

TARP Investments: Financials and Politics?

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Introduction

The Troubled Asset Relief Program (TARP), initiated in October of 2008 to combat the financial crisis, authorized the U.S. Department of Treasury to invest federal capital in financial institutions. However, the legislation specified loose guidelines with respect to what assets will be purchased, how they will be valued, and how these funds can be used by financial institutions.¹

According to an independent valuation report by the Congressional Oversight Panel, the Treasury substantially overpaid for its investments under TARP in 2008, effectively subsidizing select banks.² In this paper, we study which institutions were more likely to receive these funds. In particular, we examine whether banks' political activism affected federal funding, and whether capital investments were made in stronger or in weaker financial institutions.

The main goal of the paper is to investigate the effect of banks' political ties and lobbying activity, if any, on the likelihood and amount of federal investments. One hypothesis is that banks with stronger political connections received favorable treatment in capital allocation. This view would be consistent with theories on the politics of government ownership and investment (Shleifer and Vishny, 1994), which suggest that federal capital would be used to accommodate private interests of politicians, such as transferring resources to favored institutions (e.g., banks in politicians' voting districts). However, according to an alternative hypothesis, public scrutiny of banks' political actions, as well as the review and audit of TARP investments, negate and even reverse the attempts to influence government decisions. For example, career concerns of federal officials under close monitoring (e.g., Fama, 1980), represent one mechanism limiting the efficacy of banks' political activity. In fact, government officials may treat investments in connected institutions with extra caution to defend themselves against future accusations.

The second goal of the paper is to investigate the relation between banks' financial strength and the likelihood of receiving TARP investments. One hypothesis is that capital investments were made in the strongest financial institutions with better earnings, lower risk, and higher capitalization. Retaining the healthiest banks in the financial system would be consistent with the theoretical framework in Atkinson and Stiglitz (1980) and Stiglitz (1993), in which

¹ The GAO provides the following summary about the use of TARP capital by largest participants: "With the exception of two institutions, institution officials noted that money is fungible and that they did not intend to track or report CPP capital separately." GAO Report to Congressional Committees, Dec. 2008, p.25.

² Valuing Treasury's Acquisitions: A Congressional Oversight Panel Report, February 6, 2009, p. 4-5.

government aid improves economic stability and social welfare. This view is also consistent with the program's objective to invest in banks that are "sound and not in need of government subsidization."³ On the other hand, anecdotal evidence from the financial media suggests that at least some federal investments were made in weaker banks to prevent their failure and avoid bank runs. According to these claims, banks with weaker earnings, lower capitalization, and higher risk would be more likely to receive federal funds. Under this scenario, government aid programs would subsidize underperforming institutions, resulting in misallocation of capital, an outcome predicted by Banerjee (1997) and Hart, Shleifer, and Vishny (1997).

Our empirical analysis focuses on the Capital Purchase Program (CPP), the largest TARP initiative by the number of participants and the amount of expended capital at the time of writing. As of May 15, 2009, 594 financial institutions received a total of \$199.2 billion under this program, an amount exceeding 91% of the program's total projected investment funds.

To measure political influence, we introduce four variables at the level of bank regulators and at the federal level. Our first measure approximates political influence on the Federal Reserve, which is involved in the initial review of applications from the majority of qualified banks. We consider a qualified financial institution (QFI) to be connected to the Federal Reserve if an executive from this QFI holds a seat on the board of directors at one of the twelve Federal Reserve Banks or their branches.

At the federal level, our second proxy is a bank's connection with a House member serving on the Congressional Committee on Financial Services and its subcommittees on Financial Institutions and Capital Markets, which played a significant role in the development of TARP and its amendments. We consider a bank connected with a House member if it is headquartered in the congressman's election district. As another measure of Congressional representation, we use the number of House members from a bank's state scaled by the number of banks headquartered in that state. Finally, our fourth proxy for political activism is bank-level expenditures on lobbying the Treasury and banking regulators on the issues of banking or finance.

Our main finding is that political connections are positively related to the likelihood of receiving CPP funds. This evidence appears whether political connections are measured via board seats at the Federal Reserve, ties with House members serving on key finance committees,

³ Valuing Treasury's Acquisitions: A Congressional Oversight Panel Report, February 6, 2009, p. 5.

or state-level Congressional representation, and after controlling for QFI-level financial indicators and demographics. The results also hold after excluding the largest banks, banks headquartered in New York, and banks with the best or worst financial condition.

The estimated magnitudes are nontrivial: a board seat at a Federal Reserve Bank is associated with a 31.3 percent increase in the likelihood of receiving CPP funds, while bank's connection to a House member on key finance committees is associated with a 26.3 percent increase. A one standard deviation increase in the scaled number of state House members increases the likelihood by 7.6 percent, controlling for other factors.

Our findings also suggest that QFIs were more likely to receive an investment from CPP if they were bigger, had lower earnings, and lower capital. This evidence is consistent with an investment strategy seeking to support systemically important institutions experiencing financial distress. We also find that the likelihood of receiving CPP capital is positively related to asset and management quality, and negatively related to the amount of foreclosed real estate and mortgage-backed securities. One interpretation of these results is that these banks had a higher likelihood to survive the crisis after receiving federal capital.

