and statistically significant coefficient β_2 in Model (4) of the DID analysis in Panel A. Economically, the DID coefficient suggests that growth in individual loans in banks in Democrat states outpaces banks in Republican states by 0.52%. The same finding holds in the RD setting (Panel B), with a larger economic magnitude related to the impact of Democrat governors. There is also evidence that mortgages increase following a close election of a Democrat governor, as suggested by the significantly positive coefficient β_1 in Models (1) and (2) of the RD setting in Panel B (although it is not statistically significant in the DID analysis in Panel A). The DID analysis in Panel A also shows that real estate loans grow significantly in Democrat states, and this finding holds in Model (3) of the RD analysis.

In contrast, banks do not significantly change their commercial and industrial (C&I) loans in either Democrat or Republican states.[38] The difference in the relative change in this type of loans between banks in Democrat states and banks in Republican states is insignificant. Neither the estimated coefficient β_2 in Model (3) of Panel A nor the estimated coefficient β_1 in both Models (5) and (6) of Panel B is significant. Similar findings can be seen for agricultural loans.

[Table 4 goes here]

Overall, our finding is consistent with the evidence on the impact of politics on consumer credit, especially for underserved households (see, for example, Antoniades and Calomiris (2016) and Chavaz and Rose (2019)).[39] In explaining banks' lending decisions, we also control for bank characteristics that include: size (*Asset(log)*), bank capital (*Book equity*), and bank financial health variables, all of which are measured as of the prior year end. Following the literature (e.g., Berger and Udell (2004)), we use the level of reserve allocation for loan losses (Loan loss allowance, or *LLA*) and return on equity (*ROE*) to measure bank financial health. *LLA*, also known as the reserve for loan

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[36] The loans that most clearly fall in this category are individual loans. Mortgages are both residential and commercial, as is real estate.

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

[38] 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.

[39] In results not tabulated for brevity, we also find a significant increase in the share of individual loans among the banks' loan portfolios following the election of Democrat governors. Our findings are also robust if we focus on a subsample of banks for which information on all types of loans is available.

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

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

B. Nature of the Elevated Lending

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

B.1. Test 1: Branching in low-income counties

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

Specifically, we examine the change in the proportion of a bank's branches in low-income counties in a state around elections. A county is defined to be low-income in a year if its per capita personal income falls below its median level in the year among all counties in the state. The results, reported in *Table 5*, show that banks increase the proportion of their branches in low-income counties after Democrat governors are elected. The coefficient β_2 in the DID analysis (Model (1) of Panel A) is positive, although statistically insignificant. The coefficient β_1 in the RD setting in Models (2) of Panel B is significantly positive, and its economic magnitude suggests that the proportion of branches in low-income counties increases by 3.25% after a Democrat becomes governor in a close election.

Such a change is noteworthy because the median bank experiences no change in this proportion over the sample period.

B.2. Test 2: CRA ratings

Because the CRA seeks to address distributional inequities, it fits well our notion of politically-favored lending. Evidence that the CRA ratings of banks improve when they lend more would suggest that these banks are making more loans that politicians endorse. Compared with our evidence on specific loan types and branching decisions discussed above, it is suggestive of banks' overall behavior.

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

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

Since loans to low- and moderate-income neighborhoods under the CRA standards are also politically favored by Democrat governors, we expect the lending behavior of banks in Democrat states to be more CRA-compliant, with consequently higher CRA ratings (lower rating scores) for banks. This is likely, given our finding that banks in Democrat states increase individual loans and mortgages to low-income households as well as increase branching in low-income counties. Model (2) of Panel A in *Table 5* reports the DID regression results of our direct test of this hypothesis. Consistent with our hypothesis, the CRA ratings of banks improve significantly in states in which Democrat governors are elected relative to those of banks in states in which Republican governors are elected. The coefficient β_2 is negative and statistically significant. The RD results presented in Models (3) and (4) of Panel B in *Table 5* confirm the robustness of the finding from the DID analysis, with greater

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[40] 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.

economic magnitudes of the impact of Democrat governors. The coefficient β_1 in Model (3) of Panel B is -0.066 and statistically significant, suggesting that the change in the CRA rating following a close election of Democrat governors is noteworthy, given the low frequency of CRA examinations.[41] The review cycle for the majority of our sample banks is two years.[42] The sample in this test is small because CRA ratings are available only for FDIC-insured banks.

