The Role of Political Frictions in Financial Crises

Politics & Economics of International Finance

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CIFAR, NBER

The Role of Political Frictions in Financial Crises

Build-up to the Crisis

Aftermath of the Crisis

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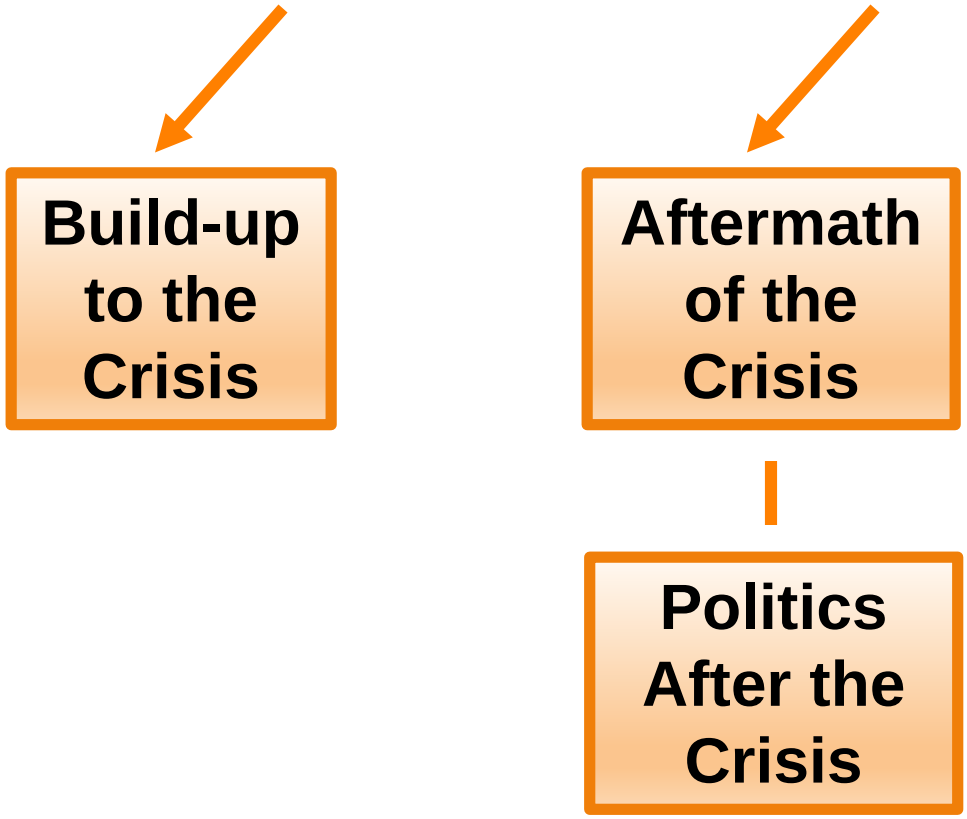


The Role of Political Frictions in Financial Crises

Build-up to the Crisis

Aftermath of the Crisis

Politics After the Crisis

2 Specific Instances of Response to Crisis

Dodd-Frank Act of 2010

EU Banking Union of 2012

The Role of Political Frictions in Financial Crises

Build-up to the Crisis

Rajan *Fault Lines* 2010

Johnson, Kwak *13 Bankers* 2011

Igan, Mishra, Tressel *NBER Macro Annual* 2012

Igan, Mishra *JLE* 2015

Aftermath of the Crisis

McCarty, Poole, Rosenthal *Political Bubbles* 2013

Politics After the Crisis

Frieden *JIMF* 2015

Posner, Weyl *AER P&P* 2013

Dodd-Frank Act of 2010

EU Banking Union of 2012

The Role of Political Frictions in Financial Crises

Build-up to the Crisis

Mian, Sufi, Trebbi *QJPS* 2013

Aftermath of the Crisis

Mian, Sufi, Trebbi *AER* 2010

Politics After the Crisis

Mian, Sufi, Trebbi *AEJ Macro* 2014

Agarwal, Lucca, Seru, Trebbi *QJE* 2014

Bertrand, Bombardini, Trebbi 2015

Dodd-Frank Act of 2010

EU Banking Union of 2012

Politics After the Crisis

- Focus on **aftermath of financial crises** (banking, currency, debt, inflation).
- Known stylized facts:
  - **Deep economic contractions** (output and employment). Reinhart and Rogoff (2009), Reinhart and Reinhart (2010).
  - Sustained waves of **volatility**, often resulting in 'secondary' crises (e.g. debt crises following banking crashes Reinhart and Rogoff, AER 2011).
- This is not all. **Economies polarize**:
  - 1997 Asian Crisis: Korea experienced a 5% increase in Gini from 1996 to 1998 (Cheong, 2005). 4% in the Philippines. Klein and Shabbir (2006, ch.1).
  - World Bank (2000) reports increases in inequality in 15 out of 20 crisis episodes in Latin America.

Politics After the Crisis

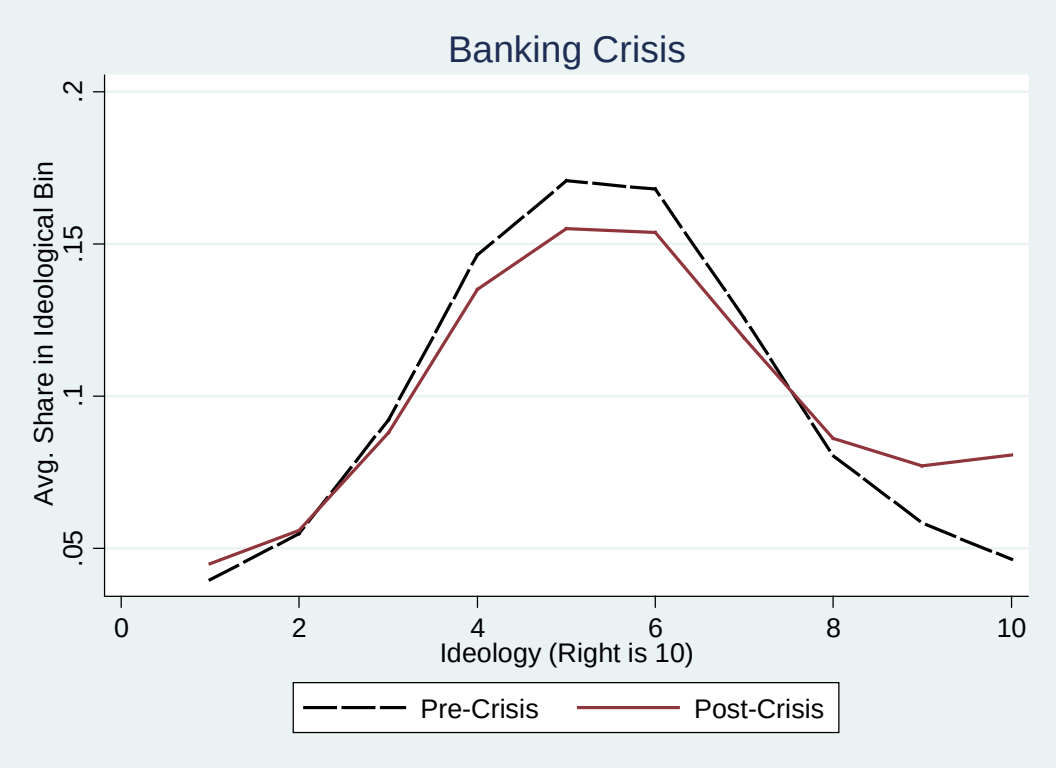
- Mian, Sufi, Trebbi (2014) show that not only economic, but **political polarization systematically increases around financial crises**:

  - ❑ Voters become more ideologically polarized;
  - ❑ Government coalitions become weaker:
    - ➢ in terms of both vote shares & seat shares;
  - ❑ Oppositions become larger;
  - ❑ Party fragmentation increases across the board.

- **Political gridlock & lack of reform/intervention is a natural outcome.**

(i.e. the failure of the US Congressional Supercommittee on deficit is the norm, not the exception).

Example: Post-Crisis Decreases Mass at Ideological Center



Notes: All 70 Reinhart and Rogoff (2011) Countries. All Crises 1975-2010.
Pre-Crisis Sample: 5 years before first year of crisis. Post-Crisis Sample: 5 years after last year of crisis.
Self Positioning in Political Scale, World Values Survey 1981-2008 Official Aggregate (e033, 2009).