We also study the determinants of CPP investment amounts, and find that the scaled amount of federal investment is positively related to a bank's lobbying expenditures scaled by bank size. A one standard deviation increase in scaled lobbying amounts is associated with an additional \$10.4 million in raw CPP investment, controlling for other bank characteristics. Other political variables do not significantly explain investment amounts, possibly because bank regulators and House members, while plausibly helpful in supporting QFI applications, have little influence on the final amount of funds awarded.

The amount of CPP investments is negatively related to capital adequacy, earnings and liquidity, and positively related to bank size. This evidence is consistent with a strategy seeking to strengthen the capital position of approved participants to a common acceptable level, while providing an extra buffer for larger institutions that play a greater role in the stability of the financial system.

Interpreted broadly, our results show that political connections play an important role in a firm's access to capital. Subsequent in-depth analysis indicates that the effects of political ties on federal capital investment are strongest for companies with weaker fundamentals, lower liquidity and poorer performance. This finding suggests that political ties shift capital allocation towards underperforming institutions.

To our knowledge, this paper is the first empirical investigation of the association between firm fundamentals, political influence, and the choice of TARP investments. At a broader level, our paper is part of a literature pioneered by Stigler (1971) and Peltzman (1976) that studies how economic regulation is influenced by politics.⁴ More specifically, our research adds to the literature on the role of political factors in capital allocation, a topic that so far has been examined primarily in foreign markets. For example, Khwaja and Mian (2005) show that politically-connected firms in Pakistan borrow more from government banks (but not from private banks) and default more frequently on these loans. Sapienza (2004) finds that the interest rates charged by government-owned banks in Italy reflect the power of the party controlling the bank, resulting in preferential access to capital for party-affiliated borrowers. Faccio, Masulis, and McConnell (2006) provide evidence that politically-connected firms are more likely to receive government funds in case of distress in 35 countries. Dinc (2005) finds that government-owned banks outside the United States increase their lending activity in election years to gain voter support. In contrast, our paper provides evidence on the relation between political ties and capital allocation in the United States during a financial crisis of historical magnitude.

Our research also contributes to the literature on political activism and firm value and helps reconcile prior empirical findings. In previous studies, Roberts (1990), Fisman (2001), Faccio (2006), Faccio and Parseley (2009), and Cooper, Gulen, and Ovtchinnikov (2009) find that a firm's political activism has a positive effect on firm value. Others, such as Aggarwal, Meschke, and Wang (2009), argue that political activism is indicative of agency problems and show that firms with high political contributions experience significantly lower risk-adjusted returns. The evidence in our paper suggests that political connections and activism serve as an insurance mechanism against extreme events. Thus, for example, the victory of a politician connected to the firm will increase the value of the insurance. However, the value of this insurance will gradually decrease absent the occurrence of extreme events, explaining the underperformance of stocks of politically active firms compared to those of non-politically-active companies.

Previous literature has also showed that politically connected firms have higher leverage ratios than their non-connected peers (e.g., Chiu and Joh, 2004, Cull and Xu, 2005, Johnson and

⁴ One broad line of empirical investigation is focused on the impact of corruption on aggregate outcomes such as growth and investment rates across countries (cf. Mauro, 1995; Keefer and Knack, 1995; Hall and Jones, 1999; La Porta et al., 1999; Glaeser and Saks, 2006).

Mitton, 2003). The results in this paper are consistent with one possible explanation of these findings, namely that lenders may rely on an implicit government guarantee that politically connected firms will be bailed out in a crisis.

Finally, our paper adds to the literature on the interaction between firms and Congressional committees. Kroszner and Stratmann (1998) develop a positive theory of specialized, committee-based Congressional organization that fosters ties between interest groups and legislators through reputation building. Our paper supports this theory by showing that connections of financial institutions to specific Congressional sub-committees affect the allocation of TARP funds.

The rest of the paper is organized as follows. Section 1 provides detail about the Capital Purchase Program, its investment criteria, and the application process. Section 2 describes our measures of political influence. Section 3 discusses the sample and data. Section 4 presents our main results. Section 5 discusses extensions. The conclusion provides summary and commentary.

1. Emergency Economic Stabilization Act and the Capital Purchase Program

On October 3, 2008, the Emergency Economic Stabilization Act (EESA) was signed into law. The act authorized the Troubled Assets Relief Program (TARP) – a system of federal initiatives aimed at stabilizing the U.S. financial system. According to the original plan, the Treasury intended to buy insolvent bank loans and mortgage-backed securities, hold these assets, and later sell them to private investors. However, on October 14, 2008, the government announced a revised plan – the Capital Purchase Program (CPP) – which authorized Treasury to invest up to \$250 billion in financial institutions in exchange for their preferred stock and warrants. On March 30, 2009, Treasury announced that it plans to expend \$218 billion of the \$250 billion authorized under this program.⁵

After the initiation of CPP, many other TARP initiatives were introduced. As of May 15, 2009, TARP included 12 financial programs. Yet CPP remains by far the largest by the amount of expended capital. This program is the primary focus of our paper.

