Topics in Banking and Political Economy

Module 3: Political Economy of Financial Crises

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Key questions

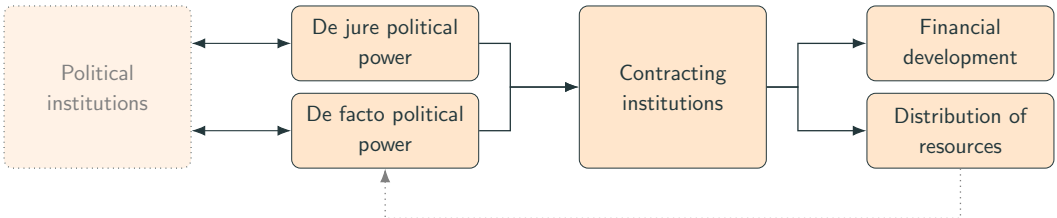
How can financial instability reflect a political equilibrium rather than unavoidable vulnerabilities or external shocks?

How do constituent and special interests affect the prevention, management, resolution, and recovery of financial crises?

What role does regulatory capture play in financial crises?

How can distortions arising from regulatory capture be mitigated?

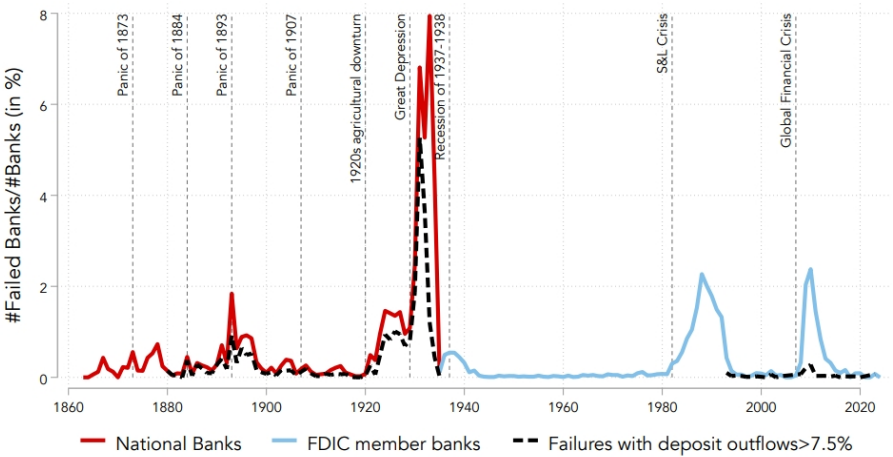
Conceptual framework



Source: Lambert and Volpin (2018 [24])

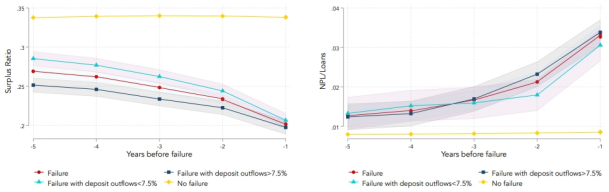
Bank failures: predictability and consequences

Bank failures in the U.S., 1863–2024



Source: Correia, Luck and Verner (2026 [12])

Failing banks exhibit deteriorating fundamentals, 1863–1934



(a) *Surplus profit relative to total equity*

(b) *Nonperforming loans to total loans*

(c) *Noncore funding ratio*

(d) *Deposits to assets*

Source: Correia, Luck and Verner (2026 [12])

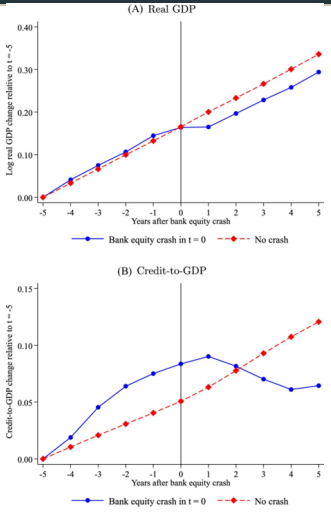
▸ Liquidity vs. solvency

Dynamics of output and credit around banking crises

Baron, Verner and Xiong (2021 [3]) argue that:

- panic runs are not necessary for banking crises, and panics are preceded by bank equity declines, reflecting the realization of weak fundamentals
- Banking sector distress leads to severe contractions in both output and credit

See also Baron and Xiong (2017 [4]) who show that rapid bank credit expansion predicts higher bank equity crash risk



Source: Baron et al. (2021 [3])

Two broad perspectives on financial regulation

The economic approach views regulation as a tool to enhance efficiency and financial stability:

- Policymakers balance financial stability and economic growth
- Financial crises stem from exogenous shocks (e.g. pandemics, wars) or novel factors (e.g. financial innovation)

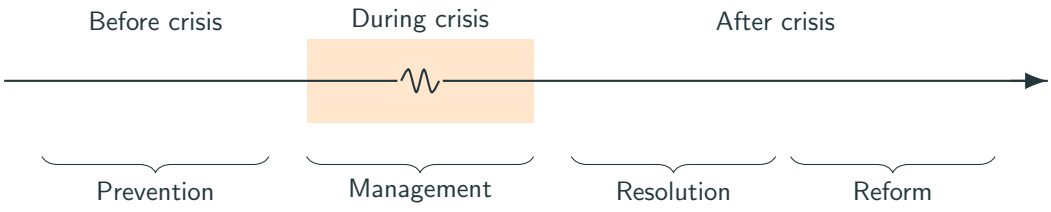
The political approach views regulation as endogenously reflecting policymakers' incentives and special interests:

- Policymakers may adopt ex ante inefficient regulations
- Regulation may favor policymakers themselves and influential groups
- Financial crises emerge as predictable outcomes of political equilibrium

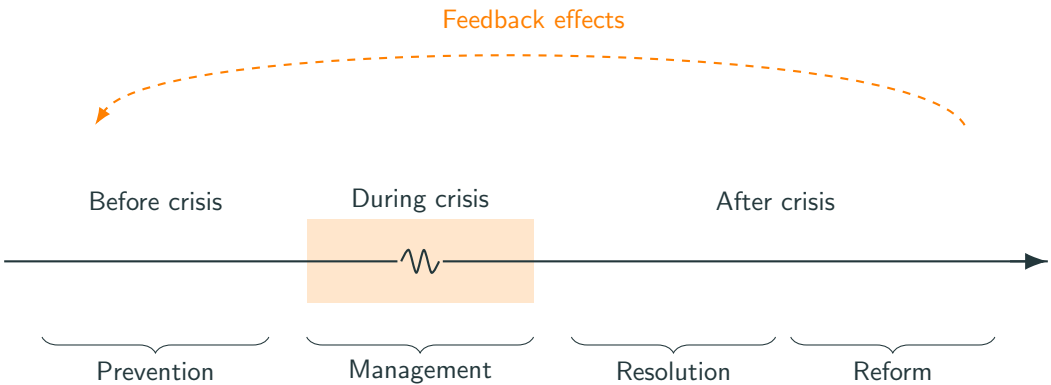
The role of political frictions in financial crises

From build-up to recovery

From build-up to recovery



From build-up to recovery



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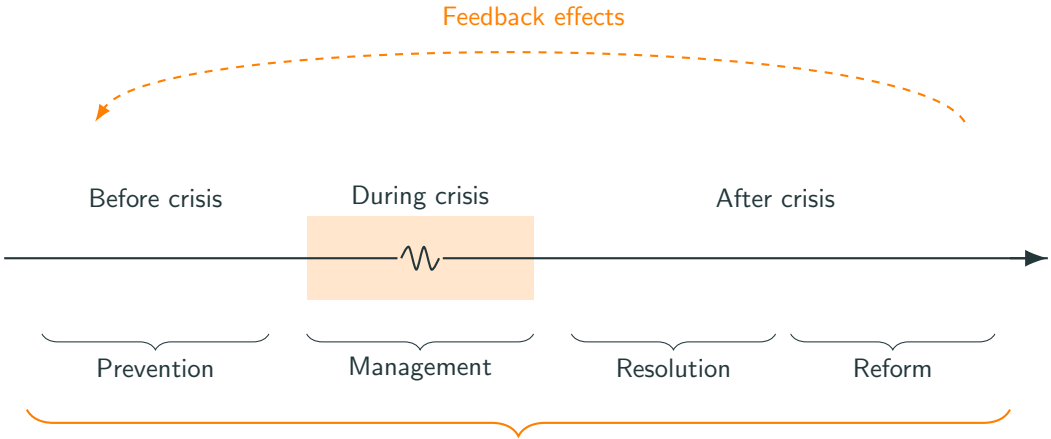
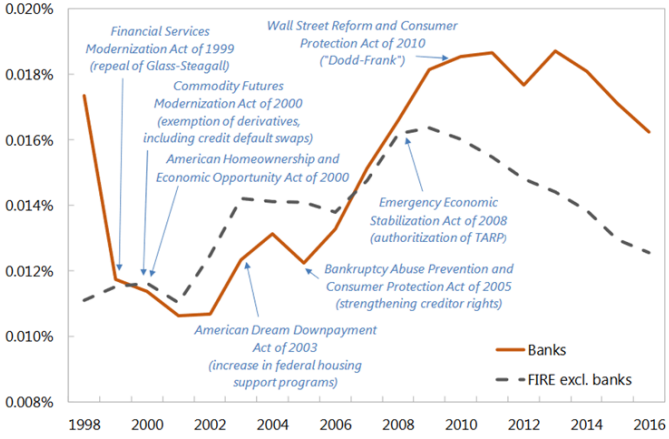


Political economy across the financial crisis cycle

Phase	Paper discussed	Topic covered
Prevention & build-up	Igan, Mishra and Tressel (2012 [21])	Credit boom
	Igan and Mishra (2014 [20])	Financial deregulation
	Lambert (2019 [23])	Bank supervision
	Liu and Ngo (2014 [25])	Timing of bank failures
Management	Mian, Sufi and Trebbi (2010 [26])	Bailout bills
	Duchin and Sosyura (2012 [17])	TARP
Resolution & reform	Agarwal, Amromin, Ben-David and Dinc (2018 [1])	Foreclosure resolution
	Igan, Lambert, Wagner and Zhang (2022 [19])	Failed-bank resolution
	Anecdotes	Dodd–Frank Act

Bank lobbying in the U.S. prior to the financial crisis



Source: Igan and Lambert (2019 [22])

A vector of political influence

Lobbying is only one component of a vector of political influence

Other components include:

- Electoral support (endorsements, campaign contributions, political ads, . . .)
- Charitable giving and philanthropy
- Grassroots mobilization
- Coalition building
- Testimony
- Public advocacy (form of "reverse lobbying")
- Judicial strategies
- Media influence
- Personal networks
- . . .

Complications

The vector of political influence is complex to identify and study systematically

Lobbying and campaign contributions are relatively visible and disclosed

Other channels (dark money, shadow lobbying, informal networks, . . .) are often undisclosed or hard to trace

We keep uncovering avenues via which the influence chain develops

Most empirical evidence comes from the U.S., but similar dynamics very likely exist in Brussels and the E.U.