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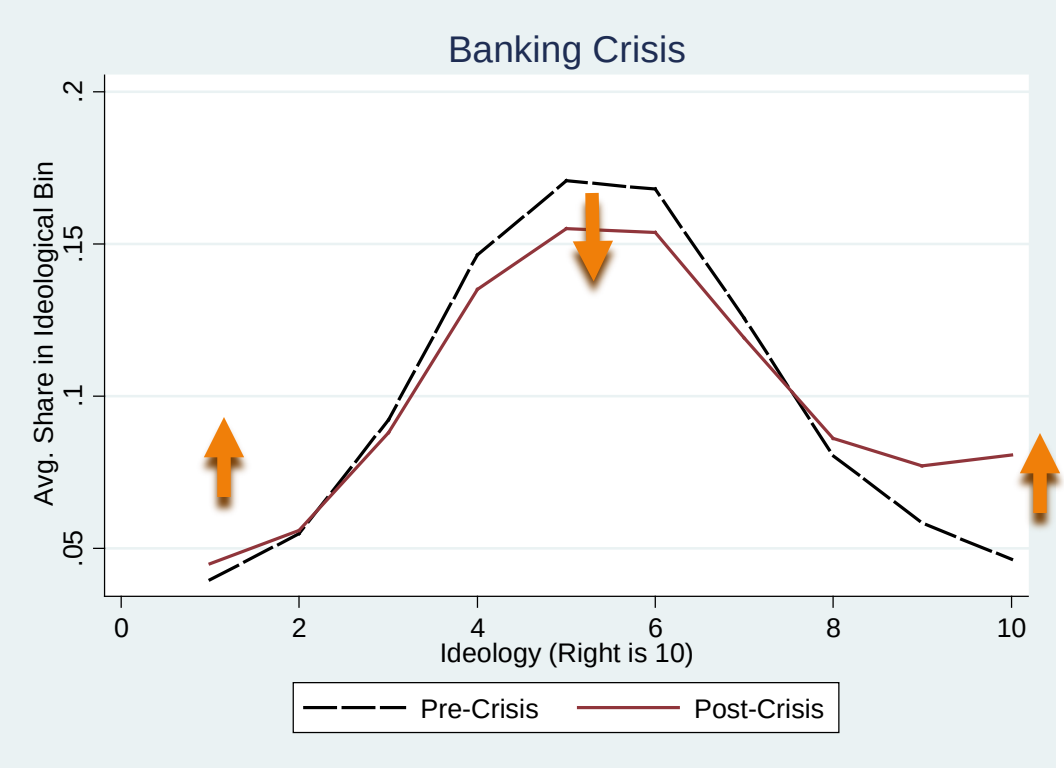

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Why is this important?

1. Crises bring gridlock through polarization. Any model of post-crisis macro intervention that leaves this political feature aside forgoes an important dimension. Any type of reform becomes harder. Including bailouts.

2. Crises are occasionally thought of as critical junctures where macroeconomic reform unlocks by shattering entrenched conditions. Benefits of crises: Drazen & Grilli (AER 1993); Drazen & Easterly (E&P 2001). The opposite seems true.

3. Gridlock delays reform & possibly makes recovery slower (explains long recessions).

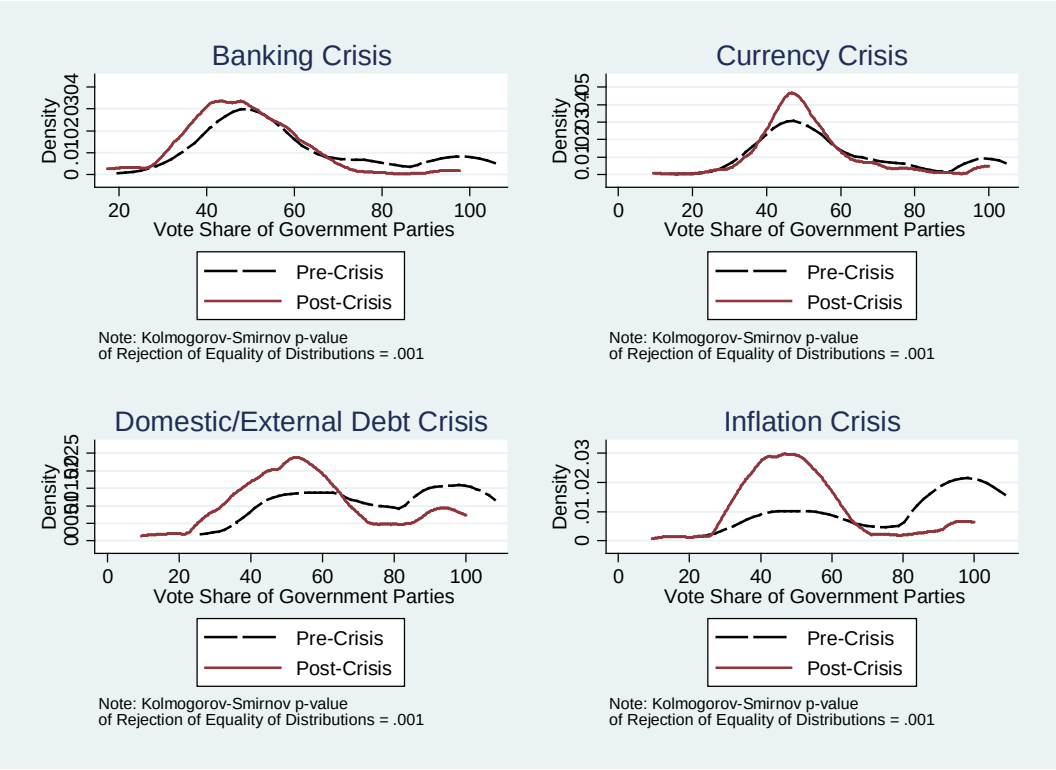
4. Gridlock brings political uncertainty. Markets for sovereign debt do not like that → Debt crises. E.g. EU.

5. Gridlock brings selective intervention. If a reform overcomes political gridlock, it's because of strong political organization. Organized special interests (Banks) get a sizeable bailout. Diffused special interests (Mortgage debtors) don't. Olson (1965).

Application & Methodology

- Pre- & Post-Crisis samples. 5 years windows around Reinhart and Rogoff's (2011) crises.
- Within-country analysis (country F.E.) & time F.E. (accounts for cross-border contagion, possibly too harsh a constraint).
- Employ survey data on individual ideological positioning. (E.g. World Values Survey panels; ANES; etc). Data coverage is not good unfortunately.
- Employ electoral and political data from Database of Political Institutions (World Bank) & IMF Reform Database. Data coverage is excellent.

Post-Crisis Decrease in Majority Margins for Government.



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Opposition share from Database of Political Institutions (World Bank, 2010).

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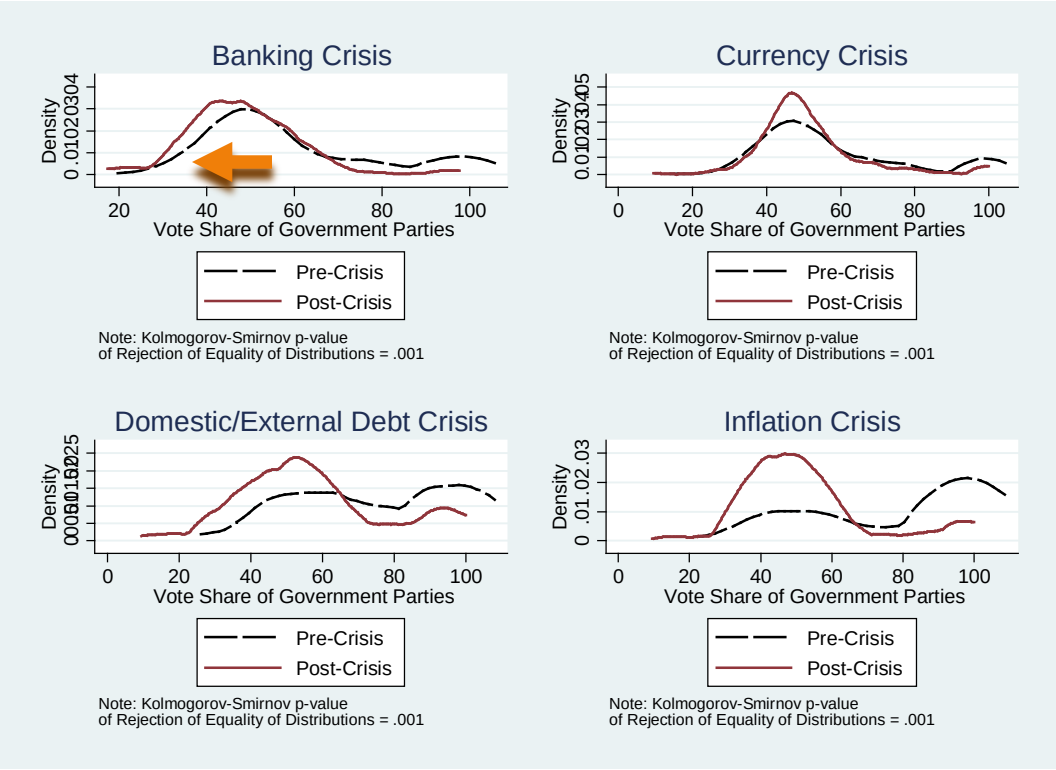