⁵ SIGTARP Quarterly Report to Congress. April 21, 2009, p. 34.

Our focus on CPP is motivated by several reasons. First, CPP encompasses the greatest number of participating institutions among all TARP initiatives. Further, the program focuses on a relatively homogeneous group of firms – primarily domestically-controlled banks, thrifts, and their holding companies. Next, while many TARP programs are still in their early stages, the vast majority of CPP funds has been invested. As of May 15, 2009, investments under CPP totaled \$199.2 billion, reaching 91% of the program’s forecasted funding. Finally, while many TARP programs have evolved since their initiation, the rules and participation criteria for CPP have remained largely the same since the program’s initiation in October 2008.

1.1 Qualifying Institutions and their Primary Regulators

Financial institutions eligible to participate in CPP include domestically-controlled banks, bank holding companies, savings associations, and savings and loan holding companies. For all banks and savings associations controlled by a holding company, CPP investments are made at the level of the holding company.

To apply for CPP funds, qualifying financial institutions (QFIs) submit an application to their primary federal banking regulator. If the initial review is successful, the application is forwarded to the Treasury’s investment committee, which makes a recommendation to the Assistant Secretary for Financial Stability, who makes the final decision regarding the investment. The CPP is administered by the Treasury’s Office of Financial Stability, which was created by the EESA.

Primary federal banking regulators include the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). Each of the four regulators has oversight responsibilities over different types of banking institutions, which are discussed in more detail in Appendix A.

1.2 Application Process and Selection Criteria

The application process begins with submitting a 2-page CPP application form to the primary regulator of the applying institution. In cases where the applying institution is a bank holding company, the application is submitted both to the regulator overseeing the largest bank of the holding company and to the Federal Reserve. This detail is important for our study, since it provides the Federal Reserve an opportunity to review applications from the vast majority of QFIs. Prior to submitting an application, banks are also encouraged to consult with their banking regulator whether to apply.⁶

After receiving an application, the banking regulator evaluates the financial strength and long-term viability of the financial institutions based on a set of standardized ratios and examination ratings. While the specific weighting of factors is not made public, bank regulators generally use the Camels rating system to assess institution's financial condition. The system derives its name from the 6 factors that are evaluated: *Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk*. The ratings are based on financial statements and on-site examinations by regulatory authorities. A score from 1 (best) to 5 (worst) is assigned for each of the 6 factors, and then these scores are aggregated to derive an overall score of a bank's financial health. The weighting of factors and banks' combined ratings are not made public, even on a historical basis.

Applications from banks with the strongest ratings receive presumptive approval from the banking regulators and are forwarded to the Investment Committee at the Treasury's Office of Financial Stability (OFS).⁷ Applications from banks with mediocre ratings are referred for further review to the CPP Council, which considers other factors that may outweigh the lower ratings, such as private equity investments in the institution or a pending merger of the applying institution.⁸ Finally, institutions with low ratings are encouraged to withdraw their applications. All application submissions and withdrawals are kept confidential to protect banks' interests.

In the final stage of the process, OFS's Investment Committee reviews applications forwarded by the banking regulators and the CPP Council. The committee then makes a

⁶ "Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency." GAO Report to Congressional Committees, December 2, 2008, p. 23.

⁷ The Investment Committee consists of 5 investment officers: OFS's Chief Investment Officer (committee chair) and the assistant secretaries for financial markets, economic policy, financial institutions, and financial stability.

⁸ The CPP Council consists of representatives from the four federal banking regulators and Treasury officials, who act as observers.

recommendation to the Assistant Secretary for Financial Stability, who makes the final decision about the investment. If the approval of the application is unlikely at this stage, the application can still be withdrawn at any time.

1.3 Financial Conditions of the Program

In exchange for CPP capital, banks provide the Treasury with cumulative perpetual preferred stock. The preferred shares are issued at par and are equivalent in seniority to the most senior type of the QFI's preferred stock. The shares pay quarterly dividends at an annual yield of 5% for the first five years and 9% thereafter. The amount of the investment in preferred shares is determined by the Treasury, although QFIs state the requested amount in the CPP application.

In addition to preferred stock, the Treasury also obtains warrants for the common stock of publicly-traded QFIs. The warrants, valid for a 10-year period, are issued for such number of common shares that the aggregate market value of the covered common shares is equal to 15% of the investment in the senior preferred stock. The initial exercise price for warrants is determined as the average closing price of common shares over the trailing 20 trading days ending on the date of the investment in preferred shares. As of May 15, 2009, no common stock warrants in public companies had been exercised.

In cases of private companies, the Treasury receives warrants to purchase additional shares of preferred stock that pay dividends at a higher annual rate of 9%. These warrants have an exercise price of \$0.01 and are exercised immediately to entitle the Treasury to dividends on the new shares. Appendix B offers additional detail on the terms of capital redemption, conditions imposed on participating institutions, and investments in "S" corporations and mutual organizations.

1.4 Oversight

The execution of TARP, including CPP investments, is overseen by several monitors: the Financial Stability Oversight Board (FSOB), the Congressional Oversight Panel, the Office of the Special Inspector General (SIGTARP), and the Comptroller General. Appendix C provides the details about the authority and structure of these entities.