[Table 5 goes here]

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

C. Test of Hypothesis 3: Loan Quality

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

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

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

[42] 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.

[43] 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.

a mechanical result of the change in loan growth. Specifically, in the DID analysis, the estimated coefficient β_2 is positive and statistically significant. In the RD analysis, the estimated coefficient β_1 is positive and significant with a much larger economic magnitude than that in the DID analysis. Based on Model (1) of Panel B, it is 0.21% which amounts to over 16% of the median *LLA* in the sample. Such an increase in *LLA* by banks in Democrat states is in sharp contrast to the annual average decrease in *LLA* of 0.0028% by sample banks. Not surprisingly, loan loss provisions (*LLP*) are positively related to *LLA* because they add to *LLA*. Overall, the results are consistent with *Hypothesis 2* that the increased politically-favored loans in Democrat states are riskier.

[Table 6 goes here]

D. More on Hypothesis 3: Bank Performance

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

Specifically, in the DID analysis, the coefficient β_2 is negative and significant. The finding is robust in the RD analysis. To ease interpretation, the dependent variable is expressed as a percentage. Economically, as shown in Model (4) of Panel B, *Earnings growth* in banks in Democrat states declines by an annual rate of 1.48%.

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

Our theoretical argument implies that political influence on lending will lower bank profits and hence not sought by banks. While our evidence on banks' profitability and loan risk supports this, we investigate this further by examining how the chartering decisions of banks are related to political influence. Agarwal, Lucca, Seru, and Trebbi (2014) call for future research to understand why some state banks switch to a national charter despite more lenient state supervision. As discussed in Section IV, we have tested and found that the laxity of state regulators relative to federal regulators is greater under Democrat governors than under Republican governors. Hence, if state banks are more likely to switch to a national charter after a Democrat is elected (despite her more lenient supervision), it is

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

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strongly suggestive that banks are averse to political influence on their lending. To test this, we pool bank-years of state-chartered banks and federally-chartered banks and examine the impact of the election of Democrat governors on a state bank's decision to switch to a national charter, using Specification (1) for the DID analysis and Specification (2) for the RD analysis. The dependent variable, *Federal charter*, is a dummy that equals one if a bank is federally chartered in a year and zero otherwise. We estimate using a linear probability model in both the DID analysis and the RD analysis; this permits use of bank fixed effects in the DID specification.

The results are presented in *Table 7* with Panel A for the DID analysis and Panel B for the RD analysis. Specifically, the DID coefficient β_2 is insignificant, both economically and statistically. The RD coefficients β_1 are positive and highly significant in both models of Panel B, suggesting that state banks are more likely to switch to a federal charter following the election of Democrat governors. The coefficient β_1 in Model (2) of Panel B suggests that the probability of a state bank switching to a federal charter increases by 0.12% under Democrats. The economic impact is substantial, given the unconditional probability of a state bank switching to a federal charter in a given year for our sample is only 0.88%.

[Table 7 goes here]

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

VII. ROBUSTNESS CHECKS AND DISCUSSIONS

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

A. Falsification Test: Federally-Chartered Banks

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

We repeat the baseline DID regressions on banks' capital structure, loan-making decisions, and performance using federally-chartered banks only. As *Table 8* shows, the overall impact of the gubernatorial elections on federally-chartered banks in the state is insignificant. Specifically, as shown in Panel A, none of the coefficients β_2 is statistically significant in all three models where bank capital, dividends, and stock sales are the dependent variables. That is, federally-chartered banks do not increase dividends and buybacks and reduce capital following the election of Democrat governors.

Panel B presents results on the growth of different types of loans made by federally-chartered banks. There is some evidence that, when Democrats become governors, banks increase real estate and C&I loans that are unlikely to be most politically-favored. In contrast, there is no significant increase in mortgage and household loans. Also, as shown in Panel C on the nature of the increased lending by federally-chartered banks, there is no evidence that federally-chartered banks increase branches in low-income counties or have their CRA ratings improved after Democrats were elected governor. That is, new loans made by federally-chartered banks do not appear to be politically favored.

