Seven Questions about Political Influence and the Financial Crisis

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As options to reshape the financial landscape are discussed, the issue of how political influence of the financial industry comes into play attracts attention. A few recent papers look at different aspects of this issue. Based on the results of these studies and the broader literature on political economy and financial crises, this article provides brief answers to some commonly asked questions.

Question 1: How did we get here?

Much has been said about the factors that paved the way to the worst financial crisis since the Great Depression. In recounting these factors, Claessens and others (2009) pay particular attention to regulatory failure. Regulators and supervisors have been accused of missing the warning signs and failing to take the necessary actions that would have contained the risks. Yet, an important piece of the puzzle as to why regulators failed seems to be missing. The political process of establishing the legal framework that gives supervisors the ability to guard financial stability is not immune from being influenced by the groups that are affected by this framework. In fact, these groups engage in targeted activities, through campaign contributions and lobbying, in order to impact policymaking.

For example, *The Wall Street Journal* reported on December 31, 2007 that Ameriquest Mortgage and Countrywide Financial spent millions of dollars in political donations, campaign contributions, and lobbying activities from 2002 through 2006 to defeat anti-predatory lending legislation (Simpson, 2007). Does this mean that timely regulatory response that could have mitigated reckless lending practices and the consequent rise in delinquencies and foreclosures was shut down by the industry? Such anecdotes suggest that the political influence of the financial industry contributed to the financial turmoil in subprime mortgages that started in the spring of 2007 and, since then, generalized into a full-blown credit crisis. Recent studies that involve formal analyses of the political economy of the crisis include Igan, Mishra, and Tressel (forthcoming) and Mian, Sufi, and Trebbi (forthcoming).

Question 2: What is lobbying and how does it work in the United States?

Since the 1970s, rent-seeking has been identified as a key activity of economic agents in market economies. In developing countries, rent-seeking by firms is more often performed through personal connections with politicians to obtain private benefits and can materialize through a variety of channels (preferential access to credit, bail-out guarantees, privileged access to licenses, procurement contracts, etc.). In developed countries, lobbying—broadly defined as a legal activity aiming at changing existing rules or policies or procuring individual benefits—is a common form of rent-seeking.

Lobbyists in the United States—often organized in special interest groups—can legally influence the policy formation process through two main channels. First, they offer campaign finance contributions, in particular through political action committees. These activities have received a fair amount of attention in the literature. Second, they spend billions of dollars each year to lobby members of Congress and federal agencies. In contrast to the focus on campaign contributions, these lobbying activities, which account for about 90 percent of expenditures on targeted political activity, have received scant attention in the literature. In order to engage in lobbying, some special interests hire lobbying firms; others have lobbyists working in-house. The Lobbying Disclosure Act of 1995 requires lobbying firms and companies with in-house lobbying units to file reports of their lobbying expenditures with the Secretary of the Senate and the Clerk of the House of Representatives. Legislation requires the disclosure not only of the dollar amounts actually spent, but also of the issues regarding which the lobbying is carried out. Such detailed information is reported by roughly 9,000 companies, around 600 of which are in the finance, insurance, and real estate industry.

Question 3: Was lobbying by the finance, insurance, and real estate industry associated with loosening lending standards?

Igan, Mishra, and Tressel (forthcoming) show that lobbying on specific issues related to mortgage lending and

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securitization is linked to riskier lending practices. Risky lending practices are proxied by three alternative measures: loan-to-income ratio, proportion of mortgages securitized, and growth rate of loans originated. The loan-to-income ratio is reminiscent of the requirement that mortgage payments cannot exceed a certain proportion of the applicant's income. As the maximum proportion allowed increases, the burden of servicing the loan becomes more difficult and the default probability increases. Recourse to securitization is considered to weaken monitoring incentives; hence, a higher proportion of mortgages securitized can be associated with lower credit standards. Fast expansion of credit could be associated with lower lending standards because (1) the increased number of applications will, with constraints on training and employing new loan officers, lead to less time and expertise allocated to each application to assess its quality; (2) in a booming economy, rising collateral values increase creditworthiness of intrinsically bad borrowers and, when collateral values drop during the bust, these borrowers are exposed; or (3) competitive pressures compel lenders to loosen lending standards in order to preserve market shares.

The paper finds that, during 2000–07, lenders that lobbied more intensively to prevent tightening of laws and regulations on mortgage lending and securitization (1) originated mortgages with higher loan-to-income ratios, (2) increased their recourse to securitization more rapidly, and (3) had faster growing mortgage loan portfolios. These findings suggest that lobbying by the finance, insurance, and real estate industry was a factor driving the deterioration in credit and build-up of risk prior to the crisis.