Despite the several overseeing authorities, many officials have acknowledged the lack of transparency in the Treasury's investment decisions. To illustrate, in his confirmation hearing at the Senate in January 2009, Timothy Geithner, the Treasury Secretary, admitted that "there are serious concerns about transparency and accountability, confusion about the goals of the program, and a deep skepticism about whether we are using the taxpayers' money wisely."⁹ A similar issue is voiced in SIGTARP's quarterly report to Congress released on April 21, 2009, which informs about the initiation of an audit to investigate the external influence on the decisions of the Treasury and primary bank regulators. In the next section, we introduce several variables that seek to measure political influence of interested parties on the Treasury and bank regulators.

2. Measures of Political Influence

We construct several measures of political influence. At the level of bank regulators, we use board memberships at the Federal Reserve as a proxy for the potential influence on the decisions of a banking regulator. At the level of the federal government, we use three measures. The first is QFIs' representation on key committees in Congress involved in oversight of banking and capital markets. The second is QFIs' expenditures on lobbying the Treasury and banking regulators. The third is the total number of House representatives from a QFI's state, scaled by the number of banks headquartered in the state. This section describes each type of connection.

2.1 Federal Reserve Boards of Directors

Among the four banking regulators that conduct the initial review of CPP applications, we focus on the Federal Reserve for two reasons. First, this regulator is responsible for the oversight of bank holding companies and state-chartered member banks, which comprise over 85% of QFIs that received CPP investments. Second, unlike other regulators, boards of directors at Federal Reserve Banks include QFI executives, providing them with significant influence and authority.

⁹ Confirmation Hearing Statement of Treasury Secretary nominee Timothy Geithner before The U.S. Senate Committee on Finance, January 21, 2009.

For example, board members at a Federal Reserve Bank appoint presidents and vice presidents of their bank, as well as all of its officers, and oversee the bank's internal audit program.¹⁰

QFI executives serving on the boards of the main offices of Federal Reserve Banks are elected by member banks in each district for 3-year terms. In the election, banks are divided into three categories by the amount of capital: large, medium, and small, and each category elects one director from member institutions. This detail is important because it implies that our measure of connections to the Federal Reserve board members is not biased towards larger banks. Appendix D provides additional detail on Federal Reserve directors, their tenure, and affiliation.

We consider a QFI connected to the Federal Reserve if an executive or an officer of this QFI served on the board of directors of a Federal Reserve Bank or its branch in 2008 or 2009. In our sample, 83 financial institutions (1.1% of our sample) have this type of connection. The data on board composition are collected from annual reports of Federal Reserve Banks and the Board of Governors.

2.2 Bank Representation on the House Financial Services Committee

At the level of Congress, we investigate the ties between QFIs and the members of the House Financial Services Committee and its two subcommittees: the Subcommittee on Financial Institutions and the Subcommittee on Capital Markets.¹¹ The Committee on Financial Services reviews and develops legislation in all areas of the financial system. This committee played a key role in the development of the EESA and continues to exert strong influence on amendments related to expanding and modifying TARP, which require Congress approval.

Within the Financial Services Committee, we focus on two subcommittees, which oversee banking and financial markets. The Subcommittee on Financial Institutions supervises all primary banking regulators and matters related to the soundness of the banking system. The Subcommittee on Capital Markets reviews laws regulating investment banks and capital markets, among other issues. The House Financial Services Committee comprises 4 more subcommittees, whose jurisdiction covers other finance issues, such as monetary policy, international trade, and technology.

¹⁰ The appointment of Federal Reserve banks' presidents and vice presidents is subject to approval by the Board of Governors.

¹¹ The full names of the 2 subcommittees are: Subcommittee on Financial Institutions and Consumer Credit, and Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

We focus on the committees in the House of Representatives rather than the Senate for several reasons. First, election districts for the House are substantially smaller, resulting in a tighter link between the politician and QFIs headquartered in his district.¹² Second, districts of all congressmen are approximately equal by the number of voters (about 600,000 voters per district), providing an equitable comparison base in the cross-section. Finally, our focus on the House of Representatives enables us to cover all eligible QFIs, including those located in Washington D.C., Puerto Rico, and U.S. territories, which elect delegates to the House but have no representation in the Senate.

To identify House members representing the district of each QFI, we use the zip code of the institution's headquarters. We collect data on congress representatives that held office in 2008 (110th Congress) and in 2009 (111th Congress). Overall, approximately 87% of House representatives from the 110th Congress were reelected in 2008 for the next term. Our combined sample for 2008 and 2009 includes 499 members.

Using Congress records, we identify the members of the House Financial Services Committee and its subcommittees on Financial Institutions and Capital Markets. Next, for each QFI, we calculate a measure of representation on key committees. This proxy is computed as the average of 6 indicators, each equal to 1 if the representative from the QFI's district served on the Financial Services Committee, the Subcommittee on Financial Institutions, or the Subcommittee on Capital Markets, respectively, in either 2008 or 2009. Thus, we have 3 indicators for each of the two years. For example, if a representative served on the Financial Services Committee and the Financial Institutions Subcommittee but not the Capital Markets Subcommittee in both 2008 and 2009, a QFI from this congressman's district will be assigned a score of 0.67.¹³ In the empirical section, we also disentangle the effects of each committee.