Panel D presents results on the riskiness of new loans made by federally-chartered banks and its impact on bank performance. We find that the new loans made by these banks in Democrat states somehow are riskier and result in a decline in these banks' earnings growth following the election of Democrat governors.

[Table 8 goes here]

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

B. Geographically-Proximate Banks across State Borders

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

Specifically, we obtain each county's distance to a state border from Holmes (1998) and include in the sample only banks that have all their operations (headquarter and branches) in counties within 50 miles of a state border.[46] The results of the baseline regressions, tabulated in *Table I.A.2* of the online Appendix, continue to hold generally. There are two exceptions – when dividends and growth in individual loans are the dependent variables, the coefficient β_2 has a positive sign as expected but becomes insignificant in both cases (t-statistics = 0.936 and 0.846, respectively); see Panels A and B. Overall, the finding for this subsample further alleviates the endogeneity concern.

C. Heterogeneity in Geographic Operations among State Banks

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

The results in *Table I.A.3* of the online Appendix, where we repeat the baseline regressions for the subsample of single-state banks in the odd columns and the subsample of multi-state banks in the even columns, confirm this. We note that most banks have their operations in their chartering states only. In the table, we only tabulate the coefficients β_1 and β_2 but not others for brevity, while other control variables are included in the regressions. The coefficients β_2 in Panels A through D are consistent with their counterparts in *Tables 2, 4, 5* and *6* for the subsample of single-state banks, both economically and statistically. In contrast, the coefficients β_2 for the subsample of multi-state banks

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[45] A related identification strategy is used by Mian, Sufi, and Trebbi (2015).
[46] To avoid any potential confounding effects, we exclude banks operating in counties that are within 50 miles of multiple border lines, especially those in smaller states.

are mostly insignificant or in the opposite signs. These findings thus provide further support for our hypothesis.

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

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

Specifically, we aggregate the individual mortgage originations to the bank-year level.[47] We then examine whether proportionally more low-income households apply for mortgages and whether banks allocate more of their mortgage lending to low-income households following a Democrat election win. That is, we investigate changes in the following variables around elections: (i) The proportion of mortgage applications to a bank from low-income households among all applicants of the bank (labeled as *Mortgage application*); and (ii) the size of a bank's mortgage lending to low-income households relative to its total mortgage asset origination (*Mortgage size*) in the year. An applicant is classified as low-income if his/her income is below the state per capita personal income in the year.

The results appear in *Table I.A.4* of the online Appendix for brevity, where Panel A is for the Differences-in-differences specification (DID) and Panel B the Regression Discontinuity (RD) design. The results from both the DID and RD settings show that the proportion of mortgage applications from low-income households increases significantly when a Democrat becomes governor. Moreover, the share to low-income households in banks' overall mortgage lending increases following a close election of a Democrat as governor; the coefficient β_1 is significantly positive in the RD setting when the polynomial order is three. The estimated coefficient on β_2 in the DID analysis (Panel A) of *Mortgage size* is neither economically nor statistically significant. When *Mortgage size* is the dependent variable, we control for the corresponding ratio of the accepted low-income applicants' income to all

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[47] For those banks operating in multiple states, we aggregate the individual mortgage originations to the bank-state-year level.

accepted applicants' income for the bank (*Mortgage applicant income*) to account for the effect of applicants' income on loan size.

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

E. Tests and Discussions of Alternative Interpretations

We further discuss some alternative interpretations of banks' capital responses.

E.1. Change in investment opportunities?

Could the bank equity decline following a Democrat election win due to poorer investment opportunities for banks? In our baseline analysis, we have controlled for a set of state-year variables that capture the change in state economic conditions. Nonetheless, we conduct a further check of several factors that might reflect banks' investment opportunities, including GDP growth, house prices, and income inequality, all at the state-year level. We, however, do not find any significant differences in them under Democrat governors (results in *Table I.A.5* of the online Appendix).

E.2. Change in state income tax?

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

E.3. Difference in regulatory forbearance?

Some argue that Democrats are more likely to exercise regulatory forbearance, with a greater propensity for bank bailouts. This engenders moral hazard – banks thus respond with lower capital ratios and greater risk taking. However, we are not aware of any evidence that one party has been more inclined to bail out failed banks than the other.[49] Also, state banks are unlikely to be too big to fail (TBTF). Furthermore, even if Democrats have a great proclivity for bailouts due to TBTF concerns, it should be more evident for larger banks. This means that the effects we document should

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[48] The idea is that a higher tax rate increases the value of the debt tax shield and encourages banks to keep lower equity capital.