$\rightarrow$ This lecture focuses primarily on lobbying though

Lobbying

Definition

The strategic communication of politically relevant information

Targets include politicians, congressional staff, regulators, administrative agencies, and executive officials

The First Amendment protects the right to petition the government

Lobbying is a $5bn+ industry in the U.S. in 2025

Lobbying seeks to influence decisions affecting trillions of $ of government spending and nonmarket intervention

Much lobbying occurs behind the scenes

K Street, Washington D.C. — symbolic center of the lobbying industry

Lobbying legislation and disclosure

The Lobbying Act of 1946 is the principal bill governing lobbying, which is now integrated with the Lobbying Disclosure Act of 1995 and Honest Leadership and Open Government Act of 2007

In United States v. Harriss, 347 U.S. 612 (1954), the Supreme Court limited the 1946 Act's jurisdiction only to direct lobbying of Congress by a hired lobbyist

So, a firm's employees involved in government relations in Washington are required to register as lobbyists

The Lobbying Act does not pertain consultants, advisors, grassroots efforts and public relations

Lobbying legislation and disclosure (cont'd)

Recently the controls on lobbying have been extended heavily, particularly with respect to disclosure clauses

Lobbyists are required to register with the Clerk of the House and the Secretary of the Senate

They have to file extensive quarterly lobbying reports, listing:

- the issues and the bills on which they are lobbying
- the amounts involved
- details about their clients

▸ Lobbying report ▸ U.S. lobbying

Lobbying legislation and disclosure (cont'd)

There are today approximately 13,000 registered lobbyists in Washington, D.C., lobbying both the executive branch and members of Congress and their staff

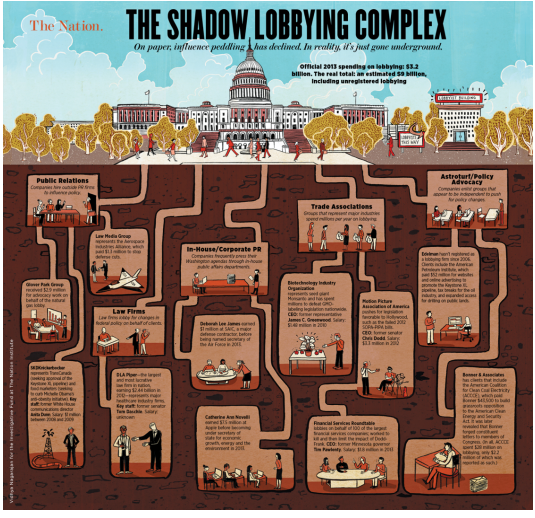
The Lobbying Act as well as Senate and House rules prohibit gifts, dinners and privately paid travel to convention and events

However they allow grassroots political effort, organization of political support supplemental effort in drafting legislation

- Example: The 2008 American Housing Rescue and Foreclosure Prevention Act of 2008 was initially drafted by Credit Suisse

The Ethics in Government Act of 1978 prohibits an immediate revolving door, with politician immediately becoming lobbyists after leaving office $\rightarrow$ "cool down" period

Shadow lobbying



Information conveyed: "what you know"

Technical information: data, expertise, and forecasts about the economic consequences of political alternatives

Political information:

- Information about how political alternatives affect a politician's constituency or policy objectives
- Political information is often crucial for moving legislation, as politicians are responsive to electoral incentives
- Many firms develop detailed data on their economic footprint, including employment and supply-chain exposure across congressional districts

Lobbyists provide policymakers with expertise and information, though often with a strategic or selective framing

Access: "whom you know"

Access to key players (committee chairs, party leaders, ...) is a central asset

Powerful lobbyists provide privileged access to political and regulatory elites

Access is often exchanged for politically valuable resources:

- campaign contributions
- grassroots mobilization
- political and constituency information
- electoral support

Large lobbying firms explicitly market access through former cabinet members, former legislators, congressional aides, and regulators

The revolving door between government and lobbying reinforces networks of influence

Is it whom you know or what you know?

Bertrand, Bombardini and Trebbi (2014 [7]) answer this question

Are lobbyists issue experts, or are they simply well connected? The answer is both

Are connections a key asset in the lobbying process, or are they "grease" in the transmission of information? The answer is key asset

What makes a lobbyist truly valuable?

- Returns to both issue expertise and connections
- Connections are where the money is

Implications: understanding lobbying requires understanding why connections matter on K Street

Bank lobbying and credit in 2000–2007

Lobbying and Loan-to-Income Ratio

	(1)	(2)	(3)	(4)	(5)	(6)
Dummy = 1 if lender lobbies on specific issues	**.016*** [.005]**	**.144*** [.004]**	**.075*** [.004]**	**.138*** [.004]**	**.145*** [.004]**	**.142*** [.004]**
Dummy = 1 if lender lobbies only on other issues						**−.017*** [.005]**
Number of observations	648,938	581,105	648,938	581,105	648,938	648,938
R^2	.00	.10	.14	.16	.18	.18
MSA fixed effects	No	No	Yes	Yes	Yes	Yes
Year fixed effects	No	No	Yes	Yes	Yes	Yes
MSA*year fixed effects	No	No	No	No	Yes	Yes
Additional controls	No	Yes	No	Yes	Yes	Yes

Notes: Dependent variable: Loan-to-income ratio at (lender, MSA, year) level. The regressions are run on the lender-MSA-year panel from 1999–2007. The dummy for lobbying on specific issues is equal to 1 if the lender lobbies for those issues in any year during 1999–2006. Lobbying on specific issues refers to lobbying on bills and regulations related to mortgage lending and securitization. Columns (2) and (4) include MSA-year-level controls for average income, GDP growth rate, self-employment rate, unemployment rate, population, house price appreciation, number of competing lenders, and number of loan applications, as well as lender-year-level controls for assets and dummies for HUD regulation and subprime, and MSA-lender-year-level controls for market share of lender and average income of loan applicants (calculated for each lender separately in each MSA using the loan applications and originations by the lender in a particular MSA in a given year). Columns (5) and (6) include only the MSA-lender-year-level and lender-year-level controls. Standard errors denoted in parentheses are clustered at the lender-MSA level.

Source: Igan et al. (2012 [21])

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MSA fixed effects	No	No	Yes	Yes	Yes	Yes
Year fixed effects	No	No	Yes	Yes	Yes	Yes

First key results

Lenders that lobbied more intensively on specific issues:

1. originated mortgages with higher loan- to income ratios (proxy for lending standards)
2. securitized a faster growing proportion of loans originated
3. had faster growing mortgage loan portfolios (proxy for risk-taking)

Source: Igan et al. (2012 [21])

Loan performance of lobbying banks in 2008

Lending by Lobbying Lenders and Delinquency Rates

		Excl. CA, FL, NV, and AZ		IV: 2SLS	IV: LIML
	(1)	(2)	(3)	(4)	(5)
Growth in market share of lenders lobbying on specific issues (average 2000–2006)	**.718*** [.152]**	**.662*** [.147]**	**.734*** [.158]**	**2.052** [.816]**	**2.064** [.825]**
Growth in market share of lenders lobbying on other issues (average 2000–2006)			−.022 [.059]		
F-test of excluded instruments				9.63	9.63
Observations	305	253	305	305	305
R^2	.53	.61	.53	.34	.33
Hansen's J stat (*p* value)				.744	.745

Notes: Dependent variable: Delinquency rate in 2008 at MSA level. The regressions are run on the MSA cross-section. Lobbying on specific issues refers to lobbying on bills and regulations related to mortgage lending and securitization. All regressions include controls for average income, GDP growth rate, self-employment rate, unemployment rate, population, number of competing lenders, number of loan applications, share of subprime loans, share of Hispanics, and share of college graduates (averages over 2000–2006 for each MSA). We also include house price appreciation, which is the cumulative change in house prices from 2000 to 2006. In columns (4) and (5), growth in market share of lenders lobbying on specific issues is instrumented by the initial market share of lenders lobbying on specific issues weighted by the distance of headquarters to DC (in logs) and the initial market share of lenders lobbying on unrelated issues weighted by the distance of headquarters to DC (in logs). Robust standard errors are in brackets.

Source: Igan et al. (2012 [21])

Stock market performance of lobbying banks

Lobbying and Abnormal Stock Returns

Market Event	Bear Stearns and Lehman Failures (1)	Lehman Failure (2)	Bailout Announcement (3)
Dummy = 1 if lender lobbies on specific issues	**−.207****	**−.365****	**.301*****
	[.090]	**[.175]**	**[.106]**
Dummy = 1 if regulator is HUD	−.044	−.091	−.18
	[.106]	[.204]	[.143]
Dummy = 1 if lender is subprime	.210**	.373**	−.105
	[.096]	[.185]	[.122]
Assets (in logs)	−.017	−.033	.018
	[.014]	[.026]	[.018]
Mortgage loans originated/assets	.0000	−.0001	−.0003**
	[.000]	[.000]	[.000]
Number of observations	92	45	45
R^2	.14	.22	.37

Notes: Dependent variable: Market- and risk-adjusted return at lender level. Market- and risk-adjusted return is the stock price return over the month of the event, adjusted for the predicted return based on a CAPM where the market portfolio is proxied by the stock price index of financial institutions in the S&P500. Market events around which market- and risk-adjusted returns are analyzed are (1) March 11–16, 2008: JP Morgan acquired Bear Stearns after Fed provided $30 billion in nonrecourse funding; (2) September 15–16, 2008: Lehman Brothers filed for bankruptcy and the authorities stepped in to rescue AIG; and (3) October 14, 2008: Troubled Asset Relief Program (TARP) making $700 billion available for asset purchases was announced. The dummy for lobbying on specific issues is equal to 1 if the lender lobbies for those issues in any year during 1999–2006. Lobbying on specific issues refers to lobbying on bills and regulations related to mortgage lending and securitization. The HUD and subprime dummies are equal to one if the lender was HUD regulated or subprime respectively in any year during 1999–2007. Assets and mortgage loans to assets are for the year 2006. Event fixed effects are included in column (1). Robust standard errors are in brackets.

Source: Igan et al. (2012 [21])

Stock market performance of lobbying banks

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HUD regulated or subprime respectively in any year during 1999–2007. Assets and mortgage loans to assets are for the year 2006. Event fixed effects are included in column (1). Robust standard errors are in brackets.

Takeaways from Igan et al. (2012 [21])

Lenders that lobby more intensively on regulations related to mortgage lending and securitization ("specific issues") engaged in riskier lending practices ex ante, suffered from worse outcomes ex post, and benefited more from the bailout program

Source: Igan et al. (2012 [21])

Wall Street, Capitol Hill, and K Street

Igan and Mishra (2014 [20]) show that financial-industry influence is associated with legislators taking more deregulatory positions

Political influence is measured through:

1. Lobbying expenditures by financial firms on specific bills
2. Lobbyist–legislator connections
3. Wall Street–legislator connections

Voting behavior and bill (co-)sponsorship are used to measure support for deregulation in the run-up to the crisis:

- Support for "lax" vs. "tight" financial regulation bills

Lobbying expenditures on bills and their passage

Lobbying Expenditures on Bills

Incarnation	Commodity Futures Modernization Act[a]	Bankruptcy Abuse Prevention and Consumer Protection Act[b]	American Dream Downpayment Act[c]	FHA Multifamily Housing Mortgage Loan Limit Adjustment Act[d]	Predatory Lending Consumer Protection Act[e]	Financial Services Regulatory Relief Act[f]
1	52	30	10	14	5	4
2	29	1	8	17	4	27
3	19	1	18	5	5	14
4		11	19	3	5	19
5		34	7	52	10	20
6		22	7	8	2	17
7		1	3		6	
8			14		4	
9			9		29	
10			5		6	
11					3	
12					6	
13					11	
14					1	
15					3	

Note. Values are percentages of lobbying expenditures for all attempts to pass a bill. The bills are grouped into six categories on the basis of similarities in their titles, descriptions, and provisions. Each attempt to pass a bill in a given category is considered an incarnation.

Passage of Bills, 2000–2006

	Signed into Law (%)		Total (*N*)
	No	Yes	
Individual bills:			
Lax	84	16	32
Tight	100	0	15
Total (*N*)	42	5	47
Bills categorized:			
Lax	40	60	5
Tight	100	0	1
Total (*N*)	3	3	6

Note. Values are the proportions and numbers of bills signed into law. Bills are categorized as lax or tight on the basis of the rules they would impose on financial institutions. Bills are grouped in six categories: Commodity Futures Modernization Act, Bankruptcy Abuse Prevention and Consumer Protection Act, American Dream Downpayment Act, FHA Multifamily Housing Mortgage Loan Limit Adjustment Act, Predatory Lending Consumer Protection Act, and Financial Services Regulatory Relief Act.

Source: Igan and Mishra (2014)

Basic statistics

Summary Statistics

Variable	*N*	Mean	SD	Min	Max
Bills	47				
Legislators	790				
Lobbyists	575				
Switch to Being in Favor of Deregulation	32,390	.06	.24	0	1
Stance in Favor of Deregulation	32,390	.39	.49	0	1
Roll Call Vote in Favor of Deregulation	3,006	.69	.46	0	1
Lobbying Expenditures:					
U.S.$	32,390	3,896,924	3,788,612	262,374	14,700,000
Log	32,390	14.7	1.03	12.48	16.51
Purged (U.S.$)	32,390	1	.09	.75	1.33
Purged (U.S.$), collapsed data	47	1.25	.82	.28	3.65
PAC Contributions:					
U.S.$	32,390	2,341	5,983	1	83,861
Log	32,390	2.96	3.98	0	11.34
Purged (U.S.$)	32,390	9.8	73.23	0	6250.48
Lobbying Expenditures:					
Consumer organizations (U.S.$)	32,390	22,149	67,172	1	287,260
Consumer organizations (log)	32,390	3.04	4.47	0	12.57
Housing industry (U.S.$)	32,390	1,458	8,943	1	58,000
Housing industry (log)	32,390	.58	2.16	0	10.97
Government-sponsored enterprises (U.S.$)	32,390	22,780	143,689	1	931,532
Government-sponsored enterprises (log)	32,390	.53	2.41	0	13.74
Ideology Score	31,406	.08	−.47	.76	1.09
Republican	32,226	.52	.5	0	1
Worked on Wall Street	32,390	.14	.35	0	1
Worked on Wall Street after Congress	32,390	.05	.21	0	1
Connection between Lobbyist and Legislator	32,390	.33	.47	0	1
Connection through Legislator's Office	32,390	.33	.47	0	1
Connection through Committee	32,390	.07	.25	0	1
Connected Lobbyists	32,390	.9	2.09	0	24

Source: Igan and Mishra (2014)

Empirical specification

$$S_{iBR} = \beta L_{BR} + s_i \times t_c + \nu_B \times t_c + \mu_R \times t_c + \varepsilon_{iBR}$$

Dependent variable:

- S_{iBR}: dummy equal to 1 if legislator i switches from being against to being in favor of deregulation across reincarnations R of bills in category B

Main explanatory variable:

- L_{BR}: log lobbying expenditures by affected financial firms on bill category B and reincarnation R
- Replace L_{BR} with N_{iBR},where N_{iBR} captures connections between legislators and lobbyists

Fixed effects:

- $s_i \times t_c$: legislator $\times$ Congress FE
- $\nu_B \times t_c$: bill-category $\times$ Congress FE
- $\mu_R \times t_c$: reincarnation $\times$ Congress FE

Additional controls:

- Bill complexity
- Dummy for tight bills

Lobbying, connections, and probability of switching

Lobbying, Connections, and Probability of Switching

	Collapsed Data	Full Sample		Unconnected Lobbyists	Connected Lobbyists
	(1)	(2)	(3)	(4)	(5)
Lobbying Expenditures	.077*	.370**		.262**	.464**
	(.034)	(.067)		(.094)	(.028)
Connection between Lobbyist and Legislator			.025*		
			(.010)		
Observations	41	32,390	32,390	21,662	10,728
R^2	.28	.48	.46	.45	.62
Legislator × Congress fixed effects	No	Yes	Yes	Yes	Yes
Category × Congress fixed effects	No	Yes	Yes	Yes	Yes
Reincarnation × Congress fixed effects	No	Yes	Yes	Yes	Yes

Note. The dependent variable is the fraction of legislators who switch stances from against to in favor of deregulation. Column 1 is estimated as an ordinary least squares model. All other regressions are estimated as linear probability models. All regressions include dummies for bill complexity and tightness. Robust standard errors clustered at the bill-category–reincarnation level are in parentheses.