The Financial Services Committee includes 71 members, and its subcommittees on Financial Institutions and Capital Markets comprise 45 and 50 members, respectively. 1,205 QFIs (16.6% of our sample) have a representative who is a member of at least one of the three groups.

¹² Unlike senators, who are elected in a state-wide election, House representatives are elected in smaller districts within each state, with an average of 9 election districts per state.

¹³ $0.67 = (1+1+1+1+0+0)/6$

To illustrate the power of the Committee on Financial Services, consider the following example, which appeared in the Wall Street Journal on January 22, 2009.¹⁴ In late September 2008, Boston-based OneUnited Bank found its capital depleted and its management compromised with a cease-and-desist order from the FDIC for poor lending practices and the abuse of management pay. Yet in mid-December 2008, the bank received \$12,063,000 from the CPP.

The bank is based in the home state of Rep. Barney Frank, the head of the Financial Services Committee, who acknowledges that he had included into TARP a provision aimed at helping this particular bank and recommended to regulators that OneUnited be considered for capital investment under TARP. The bank's lawyer admitted that he had discussed the bank's financial situation over the phone not only with Rep. Barney Frank, but also with Rep. Maxine Waters (a member of the Financial Services Committee and Financial Institutions Subcommittee), whose husband used to be a OneUnited director.

2.3 Lobbying Expenditures

Lobbying refers to the practice of petitioning government agencies. As a form of political influence, lobbying has several distinct features. First, it is usually focused on government legislation or specific issues rather than particular politicians. Second, most companies lobby their interests by hiring an external lobbying firm, which works with government officials on behalf of its clients.

According to the Lobbying Disclosure Act of 1995, organizations with annual lobbying expenditures greater than \$25,000 must register with the Senate's Office of Public Records and submit lobbying reports, which are available to the public. Since lobbying reports are filed by lobbyists rather than their clients, the threshold of \$25,000 in annual expenditures obligates virtually all lobbying firms to file such reports, even if the annual spending of a particular client is below the threshold.

We collect lobbying data from the Center of Responsive Politics, which maintains a database of lobbying reports. Each report provides information on the issues lobbied, the

¹⁴ "Political Interference Seen in Bank Bailout Decisions" by Damian Paletta and David Enrich, the Wall Street Journal, January 22, 2009.

government agencies petitioned, and the amount spent.¹⁵ The issue and agency classifications are fairly detailed, and include 78 and 311 categories, respectively.

To identify lobbying expenditures most likely associated with banking regulation and TARP programs, we select only the reports in which the category of issues lobbied includes banking or finance, and the agencies lobbied include the Treasury or one of the four primary banking regulators. We also require that the lobbying be performed on behalf of a QFI in 2008 through the first quarter of 2009. In cases when lobbying is done by a bank held by a holding company or by a bank subsequently acquired prior to September 30, 2008, the total lobbying amount is attributed to the combined firm.

After applying these filters, we end up with 441 reports submitted on behalf of 39 QFIs. As shown in Panel A of Table 1, the average (median) amount of total lobbying expenditures in our sample in 2008-2009 is \$2.2 million (\$637 thousand) per QFI.

3. Sample and Data

3.1 Qualifying Financial Institutions

To construct a sample of QFIs, we begin with a list of all FDIC-insured financial institutions that were active as of September 30, 2008. This group includes 8,391 institutions. Because CPP capital is invested at the level of holding companies, we treat institutions held by the same holding company as one QFI and aggregate their financials.¹⁶ The vast majority of holding companies (91%) hold only one institution. Independent institutions, which are not held by higher holders, are treated as individual QFIs. Overall, we have 7,343 holding companies and independent institutions in our sample.

Following the CPP eligibility criteria, we exclude 49 banks or holding companies with foreign control.¹⁷ We also eliminate institutions that made a public announcement that they are not applying to CPP. To identify these institutions, we search the Press Release News Wire and news publications in the Factiva database for different variations of an institution's statement not

¹⁵ Lobbyists are obligated to disclose the category of the issues lobbied if the amount of lobbying expenditures exceeds \$5,000.

¹⁶ We ascertain the correctness of matching between institutions and holding companies by cross referencing the FDIC records with the data from the Federal Reserve, both of which provide the ultimate parent for banking institutions.

¹⁷ For the purposes of CPP, control is defined as direct or indirect ownership of at least 25% of a bank's shares.

to apply to CPP or to decline CPP funds. We are able to identify a total of 94 institutions that made such statements, of which 39 announced their decision not to apply and 55 applied to CPP and were approved, but decided to decline the investment. We exclude the 39 institutions that declined to apply. For the purposes of our tests, we treat the 55 declining institutions that were approved as CPP recipients. As a result of these filters, we end up with 7,255 QFIs in our sample, whose summary statistics are provided in Panel A of Table 1.

One challenge in our sample construction is that we cannot identify the specific institutions that applied to CPP, since these data are kept confidential. According to the GAO report to Congress, thousands of CPP applications were submitted.¹⁸ This estimate provides some comfort that our sample, while undoubtedly larger, is of similar order of magnitude to the pool of CPP applicants.