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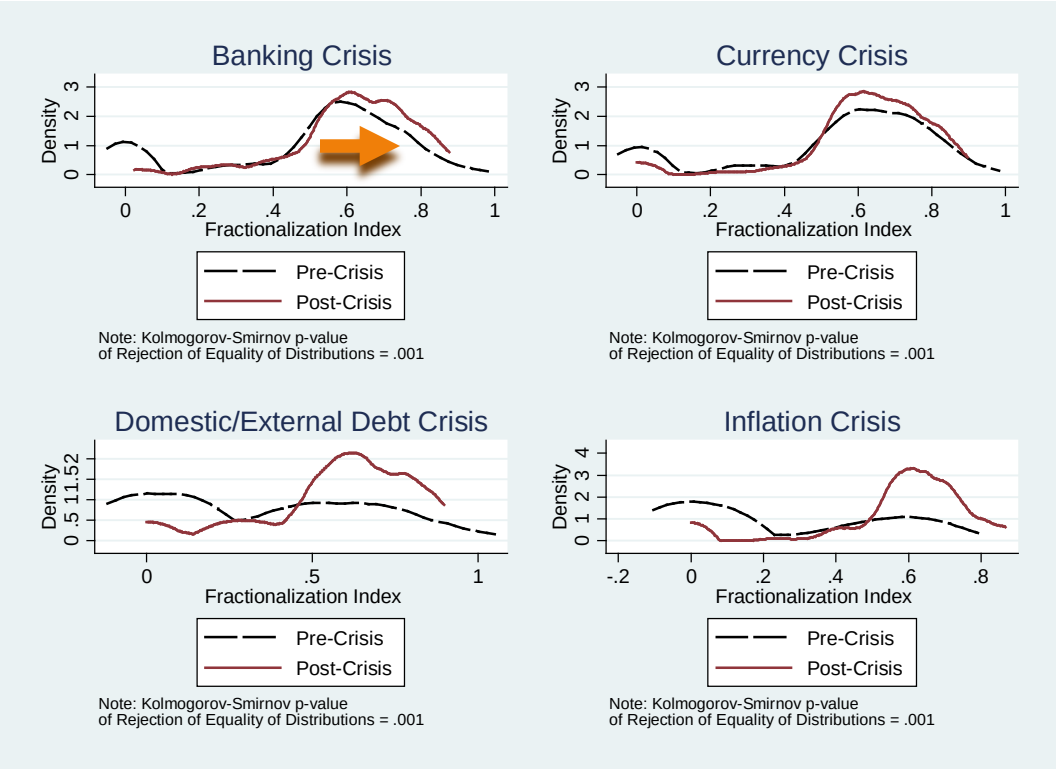
Weak Governments After Crises

Table 6

	Banking Crisis		Currency Crisis		Dom./External Debt Crisis		Inflation Crisis	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable: Government Vote Share								
Post -Crisis	**-10.6029**	**-6.8459**	**-5.6889**	**-2.9830**	**-17.0451**	**-3.3900**	**-26.6331**	**-10.2615**
	[1.4469]**	**[1.4906]****	**[1.4648]****	**[1.0052]****	**[2.8974]****	**[2.3458]**	**[2.9077]****	**[1.6419]****
R^2	0.09	0.67	0.03	0.77	0.13	0.84	0.27	0.92
N	534	534	599	599	236	236	279	279
Dependent Variable: Opposition Vote Share (Excluding Unaligned Parties)								
Post -Crisis	**8.6544**	**7.7531**	**2.8580**	**0.5635**	**10.9867**	**2.5713**	**20.4801**	**6.3344**
	[1.5059]**	**[1.3673]****	**[1.5110]**	**[1.0068]**	**[2.7145]****	**[2.6374]**	**[2.8892]****	**[2.1033]****
R^2	0.06	0.71	0.01	0.75	0.07	0.74	0.17	0.86
N	534	534	599	599	236	236	279	279
Dependent Variable: Polarization								
Post -Crisis	0.1761	0.1002	0.0971	0.0605	0.2732	0.1126	0.4836	0.1099
	[0.0625]**	[0.0637]	[0.0646]	[0.0489]	[0.0753]**	[0.0840]	[0.0616]**	[0.0727]
R^2	0.01	0.64	0.00	0.63	0.03	0.57	0.09	0.67
N	752	752	753	753	366	366	411	411

Note: Columns (2), (4), (6), and (8) include country and year fixed effects. Robust standard errors in brackets. ** Significant at .01 * significant at .05. Includes only country and year observations within 5 years before or after a crisis.

Post-Crisis Increase in Party Fractionalization in Legislative



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Fractionalization Index from Database of Political Institutions (World Bank, 2010).

Reform After the Crisis: It's there but it's weak & rare

- We perform same event study methodology, but looking at reforms.
- Focus on any change in i) the degree of liberalization of interest rate controls; ii) directed credit/reserve requirements; iii) entry barriers/pro-competition measures; iv) privatizations; v) capital account restrictions; vi) banking supervision; and vii) security markets liberalizations. See Abiad et al., 2008
- Large reforms (either liberalizations or retrenchments) appear rare. Roughly 1 in 10 crises produces a sizeable response (e.g. case of creditor rights reform).

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

Poster Child of Post-Crisis Reform: Dodd-Frank Act of 2010

- Largest regulatory intervention in finance & banking since 1930s.
- Statute is 848 pages. Includes 398 Rulemaking Requirements. As of 2015, Finalized Rules run around19,000 pages.

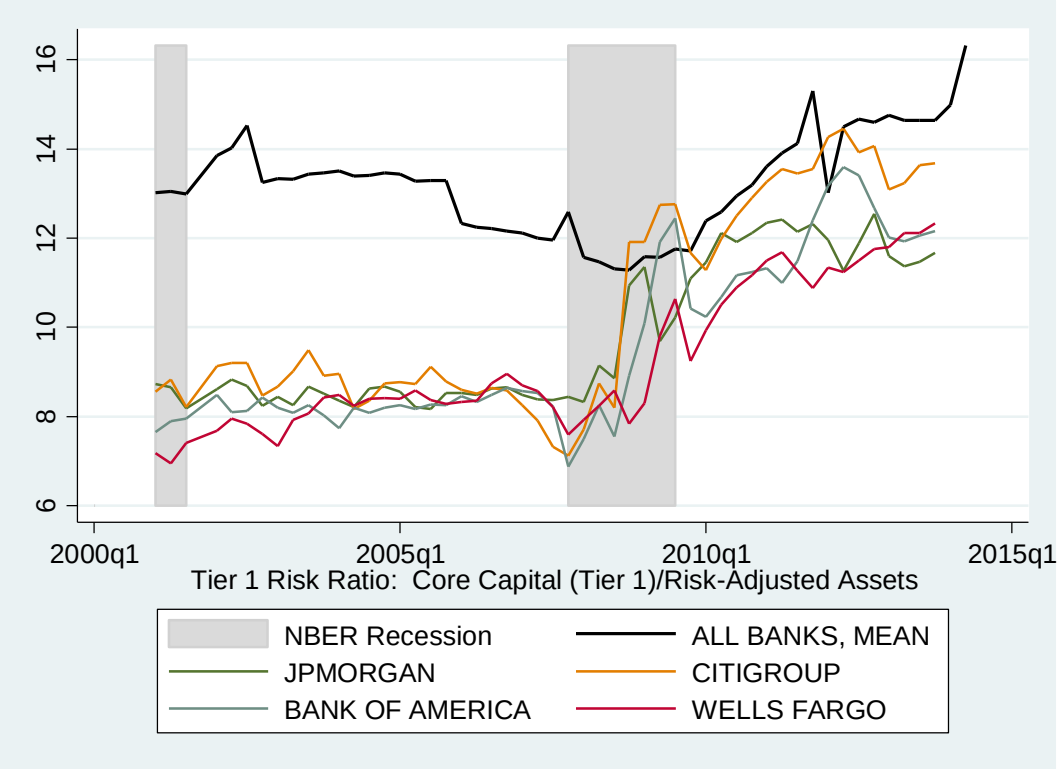
- Covers:

i. Creating Financial Stability Oversight Council
ii. Regulatory reorganization (OTS dissolved)
iii. Securitization Reform ("Skin in the game for mortgage originators")
iv. Derivatives Regulation (CFTC oversight, Clearing Requirements)
v. Creating Consumer Financial Protection Bureau
vi. Rating Agency reform
vii. Limits to Proprietary Trading ("Volcker Rule")
viii. Executive Compensation
ix. Capital Requirements (esp. Banks > $50 Billion in assets)