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

be stronger for larger banks. The results, in *Table I.A.7* of the online Appendix, are the opposite of this, however. In particular, our main finding holds only for the subsample of small banks. This evidence is more consistent with small banks being more susceptible to political influence than large banks, possibly due to their lower bargaining power.

E.4. Impact of political connection?

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

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

VIII. CONCLUSION

This paper has theoretically and empirically examined the idea that legislators/regulators may be motivated to influence on banks' credit allocation either through informal mechanisms like jawboning or by enacting regulations aimed at influencing bank lending. It may even be the case that banks are merely catering to what they *perceive* to be political pressure based on the stated preferences of the party in power. The political preference for such lending may arise from social efficiency considerations, fairness/equity concerns, the desire to address social problems like income inequality, and/or private benefits for politicians. Anticipation of such pressure may encourage banks to keep

lower levels of capital in order to increase their fragility, which would then deter credit allocation pressure on banks. Nonetheless, political pressure is predicted to induce banks to make more politically-favored loans that are riskier and lead to lower bank performance.

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

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

Appendix: Variable Definitions

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

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Table 1 Summary Statistics

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

Panel A: Gubernatorial elections

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

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

	Mean	Median	Std	N
Assets (log)	11.26	11.13	1.308	40913
Book equity	0.100	0.092	0.034	40913
Dividend	0.005	0.003	0.006	40332
Stock sale	0.049	0	0.276	22554
ROA	0.009	0.011	0.01	40913
ROA growth	-8.76e-06	2.08e-06	0.008	40913
Earnings	0.082	0.081	0.024	40913
Earnings growth	-0.04	-0.03	0.184	40903
Loan loss allowance	0.016	0.013	0.009	40727
Loan loss provision	0.006	0.003	0.01	40719
Loan growth	0.096	0.067	0.182	40728
Branching (%)	35	0	43.40	25920
Mortgage application (%)	22.61	20	18.33	7947
Mortgage size (%)	13.99	9.64	15.73	6564
CRA rating	1.888	2	0.416	7268
State GDP(log)	12.04	12.05	1.01	40913
State GDP growth	0.045	0.049	0.033	40913
State unemployment rate	5.64	5.30	1.837	40913

Table 2 The Effect of Democrat Governors on Bank Capital Decisions

This table presents results of regressions that examine the effect of Democrat governors on bank capital. The dependent variables are indicated on the top of each column, and *Book equity* and *Dividend* are both multiplied by 100. In Panel A (DID regressions), the sample includes all state-chartered commercial banks in the three years prior to gubernatorial elections and in the three years after gubernatorial elections during 1990-2012. In Columns (1) and (2), linear regressions are run, while in Column (3) an ordered logistic regression is run. In Panel B, estimations are done in a regression discontinuity (RD) design for a subsample of banks in states that hold gubernatorial elections with a winning vote margin within 20%, which includes all state commercial banks in the three years after those elections during 1990-2012. The first four models are estimated with OLS regressions in which *Book equity* and *Dividend* are the dependent variables, respectively, and the last two with ordered logistic regressions in which *Stock sale* is the dependent variable. All variables are defined as in the Appendix. Robust standard errors are clustered at the bank level, and t-statistics are reported in parentheses below. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Panel A: Bank capital decisions (DID)

	(1)	(2)	(3)
VARIABLES	Book equity	Dividend	Stock sale
After	0.037	-0.004	0.189**
	(1.363)	(-0.504)	(2.431)
After*Democrat	-0.046**	0.009**	-0.017
	(-2.005)	(2.400)	(-0.352)
ROA	44.464***		
	(19.898)		
ROA growth	-10.811***		
	(-7.329)		
Asset(log)	-0.961***		0.005
	(-17.020)		(0.206)
State GDP(log)	-0.419	0.120***	-0.561
	(-1.641)	(2.752)	(-1.075)
State GDP growth	-0.199	0.049	0.358
	(-0.659)	(0.601)	(0.426)
State unemployment	-0.037***	-0.002	0.034
	(-3.248)	(-1.022)	(1.403)
Earnings		0.049***	0.150***
		(23.455)	(12.329)
Prior-year dividends		26.690***	
		(42.326)	
Earnings growth			-5.437***
			(-4.840)
Observations	230,256	226,888	126,364
R-squared	0.110	0.128	0.083
Bank FE	Yes	Yes	No
Election FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes

