A major task of financial economics and political science is to explain the raison d’être, but also the consequences, of the influence of the banking industry on the government. When the banking system fails to deliver outcomes serving the public interest, it is necessary to use regulatory actions to correct these failures. Regulatory agencies, however, are subject to agency problems and economic incentives that may serve the regulated industry at the expense of the public interest, thus resulting in regulatory capture. The forces promoting capture include career concerns, relationships, social identification, campaign contributions, and lobbying. Lobbying is one of the most salient forces of influence for the banking industry, enabling it to realize benefits, such as self-serving regulation, but also to avoid costs, such as enforcement actions.

The 2008 financial crisis demonstrated that weaknesses in regulatory oversight and enforcement significantly contributed to the buildup of risk ahead of the crisis. In particular, regulatory capture, associated with the influence of banks’ lobbyists, increased the moral hazard problem—expecting to avoid enforcement actions when things get bad, influential banks were able to take extra risks. Despite the continuing debate on this issue, little systematic examination of the evidence has been undertaken on the incidence and drivers of lobbying efforts made by the banking industry.

I contribute to this task by pursuing two goals. First, I empirically examine the relationship between bank lobbying and supervisory decisions of regulators. In particular, I analyze the issuance of regulatory enforcement actions, which are crucial supervisory tools to ensure the safety and soundness of the banking system. Two sets of existing theories motivate the examination of this relationship. On the one hand, the decision to lobby regulators may be driven by information-transmission motives. Banks have superior information to regulators and partly reveal their information by endogenously choosing their lobbying effort.

Under this information-based view, lobbying provides regulators with valuable information about the bank that results in better-informed supervisory decisions that do not impede the bank’s objective to maximize long-term value. This view predicts that regulators are less likely to issue a (costly) enforcement action against lobbying banks, which are in turn likely to perform relatively better than their nonlobbying peers.
On the other hand, regulators might be laxer in their enforcement decisions because they may be manipulated by banks they supervise, consistent with the theory of regulatory capture. Under this view, lobbying banks engage in specialized rent seeking for preferential treatment. This view also predicts a negative association between lobbying and the probability of an enforcement action, which accordingly involves moral hazard elements.

As the merit of these two views is ultimately an empirical question, my second goal is to provide insights into these theories. To do so, I explore the implications of lobbying by banks on their risk-taking behavior and performance.

I address the first goal by making use of a large data set of commercial and savings banks spanning the period of intense enforcement activity that characterized the financial crisis and its aftermath. I focus on severe formal enforcement actions issued by federal agencies in charge of the supervision of commercial and savings banks in the United States—namely, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, and the Federal Reserve System.

My analysis reveals clear evidence that banks engaged in lobbying activities are less likely to be subject to a severe enforcement action relative to their nonlobbying peers. According to my estimates, lobbying reduces the probability of getting a severe enforcement action by 44.7 percent. I also find that banks benefit from experience in lobbying to obtain favorable treatment: one additional year of lobbying experience reduces the probability of an enforcement action by 11.4 percent. Although the documented effects hold regardless of the regulatory agency considered, they are significantly more pronounced for national banks lobbying the OCC.

With regard to the second goal, I seek to disentangle the competing explanations of these results by examining the risk-taking behavior of lobbying banks and their performance. I first examine aggregate bank risk and find evidence that lobbying banks are associated with higher risk taking. In economic terms, lobbying banks increase their default risk by 12 percent. I also consider liquidity and credit risk and find consistent results. Specifically, I find that lobbying banks expanded more aggressively (on and off the balance sheet) in the run-up to the financial crisis, but ended up with bad loans following it. Second, I find that lobbying banks reliably underperform their nonlobbying peers. In economic terms, lobbying banks experience almost a 50 percent reduction in their return on assets. Underperformance persists in the longer run as well as when regulators face greater uncertainty (normally favoring informational lobbying).

Overall, the evidence is consistent with a view that moral hazard likely contributed to the increase in risk taking at lobbying banks and, thereby, suggests specialized rent seeking for preferential treatment. In other words, the negative link between lobbying and the probability of being subject to an enforcement action fits better with the theory of regulatory capture, even though it is hard to firmly establish that some information-based considerations do not also drive the lobbying decisions made by banks.

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