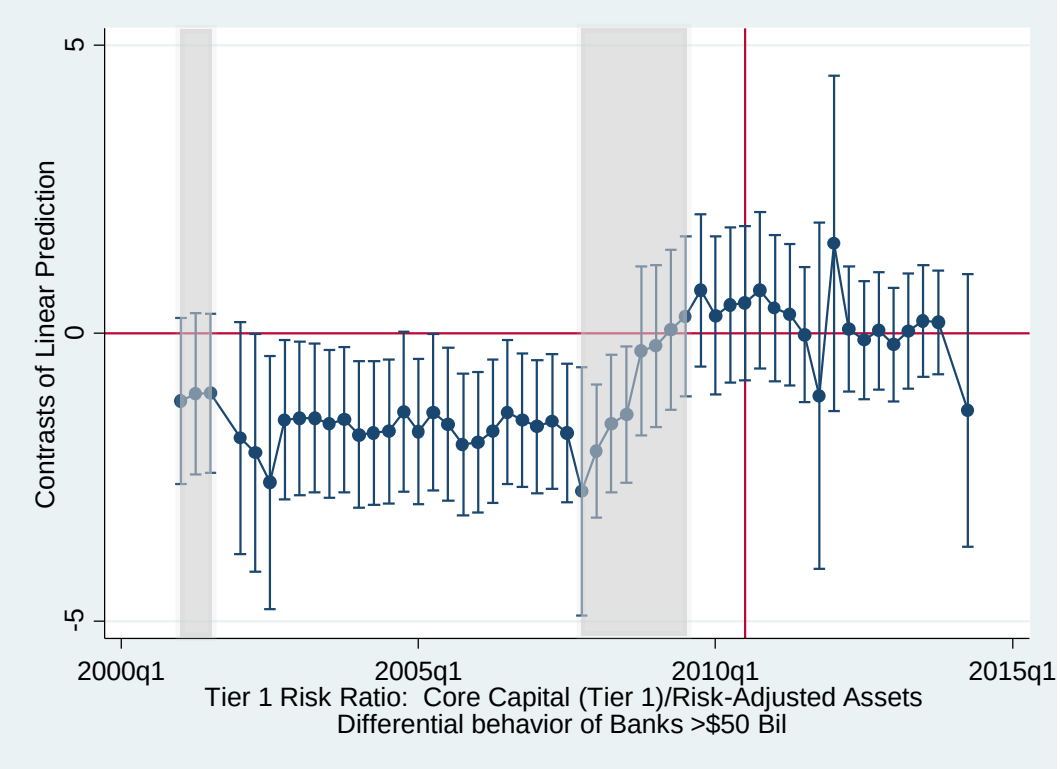
- For entities above $50 Billion in consolidated assets Dodd-Frank imposes "enhanced minimum standards for compliance programs"

- Bertrand, Bombardini, Trebbi 2015

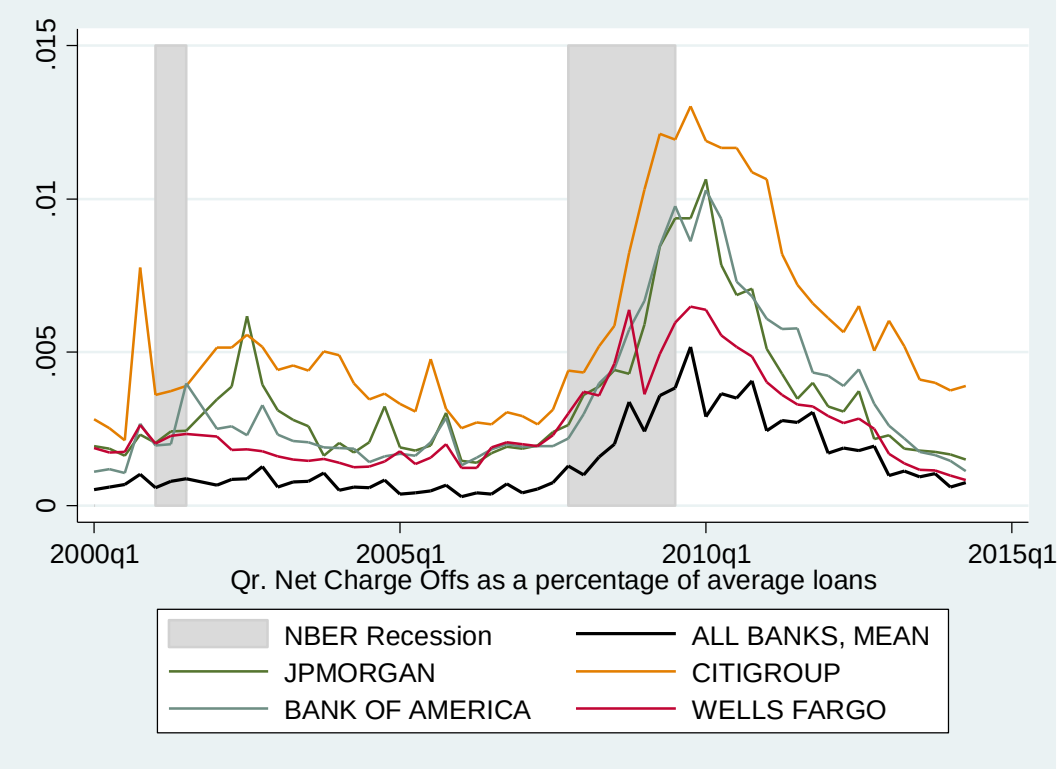
Bank Capitalization: Tier1 of Top-4 Banks



Bank Capitalization: Tier1 of Banks >$50B



Charge-offs by Top-4 Banks: Who Performed the Worse in the Crisis?