* Significant at the 5 percent level.

** Significant at the 1 percent level.

Source: Igan and Mishra (2014 [20])

Lobbying, connections, and probability of switching

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Observa					
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Legislat					s
Categor					s
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Note. T
least squ
standard
* Sign
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ordinary
Robust

Takeaways from Igan and Mishra (2014 [20])

- Evidence that lobbying spending and network connections are positively associated with the probability of a legislator changing positions in favor of deregulation
- Further evidence that lobbying has a stronger link to moving support toward deregulation if the legislator is more conservative and if she has worked on Wall Street

Bank lobbying on micro-prudential supervision

Lambert (2019 [23]) asks whether there is a relation between bank lobbying and regulatory enforcement actions. If so, what is the transmission mechanism?

Main hypothesis: Lobbying banks are associated with lower probability of receiving a severe enforcement action

- Information-based theory: Banks have better information than regulators and partly reveal their information by endogenously choosing their lobbying effort (Grossman and Helpman 2001 [18])
- Capture theory: Banks lobby to incentivize the regulator to provide favorable treatment (Stigler 1971 [28])

Data: 7.698 banks supervised by federal agencies (OCC, FDIC, and Fed) and 1,677 severe (4,494 less) enforcement actions

Severe enforcement actions and bank lobbying

Probit model: $\text{Prob}(Y_{it}|\boldsymbol{X_{it}}) = F(\alpha + \boldsymbol{X_{it}}\boldsymbol{\beta})$

	(1)	(2)	(3)	(4)
	2008-12 Sample		1998-2012 Sample	
Lobbying	-0.021***		-0.007***	
	(0.007)		(0.003)	
Lobbying experience		-0.008**		-0.003*
		(0.003)		(0.002)
Capital adequacy	-0.116***	-0.116***	-0.060***	-0.060***
	(0.034)	(0.034)	(0.007)	(0.007)
Asset quality	-1.738***	-1.737***	0.073***	0.072***
	(0.102)	(0.102)	(0.023)	(0.023)
Management quality	-0.003	-0.003	-0.019***	-0.019***
	(0.010)	(0.010)	(0.003)	(0.003)
Earnings	-0.838***	-0.838***	-0.717***	-0.717***
	(0.080)	(0.080)	(0.019)	(0.019)
Liquidity	0.035***	0.035***	0.019***	0.019***
	(0.011)	(0.011)	(0.005)	(0.005)
Sensitivity to market risk	-0.008	-0.008	-0.017***	-0.017***
	(0.008)	(0.008)	(0.003)	(0.003)
Other firm & regional controls	Yes	Yes	Yes	Yes
Regulator, Year & State FE	Yes	Yes	Yes	Yes
Pseudo R^2	0.273	0.273	0.252	0.252

Severe enforcement actions and bank lobbying

Probit model: $\text{Prob}(Y_{it}|\boldsymbol{X_{it}}) = F(\alpha + \boldsymbol{X_{it}}\boldsymbol{\beta})$

	(1)	(2)	(3)	(4)
	2008-12 Sample		1998-2012 Sample	
Lobbying	-0.021***		-0.007***	
	(0.007)		(0.003)	
Lobbying experience		-0.008**		-0.003*
		(0.003)		(0.002)
Capital adequacy	-0.116***	-0.116***	-0.060***	-0.060***
	(0.034)	(0.034)	(0.007)	(0.007)
Asset quality	-1.738***	-1.737***	0.073***	0.072***
	(0.102)	(0.102)	(0.023)	(0.023)
Management quality	-0.003	-0.003	-0.019***	-0.019***
	(0.010)	(0.010)	(0.003)	(0.003)
Earnings	-0.838***	-0.838***	-0.717***	-0.717***
	(0.080)	(0.080)	(0.019)	(0.019)
Liquidity	0.035***	0.035***	0.019***	0.019***
	(0.011)	(0.011)	(0.005)	(0.005)
Sensitivity to market risk	-0.008	-0.008	-0.017***	-0.017***
	(0.008)	(0.008)	(0.003)	(0.003)
Other firm & regional controls	Yes	Yes	Yes	Yes
Regulator, Year & State FE	Yes	Yes	Yes	Yes
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Other firm & regional controls	Yes	Yes	Yes	Yes
Regulator, Year & State FE	Yes	Yes	Yes	Yes
Pseudo R^2	0.273	0.273	0.252	0.252

Key results

- Banks active in lobbying are 44.7% less likely to receive a severe enforcement action
- A one additional year of experience in lobbying ↓ the probability of a severe enforcement action by 2.5%

Severe enforcement actions and bank lobbying

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	2008-12 Sample		1998-2012 Sample	
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Risk taking at lobbying banks

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

	(1)	(2)
Lobbying	-0.120**	
	(0.061)	
Lobbying experience		-0.083*
		(0.049)
Controls	Yes	Yes
Year FE	Yes	Yes
Bank FE	Yes	Yes
Within R^2	0.155	0.156

Risk taking at lobbying banks

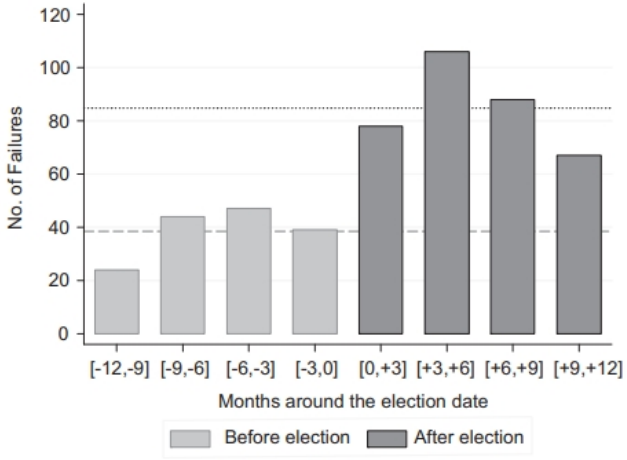
$$\ln(\textit{Z-score})_{it} = \alpha + \beta L_{it} + X_{it}\gamma + \epsilon_{it}$$

	(1)	(2)
Lobbying	-0.120**	
	(0.061)	

Takeaways from Lambert (2019 [23])

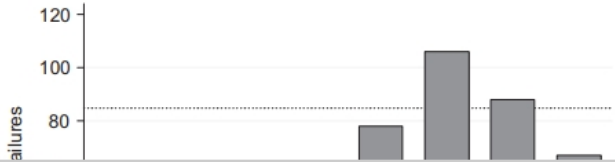
- Lobbying banks are less likely to be subject to severe actions
- Banks that engage in lobbying show a $\downarrow$ of 12% in their Z-score
- Liquidity and credit risks also $\uparrow$ pre-crisis
- Banks further show a $\downarrow$ in their performance following their lobbying activities, ruling out (somehow) an explanation echoing the informational lobbying literature

Elections and outright bank failures



Source: Liu and Ngo (2014 [25])

Elections and outright bank failures



Takeaways from Liu and Ngo (2014 [25])

- The timing of U.S. bank failures is influenced by gubernatorial elections, whose timing is predetermined by law
- Banks are about 45% less likely to fail in the year preceding an election (based on hazard analysis).
- The decline in bank failures is strongest when political competition is weak, suggesting that political control drives the effect

Source: Liu and Ngo (2014 [25])

Two major bills adding more than $1tn to U.S. national debt

Foreclosure Prevention Act (AHRFPA) of July 2008

- Up to $300bn FHA insurance for refinanced mortgages
- Support for distressed homeowners and housing markets
- Expanded Treasury backing for Fannie Mae and Freddie Mac
- Seen as a transfer toward borrowers and mortgage markets

Emergency Economic Stabilization Act (EESA) of October 2008

- Authorized up to $700bn government intervention in financial markets
- Treasury could purchase distressed assets and recapitalize banks
- Included direct support to the financial sector
- Widely viewed as a bank bailout

The AHRFPA of 2008 and the role of constituent interests

TABLE 4—CONSTITUENT INTERESTS AND VOTING PATTERNS ON THE AHRFPA OF 2008
Dependent variable: voted in favor of AHRFPA 2008 (July 26, 2008)

	(1)	(2)	(3)	(4)	State fixed effects (5)	With census controls (6)	May 8, 2008 vote (7)	Probability of voting Yes in July given Yes on May 8 (8)	Probability of voting Yes in July given No on May 8 (9)
Mortgage default rate (2007:IV)	6.708*** (1.448)	6.660*** (1.303)		6.691*** (1.296)	4.789** (2.260)	5.009*** (1.915)	3.697** (1.434)	6.085** (2.294)	6.028*** (1.713)
DW-Nominate ideology score		−0.866*** (0.153)	−0.836*** (0.155)	−0.821*** (0.149)	−0.578*** (0.199)	−0.809*** (0.149)	−1.083*** (0.171)	−0.520 (0.941)	−0.555*** (0.144)
ln(financial industry contributions per cycle)		0.028 (0.030)	0.031 (0.029)	0.036 (0.040)	0.041 (0.048)	0.006 (0.041)	0.035 (0.028)	0.017 (0.079)	0.006 (0.028)
Mortgage default rate (2005:IV)			1.737 (2.281)						
ΔMortgage default rate (2005:IV-2007:IV)			7.455*** (1.322)						
Finance committee				0.092 (0.090)	0.014 (0.096)	0.089 (0.088)			
Number of terms served				0.011 (0.009)	0.010 (0.011)	0.005 (0.009)			
Vote margin 2006 elections				−0.001 (0.001)	−0.000 (0.002)	−0.000 (0.001)			
Constant	−0.135* (0.080)	0.015 (0.362)	0.110 (0.352)	−0.162 (0.506)	−0.239 (0.635)	−5.629 (4.017)	0.180 (0.330)	0.265 (0.937)	0.057 (0.317)
Observations	194	194	194	194	194	194	193	38	150
Adjusted R^2	0.08	0.21	0.23	0.21	0.26	0.23	0.24	0.00	0.15

Notes: Coefficient estimates relating voting patterns on the 519 vote (July 26, 2008, passage of the AHRFPA of 2008) to the congressional district mortgage default rate as of 2007:IV. The sample includes voting Republicans only. Census controls include percentage Hispanic, percentage black, percentage living in urban setting, log of median household income, percentage below poverty, percentage less than high school, and percentage with high school only. Robust standard errors in parentheses. Column 7 presents coefficient estimates relating voting patterns on the 301 vote (May 8, 2008).