Panel B: Bank capital decisions (RD)

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

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

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

VARIABLES	(1) Non-Dem Senate Book equity	(2) Dem Senate Book equity	(3) Non-Dem Senate Dividend	(4) Dem Senate Dividend	(5) Non-Dem Senate Stock sale	(6) Dem Senate Stock sale
After	0.005	0.084**	0.011	-0.012	0.080	0.276***
	(0.092)	(2.437)	(0.726)	(-1.136)	(0.676)	(2.861)
After*Democrat	-0.093**	-0.114***	-0.003	0.016***	0.127	-0.158**
	(-2.285)	(-3.585)	(-0.557)	(3.811)	(1.544)	(-2.536)
Observations	102,951	127,305	100,428	126,460	54,344	72,020
R-squared	0.168	0.142	0.341	0.371	0.076	0.092
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Election FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes

Table 4 The Effect of Democrat Governors on Bank Loan Growth

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

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

VARIABLES	(1) Mortgage	(2) Real Estate	(3) Commercial & Industrial	(4) Individual	(5) Agriculture
After	-0.596	-1.032***	-0.163	0.223	-4.382**
	(-1.109)	(-2.590)	(-0.117)	(0.348)	(-2.362)
After*Democrat	0.353	0.969***	0.535	0.520*	-0.736
	(1.308)	(4.854)	(0.966)	(1.784)	(-0.952)
Asset(log)	-11.820***	-11.309***	-18.842***	-12.081***	-14.594***
	(-24.943)	(-28.888)	(-13.147)	(-22.215)	(-11.264)
Loan loss allowance	-243.965***	-282.245***	-85.028**	-220.021***	-271.370***
	(-11.205)	(-16.956)	(-1.987)	(-9.782)	(-5.255)
Book equity	117.718***	103.220***	115.128***	98.495***	48.270**
	(14.516)	(16.466)	(6.102)	(11.283)	(2.528)
ROE	0.632	2.905**	20.193***	7.028***	8.913
	(0.361)	(2.174)	(6.162)	(3.756)	(1.613)
State GDP(log)	21.795***	16.639***	17.367**	0.666	-6.268
	(7.353)	(7.250)	(2.366)	(0.212)	(-0.657)
State GDP growth	-7.727	5.985	8.246	17.904***	-4.856
	(-1.395)	(1.510)	(0.685)	(3.205)	(-0.291)
State unemployment	-2.258***	-2.083***	-1.590***	-1.801***	-0.955
	(-12.445)	(-15.931)	(-4.081)	(-9.418)	(-1.503)
Observations	224,560	225,840	122,904	225,311	161,651
R-squared	0.061	0.098	0.028	0.055	0.008
Bank FE	Yes	Yes	Yes	Yes	Yes
Election FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

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

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

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

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

Panel A: Nature of lending (DID)

	(1)	(2)
VARIABLES	Branching	CRA Rating
After	0.591	0.024
	(1.424)	(1.552)
After*Democrat	0.303	-0.017**
	(1.022)	(-2.296)
ROA	-36.499**	-1.361***
	(-2.293)	(-2.931)
ROA growth	-14.092	0.921**
	(-1.255)	(2.192)
Asset(log)	-1.196**	-0.008
	(-2.472)	(-0.840)
State GDP(log)	5.091	0.110
	(1.593)	(1.362)
State GDP growth	5.268	-0.132
	(1.290)	(-0.936)
State unemployment	0.110	0.006
	(0.676)	(1.416)
Observations	167,011	47,084
R-squared	0.012	0.084
Bank FE	Yes	Yes
Election FE	Yes	Yes
Year FE	Yes	Yes

Panel B: Nature of lending (RD)

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

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

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

Panel A: Loan quality and bank Performance (DID)