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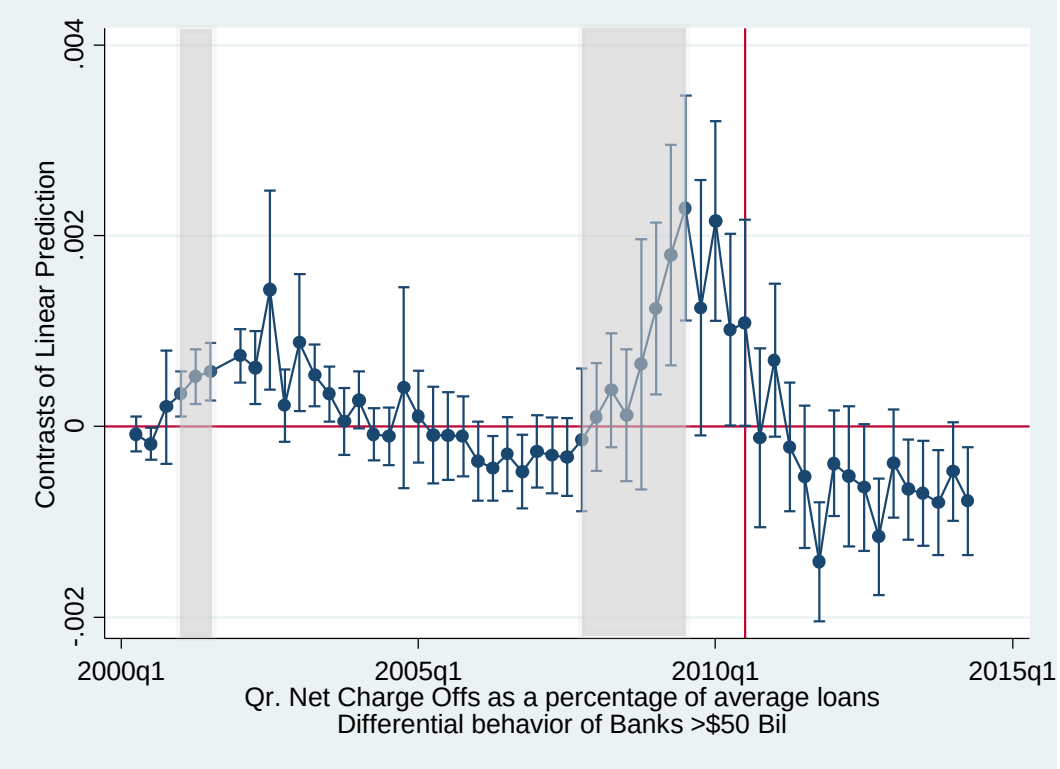
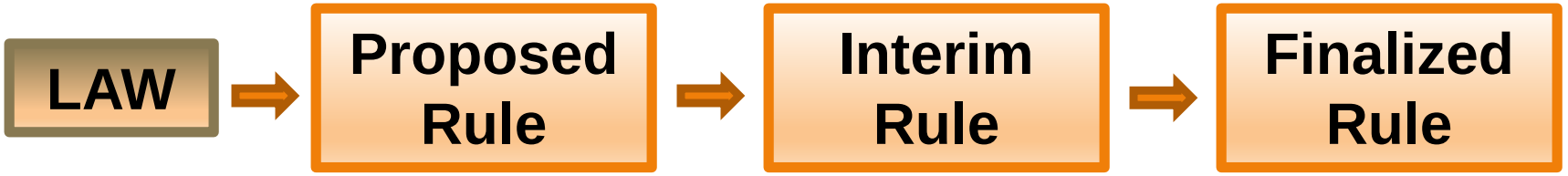
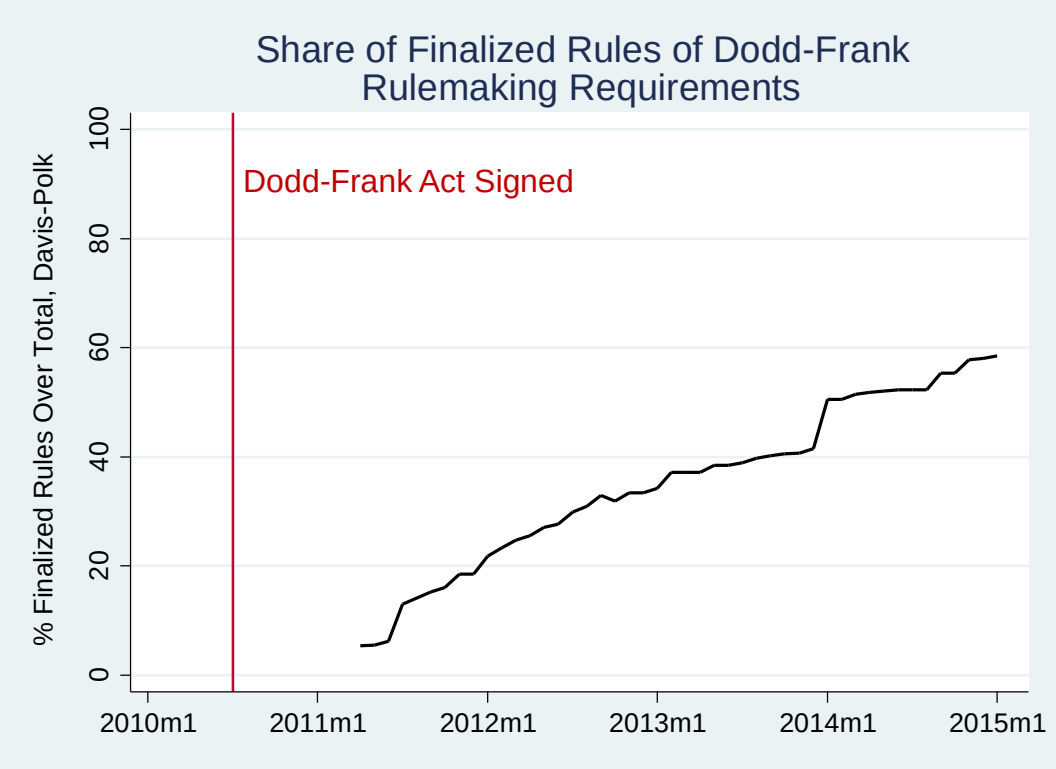


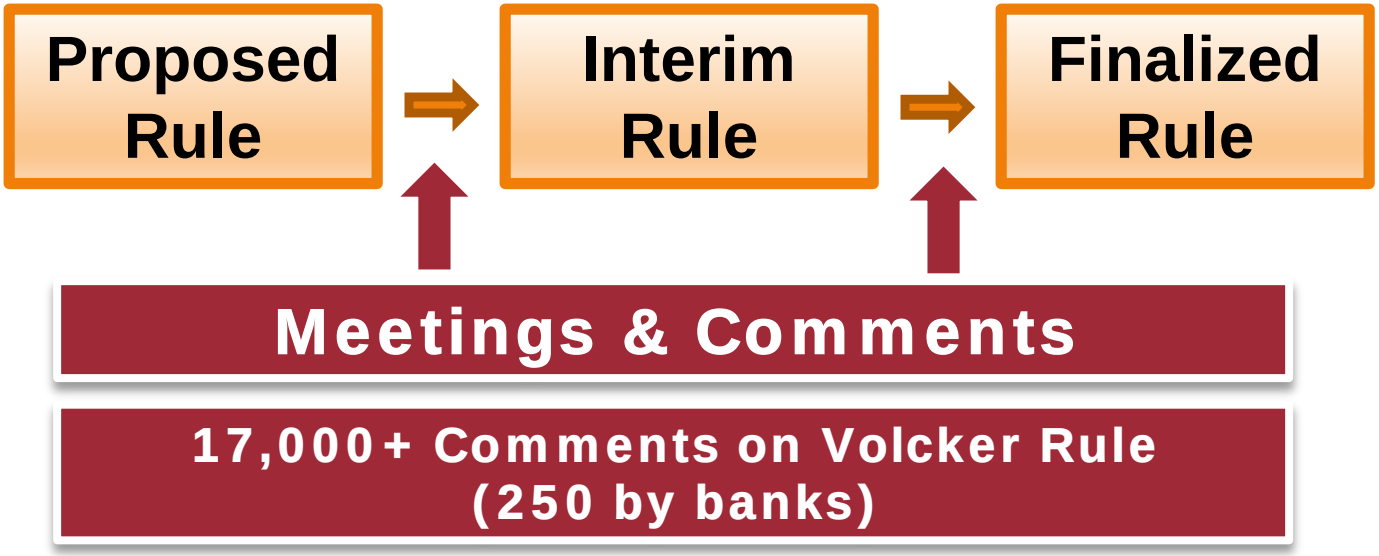
Regulatory Rulemaking Process



Dodd-Frank Act of 2010: Rulemaking Completion



Measuring Banks' Influence on Regulators



Dodd-Frank Act of 2010: Role of the Banks

- According to disclosed commentary and meeting information roughly **2%** of total comments come from banks.
- However, about **90%** of meetings of regulators are with bankers/bank lobbyists.
- Things we do:

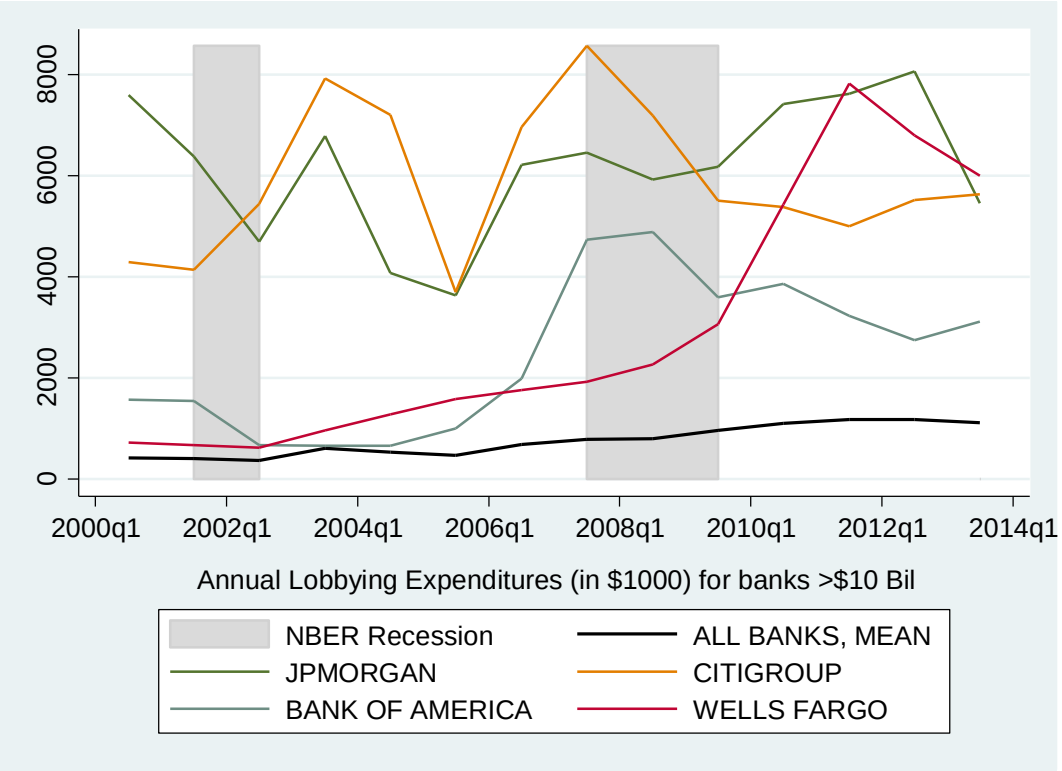
Assess special interests role in regulation:

E.g. Compute the amount of regulatory text in Finalized Rule that cannot be traced back to corresponding Interim or Proposed Rules.

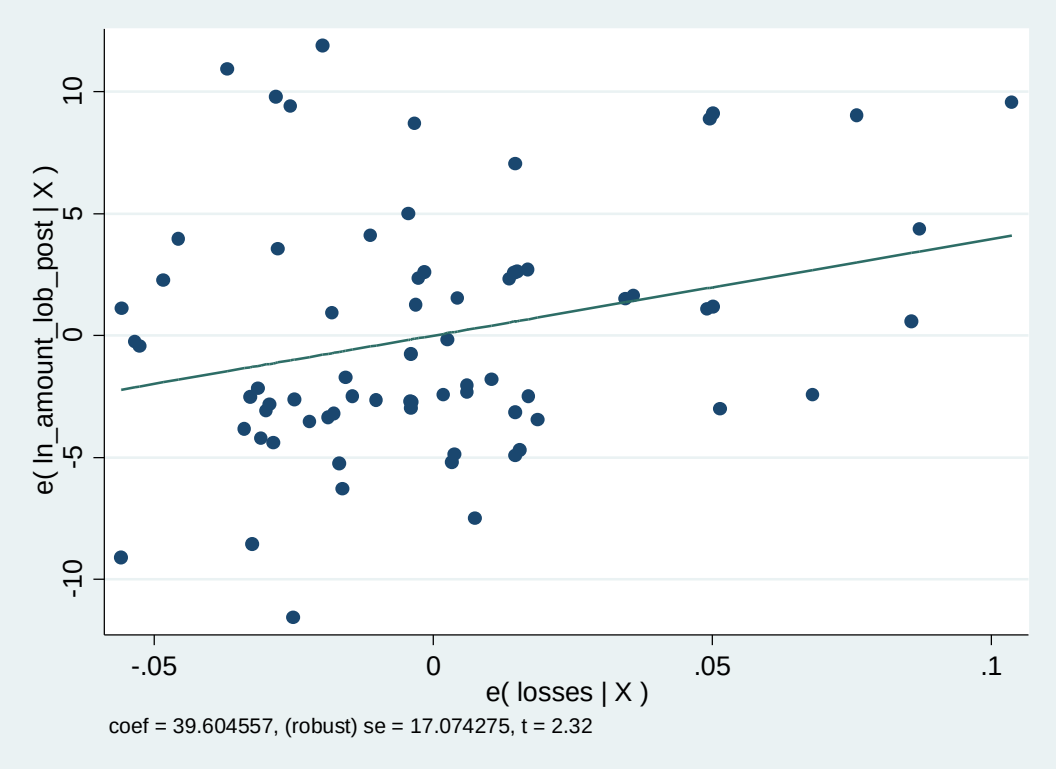
Which are the banks that comment on the rules that end up changing the most?

e.g. Goldman Sachs' influence is determined by whether systematically Goldman Sachs' comments on rules that change a lot.

Dodd-Frank Act of 2010: Bank Lobbying Expenditures

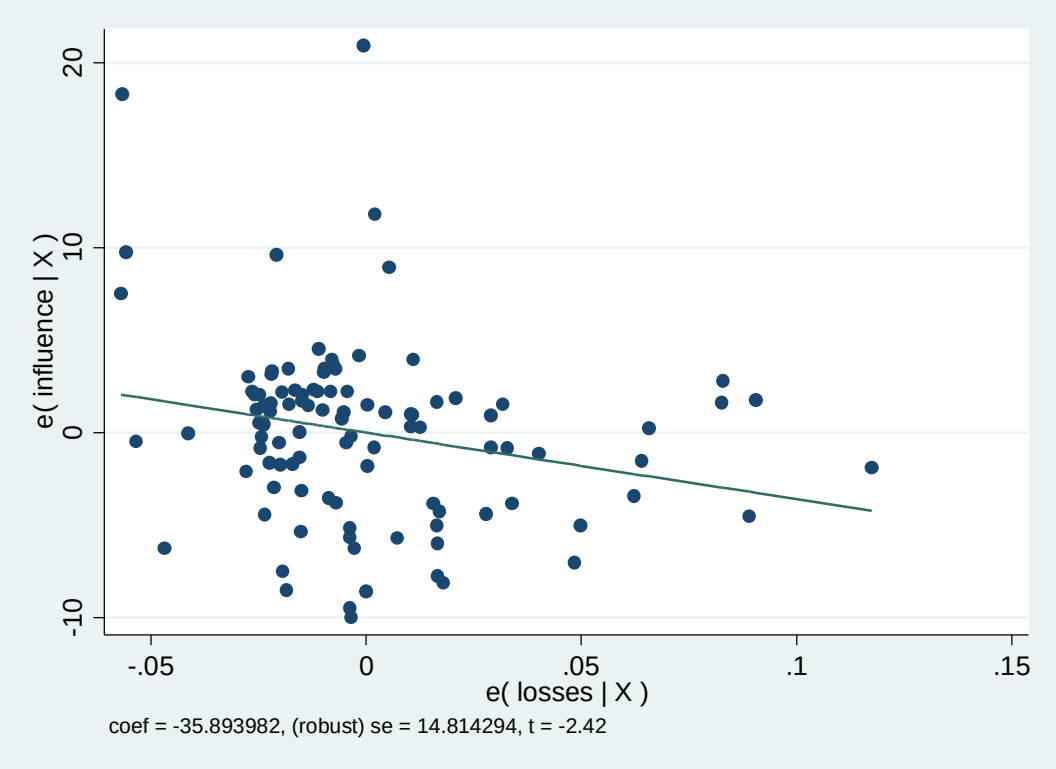


Correlation between Lobbying & Charge-offs in the Crisis



Note: log(total amount lobbied between 2012 and 2015). Losses are proxied by total net charge offs between 2008-2012 as share of avg. assets held between 2008-2012. Correlation conditional on: i) log(avg. assets held between 2008-2012); ii) log(total amount lobbied between 2000 and 2007).

