



Political capital and moral hazard[☆]

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ABSTRACT

This paper examines how political connections affect risk exposure of financial institutions. Using a geography-based measure, I find that politically connected firms have higher leverage and their stocks have higher volatility and beta. Furthermore, prior to the 2008 financial crisis, politically-connected financial firms had higher leverage and were more likely to increase their leverage during the housing bubble in response to local growth in median housing prices. During the crisis, higher leverage was associated with worse performance but being in a state with a US Senator on the Banking Committee was correlated with weakly improved stock returns and reduced bankruptcy probability, highlighting the value of political connections for financial firms.

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1. Introduction

Do political connections affect risk-taking behavior? Did they play a role in risk taking by financial institutions that preceded the 2008 financial crisis? Throughout that crisis, moral hazard was one of the main concerns confronting policy makers in deciding whether to rescue financial institutions such as Bear Stearns, Lehman Brothers, and AIG. The idea of moral hazard was originally studied in the context of health insurance (see, e.g., Arrow, 1963; Zeckhauser, 1970) but has recently been used to describe the risk-taking behavior of financial institutions that believe they would be bailed out by the government. In fact, the history of bailouts in the United States, going

back to Continental Illinois in 1984 and continuing with the savings and loan (S&L) and the Long-Term Capital Management rescues of the 1980s and 1990s, suggests that US financial institutions had reasonable expectations of such bailouts during the years leading up to the 2008 financial crisis.

Government bailouts are discretionary and, like all government decisions, they can be influenced by political considerations and political connections. So, a moral hazard-based theory would predict that firms with better political connections should take on more risk.¹ I test this hypothesis by regressing measures of risk exposure on political connections. Because most measures of political connections are endogenous, I mainly use a geographic-based measure of political connections; whether a firm is headquartered in a state with a senator on the influential United States Senate Committee on Banking, Housing, and

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¹ Famous examples of this discretion were the decisions to bail out Bear Stearns but not bail out Lehman Brothers.

Urban Affairs (Senate Banking Committee). Similar measures were used in previous research on political decisions (e.g., [Duchin and Sosyura, 2012](#); [Cohen, Coval, and Malloy, 2011](#)), and they are more likely to be exogenous because financial firms rarely move across state lines and the financial sector is more evenly dispersed across the United States than most industries.² I find that the presence of a committee senator is associated with approximately a 10% increase in leverage and a 5% to 8% increase in stock volatility. The results persist with the addition of firm fixed effects, suggesting that financial firms respond to changes over time in Senate Banking Committee membership. I also sort firms into portfolios based on having a committee senator connection and find that portfolios of politically connected firms are significantly more sensitive to the market factor (have a higher market beta) than portfolios of unconnected firms.

Political connections are likely to be most useful during a market-wide event that has the potential to affect the entire economy and thus leads to government intervention. Therefore, risk exposure around the 2008 financial crisis is a particularly useful setting in which to study the role of political connections and risk-taking behavior. I show that connected and nonconnected firms had largely similar leverage ratios in 2002, prior to the start of the US housing bubble, but this changed dramatically by the first quarter of 2008. By that time, firms in a state with a committee senator had leverage ratios that were approximately 18% higher than firms without such political connections, after controlling for firm and CEO characteristics. For this sample period, I also have the data to investigate the effects of two other frequently used measures of political connections that are choice variables of the firm: lobbying spending and politically connected directors on firm boards. I find that while these two measures are positively correlated with precrisis leverage, the results are not statistically significant.

Next, I examine closer the relation between political connections, leverage, and real estate price appreciation during the US housing bubble. I test the hypothesis that risk exposure at politically connected firms was more sensitive to local housing price growth than at unconnected firms due to ex ante expectations of government support. I regress leverage changes during the housing bubble on lagged local (metropolitan area where firm is headquartered) housing price changes, and I find a positive and significant effect for firms with a committee senator connection, and an insignificant effect for firms without one. A statistically significant interaction term confirms the difference in sensitivities between connected and unconnected firms. This new evidence demonstrates how decisions during the housing bubble were shaped by whether or not financial firms believed their exposure to risk would be shielded by their political connections.

Finally, I investigate the consequences of decisions made during the housing bubble on performance during

the financial crisis, by looking at bankruptcy probabilities and 2008 stock returns. Unsurprisingly, firms with higher precrisis leverage were more likely to go bankrupt and had lower stock returns. This result illustrates the negative effects of moral hazard. Interestingly, after controlling for leverage and other firm characteristics, firms with a committee senator connection in October 2008 [when the Troubled Asset Relief Program (TARP) was passed and began to be distributed] were, if anything, slightly less likely to go bankrupt and had insignificantly higher stock returns. On the surface, this finding might seem counterintuitive. But, because TARP ended up being structured as a lump-sum capital infusion and not a post-default bailout of debtholders, the result is entirely consistent with the conclusion of [Duchin and Sosyura \(2012\)](#) that political connections played a role in whether or not a firm received TARP assistance (and how much).

The foundation for this paper is the seminal work on rent seeking by [Krueger \(1974\)](#), which describes how economic agents can secure an advantage over their competitors through government means. Value to firms from rent seeking can come in the form of favorable trade restrictions, tax benefits, government contracts, fewer regulations (see [Stigler, 1971](#)), or bailouts. More recent work by [Fisman \(2001\)](#) and [Faccio \(2006\)](#) has focused attention on the importance of political connections in the process of extracting rents from the government. In this paper, I focus on a different side of political connections—the incentives that they create for firms to take on extra risk.

Furthermore, political connections seem to pay off when companies are in distress. [Duchin and Sosyura \(2012\)](#) find that connections to powerful government officials in Congress and to the Federal Reserve system correspond to a higher likelihood of receiving TARP capital. In a broad sample of firms from around the world, [Faccio, Masulis, and McConnell \(2006\)](#) show that a higher probability of receiving a government bailout is an important benefit of political connections. Economic theory would suggest that corporate managers with rational expectations should adapt corporate policies to the probability of government bailouts. Consistent with this paper's results for US financial institutions, [Dam and Koetter \(2012\)](#) find that risk taking by German banks responds to changes in bailout expectations from political connections.

Understanding what caused the 2008 financial crisis is critical for preventing a similar episode in the future, and economists have examined several possible explanations. [Beltratti and Stulz \(2012\)](#) investigate the role of lax governance and regulation in the crisis and find that banks with better governance (more shareholder-friendly boards) performed worse during the crisis, while banks in countries with stricter banking regulations had better performance. [Cheng, Hong, and Scheinkman \(2014\)](#) find a correlation between size-adjusted executive compensation and market-based measures of risk such as stock volatility and beta. In contrast, [Fahlenbrach and Stulz \(2011\)](#) find no evidence that CEO compensation aligned with the interests of shareholders led to less risk taking and better performance during the crisis.

However, not much attention has been paid to the role of moral hazard from government intervention as one of

² One exception is New York City, which is a financial industry hub. However, robustness checks that drop New York State from the sample do not change my results.

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