VARIABLES	(1) LLA	(2) Earnings Growth
After	-0.013*	0.501*
	(-1.752)	(1.683)
After*Democrat	0.035***	-0.454***
	(5.311)	(-3.982)
Asset(log)	-0.129***	-3.688***
	(-10.580)	(-18.146)
Loan growth	-0.883***	31.279***
	(-48.716)	(57.459)
State GDP(log)	-0.413***	-8.295***
	(-5.752)	(-5.969)
State GDP growth	0.336***	10.947***
	(3.698)	(4.087)
State unemployment	0.033***	0.476***
	(9.409)	(5.880)
Loan loss provision	30.431***	
	(57.851)	
Loan loss allowance		35.004***
		(3.697)
Observations	229,009	227,111
R-squared	0.285	0.260
Bank FE	Yes	Yes
Election FE	Yes	Yes
Year FE	Yes	Yes

Panel B: Loan quality and bank performance (RD)

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

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

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

Panel A: Switching to Federal Charter (DID)

	(1)
VARIABLES	Federal charter
After	-0.000
	(-0.334)
After*Democrat	-0.000
	(-0.431)
ROA	-0.353***
	(-4.298)
ROA growth	0.067
	(1.392)
Asset(log)	-0.005*
	(-1.696)
State GDP(log)	-0.031**
	(-2.413)
State GDP growth	0.009
	(0.744)
State unemployment	-0.001*
	(-1.652)
Observations	313,846
R-squared	0.035
Bank FE	Yes
Election FE	Yes
Year FE	Yes

Panel B: Switching to Federal Charter (RD)

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

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

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

Panel A: Bank capital decisions (DID)

VARIABLES	(1) Book equity	(2) Dividend	(3) Stock sale
After	0.045	-0.010	-0.102
	(0.397)	(-0.418)	(-0.647)
After*Democrat	-0.065	0.010	-0.001
	(-0.945)	(1.186)	(-0.015)
ROA	66.571***		
	(7.476)		
ROA growth	-29.904***		
	(-4.399)		
Asset(log)	-2.174***		0.023
	(-8.042)		(0.807)
State GDP(log)	1.428*	0.245**	-1.033
	(1.958)	(2.496)	(-1.127)
State GDP growth	-3.024***	-0.037	-1.050
	(-2.967)	(-0.213)	(-0.706)
State unemployment	0.087**	-0.012**	-0.053
	(1.989)	(-2.284)	(-1.344)
Earnings		0.043***	0.025***
		(14.175)	(5.037)
Prior-year dividends		14.282***	
		(13.195)	
Earnings growth			0.932
			(0.841)
Observations	83,590	81,454	52,217
R-squared	0.141	0.095	0.055
Bank FE	Yes	Yes	No
Election FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes

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

	(1)	(2)	(3)	(4)	(5)
			Commercial &		
VARIABLES	Mortgage	Real Estate	Industrial	Individual	Agriculture
After	0.043	-0.513	-0.730	0.462	0.483
	(0.035)	(-0.535)	(-0.392)	(0.402)	(0.097)
After*Democrat	0.665	0.751*	2.064**	0.589	2.432
	(1.273)	(1.921)	(2.467)	(1.205)	(1.410)
Asset(log)	-14.303***	-12.748***	-16.350***	-13.676***	-25.592***
	(-14.775)	(-17.198)	(-11.222)	(-16.357)	(-9.412)
Loan loss allowance	-170.034***	-212.409***	-42.745	-125.329***	-85.371
	(-4.901)	(-7.721)	(-0.898)	(-3.644)	(-0.802)
Book equity	66.879***	55.223***	60.719***	53.123***	14.134
	(4.349)	(4.565)	(2.707)	(3.804)	(0.297)
ROE	4.602	4.423**	17.097***	7.375***	7.973
	(1.634)	(2.110)	(5.340)	(2.618)	(0.792)
State GDP(log)	26.224***	16.161***	9.990	0.299	2.462
	(4.785)	(4.261)	(1.162)	(0.060)	(0.151)
State GDP growth	17.924*	23.973***	14.079	49.293***	23.875
	(1.868)	(3.305)	(0.871)	(5.201)	(0.670)
State unemployment	-2.781***	-2.238***	-1.665***	-1.208***	1.721
	(-8.045)	(-8.777)	(-3.566)	(-3.850)	(1.297)
Observations	80,178	80,408	52,104	80,769	59,159
R-squared	0.055	0.078	0.044	0.063	0.014
Bank FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