Source: Mian et al. (2010 [26])

The AHRFPA of 2008 and the role of constituent interests

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Mortgage default			1.737						

First main result

- A one-SD ↑ in the mortgage default rate leads to a 12.6 pp ↑ in the likelihood of (Republican) voting for AHRFPA
- A one-SD ↑ in the "conservativeness" of a politician leads to a 16.3 pp ↑ in the likelihood of voting against the bill
- Campaign contributions by the financial services industry do not affect voting patterns

▸ HFSC (119th Congress)

The EESA of 2008 and the role of special interests

TABLE 9. PANEL A—SPECIAL INTERESTS AND VOTING PATTERNS ON THE EESA OF 2008
Dependent variable: voted in favor of EESA 2008 (October 3, 2008)

	(1)	(2)	State fixed effects (3)	With political, census controls (4)	2008 cycle measures of campaign contributions (5)	(6)	Other measures of constituent interests, (8) with census and political controls (7)	(8)	Retiring politician interaction (9)
Mortgage default rate (2007:IV)	0.447	0.438	0.137	0.656	0.179	0.413	1.141	1.170	1.378
	(0.814)	(0.823)	(1.004)	(1.407)	(0.837)	(0.841)	(0.874)	(1.415)	(0.970)
DW-Nominate ideology score	−0.316***	−0.447***	−0.298***	−0.253***	−0.307***	−0.368***	−0.296***	−0.257***	−0.305***
	(0.045)	(0.124)	(0.054)	(0.051)	(0.045)	(0.045)	(0.045)	(0.050)	(0.047)
ln(finance contributions per cycle)	0.063***	0.068***	0.067**	0.129***			0.046*	0.124***	0.122***
	(0.023)	(0.023)	(0.026)	(0.028)			(0.024)	(0.028)	(0.029)
Republican indicator		0.140							
		(0.128)							
ln(finance contributions, 2008 cycle)					0.061**	0.118***			
					(0.025)	(0.028)			
ln(all nonfinance contributions, 2008 cycle)						0.009			
						(0.033)			
Fraction constituents working in finance							0.032***	0.035***	0.034***
							(0.010)	(0.012)	(0.010)
Fraction constituents with >$200K income							2.537***	1.947	1.997**
							(0.955)	(1.793)	(0.936)
Retiring representative									1.897**
									(0.775)
Retiring representative × ln(financial industry contributions per cycle)									−0.129*
									(0.067)
Observations	434	434	434	434	434	398	434	434	434
R^2	0.11	0.11	0.11	0.19	0.11	0.17	0.15	0.21	0.22

Notes: Coefficient estimates relating voting patterns on the 681 vote (October 3, 2008, passage of the EESA of 2008) to contributions by the finance industry. Political controls include a finance committee indicator, 2006 vote margin, and number of terms. Census controls include percentage Hispanic, black, living in urban setting, below poverty, less than high school, and high school only in addition to log of median household income. Column 9 examines the differential effect of campaign contributions for 34 representatives not running in the 2008 election. Robust standard errors in parentheses.

Source: Mian et al. (2010 [26])

The EESA of 2008 and the role of special interests

TABLE 9. PANEL A—SPECIAL INTERESTS AND VOTING PATTERNS ON THE EESA OF 2008
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Republican indicator		0.140 (0.128)							
ln(finance contributions, 2008 cycle)					0.061** (0.025)	0.118*** (0.028)			
ln(all nonfinance						0.009			

Second main result

- A one-SD ↑ in the log of contributions per cycle (0.97) is associated with a 6 pp ↑ in the likelihood of voting in favor of the bill
- An ↑ in the conservativeness of politician ideology has a strong ↓ effect on the likelihood of voting in favor of the bill

number of terms. Census controls include percentage Hispanic, black, living in urban setting, below poverty, less than high school, and high school only in addition to log of median household income. Column 9 examines the differential effect of campaign contributions for 34 representatives not running in the 2008 election. Robust standard errors in parentheses.

Source: Mian et al. (2010 [26])

The Capital Purchase Program under TARP

The Capital Purchase Program (CPP) was the first and largest initiative under TARP

- Introduced in October 2008 during the financial crisis
- Treasury invested approximately $205 billion in 707 financial institutions
- Banks received capital injections in exchange for preferred shares and warrants

Duchin and Sosyura (2012 [17]) examine CPP status and approval:

- Politically connected banks were more likely to receive CPP funds
- Connections included lobbying, campaign contributions, and ties to banking regulators and House of Financial Services Subcommittee
- CCP investment in politically connected firms subsequently underperformed

Main implication: government interventions is not purely shaped by economic efficiency

Delayed foreclosures during the crisis

Agarwal et al. (2018 [1]) examines whether banks strategically delay foreclosures for political reasons

They compare foreclosure timing between U.S. districts of HFSC members (71 in 111th Congress) and nonmembers

HFSC was central to post-crisis financial regulation (e.g. Dodd-Frank, TARP oversight)

Their data:

- Loan-level mortgage servicing data
- 370,000 delinquent mortgages in 2009–2010

Finance Committee Membership and the Time to Foreclosures

This table presents results of maximum likelihood tests in which the dependent variable is the logarithm of the length of time between the onset of 90-day delinquency and the start of foreclosure. Each regression is estimated under a different assumption for the error term distribution and takes right-censoring into account. The sample period covers the 111th Congress (January 2009 through December 2010). The sample includes all mortgages that become 90-day delinquent for the first time during the sample period. The estimation uses single-observation survival-time data, where each regressor is set to its value in the month of 90-day delinquency. *Finance committee* is a binary variable equal to 1 if the loan is for a house located in a district whose U.S. House representative is a member of the House Financial Services Committee. Predicted mean (median) is the average (median) time to foreclosure starts predicted by the model. Finance committee marginal effect for mean (median) is the marginal effect of being in a finance committee district on the predicted mean (median) for the time to the start of foreclosures. Standard errors, reported in parentheses, are robust to clustering at the congressional district level. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Error Term Distribution	Normal (1)	Logistic (2)	Extreme Value (3)	Extreme Value with a Scale Parameter (4)
Finance committee	0.037***	0.043***	0.043***	0.044***
	(0.014)	(0.015)	(0.014)	(0.014)
Majority party	0.010	0.011	0.013	0.013
	(0.010)	(0.011)	(0.010)	(0.011)
Borrower-level controls	Yes	Yes	Yes	Yes
Loan-level controls	Yes	Yes	Yes	Yes
Zip code–level controls	Yes	Yes	Yes	Yes
Fixed effects	State, month	State, month	State, month	State, month
Predicted mean (months)	18.714***	33.762***	12.122***	12.620***
	(0.606)	(1.424)	(0.247)	(0.259)
Finance committee marginal effect on mean (months)	0.698***	1.482***	0.522***	0.559***
	(0.256)	(0.518)	(0.168)	(0.167)
Predicted median (months)	7.687***	7.744***	8.402***	8.464***
	(0.186)	(0.187)	(0.171)	(0.174)
Finance committee marginal effect on median (months)	0.287***	0.340***	0.362***	0.375***
	(0.105)	(0.119)	(0.117)	(0.112)
Clustering level	Congressional district	Congressional district	Congressional district	Congressional district
Number of loans	369,540	369,540	369,540	369,540

Source: Agarwal et al. (2018 [1])

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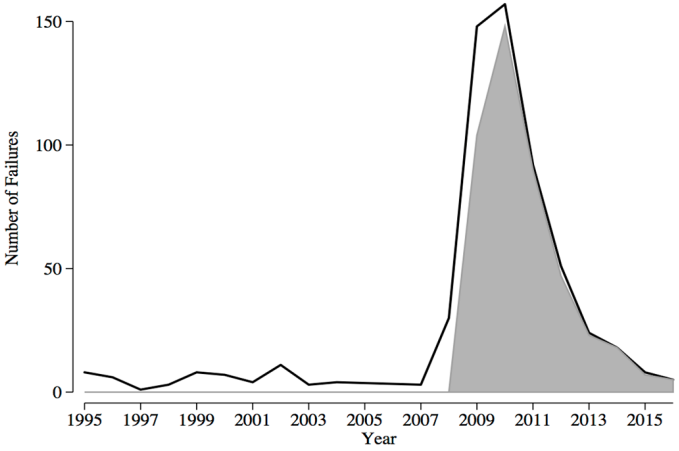
				0.044***
				(0.014)
				0.013
				(0.011)
				Yes
				Yes
				Yes
				State, month
				12.620***
				(0.259)
				0.559***
				(0.167)
				8.464***
				(0.174)
				0.375***
				(0.112)
				Congressional district
				369,540

Main results of Agarwal et al. (2018 [1])

- Banks delayed foreclosure starts in HFSC districts
- Average delay: about 0.5 months relative to a 12-month average
- No difference in delinquency rates across committee vs. noncommittee districts
- Estimated lender cost of delays: $\approx$ \$30 million

Source: Agarwal et al. (2018 [1])

Bank failures during the crisis



Source: Igan et al. (2022 [19])

The sale of failed banks

The FDIC acts as the receiver, or the liquidating agent, for failed, federally insured depository institutions

FDIC sold 470/509 banks in receiverships from 2007 to 2014 (90%)

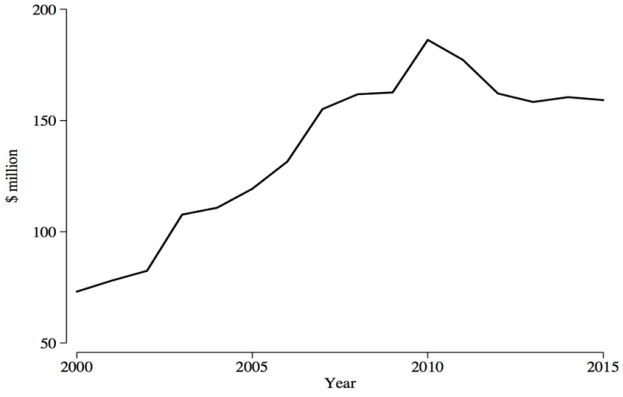
These failures imposed substantial costs on the FDIC

- The average cost of a sold failed bank in our sample is 24
- The resolution of bank failures led to Deposit Insurance Fund (DIF) costs of approximately $75 billion

Also large recipients of government programs (e.g. TARP)

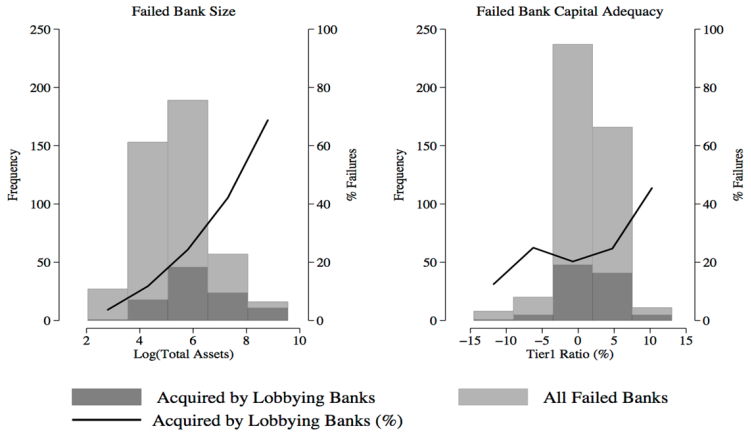
▸ Resolution process

Lobbying by prospective bidders



Source: Igan et al. (2022 [19]). Note: FDIC criteria: (1) be a financial institution or in the process of applying for a bank charter; (2) be well-capitalized; (3) possess a CAMELS rating of 1 or 2; (4) have a satisfactory anti-money-laundering record; (5) have a satisfactory CRA rating; (6) be sufficiently large (i.e. twice the size of the failed institution if located in the same state, even larger otherwise).

Eventual acquirers engaged in targeted lobbying



Source: Igan et al. (2022 [19])

Winning connections

Auction Winning Likelihood. This table reports the average marginal effects on the likelihood of winning an auction. The dependent variable of the probit regression is Win and the independent variables of interest are the measures of special interests—Lobbying Regulators>0, Lobbying Regulators, Past Lobbying Regulators>0, Board Connection, Campaign Contribution, Banking Subcommittee Representation. Control variables include financial characteristics of bidders in the quarter prior to failure dates—Size, Liquidity Ratio, Tier 1 Capital Ratio, NPL Ratio, OREO Ratio, CRE Loans (%), C&I Loans (%), and Residential Loans (%)—and proximity measures—Distance, Distance X Loans, and Change in HHI. See Table A1 for more details about variable definitions. All variables are winsorized at the 1st and 99th levels. Robust standard errors of marginal effects are presented in the parentheses and clustered at the level of the failed bank's state headquarters. ***, **, and * represent statistical significance at 1%, 5%, and 10% levels.

