Banks and bailouts: Playing politics?

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(PhysOrg.com) -- Banks with strong political connections were more likely to receive bailout money from the government—and more of it—in the past year than those with weaker ties, say University of Michigan researchers.

A new study by Ran Duchin and Denis Sosyura of Michigan's Ross School of Business found that banks with connections to members of congressional finance committees and banks whose executives served on Federal Reserve boards were more likely to receive funds from the Troubled Asset Relief Program, the federal government's program to purchase assets and equity from financial institutions to strengthen its financial sector.

Further, their research shows that TARP investment amounts were positively related to banks' political contributions and lobbying expenditures, and that, overall, the effect of political influence was strongest for poorly performing banks.

"Our results show that political connections play an important role in a firm's access to capital," said Sosyura, U-M assistant professor of finance. "The effects of political ties on federal capital investment are strongest for companies with weaker fundamentals, lower liquidity and poorer performance—which suggests that political ties shift capital allocation towards underperforming institutions."

In their study, Duchin and Sosyura focused on the Capital Purchase Program, the largest TARP initiative in terms of the number of participants and the amount of expended capital. As of late September, nearly 700 financial institutions had received about $205 billion under the program.

The researchers used four variables to measure political influence: 1) seats held by bank executives on the board of directors at any of the 12 Federal Reserve banks or their branches (the Federal Reserve is involved in the initial review of CPP applications from the majority of qualified banks); 2) banks with headquarters located in the district of a U.S. House member serving on the Congressional Committee on Financial Services or its subcommittees on Financial Institutions and Capital Markets (which played a major role in the development of TARP and its amendments); 3) banks' campaign contributions to congressional candidates; and 4) banks' lobbying expenditures.

They found that a board seat at a Federal Reserve Bank was associated with a 31 percent increase in the likelihood of receiving CPP funds, while a bank's connection to a House member on key finance committees was associated with a 26 percent increase, controlling for other bank characteristics such as size and various financial indicators.

"Our findings also suggest that qualified financial institutions were more likely to receive an investment from CPP if they were bigger and had lower earnings and lower capital," said Duchin, U-M assistant professor of finance. "This is consistent with an investment strategy seeking to support systematically important institutions experiencing financial distress."

In addition, the study found the amount of CPP investments was strongly related to banks' political contributions and lobbying expenditures. A one standard-deviation increase in political contributions to congressional candidates was associated with a $14.6 million increase in allotted CPP funds, while a one standard-deviation increase in lobbying amounts was associated with an additional $10.4 million in CPP funds.

Duchin and Sosyura say the amount of CPP investments was negatively related to capital adequacy, earnings and liquidity, and positively related to bank size.

"Collectively, these findings are consistent with an investment strategy seeking to increase the capitalization and liquidity of participating banks to an adequate level, but also highlight the importance of political connections in the choice of federal investments," Sosyura said.

Provided by University of Michigan

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