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Political power, economic freedom and Congress: Effects on bank performance ☆

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ABSTRACT

This paper studies the linkages between bank performance, connections to powerful politicians, and the degree of economic freedom in a bank's home state. We find that bank performance is positively related to state economic freedom. We also reconfirm the finding of Gropper et al. (2013) that bank performance is improved by political connections. However, the positive effect of political connections appears to be significantly reduced when there is a higher degree of economic freedom in the state, indicating that political connections may matter less to banks when there is more economic freedom. Economic freedom in a state can have a beneficial effect on state economic growth and hence may outweigh any political connection benefits. However, the declines in state economic freedom in recent years could make political connections potentially more valuable to banks.

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1. Introduction

The link between firm performance and political connections and influence has long captured the interest and attention of researchers across the spectrum of business and politics. This is particularly important for firms in more highly regulated industries where a simple change in either law or regulatory policy can result in significant costs, or open new profitable opportunities. Firms in such industries may devote a great deal of time and resources toward lobbying efforts directed at influencing elected officials, regulators, or public opinion. There has been much research that demonstrates the importance of such political connections not only in the U.S. but also in other countries (Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006; Faccio et al., 2006; Ferguson and Voth, 2008; Bunkanwanicha and Wiwattanakantang, 2009; Niessen and Ruenzi, 2010; Chaney et al., 2011; Cingano and Pinotti, 2013; Amore and Bennedsen, 2013, among others).

The specific strategies undertaken by firms vary from making political campaign contributions and lobbying expenditures (Cooper et al., 2010; Hill et al., 2013), having family ties with local politicians (Amore and Bennedsen, 2013), building the social network of educational backgrounds (Do et al., 2012, 2014), having top officers and large shareholders who enter politics (Faccio, 2006; Faccio et al., 2006), to the selection of former politicians for seats on the firm board of directors (Goldman et al., 2009, 2013). According to Kim et al. (2013), many firms use a multi-faceted approach to gaining influence. Clearly, the overall goal is to insure that the business environment for the firm and industry is such that adequate profits can be earned.

A question arises as to the business and economic environment where such influence proves to be most important. In this research, we investigate how the degree of economic freedom in the respective states affects bank performance and how it interacts with the importance of political connections. That is, if a bank operates primarily in a state that is characterized by a greater degree of economic freedom, then does political influence still carry much importance?

We focus on the banking industry given the high level of regulatory oversight. Such a high level of oversight may suggest that

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political connections and influence become even more valuable. The industry has witnessed many significant legislative actions with major changes occurring since the early 1980s, beginning with the Depository Institutions Deregulation and Monetary Control Act of 1980. Since the 1980s, legislation has removed prior restrictions, so that now full interstate banking is allowed, with subsequent consolidation in the industry and decline in the number of banks from over 15,000 to under 7000. The entire financial sector has been affected more recently by the Dodd–Frank Act, which was enacted largely in response to the latest financial crisis. In essence, the banking environment has changed considerably and will likely continue to change as the U.S. Congress acts in response to economic conditions and as the regulations which flesh out Dodd–Frank are fully developed (Barth et al., 2012). The U.S. Congress is often a reactive body rather than proactive as we have seen with Dodd–Frank and more recently the Jumpstart Our Business Startups Act of 2012. In a recent paper, Gropper et al. (2013) analyze the banking industry and the role elected members of the U.S. Congress play in their positions as chair of their respective banking committees. They provide evidence that banks headquartered in states where a Senator or member of the House of Representatives serves as the chairman on their respective banking committee in Congress outperform banks headquartered in other states.

In this paper we examine whether political connections provide any measurable benefits to banks in a particular state and whether such effects are mitigated by the economic environment in that state. To operationalize this question, we consider both profitability and stock performance of banks and use the Economic Freedom Index of the States to capture the overall economic environment in a particular area. Further, we examine such connections in the context of financial crises.