	(1)	(2)	(3)	(4)	(5)	(6)
	Pr(Win)					
Lobbying Regulators > 0	0.1434***	0.2876***	0.1849***			0.1818**
	(0.0441)	(0.0647)	(0.0676)			(0.0792)
Lobbying Regulators				0.0130***		
				(0.0043)		
Past Lobbying Regulators > 0					0.1647***	
					(0.0588)	
Board Connection						0.1792**
						(0.0749)
Campaign Contribution						0.0037
						(0.0404)
Banking Subcommittee Representation						0.0163
						(0.0522)
Size			0.0676***	0.0681***	0.0669***	0.0634***
			(0.0184)	(0.0184)	(0.0189)	(0.0190)
Liquidity Ratio			0.0011	0.0011	0.0012	0.0015
			(0.0023)	(0.0023)	(0.0023)	(0.0024)
Tier 1 Capital Ratio			0.0071*	0.0070*	0.0067	0.0066
			(0.0041)	(0.0042)	(0.0042)	(0.0041)
NPL Ratio			−0.0089	−0.0090	−0.0091	−0.0074
			(0.0081)	(0.0082)	(0.0082)	(0.0081)
OREO Ratio			−0.0011	−0.0008	0.0003	0.0019
			(0.0329)	(0.0330)	(0.0333)	(0.0328)
CRE Loans (%)			−0.0027	−0.0028	−0.0028	−0.0029
			(0.0022)	(0.0022)	(0.0022)	(0.0023)
C&I Loans (%)			0.0020	0.0021	0.0020	0.0014
			(0.0034)	(0.0034)	(0.0035)	(0.0035)
Residential Loans (%)			−0.0031	−0.0032	−0.0032	−0.0031
			(0.0026)	(0.0026)	(0.0026)	(0.0026)
Distance			−0.0743***	−0.0740***	−0.0740***	−0.0694***
			(0.0146)	(0.0146)	(0.0145)	(0.0147)
Distance CRE Loans (%)			−0.0005	−0.0005	−0.0006	−0.0006
			(0.0021)	(0.0021)	(0.0021)	(0.0021)
Distance C&I Loans (%)			−0.0012	−0.0011	−0.0012	−0.0011
			(0.0030)	(0.0030)	(0.0030)	(0.0030)
Distance Residential Loans (%)			0.0003	0.0002	0.0003	0.0001
			(0.0017)	(0.0017)	(0.0016)	(0.0016)
Change in HHI			−0.0004	−0.0004	−0.0007	−0.0008
			(0.0011)	(0.0011)	(0.0011)	(0.0011)
Quarter Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Failed Bank State Fixed Effects	Yes	No	No	No	No	No
Failed Bank Fixed Effects	No	Yes	Yes	Yes	Yes	Yes
Pseudo R-squared	0.057	0.066	0.099	0.099	0.099	0.105
Auctions	434	288	285	285	285	285
Observations	1197	1029	1021	1021	1021	1021

Source: Igan et al. (2022 [19])

Winning connections

Auction Winning Likelihood. This table reports the average marginal effects on the likelihood of winning an auction. The dependent variable of the probit regression is Win and the independent variables of interest are the measures of special interests—Lobbying Regulators>0, Lobbying Regulators, Past Lobbying Regulators>0, Board Connection, Campaign Contribution, Banking Subcommittee Representation. Control variables include financial characteristics of bidders in the quarter prior to failure dates—Size, Liquidity Ratio, Tier 1 Capital Ratio, NPL Ratio, OREO Ratio, CRE Loans (%), C&I Loans (%), and Residential Loans (%)—and proximity measures—Distance, Distance X Loans, and Change in HHI. See Table A1 for more details about variable definitions. All variables are winsorized at the 1st and 99th levels. Robust standard errors of marginal effects are presented in the parentheses and clustered at the level of the failed bank's state headquarters. ***, **, and * represent statistical significance at 1%, 5%, and 10% levels.

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	(0.0441)	(0.0647)	(0.0676)			(0.0792)
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						(0.0522)
Size			0.0676***	0.0681***	0.0669***	0.0634***
			(0.0184)	(0.0184)	(0.0189)	(0.0190)

Takeaways from Igan et al. (2022 [19])

- Lobbying bidders are more likely to win the auction
- Lobbying bidders have to pay relatively less in order to win (the transfer to lobbying bidders is estimated at 24.8% of the total resolution losses)
- Lobbying distorts the efficient allocation of failed banks (match quality and post-acquisition performance)

Source: Igan et al. (2022 [19])

Poster child of post-crisis reform: Dodd-Frank Act of 2010

"Passing this bill was no easy task. To get there, we had to overcome the furious lobbying of an array of powerful interest groups and a partisan minority determined to block change." — President Barak Obama at Dodd-Frank signing ceremony (July 21, 2010)

Source: whitehouse.gov

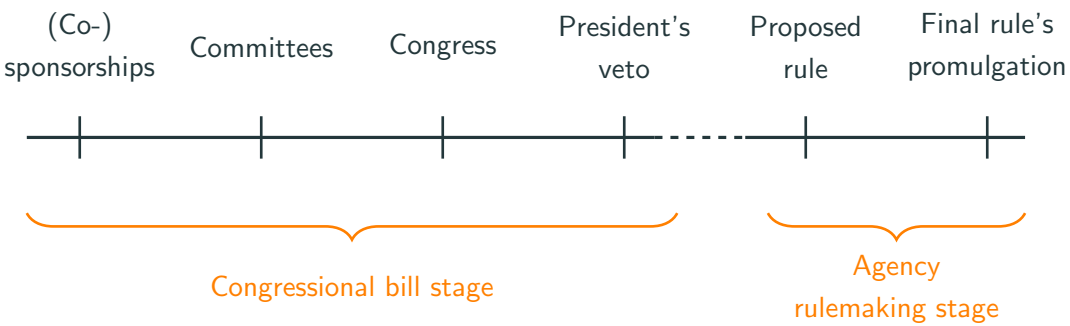
Largest regulatory intervention in finance and banking since the 1930s

The statute is 848 pages and includes 398 rulemaking requirements and, as of 2015, finalized rules amounted to roughly 19,000 pages

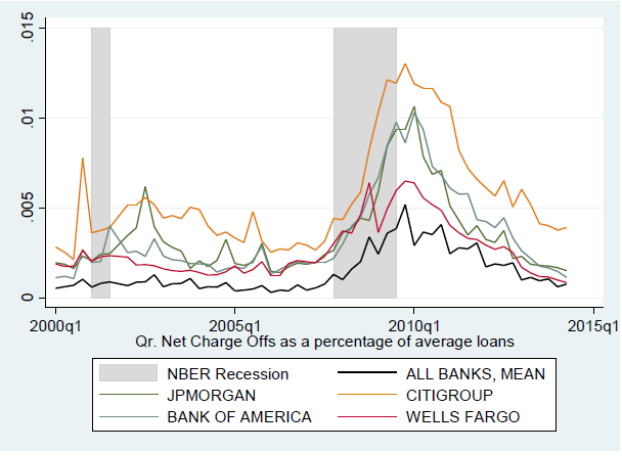
Main areas covered by Dodd-Frank Act:

1. Financial Stability Oversight Council
2. Regulatory reorganization, including dissolution of the OTS
3. Securitization reform: "skin in the game" for mortgage originators
4. Derivatives regulation: CFTC oversight and clearing requirements
5. Consumer Financial Protection Bureau
6. Rating agency reform
7. Limits to proprietary trading: the Volcker Rule
8. Executive compensation
9. Capital requirements and compliance standards, especially for banks $>$ \$ 50 bn

From legislation to rulemaking

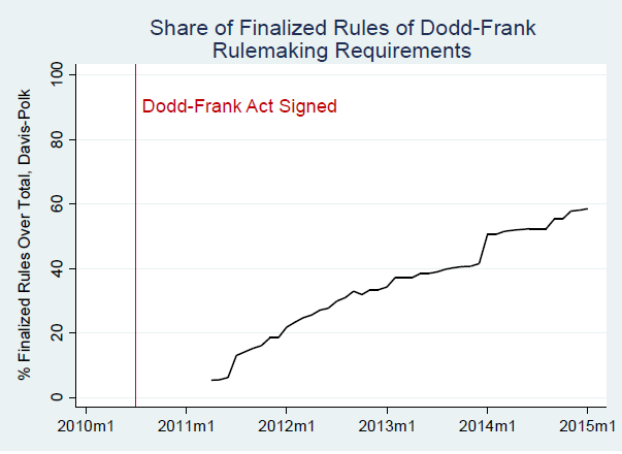


Who performed the worse in the crisis?



Source: based on data from Bertrand, Bombardini and Trebbi

Rulemaking completion



Source: based on data from Bertrand, Bombardini and Trebbi

Rulemaking completion

Volcker rule:

- 11 pages on July 21, 2010
- 298 pages on November 7, 2011 → proposed rule
- 1077 pages on December 10, 2013 → finalized rule
- 17,000+ comments by 250 banks + many meetings

Source: based on data from Bertrand, Bombardini and Trebbi

The role of banks in Dodd–Frank rulemaking

Banks account for only about 2% of submitted comments

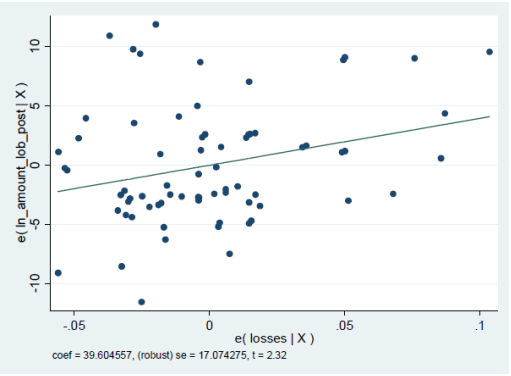
Yet roughly 90% of regulator meetings involve bankers or bank lobbyists

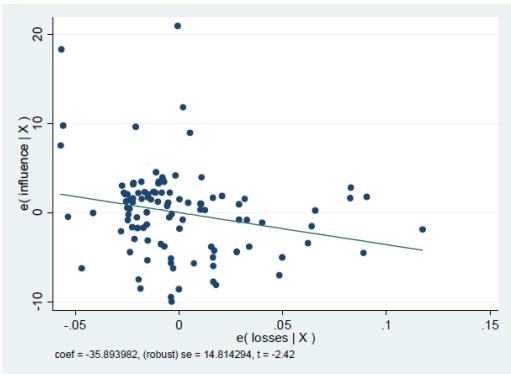
How do special interests influence regulation?

- Measure how much finalized regulatory text differs from interim or proposed rules
- Identify which banks comment on rules that subsequently change the most
- Estimate influence by linking bank comments to later regulatory revisions
- Example: Goldman Sachs is influential if rules it comments on are systematically revised more extensively

▸ Agencies' influence

Lobbying, influence, and charge-offs during the crisis





Source: based on data from Bertrand, Bombardini, and Trebbi.

Reform after the crisis: The EU Banking Union of 2012

The GFC accelerated the move toward EU-wide financial supervision

European Banking Authority (EBA) established in 2010:

- Coordinates EU bank stress tests
- Promotes supervisory convergence across member states

European System of Financial Supervision (ESFS):

- Coordinates supervision of banking, securities, and insurance markets
- Includes the EBA, ESMA, EIOPA, and the ESRB

Prudential banking supervision nevertheless remained largely national:

- Limited integration across the EU and Eurozone
- Weak framework for supervising cross-border banking groups

Single Supervisory Mechanism (SSM)

In September 2012, the European Commission proposed the SSM for banks

The reform gave the ECB a new role as a supranational prudential supervisor:

- Bank licensing and authorization
- Assessment of qualifying holdings
- Monitoring compliance with capital requirements
- Early intervention and corrective measures

However, important supervisory powers remained national:

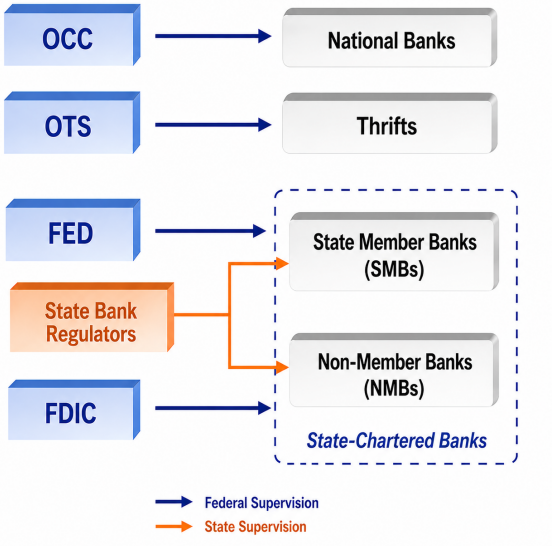
- On-site examinations primarily conducted by national supervisors
- National authorities continued validating internal risk models used for regulatory capital calculations

Laboratories for the E.U.