Question 4: How effective was lobbying by financial institutions during the crisis?

Given the evidence that lobbying was associated with more risk-taking during 2000–07, the next question is whether loans originated by lenders that lobby performed worse than those originated by lenders that do not lobby. Igan, Mishra, and Tressel (forthcoming) show that the delinquency rates in 2008 were significantly higher in areas where mortgage lending by lobbying lenders expanded relatively faster than mortgage lending by other lenders. The estimated effect is economically significant: a 1 standard deviation increase in the relative growth of mortgage loans of lobbying lenders is associated with almost a 1 percentage point increase in the delinquency rate.

A related issue is whether stocks of lobbying lenders were more severely affected by the arrival of the bad news. Igan, Mishra, and Tressel (forthcoming) conduct an event study around four important dates: August 2007, when the European Central Bank injected overnight liquidity in response to problems in BNP Paribas, IKB, and Sachsen Landesbank; December 2007, when major central banks coordinated liquidity injection to relieve pressures on short-term funding markets; March 2008, the Bear Stearns failure; and September 2008, the Lehman Brothers failure. The analysis reveals that financial institutions that lobbied on specific issues of mortgage market regulation and securitization experienced negative abnormal returns, compared to the market and other financial institutions.

Question 5: What links lobbying to lending and performance?

The evidence that lobbying is associated ex ante with riskier loans and ex post with worse outcomes is consistent with moral hazard, whereby expectations of preferential treatment (e.g., a higher probability of being bailed out in the event of a financial crisis) or the focus on short-term gains distort lending behavior. Of course, alternative explanations exist but appear to be less consistent with the evidence. Suppose, for instance, that “bad” lenders lobby more and do so in order to mimic good lenders, who lobby to signal information to the policymaker. Since bad lenders do not have the knowledge necessary to choose which issues to lobby for, they would lobby more in general and not necessarily on issues related to mortgage lending. Then, lobbying on unrelated issues would be associated with risky lending as well. Falsification tests suggest otherwise. Another alternative interpretation is that lobbying lenders specialize in catering to riskier borrowers. However, inclusion of fixed effects and instrumental variable estimations suggest that the relationship does not capture unobserved characteristics or shocks. Yet another story is that overoptimistic lenders, who underestimate the likelihood of an adverse event affecting the mortgage market, lobby more for relaxation of rules and regulations. The analysis, however, shows that the relationship is stronger in the latter period, 2005–06, and it is not clear why overoptimism would have increased during those years, when signs of stress in housing markets were becoming visible.

Question 6: What are the policy implications of a link between lobbying and lending?

The answer crucially depends on what drives the link. Consider three stories that could explain why financial institutions lobby. First, financial institutions engage in lobbying

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as a form specialized rent-seeking. Then, financial industry lobbying may lead to misallocation of resources, and curtailing lobbying is socially improving. In the second case, misgovernance and distorted incentives urge lenders to lobby and chase short-term gains. Losses in the long term are borne by the economy as a whole. Then, public oversight and enforcement of optimal contracts might be necessary to realign incentives, but curtailing lobbying is not necessarily welfare-improving. In the third case, financial industry lobbying can be an information-provision mechanism: lenders develop new products and lobby policymakers for a regulatory shift that is necessary for financial innovation to reach the market. Then, to the extent that financial innovation is welfare-enhancing, lobbying helps informed decision-making and is socially desirable. Empirical evidence does not definitely rule out any of these three stories. In general, it is hard to distinguish between rent-seeking and information provision, and policy implications are difficult to derive.

Question 7: Can regulatory reform succeed?

The role of political influence is not unique to the current crisis. Cronyism has been widely mentioned in discussions of the Asian crisis, and it has been argued that both the reasons for the crisis and the policies to resolve it were affected by political connections (Johnson and Mitton, 2003). In their analysis of congressional voting during the current episode, Mian, Sufi, and Trebbi (forthcoming) find that higher campaign contributions from the finance, insurance, and real estate industry are associated with an increased likelihood of voting in favor of the Emergency Economic Stabilization Act of 2008, a bill which transfers wealth from taxpayers to the industry. Recent reports show that financial institutions intensified their lobbying efforts in 2009, fighting against an overhaul of derivatives regulation and legislation that would enable judges to reduce mortgage payments of bankrupt households. Johnson (2009) argues that substantial reform will fail unless the political power of the finance, insurance, and real estate industry is broken. Time will tell whether these pessimistic scenarios on the potential of regulatory reform can materialize.

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