Our tests clearly show that state economic freedom is highly and positively related to a local bank's stock performance. We measure return on assets and find that high economic freedom leads to economically large ROAs. For instance, an increase in economic freedom by 0.5215 (one standard deviation in the sample) is associated with an increase of 0.71% in ROA, compared to the mean ROA of 0.84%. In the following tests, we confirm the finding in Gropper et al. (2013) showing that banks generate significantly higher ROAs when their headquarters are located in the states where a senator or member of the U.S. House of Representatives is the chair of their respective banking committee in Congress. More importantly, we find that the positive effect of the bank committee chair on the home state bank's ROA is significantly impacted by the degree of economic freedom in the state.

This pattern persists when we test bank stock performance. Buying and holding the banks that get a positive chair effect generates a significantly higher abnormal return. The average buy-and-hold-abnormal-return (BHAR) is increased up to 11.15% a year when invested in those banks that are located in less economically free states that also have a local politician serving as a chair in the respective Congressional bank committee. However, this impact on firm performance is not found for those banks headquartered in states with a high level of economic freedom. Therefore, we conclude that, while there is a significant political influence on local bank performance in the banking industry, that effect may be limited in the areas that are characterized as more economically free. However, our results also suggest that the declines in state economic freedom in recent years could make political connections potentially more valuable to banks.

This study contributes to the literature by providing an important piece of evidence in understanding the financial implications of political connections suggested by the recently established stream of research. We show that the effects of political connections should be carefully analyzed because they are substantially affected by the conditions and characteristics of specific business environments.

It is worth emphasizing that our results hold when we consider the nature of endogenous relationships and self-selection bias. We address potential concerns regarding these problems in three ways. First, we examine bank performance related to changes in the chair position for the respective member of the U.S. House or Senate. The results indicate that bank performance does indeed improve subsequent to their home state representative or senator assuming the chair position of the relevant committee. Consistent with other results, however, the positive impact from a home state committee chair would be captured primarily for banks that also experience less positive changes in economic freedom. Second, we conduct a propensity score matching analysis, which has become popular to resolve an issue related to self-selection bias. The average effect of the bank committee chair on bank performance is positive and significant only for the sample with low economic freedom. The effect turns to be insignificantly negative for the high economic freedom group. Third, we analyze whether or not our findings could be attributed to the fact that economic freedom may be highly correlated with other state characteristics, such as the level of bank business in the state, political corruption, and state size, and thus those other factors may be driving our results. We find that the positive relations of bank chair and economic freedom to a bank's ROA and the negative interaction effect are not altered by the addition of these variables. Based on these test results, we conclude that our results hold even after control for endogenity and self-selection. At the end of the paper, we show that our results are robust to the alternative methods of measuring key variables as well as to the various econometric models that control for state-, regulatory-, bank-, and year-fixed effects and clustering at the bank level.

Our study is structured as follows. The next section relates this study to the existing literature and provides expectations, followed by hypothesis development in Section 3. Section 4 includes the description of data sources and sample selection procedure. Section 5 discusses the methodology and shows the empirical results on the relations of the state economic freedom to bank chair effects. Section 6 provides the analysis of stock performance measures. Finally, the last section summarizes our study and concludes.

2. Related literature

The general research into the relationship between firm performance and political connections is varied and covers a broad array of issues. Obviously, firms have utilized various ways of connections because such connections are strongly believed to provide them substantial benefits. This expectation has been demonstrated by many studies. For example, Faccio (2006) finds that the market positively greets announcements where a CEO, other executives, and large shareholders take a political position. Goldman et al. (2009) show that when firms that have a board member who was connected to the winning party (the Republican Party) in the 2000 U.S. presidential election, the firm experienced significant and positive abnormal returns around the election dates. Moreover, these connected firms get a significant and large increase in procurement contracts after the election (Goldman et al., 2013). Others have focused on lobbying efforts and expenditures as a means of building connections and political influence (Alexander et al., 2009; Richter et al., 2009; Yu and Yu, 2011; Hill et al., 2013). In another take on gaining influence, Cooper et al. (2010) relate corporate campaign contributions to firm returns. They find a positive and significant correlation between the level of campaign contributions and firm returns. They also find what

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