1. Agarwal, Lucca, Seru and Trebbi (2014 [2]): do different supervisors implement the same rules differently? Evidence from the dual U.S. supervisory setting

2. Dessein, Gong, Lambert and Wagner (2026 [14]): does delegation improve bank supervision? Evidence from the Chinese supervisory setting

U.S. dual supervisory system

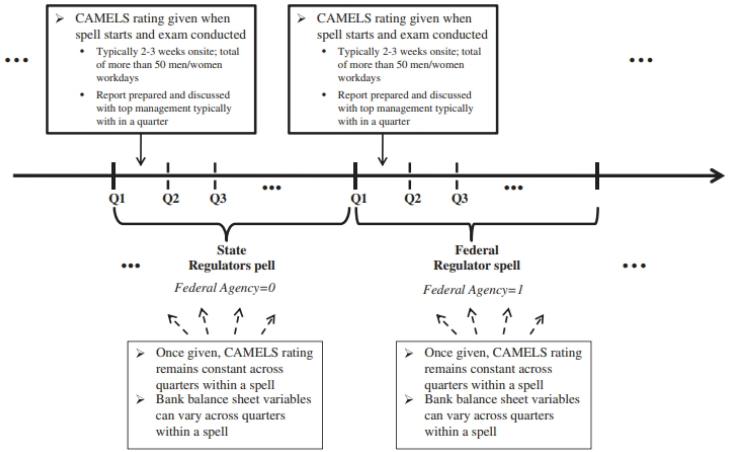


Empirical complications

Selection of banks into regulatory environments is not just a theoretical possibility:

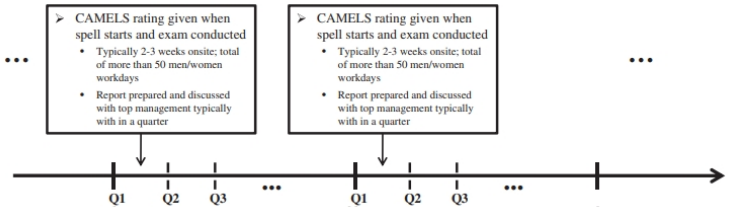
1. Negatively: *"competition for laxity"* — Chairman Burns, 1974
2. Positively: *"checks and balances of a system of more than one regulatory authority"* — Chairman Greenspan, 1993

Supervisory rotation spells and timing



Source: Agarwal et al. (2014 [2])

Supervisory rotation spells and timing



Riegle Act of 1994:

Federal agencies required to use state reports as substitute in alternate 12-month (18-month for small banks) cycle:

- Between State supervisor and FRB for SMBs
- Between State supervisor and FDIC for NMBs

70% US commercial banks covered (27% by assets)

Source: Agarwal et al. (2014 [2])

Inconsistent supervisors

Agarwal et al. (2014 [2]) focus on on-site examination, culminating in a CAMELS rating (from 1 [safe] to 5 [failing])

They exploit a legally-determined rotation policy that circumvents bank self-selection

They can track:

- Different supervisors behavior when dealing with same bank
- Bank behavioral response to differential supervisory behavior

Tabulation of Composite CAMELS Upgrades and Downgrades

	CAMELS upgrade		CAMELS downgrade		CAMELS harsh downgrade	
	Freq.	Percent	Freq.	Percent	Freq.	Percent
SMBs, FRB-STATE rotating						
FRB	111	35	477	73	199	73
STATE	208	65	178	27	75	27
Total	319	100	655	100	274	100
	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
ΔCAMELS	−1	0	1.09	0.33	1.22	0.49
NMBs, FDIC-STATE rotating						
FDIC	1222	46	3188	60	1687	69
STATE	1413	54	2103	40	769	31
Total	2635	100	5291	100	2456	100
	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
ΔCAMELS	−1	0	1.13	0.39	1.29	0.54
Federal Regualtors-STATE rotating (SMBs and NMBs)						
Federal	1333	45	3665	62	1886	69
STATE	1621	55	2281	38	844	31
Total	2954	100	5946	100	2730	100
	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
ΔCAMELS	−1	0	1.13	0.39	1.28	0.53

Notes. The table reports the frequency of composite CAMELS upgrades and downgrades by the lead supervisory agency (FRB, FDIC, or state) that took the regulatory action. Harsh downgrades are defined as downgrades such that the post–regulatory action CAMELS equals 3 or higher. The sample selection criteria are discussed in Section II. Sample period is 1996:Q1–2010:Q4.

Source: Agarwal et al. (2014 [2])

Inconsistent supervisors

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They exploit a legally-determined rotation policy that circumvents bank self-selection

They

-
-

Main results of Agarwal et al. (2014 [2])

- Federal supervisors are twice as likely to issue a downgrade in CAMELS ratings than State, which is counter-balanced by upgrades by State
- Federal supervisors induce readjustments of capital ratios, NPLs, and delinquencies, implying lower ROA

Tabulation of Composite CAMELS Upgrades and Downgrades

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NMBs, FDIC-STATE rotating						

69
31
100
Std. dev.
0.54
69
31
100
Std. dev.
0.53

es by the lead
es are defined
mple selection

Source: Agarwal et al. (2014 [2])

Why are there differences in supervisor behavior?

Local interests:

- Higher spread during "tougher" times
- Higher spread for privately funded banks

Self-interest of supervisors ("regulatory capture"):

- Higher spread for banks paying more fees
- Limited support for higher spread in states with higher corruption
- Limited support for "revolving door" explanations

Weakness of supervisors (competences/resources):

- Higher spread in states with lower movement into the private sector

At which level should banking supervision be carried out?

Supervision: ongoing monitoring and oversight of banks (more discretionary in nature than regulation)

- Example: an on-site visit that leads to discovery of problems and triggers a supervisory intervention

Level of allocation: central vs. local

- Example: SSM implemented in 2014

Following the GFC, supervision largely moved toward centralization

- Example: SSM directly supervises only significant institutions

Similar questions outside banking: fiscal decentralization or optimal currency areas

The main trade-off in the literature

Local supervisor is in better position to acquire information about banks and specialize in local conditions (Colliard 2020 [11], Carletti, Dell'Ariccia and Marquez 2021 [9])

Local supervisor has a local bias due to capture (Shleifer 1996 [27]), or because she ignores *externalities* outside the local area (e.g. Calzolari, Colliard and Gyongyi [8], Carletti et al. 2021 [9])

The empirical literature has predominantly found more stringent outcomes when a more central supervisor makes the decisions (e.g. Agarwal et al. 2014 [2], Beck, Silva-Buston and Wagner 2023 [6])

(De)centralized supervision

	Central supervisor	Local supervisor
Incentives	✓	✗
Information collection	✗	✓

Delegated supervision

	Delegated supervision*
Incentives	✓
Information collection	✓

→ Decentralization vis-à-vis a subordinated (not independent) supervisor

Authority and communication in banking supervision

A hierarchical structure facilitates the distribution of tasks → best of both worlds as each entity specializes in the activity in which it has a comparative advantage

But divergent incentives of central and local supervisors can still make communication among them less informative

Full delegation (of decision-making authority) can thus be preferred → delegation as an alternative to communication (Dessein 2002 [14])

Subordinates in charge

Dessein et al. (2026 [15]) examine whether "fully" delegated supervision affect supervisory decisions and, as a result, impact risk-taking by banks

They provide a model of supervisory communication and bias

They exploit:

- a policy reform in China that delegated supervisory decision-making authority for a subset of bank branches to a lower hierarchy (not to an independent supervisor)
- novel misconduct data from 300 local supervisory offices against 5,000+ branches

China's banking sector

Largest banking sector in the world:

- In 2020, total assets of \$38.98 trillion in China (US = \$27.71 trillion)

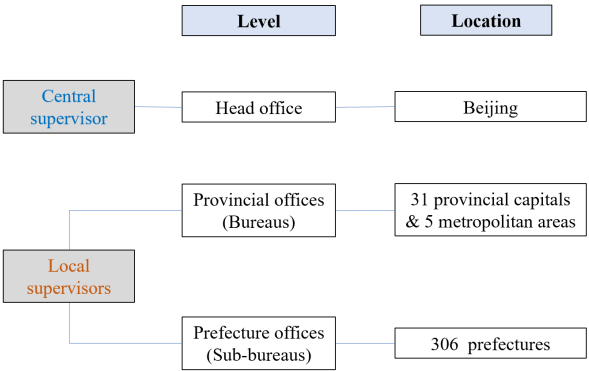
Commercial banks:

- National banks (70% of total assets): 6 state-owned and 12 joint-stock banks
- Local banks: 130+ prefecture-level commercial banks, 1600+ rural commercial banks, and numerous rural credit cooperatives and village banks

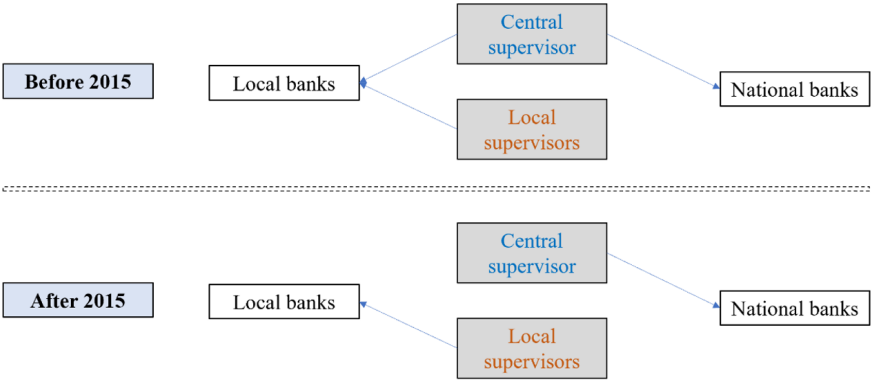
Branching network:

- A headquarter, one prefecture-level branch ("Fenhang"), several lower-level offices ("Zhihang")
- A bank has (at most) one branch in a prefecture (==administrative unit)

Structure of the Chinese Banking Regulatory Commission (CBRC)



The decentralization reform of 2015



→ The reform did not change the overall objectives of supervision (set by the central supervisor)

Model setup

Agent (local supervisor) has better information than the principal (central supervisor) but is biased against supervisory interventions

Under delegation, agent makes decisions herself, whereas under centralization she communicates information to the central supervisor who then makes the decision

Decisions: whether to intervene following information about potential misconduct of a bank and which penalty to impose

Two costs:

1. The local bias makes the agent to strategically withhold information, so principal also makes biased decisions
2. Loss of information, making supervisory decision less tailored to actual conditions

▸ More

Main result and implications

Delegation is optimal unless the local bias is large

For a wide range of parameters, delegation is optimal (Dessein 2002 [14]) and supervisory interventions increase; when delegation is suboptimal, interventions always decrease

Average penalties also decrease as (i) more minor misconduct is detected, and (ii) major misconduct is punished less harshly

Penalties are also more variable as they are more sensitive to severity of misconduct (less one-size-fits-all)

More limited central access to local information and higher local uncertainty amplify the effect of decentralization

▸ More

Sample and key data

5,429 branches of 1,074 banks in 342 prefectures for 10 years surrounding the 2015 reform

90% of the assets of the Chinese banking sector

Interventions and resulting penalties are disclosed on CBRC websites

12,000+ penalties (i.e. warning, fine, disqualification, prohibition, license revocation)

Example of a penalty

Information disclosure form for supervisory penalty, Yichang sub-bureau of the CBRC

宜昌银监分局行政处罚信息公开表

（湖北银行股份有限公司宜昌分行）

Penalty ID	行政处罚决定书文号		宜银监罚决字[2015]3号	No. 3, Yichang authority 2015
Punished entity	被处罚当事人姓名或名称	个人姓名	Individual ——	Yichang branch, Bank of Hubei
		单位 名称	Bank name 湖北银行股份有限公司宜昌分行	
		单位 法定代表人（主要负责人）姓名	Bank CEO 何青平	
Facts of misconduct	主要违法违规事实（案由）		存在贷款风险分类不准确、以贷转存吸收存款的违规行为。	Misconducts of inaccurately classifying loans based on their risk level and withholding a certain percentage of the loan as a deposit when the loan is granted.
Penalty basis	行政处罚依据		《中华人民共和国银行业监督管理法》第四十六条第（五）项	Banking Supervision and Administration Law of the PRC, Article 46(5).
Penalty decision	行政处罚决定		罚款人民币40万元	A fine of 400,000 RMB
Supervisory office	作出处罚决定的机关名称		中国银行业监督管理委员会宜昌监管分局	Yichang sub-bureau of the CBRC
Decision date	作出处罚决定的日期		2015年11月5日	November 5, 2015

Local vs. national banks

Aggregation level	Local banks	National banks
Branch-level		
Size (log of total assets in million RMB)	11.76	11.79
ROA	0.97%	0.98%
Market share (% offices)	5.03%	6.56%
Dist. of branches' pref. capital to Beijing (km)	1101.98	1183.73
credit/GDP of branches' prefecture	108.04%	112.79%
HHI of branches' prefecture (% offices)	0.09	0.10
Number of penalties	2.80	1.86
Bank-level		
Number of branches per bank	2.03	182.56
Number of penalties per bank	5.68	337.78
Aggregate-level		
Number of banks	1056	18
Number of penalties	5,998	6,080
Total fine amount (million)	1761.7	3690.69

Specification

Difference-in-differences at the bank-prefecture-year level (=branch-year):

$$Penalty_{ijt} = \alpha_i + \alpha_j + \alpha_t + \beta Localbank_i \times Post_t + \varepsilon_{ijt}. \quad (1)$$

$Penalty_{ijt}$: dummy equal to 1 if a branch receives a penalty in year t or $log1+$ number of penalties received by a branch in year t, and 0 otherwise

$Localbank_i$: dummy equal to 1 if branch belongs to a local bank i (treated group), and 0 if branch of a national bank i (control group)