Correlation between Regulatory Influence & Charge-offs in the Crisis



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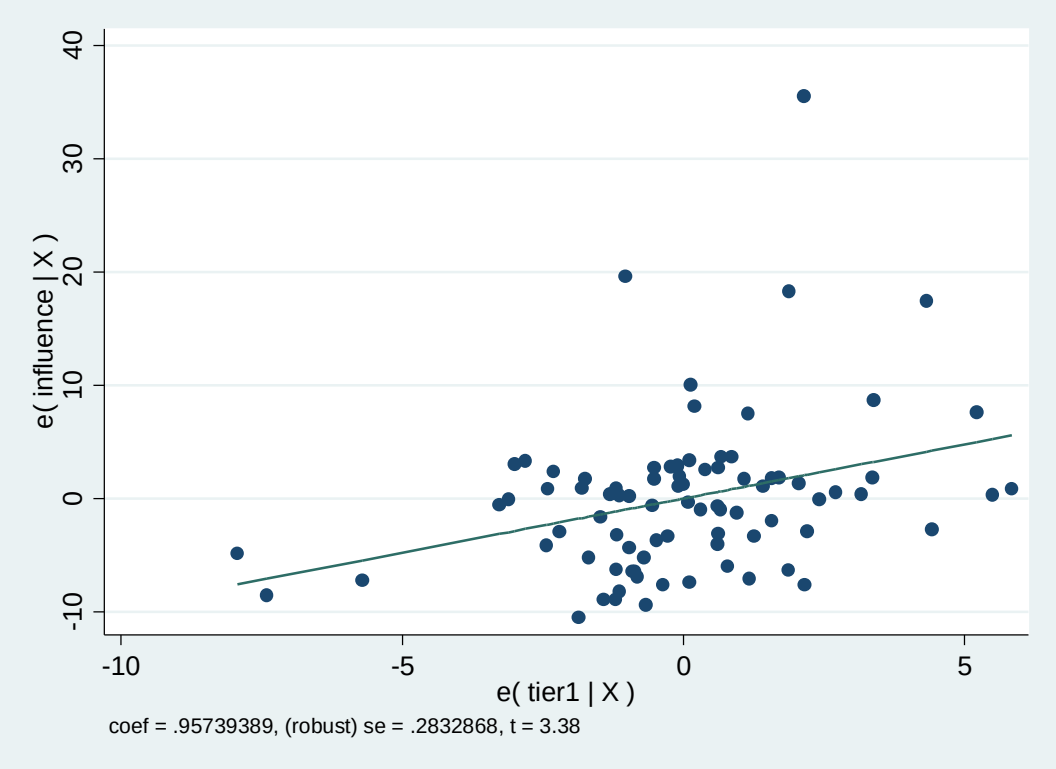
Correlation between Regulatory influence & Tier1 in the Crisis



Note: Influence is proxied by the number of mentions of comments from the bank in interim or final rulemaking documents. Tier1 is the avg. tier1 capital ratio between 2008-2012. Correlation conditional on: i) log(avg. assets held between 2008-2012); ii) log(total amount lobbied between 2000 and 2007).

Reform After the Crisis: EU Banking Union of 2012

- Possible silver lining of the crisis: Birth of EU-wide financial regulation in large scale.

- European Banking Authority (EBA), created in 2010, in charge of bank stress tests.

- European System Of Financial Supervision (ESFS). Coordinating financial services supervision (banking, securities, insurance) across Eurozone/EU.

But Banking Prudential Supervision rested with National Authorities

→Not Integrated within EU27 nor Euro17
→Not Fit for Cross-border Entities

SSM

Sept 2012, European Commission: Proposal for a **Single Supervisory Mechanism** (SSM) for banks.

New Role for ECB as Super-National Prudential Regulator:

→Licensing/Authorizing

→Assessing qualifying holdings

→Ensuring compliance in regulatory capital requirements

→Carrying out preemptive intervention measures.

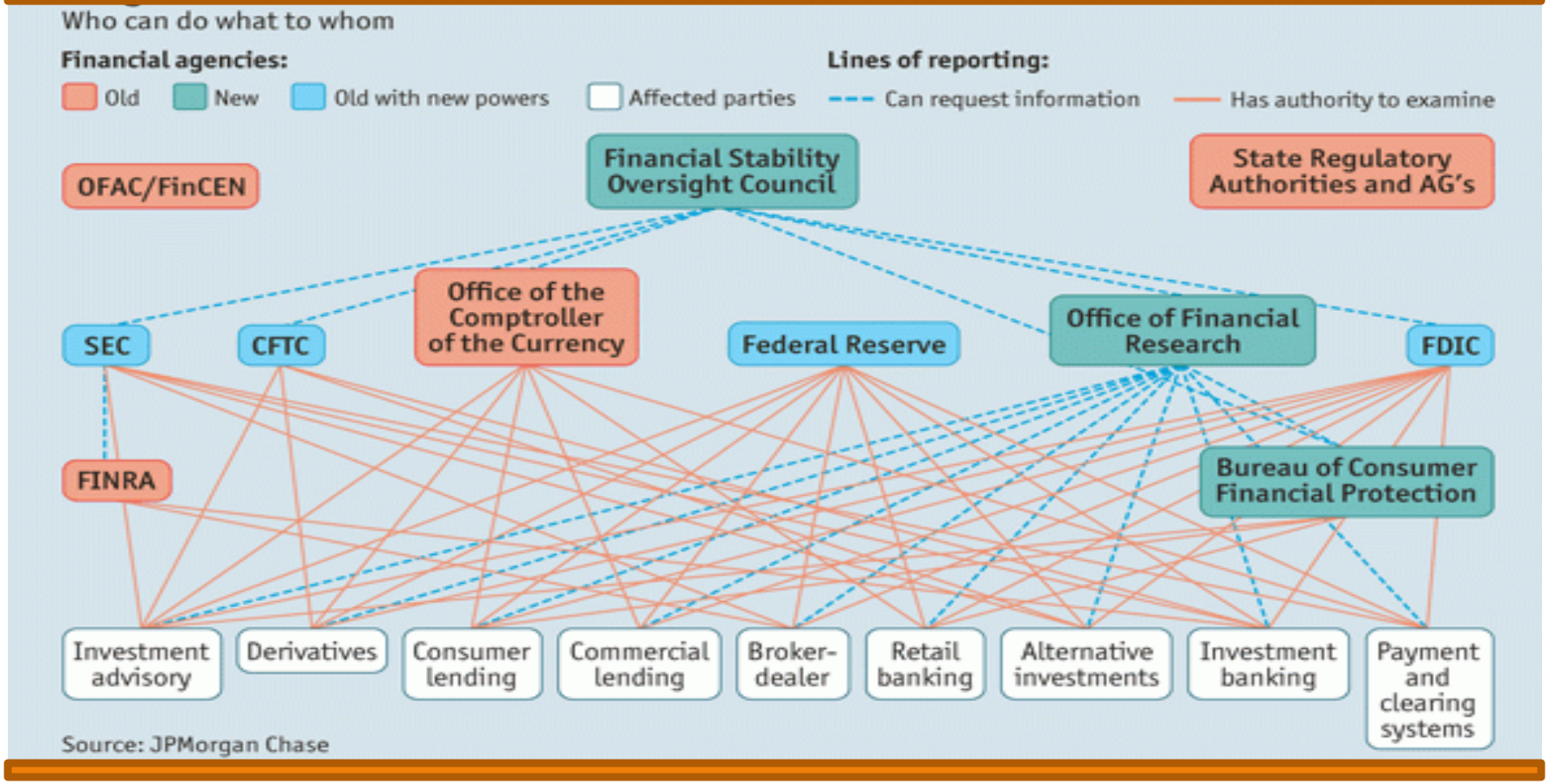
But:

→On-site examinations left to National Supervisors (w/ ECB "opt-in")