Aside from the sample size, another challenge arises from possible self-selection of CPP applicants. To address the fact that the decision to apply is unobservable, we conduct several additional tests to mitigate the concern that our results are driven by selection bias. These tests are described in the robustness part of the empirical section.

The data on the recipients of CPP funds are collected from the Office of Financial Stability, which provides the amount of funds invested, the date of investment, and the consideration received by the Treasury in exchange for capital. As of May 15, 2009, 594 financial institutions received a total of \$199.2 billion under this program. The distribution of CPP investment amounts is heavily right-skewed, and the average (median) CPP investment (including QFIs that were approved and later declined CPP funds) is \$318 (\$12) million, as shown in Panel A of Table 1.

The bank financial data are collected from the reports of condition and income filed by all active FDIC-insured institutions every quarter. Using these data, we construct an array of financial measures of banks' condition and performance.

¹⁸ "Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues." GAO Report to Congressional Committees, January 30, 2009, p.13.

3.2 Financial and Demographic Variables

Financial Variables

In constructing our financial variables, we seek to follow the Camels assessment criteria used by bank regulators. Since the data on the actual ratings assigned by bank regulators are never made public, we introduce proxy variables for each of the 6 categories in the Camels system: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Our choice of proxies is generally guided by the financial indicators employed by the FDIC in Uniform Bank Performance Reports that evaluate banks on similar dimensions. Condition ratios are computed as of September 30, 2008, the latest quarterly report prior to the CPP application deadlines for public and private institutions. Detailed descriptions of the financial variables are summarized in Appendix E.

Financial Quality Index

In addition to analyzing each dimension of the Camels system, we compute a bank's aggregate quality index. For each bank, we calculate its ranking in our sample on each Camels proxy and find the mean of these rankings to derive an aggregate index score, normalized to lie between 0 and 1. For example, a quality index of 0.90 indicates that a bank's average ranking on the Camels proxies places it in the 90th percentile of our sample, i.e. the top 10% of QFIs.

Demographics

Our demographic variables include bank size, age, and the number of employees. Size is measured by the natural logarithm of assets. The average (median) QFI in our sample holds assets worth \$1.7 billion (\$144 million). We expect that larger banks are more likely to receive CPP investments due to a greater role in the financial system. We also include the number of bank employees and hypothesize that a larger workforce may increase a bank's likelihood to receive federal aid in an effort to control unemployment and gather voters' support. Finally, bank age is included to test the hypothesis that more established banks are more likely to be saved.

Panel B of Table 1 provides the correlation matrix for our independent variables. The vast majority of correlations are low, indicating that our measures capture distinct political, financial, and demographic characteristics. In the next section, we study the relation between these variables and the likelihood of approval for CPP funds.

4. Main Results

This section presents our main empirical results. We begin with non-parametric evidence and continue with regression analysis of the effect of political, financial, and demographic factors on the likelihood of CPP investment. The section concludes with a discussion of alternative hypotheses and tests of robustness.

4.1 Univariate Evidence

Table 2 provides non-parametric comparison of the likelihood of receiving CPP capital between QFIs evaluated on three sets of indicators: political connections, financials, and demographics. For each measure of political connections, we distinguish between connected and non-connected QFIs. For each financial and demographic variable, we compare banks above and below the median value.

Table 2 shows that institutions with political connections were more likely to receive CPP capital. This finding holds across all four measures of political ties, and the differences between connected and non-connected QFIs are significant at the 5% level or higher.

Institutions with weaker financial indicators were also more likely to receive CPP investments. This finding holds for all Camels proxies, and the differences between "strong" and "weak" companies are statistically significant at the 1% level, except for sensitivity to market risk. The evidence on the quality index also indicates that QFIs with lower index values were more likely to receive CPP funds. Finally, bigger banks with more employees were also more likely to receive CPP funds.

Non-parametric evidence so far suggests that stronger political connections and weaker financial indicators are associated with a higher likelihood of CPP investment. However, the univariate tests consider variables in isolation and do not account for their interaction. In the next section, we provide regression evidence in order to examine independent variables together and to compare their relative importance.

4.2 Multivariate Analysis

We estimate cross-sectional logit regressions to determine the influence of bank characteristics on the likelihood of receiving CPP capital. The dependent variable is an indicator equal to one if

a financial institution was approved for CPP funds and zero otherwise. The independent variables include four measures of political connections, and institutions' financial and demographic indicators, described above. To control for the possibility of systematic differences in decision criteria across bank regulators, we include regulator fixed effects. Standard errors are clustered at the company level.

The results of estimating the likelihood of CPP investment are summarized in Table 3. The first four columns consider each of the political variables individually, while controlling for company-level financials and demographics. Column (5) presents the results of the joint effect of all political variables. Column (6) shows the effects of including all political, financial, and demographic variables simultaneously.