$Post_t$: dummy equal to 1 from 2015 onwards, and 0 otherwise

α_i, α_j, α_t: bank, prefecture, and year FEs

ε_{ijt}: error term

Decentralization and penalties: basic results

	Penalty dummy				Number of penalties			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Local bank	-0.015***				-0.012***			
	(0.003)				(0.002)			
Post	0.105***				0.110***			
	(0.007)				(0.008)			
Local bank × Post	0.067***	0.075***	0.063***	0.088***	0.078***	0.088***	0.073***	0.104***
	(0.007)	(0.008)	(0.008)	(0.008)	(0.009)	(0.010)	(0.009)	(0.010)
Year FE	No	Yes	No	Yes	No	Yes	No	Yes
Bank FE	No	Yes	Yes	No	No	Yes	Yes	No
Prefecture FE	No	Yes	No	No	No	Yes	No	No
Prefecture × Year FE	No	No	Yes	No	No	No	Yes	No
Bank × Prefecture FE	No	No	No	Yes	No	No	No	Yes
Observations	52773	52773	52756	52769	52773	52773	52756	52769
R^2	0.047	0.144	0.245	0.213	0.046	0.141	0.239	0.208

▸ Parallel trend

Decentralization and penalties: basic results

	Penalty dummy				Number of penalties			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
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Post	0.105***				0.110***			
	(0.007)				(0.008)			
R^2	0.047	0.144	0.245	0.213	0.046	0.141	0.239	0.208

Main result of Dessein et al. (2026 [15])

- Local banks are 6.3-8.8 pp more likely to receive a penalty post-reform
- The model suggests that results are in the range in which delegation improves supervisory outcomes

▸ Parallel trend

Interventions distortions and efficiency gains

Calibrating the model from the DiD estimates has two implications:

1. Large distortions under centralization: strategic communication collapses to two messages ($n^* = 2$), the local supervisor either signals "low risk" (no intervention) or "high risk" (intervention), withholding all finer information; the central supervisor fails to intervene in 59.5% of cases where she would ideally want to, far exceeding the local supervisor's own bias of 19.6%
2. Material welfare gains from reform: delegation eliminates 18.8% of efficiency losses under centralized supervision, mainly by detecting moderate misconduct that was previously suppressed by strategic under-reporting

Average fines and their dispersion

	Average fine (1)	Average fine (log) (2)	Fine dispersion (3)	Fine dispersion (log) (4)
Local bank×Post	-465.083*	-0.272**	0.107**	0.100*
	(276.252)	(0.116)	(0.041)	(0.055)
Year FE	Yes	Yes	Yes	Yes
Bank×Prefecture FE	Yes	Yes	Yes	Yes
Observations	3,871	3,871	3,871	3,871
R^2	0.333	0.545	0.505	0.496

Average fines and their dispersion

	Average fine (1)	Average fine (log) (2)	Fine dispersion (3)	Fine dispersion (log) (4)

A follow-up result from Dessein et al. (2026 [15])

- Average penalties (conditional on intervention) become lower consistent with more minor misconduct now being punished
- Average penalties become more dispersed consistent with them better reflecting information about misconduct

When does decentralization help most?

Limited central access to local information:

- Proxy used: distance between branch prefecture and Beijin
- Branches farther from Beijing see a significantly larger increase in supervisory interventions post-reform (even short distances matter)

Higher local uncertainty:

- Proxies used: economic volatility and leadership vacancy/turnover
- Reform effect is significantly stronger in high-uncertainty prefectures across proxies
- Intuition: local information is more valuable when central supervisor cannot predict local conditions

$\rightarrow$ Both findings are consistent with an informational interpretation of the reform and difficult to reconcile with other channels (risk, stringency, capacity)

Decentralization and bank risk-taking

Loan-level data:

- Loan announcement from listed firms
- Matched lenders with branches
- Loan spreads (i.e. interest rates) and loan quantities (log of loan amounts) to proxy for aggressiveness in lending

Result: branches of local banks are more conservative post-reform

	Loan spreads		Loan amounts	
	(1)	(2)	(3)	(4)
Local bank×Post	31.477**	31.257**	-0.385***	-0.329**
	(13.315)	(12.448)	(0.139)	(0.139)
Firm size	4.595	6.563	-0.022	-0.051
	(6.432)	(5.934)	(0.074)	(0.059)
Firm leverage	0.278	0.102	0.002	0.002
	(0.304)	(0.366)	(0.002)	(0.002)
Firm tangibility	-0.388**	-0.523***	0.001	0.000
	(0.193)	(0.183)	(0.003)	(0.002)
Firm cash holdings	0.042	0.095	0.002	-0.001
	(0.344)	(0.406)	(0.003)	(0.003)
Firm ROA	0.040	-0.373	0.001	0.001
	(0.356)	(0.371)	(0.004)	(0.003)
Year FE	Yes	Yes	Yes	Yes
Bank FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Prefecture FE	No	Yes	No	Yes
Observations	7,229	7,203	13,012	12,986
R^2	0.602	0.657	0.396	0.458

Regulatory capture

"There are multiple causes of the financial crisis. But we cannot ignore the element of 'capture' in the systemic failures of oversight, regulation, and disclosure in the financial sector."

— Daniel Kaufmann, Forbes (January 27, 2009)

What is regulatory capture?

Broad interpretation: regulatory capture is the process through which special interests affect state intervention in e.g., financial system supervision, setting taxes, monetary policy

Narrow interpretation: regulatory capture is the process through which regulated monopolies (read: systemically important financial institutions) manipulate the state agencies supposed to regulate them

→ See Dal Bó (2006 [13]) for a review

A three-layer agency problem

Supervisors do not necessarily stand in for the "common good":

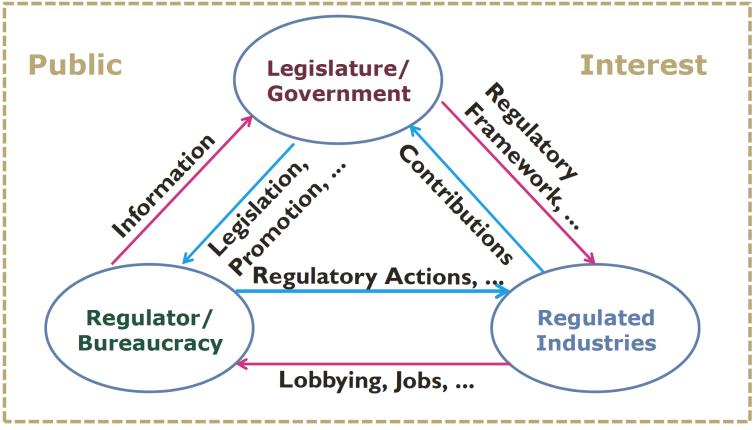
- They are delegated institutions (by elected officials, and ultimately by voters)
- They are complex institutions with their own corporate governance and internal multi-layered structure

One can identify two "levels" of incentive misalignment:

1. Moral hazard between banks (the agent) and supervisors (the principal)
2. Moral hazard between supervisors (the agent) and consumers or taxpayers (the principal)

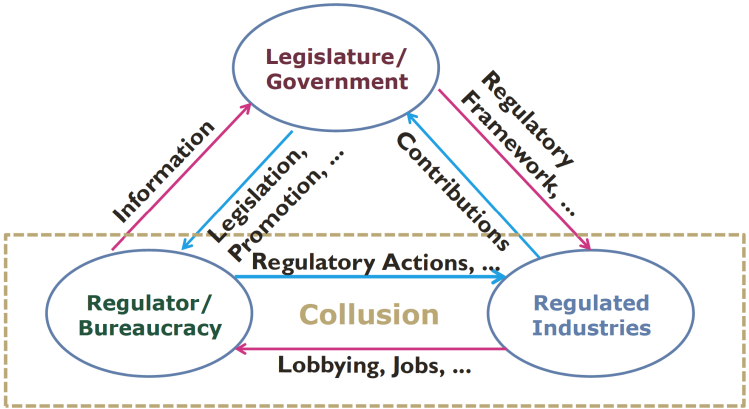
Incentive-based definition: regulatory capture emerges when the incentives of banks and supervisors become more aligned, at the expense of driving a wedge between the incentives of supervisors and taxpayers

The “iron triangle”



Source: Dockner (2014 [16])

The “iron triangle” with capture



Source: Dockner (2014 [16])

Degrees of regulatory capture

Strong capture: regulation becomes harmful — the public is better off with no regulation altogether: the costs of capture are larger than the benefits from regulation

Weak capture: regulation is inefficient, but still useful — the public is better off with captured regulation than with no regulation altogether: the costs of capture are smaller than the benefits from regulation

→ See Carpenter and Moss (2014 [10])

Two assumptions

There are two main premises to start thinking about regulatory capture:

1. Regulators' opinions can be influenced
2. Not all groups have equal opportunities in influencing them

Legal and "illegal" capture:

- we do not focus on "illegal" ways to sway a regulator (e.g. bribes) as they are the easiest to solve (i.e. just enforce the law)
- The legal forms of capture are more difficult to prevent and therefore much more pervasive (and dangerous)

Other theories of capture: e.g. "Tollbooth" theories, "life-cycle" theories, etc.

Channels for regulatory capture

1. Career concerns ▸ More
2. Information ▸ More
3. Asymmetries ▸ More
4. Environmental pressure ▸ More

Is capture natural?

Banks provide a public service: reallocate resources in the economy

Can we look, then, at banks as quasi-public institutions?

If yes, their interests overlap to an extent with the public interests

Therefore, some extent of regulatory capture is natural: perhaps there is not so much incentive misalignment?

The argument certainly is valid ex post: large banks are going to be saved from insolvency in the name of the "public interest"

Some degree of regulatory capture is therefore inevitable

Diagnosis of regulatory capture

Three steps are necessary to prove regulatory capture occurs (Carpenter and Moss 2014 [10]):

1. Establish a plausible model of public interest, i.e., what policies are most in line with welfare maximisation?
2. Establish regulation departs from the optimal regulation of the model
3. Prove action and intent by the financial industry that account for a significant part of such departure

In reality, intent is very hard to prove

Replacing intent with motive is sometimes seen as a suitable substitute, but it is not a perfect one

Preventing regulatory capture

Igan and Lambert 2019 [22]) stress two important solutions to contain capture at more "acceptable" levels (i.e. weak capture):

1. Enhanced transparency of decisions by:
   - Mandating ex post disclosure of regulatory decisions and supervisory actions
   - Making lobbying contacts, deliberations, data, and decision processes public
   - $\rightarrow$ Strengthen regulators' accountability toward the general public and other parties
2. Checks and balances within decision-making process by:
   - Implementing structures tackling the enduring disproportionate influence of banks and their lobbyists
   - Including dissenting voices (customers, smaller institutions) in the regulatory process
   - $\rightarrow$ Ensure broader participation, equal access to information, and oversight in decision-making

Baxter (2011 [5]) discuss further solutions

Conclusion

Summary

From build-up to recovery, political frictions shape the entire financial crisis cycle

Policymakers face difficult trade-offs: restricting credit growth vs. supporting economic expansion; stabilizing the system vs. avoiding "bailouts"; allocating losses fairly vs. preserving financial stability

Crises create winners and losers, generating strong incentives for political influence

We focused on lobbying, but influence operates through multiple channels at each stage of the crisis cycle

Regulatory capture is particularly acute during crises; greater transparency and stronger checks and balances are essential throughout the process

Next module: how crises shape politics $\rightarrow$ feedback effects

Thank You

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Appendix

Liquidity vs. solvency: basic framework

A bank has cash C, loans L, deposits D, and equity E: $A = C + L = D + E, \qquad D > C$

Loans pay θL at $t = 2$ and depositors choose whether to withdraw at $t = 1$ after observing θ

Solvency threshold:

$$\theta^{Solvency} = \frac{D - C}{L}$$

If $\theta < \theta^{Solvency}$, the bank cannot repay depositors even without a run

Liquidity/run threshold:

$$\theta^{Liquidity} = \frac{D - C}{(1 - \rho)L} > \theta^{Solvency}$$

If $\theta \in [\theta^{Solvency}, \theta^{Liquidity})$, the bank is solvent absent a run, but a run can force receivership and destroy value

Key distinction: some failures reflect fundamental insolvency; others may be caused by liquidity-driven runs

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Liquidity vs. solvency: empirical predictions

Hypothesis 1: weak fundamentals predict failure $\rightarrow$ failures are more likely when θ is low; higher capital ratios reduce both insolvency risk and run-triggered failure risk

Hypothesis 2: recovery rates reveal solvency $\rightarrow$ recovery rates should be higher when failures are panic-induced and lower when banks are fundamentally insolvent

Hypothesis 3: interbank liquidity reduces run failures $\rightarrow$ if banks can borrow against assets, the run region shrinks: $\theta^{Liquidity,Interbank} = \frac{D-C}{\lambda L}$

Hypothesis 4: sleepy depositors make failures more predictable $\rightarrow$ if many depositors do not withdraw, insolvent banks may remain liquid temporarily, delaying failure