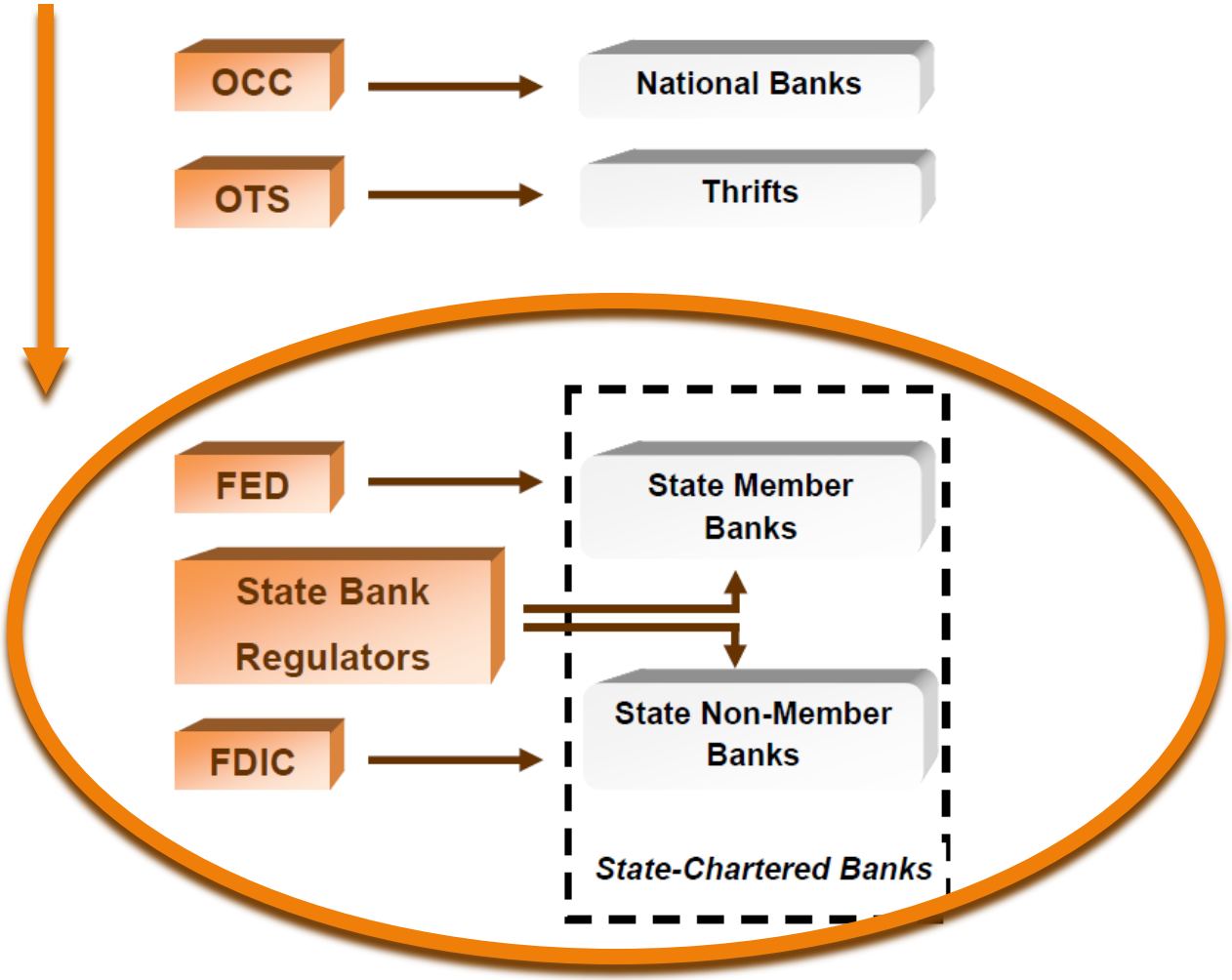
→National Supervisors still assess validity of internal risk models (for assets risk weighting for regulatory ratios).

- Much of what follows based on: Agarwal, Lucca, Seru, Trebbi (QJE 2014) & Lucca, Seru, Trebbi (JME 2014).

The US As Laboratory for the EU: Overlapping US Financial Regulators



Example: US State-Chartered Banks



CAMELS Upgrades/Downgrades

	CAMELS upgrade		CAMELS downgrade	
	Freq.	**Percent**	**Freq.**	**Percent**
Federal Regulator	1332	45%	3665	62%
State Regulator	1619	55%	2281	38%
Total	2951	100%	5946	100%

	Mean	**SD**	**Mean**	**SD**
ΔCAMELS	-1	0	1.13	0.38

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Federal regulator twice as likely to downgrade than State

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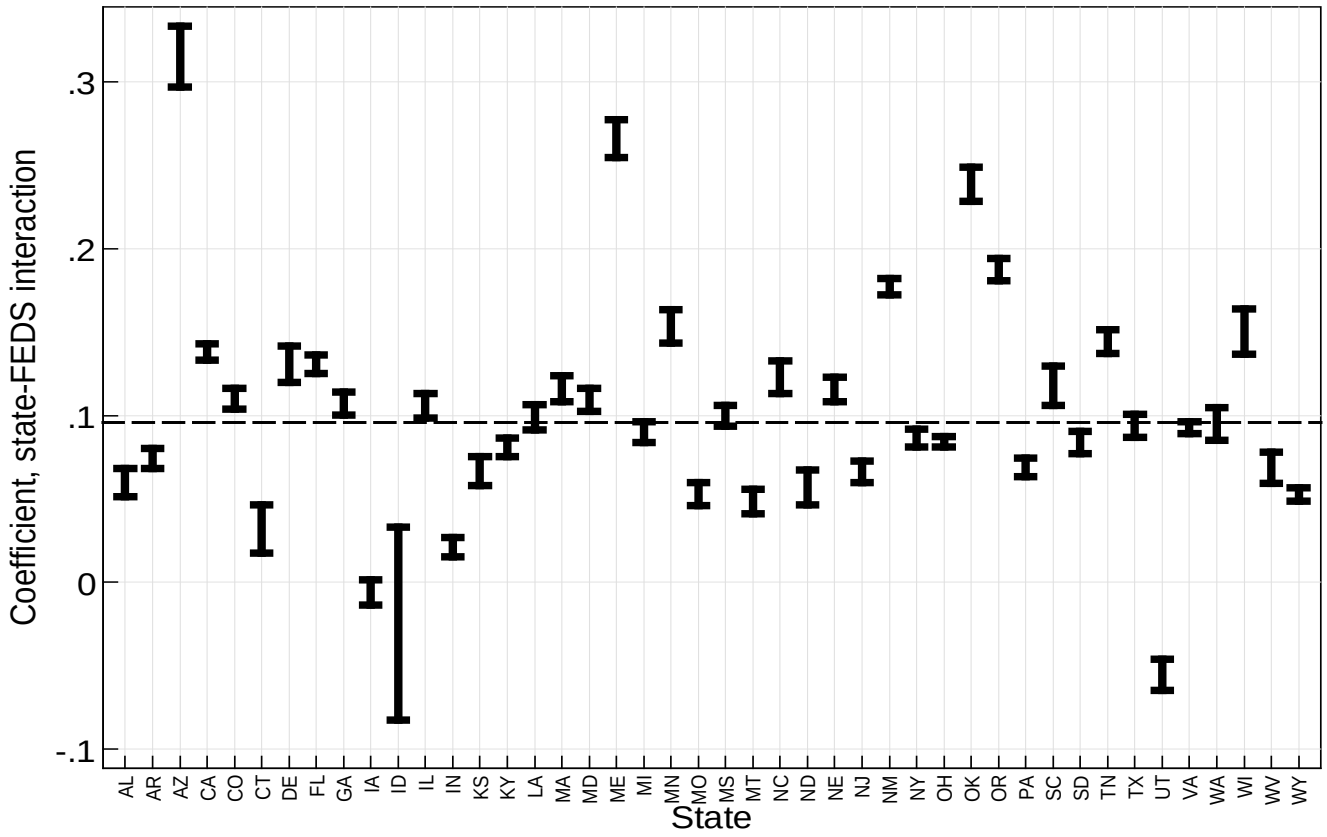
Somewhat countered by upgrades by State

Heterogeneity Across States: Regulatory "Spreads"



Additional Findings

- Banks respond to differential regulatory behavior.
  - ❑ *Federal regulators induce readjustments of*
    →Tier1 capital ratios,
    → Leverage,
    → NPLs & Delinquencies,
    → Implying lower ROA.

- State-Fed regulatory "spreads" vary across states.
  - ❑ *Larger spreads correlate/predict*
    → Higher frequency of bank failures,
    → More Problem banks,
    → Slower TARP repayment,
    → Costlier resolutions.

Why do these differences exist?

- Explaining Federal/State differences:

  - Local regulators protect local constituents
    - Higher spread during “tougher” times
    - Higher spread for privately funded banks

  - Regulatory capture
    - Limited support that higher spread in states with higher corruption
    - Limited support for “revolving door”

  - Competence/Funding of resources:
    - Higher spread in states with lower movement into private sector
    - Higher spread in states with lower training budget
    - Higher spread in states with lower # of examiners per manager

Conclusion

- Politics in the aftermath of financial crises systematically different.
  - i.e. US Debt Ceiling-type gridlocks not the exception.
- Case #1: Dodd-Frank.
  - Large, sweeping reform post crisis. Has it been systematically gamed by special interests?
- Case #2: SSM.
  - Has EU rushed into a potentially inferior regulatory architecture in the aftermath of a sovereign debt crisis?
- Main take away: Political/politico-economic frictions play massive role in aftermath financial crises.
- Cannot be disregarded in the economics of macro response to crisis. But, with rare exceptions, they are.