Panel C: Nature of lending (DID)

	(1)	(2)
VARIABLES	Branching	CRA Rating
After	-0.046	0.072
	(-0.054)	(1.547)
After*Democrat	-0.439	0.011
	(-0.784)	(0.671)
ROA	4.115	-1.959*
	(0.154)	(-1.796)
ROA growth	-15.275	2.526**
	(-0.990)	(2.441)
Asset(log)	-0.966	0.009
	(-1.238)	(0.467)
State GDP(log)	4.242	-0.078
	(0.771)	(-0.487)
State GDP growth	9.447	-0.364

	(1.348)	(-0.936)
State unemployment	0.413	0.001
	(1.318)	(0.051)
Observations	53,374	7,389
R-squared	0.027	0.124
Bank FE	Yes	Yes
Year FE	Yes	Yes

Panel D: Bank Performance (DID)

VARIABLES	(1) LLA	(2) Earnings Growth
After	-0.026	1.748**
	(-1.519)	(2.451)
After*Democrat	0.067***	-0.699***
	(4.935)	(-3.037)
Asset(log)	-0.124***	-6.265***
	(-4.697)	(-14.086)
Loan growth	-0.837***	37.296***
	(-25.798)	(36.027)
State GDP(log)	-0.492***	-6.431**
	(-3.468)	(-2.291)
State GDP growth	-0.061	20.409***
	(-0.316)	(3.685)
State unemployment	0.043***	0.760***
	(5.400)	(4.449)
Loan loss provision	30.498***	
	(31.281)	
Loan loss allowance		55.460***
		(2.962)
Observations	81,436	81,488
R-squared	0.295	0.260
Bank FE	Yes	Yes
Election FE	Yes	Yes
Year FE	Yes	Yes

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Figure 1: Yearly Plot of Average Equity Ratios of State Chartered Banks in Democrat States vs. Republican States around Gubernatorial Elections.
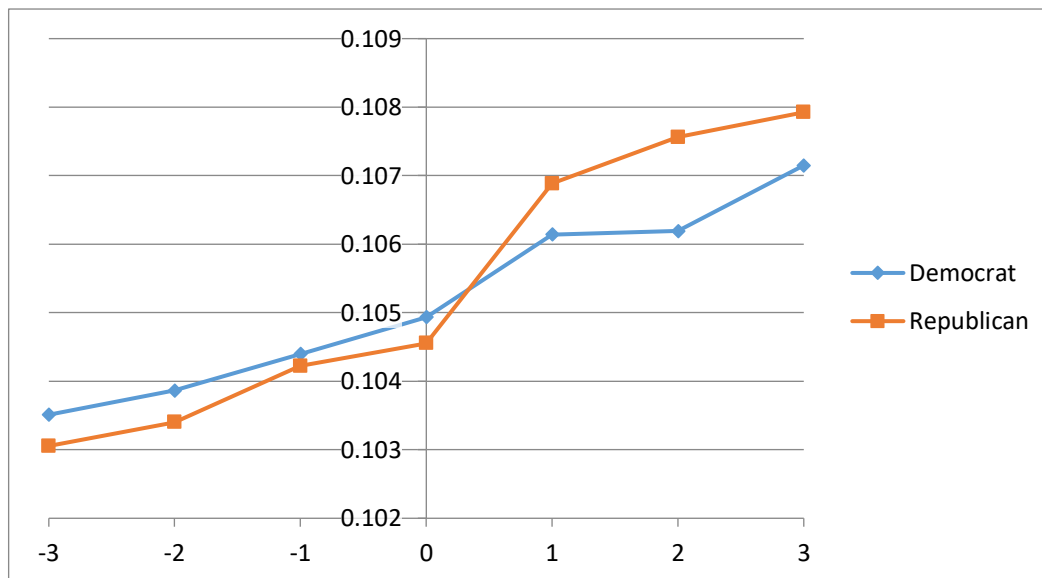
This figure plots the time-series of the annual average *Book equity* of sample banks for the seven-year window [-3, +3] around gubernatorial elections in year 0. One plot pertains to banks in states in which Democrats won and the other plot pertains to banks in states in which Republicans won.