Across different specifications, all political variables, except for lobbying, are strongly positively related to the likelihood of receiving CPP investments, and these relations are significant at the 5% level or higher. The effect of lobbying expenditures, while positive, is insignificant after controlling for bank fundamentals. It is possible that we are unable to reliably detect the marginal effect of lobbying due to the small fraction of lobbying firms in our sample. It is also feasible that the scrutiny of lobbying records available to the public motivates financial institutions to rely more heavily on other channels of political influence.

The influence of political variables is also economically significant. Based on the estimates in column (6), a board seat held by a QFI executive at a Federal Reserve Bank increases the probability of CPP investment by 31.3% for a bank with mean fundamentals. A mean bank headquartered in the district of a representative serving on key finance committees in Congress was 26.3% more likely to receive CPP funds, controlling for fundamentals. Finally, a one standard deviation increase in number of Congress representatives per state (scaled by the number of banks) is associated with a 7.6% increase in the likelihood of banks from this state to receive CPP funds.

The evidence from financial variables indicates that QFIs were more likely to receive CPP capital if they were bigger, had lower earnings, and lower capital. These findings are consistent with an investment strategy seeking to support systemically important institutions experiencing financial distress.

We also find that the likelihood of receiving CPP capital is positively related to asset quality and liquidity and negatively related to the proportion of foreclosed real estate. A combination of lower trailing earnings and weaker capital position, along with higher asset

quality and better liquidity, could be a result of writing off or selling troubled assets. Under this interpretation, CPP investments were made in the banks that had reduced their forward-looking exposure to the crisis and were likely to survive after receiving federal capital. QFIs with better management were also more likely to receive federal funding. This is consistent with investing in institutions that are likely to make better use of the money in order to withstand the crisis.

Column (7) of Table 3 evaluates the overall effect of a bank's financial strength on the likelihood of CPP investment. In this specification, the financial strength is measured by the financial quality index, measured as the bank's average rank on the 6 Camels proxies. This analysis seeks to distinguish between two hypotheses regarding CPP investment objectives: (1) strengthening the financial system by investing in the healthiest institutions; and (2) bailing out distressed banks to prevent their failure and avoid bank runs.

As shown in Column (7) of Table 3, the coefficient on the quality index is negative and strongly significant with a t-statistic of 6.1. This evidence is more consistent with the latter hypothesis, although it should be interpreted with caution, given the non-uniform direction for individual measures of financial condition. The results on the quality index are also consistent with the industry evidence from banks participating in CPP.¹⁹

4.3 Robustness

In this section, we analyze alternative explanations for our findings and present empirical evidence. We also test the robustness of our results to sample selection, extreme observations, and different measures of bank fundamentals.

The first alternative explanation we consider is sample selection. Our sample comprises all banks eligible for CPP investments rather than only the banks that applied for CPP funds. It is possible that the institutions that applied to the program were in distress and had the greatest need for capital. Under this scenario, the true sample of CPP applicants represents a subsample of QFIs with substantially weaker fundamentals. This alternative hypothesis would explain the negative relation between the likelihood of CPP investment and capital adequacy, earnings, and the overall indicator of banks' financial health.

¹⁹ For example, according to Joseph DePaolo, the CEO of Signature Bank, which received \$120 million from CPP in December 2008: "It's Congress' fault for allowing it to go from a program for healthy institutions to a program that they're giving money to weak institutions..."¹⁹. An interview to the National Public Radio, April 1, 2009, available at <http://www.npr.org/templates/story/story.php?storyId=102618967>

To test this hypothesis, we eliminate the top 25% of institutions based on capital adequacy (tier 1 capital ratio) and estimate logit regressions with all political, financial, and demographic variables using the remaining QFIs. The results of this estimation are presented in Column (1) of Table 4. Overall, the signs, magnitudes, and significance levels of all coefficients, except liquidity, remain very similar to the main specification.

As another check, we eliminate the top 25% of QFIs based on the financial quality index and repeat the estimation. The results, presented in Column (2) of Table 4, are also qualitatively similar to our main specification (Column (6) in Table 3). Altogether, this evidence suggests that our findings hold strongly after excluding the least likely CPP applicants and are unlikely to be driven by sample selection.

Another potential concern is that our results may be driven by the largest QFIs. The largest banks represent the core of the financial system and can be deemed too big to fail, even if they have weaker fundamentals, lower capital ratios, and poor financial performance. To test whether our results are driven by the largest institutions, we exclude the top 1% of banks (73 QFIs), which account for 78.3% of all QFI assets. Among the largest banks, 68.5% received CPP funds, consistent with the “too big to fail” argument. Column (3) of Table 4 shows the results of estimating our logit model after excluding the largest banks. All qualitative conclusions hold, and the quantitative results are also very similar.

As an additional robustness test, we also exclude all 173 QFIs headquartered in New York. As the finance center of the U.S., New York might be more likely to elect representatives with prior finance experience, who, arguably, are also more likely to serve on the House Financial Services Committee because of this experience. Thus, even if New York banks receive capital because they are more critical to the stability of the financial system, our tests might imply that they are more likely to receive CPP funds because of greater representation on the finance committees in Congress.

To test this alternative story, we repeat our estimation after excluding all QFIs headquartered in New York. This exclusion has little effect on our results, as shown in Column (4) of Table 4. The variables capturing Congress finance committee representation and state-level congress representation, which are determined by location, remain strongly positively related to the likelihood of CPP investment. The signs and significance of financial variables also remain largely unchanged.