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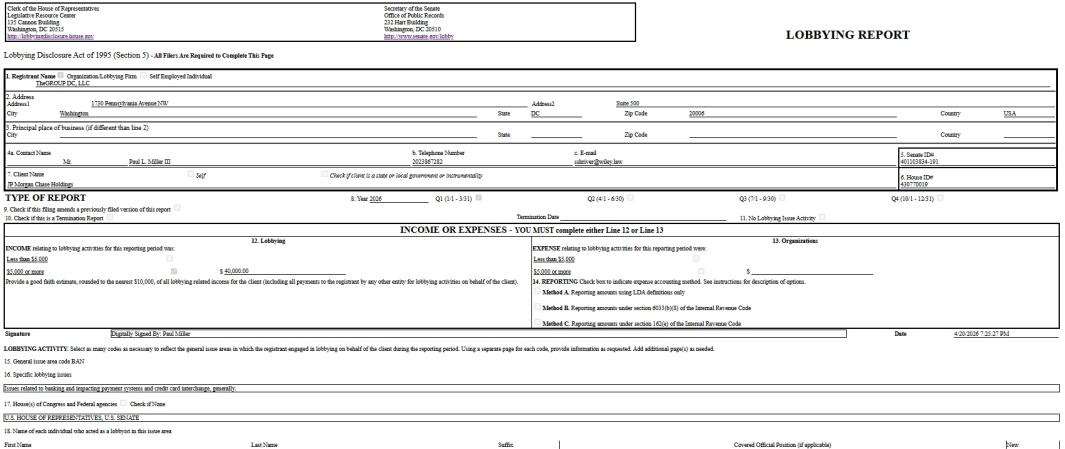
Example of a lobbying report



Clerk of the House of Representatives
Legislative Resource Center
135 Cannon Building
Washington, DC 20515
http://lobbydisclosure.house.gov

Secretary of the Senate
Office of Public Records
232 Hart Building
Washington, DC 20510
http://www.senate.gov/lobby

LOBBYING REPORT

Lobbying Disclosure Act of 1995 (Section 5) - **All Filers Are Required to Complete This Page**

1. Registrant Name ☐ Organization/Lobbying Firm ☐ Self-Employed Individual
TheGROUP DC, LLC

2. Address
Address1: 1730 Pennsylvania Avenue NW | Address2: | Suite 500
City: Washington | State: DC | Zip Code: 20006 | Country: USA

3. Principal place of business (if different than line 2)
City: | State: | Zip Code: | Country:

4a. Contact Name: Mr. Paul L. Miller III | b. Telephone Number: 2023867282 | c. E-mail: pmiller@valley.law

5. Senate ID#: 401103434-193

7. Client Name: JP Morgan Chase Holdings | ☐ *Self* | *Check if client is a state or local government or instrumentality* ☐

6. House ID#: 43877019

TYPE OF REPORT

8. Year 2026 | Q1 (1/1 - 3/31) ☑ | Q2 (4/1 - 6/30) ☐ | Q3 (7/1 - 9/30) ☐ | Q4 (10/1 - 12/31) ☐

9. Check if this filing amends a previously filed version of this report ☐

10. Check if this is a Termination Report ☐ | Termination Date | 11. No Lobbying Issue Activity ☐

INCOME OR EXPENSES - YOU MUST complete either Line 12 or Line 13

12. Lobbying

INCOME relating to lobbying activities for this reporting period was:

Less than $5,000 ☐

$5,000 or more ☑ $ 40,000.00

Provide a good faith estimate, rounded to the nearest $10,000, of all lobbying related income for the client (including all payments to the registrant by any other entity for lobbying activities on behalf of the client).

13. Organizations

EXPENSE relating to lobbying activities for this reporting period were:

Less than $5,000 ☐

$5,000 or more ☐ $

14. REPORTING Check box to indicate expense accounting method. See instructions for description of options.

Method A. Reporting amounts using LDA definitions only

Method B. Reporting amounts under section 6033(b)(8) of the Internal Revenue Code

Method C. Reporting amounts under section 162(e) of the Internal Revenue Code

Signature: Digitally Signed By: Paul Miller | **Date**: 4/20/2026 7:25:27 PM

LOBBYING ACTIVITY. Select as many codes as necessary to reflect the general issue areas in which the registrant engaged in lobbying on behalf of the client during the reporting period. Using a separate page for each code, provide information as requested. Add additional page(s) as needed.

15. General issue area code BAN

16. Specific lobbying issues

Issues related to banking and inspecting payment systems and credit card interchange, generally.

17. House(s) of Congress and Federal agencies ☐ Check if None

U.S. HOUSE OF REPRESENTATIVES, U.S. SENATE

18. Name of each individual who acted as a lobbyist in this issue area

First Name	Last Name	Suffix	Covered Official Position (if applicable)	New
Rashell	Henry			☐
Rowlanna	Rodriguez			☐

Source: https://lda.senate.gov

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U.S. lobbying: definitions

Lobbyist

Any individual:

1. who is either employed or retained by a client for financial or other compensation
2. whose services include more than one lobbying contact
3. whose lobbying activities constitute 20 percent or more of his or her services' time on behalf of that client during any three-month period

Lobbying contact

Any oral, written, or electronic communication to a covered official that is made on behalf of a client

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U.S. lobbying: definitions (cont'd)

Lobbying activities

Lobbying contacts and any efforts in support of such contacts, including preparation or planning activities, research, and other background work that is intended, at the time of its preparation, for use in contacts, and coordination with the lobbying activities of others

[lobbyingdisclosure.house.gov/amended$_l da_g uide.html section3$]

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Median house prices in the districts of HFSC members (119th Congress)

30 Republican members	State	District	House price ($ median)	24 Democrat members	State	District	House price ($ median)
J. French Hill (Chairman)	AR	2	211.300	Maxine Waters	CA	43	699.300
Frank D. Lucas	OK	3	160.900	Nydia M. Velazquez	NY	7	859.200
Pete Sessions	TX	17	239.500	Brad Sherman	CA	32	1.086.900
Bill Huizenga	MI	4	248.200	Gregory W. Meeks	NY	5	671.700
Barry Loudermilk	GA	11	392.200	James A. Himes	CT	4	663.200
Warren Davidson	OH	8	228.800	Bill Foster	IL	11	345.200
John W. Rose	TN	6	318.100	Joyce Beatty	OH	3	301.400
Bryan Steil	WI	1	262.400	Juan Vargas	CA	52	690.200
William R. Timmons IV	SC	4	275.000	Josh Gottheimer	NJ	5	582.700
Marlin A. Stutzman	IN	3	201.600	Vicente Gonzalez	TX	34	125.100
Ralph Norman	SC	5	249.400	Sean Casten	IL	6	341.500
Daniel Meuser	PA	9	205.800	Ayanna Pressley	MA	7	694.900
Young Kim	CA	40	988.100	Rashida Tlaib	MI	12	184.000
Byron Donalds	FL	19	421.300	Ritchie Torres	NY	15	532.500
Andrew R. Garbarino	NY	2	628.600	Sylvia R. Garcia	TX	29	189.000
Scott Fitzgerald	WI	5	262.400	Nikema Williams	GA	5	371.800
Mike Flood	NE	1	259.500	Brittany Pettersen	CO	7	613.800
Michael Lawler	NY	17	628.600	Cleo Fields	LA	6	177.900
Monica De La Cruz	TX	15	169.200	Janelle S. Bynum	OR	5	566.000
Andrew Ogles	TN	5	457.700	Sam T. Liccardo	CA	16	1.851.300
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
Median			**277.150**	**Median**			**549.250**
Mean			**336.860**	**Mean**			**540.671**

*Median (mean) house price across all districts, 119th Congress: 334.100 (401.501)

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Resolution process

Information gathered and failed bank marketed:

- E-mail inviting prospective buyer to secure data-room
- Confidentiality agreements
- Information about failed bank and P&A transaction
- On-site due diligence (very limited and swift)

Bidding and selling:

- Mandate: limit losses to DIF
- FDIC selects winning bidder using proprietary "least-cost" test

FDIC's discretion and power:

- The benefits are speed and clear expectations
- The downside is a lack of transparency, including fairness

Back

Influence of regulatory agencies

Special interests influence the regulators directly through their testimonies, petitions, and lobbying, and indirectly through lawsuits

Congress influences the regulators directly through the definition of mandate and oversight and indirectly through appropriating the agency budget

The President influences the regulators directly through appointing their heads and steering their policy goals

The Courts influence the regulators through judicial reviews of due process (procedural and substantive) and constitutionality

Back

Dessein et al.: setup

Bank type is given by $\theta + \delta$, where θ is i.i.d. on $[-1, 1]$ and $\delta \in \{-\varepsilon, \varepsilon\}$ with $\varepsilon > 0$

Only the agent observes θ, while both the agent and principal observe δ

The principal wants to impose a fine if $\theta + \delta > 0$, and its ideal fine is

$$F^*(\theta) = \max\{0, \theta + \delta\}$$

The agent wants to impose a fine if $\theta + \delta > b$ $(b > 0)$ and its ideal fine is

$$F_A^*(\theta) = \max(0, \theta + \delta - b\}$$

Preferences over fines $U(F, \theta)$ are represented by a loss function which is linear in the absolute distance between the actual fine F $(F \geq 0)$ and the supervisor's ideal fine

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Dessein et al.: organization design

Decentralized supervision: the local supervisor (agent) decides on the fine.
The fine thus always equals $F = \max\{0, \theta + \delta - b)\}$.

Centralized supervision: the central supervisor (principal) decides on the fine, but she can consult the local supervisor.
Any communication is modeled as cheap talk crawford1982strategic
The local supervisor sends a cheap talk message m and the principal imposes a fine

$$F = \arg\max E(U(F, \theta)|G(\theta, m))$$

Back

Dessein et al.: optimality of delegation

Proposition 1:

For $|\delta|$ sufficiently small, delegation is optimal whenever $b < 1$

Proposition 2:

(i) Whenever $b > 1$, centralization is optimal, and there is more intervention under centralization than delegation
(ii) Whenever $b \in (\frac{1}{2} - \frac{|\delta|}{2}, 1)$, delegation is optimal, but under centralization, there is strictly more intervention by the center than by the agent
(iii) Whenever $b < \frac{1}{2} - \frac{|\delta|}{2}$ delegation is optimal, and under centralization there is strictly less intervention by the center than by the agent as the agent can credibly communicate when the risk-level of the bank is low or moderate

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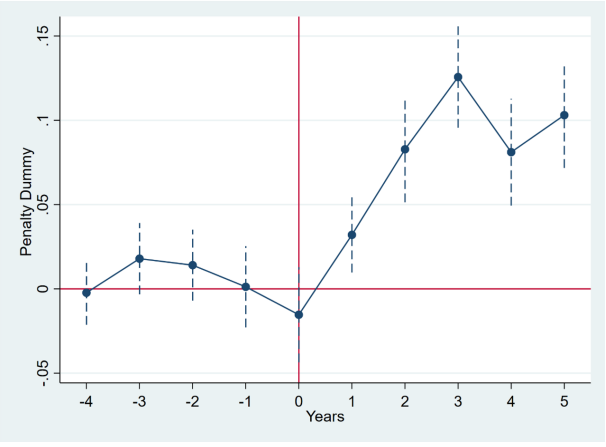
Parallel trend



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Career concerns: revolving doors

Salaries in the financial sector are typically much larger than in regulation

The regulatory capture does not require an explicit quid pro quo: money against a favorable decision

However, the phenomenon of "revolving doors" is pervasive in finance:

- Former regulators may be hired into well-paid industry positions
- All things equal, banks will prefer former regulators who expressed pro-industry views

Consequently, ex ante, regulators are likely to be more lenient with banks

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Career concerns inside regulation

Large and dispersed constituencies are poorly informed about regulatory issues

The "average" voter does not spend too much time to read (about) financial regulation

Regulators are only human: they might make mistakes

If the mistake is against large banks, then the financial system will expose the error and the regulator will lose her reputation

If the mistake is against consumers, nobody will likely notice

Therefore, the regulator is likely to bias her decisions towards the interests of the big banks

Back

Information needs

Regulators need to work with accurate data on the financial system

However, this data is generally provided by the regulated institutions themselves

There is an "implicit" bargain emerging between regulator and regulated

The regulator usually tries to establish a "cooperative environment"

Regulators generally make concessions to the industry to obtain good data to base their decision on

Again, this is an "implicit" quid pro quo

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Asymmetries

One key aspect about financial capture is the asymmetry between interests groups

Many players, even in the financial system, are small (e.g. savings banks)

Small players find it difficult to organize and lobby for their interests

Also, since each is individually small, benefits are limited

Large players can better coordinate and extract more profit from lobbying

Therefore, regulation is more likely to biased towards the largest firms from the industry

Back

Environmental pressure

Regulators (need to) posses industry-specific skills

Therefore, they are likely to have received the same education as the bank managers, and have similar views and opinions

Further, regulators have extensive networks of former colleagues in the industry

This factor naturally makes the incentives of regulators and industry converge

Is it really a bad thing in this case? How much of this convergence is expertise and how much is "culture"?

Back

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