Finally, because the condition and performance of QFIs can be measured by different proxies, we would like to test the robustness of our results to a different choice of Camels proxies. These alternative measures are discussed in Appendix E. Columns (5) and (6) of Table 4 present the results of estimation with new sets of financial variables. The qualitative conclusions for all political variables and the majority of financial variables remain unchanged.

5. Extensions

This section presents extensions of our main results. We start by providing evidence on the determinants of CPP investment *amounts*. Next, we analyze how the impact of political connections varies depending on the financial strength of qualifying institutions. The section concludes with a detailed analysis of Congress committees and board memberships that identifies the main drivers of their influence.

5.1 Investment Amounts

Our analysis so far has concentrated on the likelihood of investment. In this section, we analyze the *amounts* of CPP investments, which are allocated to institutions as Tier 1 Capital. To evaluate the relative magnitude of each investment, we follow the above classification and scale the absolute investment amount by the QFI's Tier 1 capital as of the latest quarterly report of condition and income prior to the CPP application deadline for public and private QFIs.²⁰

To analyze the determinants of investment amounts, we estimate cross-sectional OLS regressions in which the dependent variable is the scaled CPP investment. Our sample for these tests comprises 594 QFIs that received CPP funds as of May 15, 2009. In these tests we did not include the 55 banks that declined the CPP investment, since we do not have reliable data on the approved investment amounts.

The independent variables are defined as in the logit regressions and include a set of four measures of political influence, a vector of Camels proxies, bank's foreclosures, and a vector of demographic variables. As in the previous models, we include regulator fixed effects and use standard errors clustered at the company level.

²⁰ This is the report for the quarter ending September 30, 2008.

The results are summarized in Table 5. Columns (1)-(4) present evidence for each type of political influence estimated with bank fundamentals. Column (5) shows the joint effect of all political variables, and Column (6) presents the model that includes all political, financial, and demographic variables simultaneously.

The results of estimation indicate that the drivers of investment amounts differ from those of the likelihood of CPP investment. Among the political variables, the scaled investment amount is strongly positively related to bank's lobbying expenditures (measured relative to asset size), and this relation is significant at the 1% level. The effect of lobbying expenditures is also economically large. A one standard deviation increase in scaled lobbying expenditures is associated with an additional \$10.4 million in raw CPP investment, controlling for other factors.

The evidence so far helps explain the initially surprising finding that lobbying expenditures are not strongly associated with a higher likelihood of receiving CPP funds. It is possible that the majority of lobbying efforts were aimed at increasing the size of CPP investments. This interpretation is supported by the fact that the QFIs in our sample, which lobbied in 2008-2009 on the issues of banking or finance represent large institutions, which would likely be saved with or without lobbying. The focus of lobbying on additional funds by TARP recipients is also supported by the evidence in the financial media.²¹ Finally, this finding is also consistent with the recent introduction of Congress legislation aimed to impose restrictions on the lobbying activity of TARP recipients.

Other political variables do not significantly explain investment amounts. This result is not entirely surprising, since bank regulators make recommendations only on the approval or denial of applications, but do not determine investment amounts. Similarly, Congress representatives, while plausibly helpful in supporting QFI applications, are unlikely to influence the final amount of funds awarded.

The analysis of financial variables highlights capital adequacy as one of the primary fundamental drivers of investment amounts. The relation is strongly negative, with double-digit t-statistics in all specifications. A one standard deviation decrease in capital adequacy is associated with an increase of 0.45 standard deviations in scaled CPP investment (or an additional \$52.8 million in capital), controlling for other factors. The amount of investment is also negatively related to earnings and liquidity. Collectively, these findings are consistent with

²¹ "Firms Keep Lobbying as They Get TARP Cash", by Brody Mullins and Elizabeth Williamson, *The Wall Street Journal*, January 23, 2009.

an investment strategy seeking to increase the capitalization and liquidity of participating banks to an adequate level, thus providing more capital to undercapitalized, less profitable, and less liquid institutions. The allocation of greater capital amounts to weaker banks is also confirmed by the strong negative relation between banks' financial quality index and CPP investment amounts, presented in Column (7) of Table 5.

Among other variables, bank size is strongly positively related to scaled investment amounts. A one standard deviation increase in size is associated with an increase of 0.26 standard deviations in scaled investment amounts (or \$29.97 million in CPP capital), controlling for other factors. The significant positive effect of size is consistent with an investment policy aimed to provide an extra margin of safety for more systemically significant institutions.

In summary, the determinants of CPP investment amounts appear consistent with strengthening the capital position and liquidity of approved participants to an acceptable level, while providing an extra capital buffer for larger institutions. Controlling for these and other fundamental factors, banks' lobbying efforts are strongly positively related to allocated capital.

5.2 Political Influence and Financial Strength

Our main results suggest that political connections are strongly positively related to the likelihood of receiving CPP investments. In this section, we seek to understand for which types of banks these connections play the greatest role. For this analysis, we divide QFIs into terciles according to the financial quality index and investigate the influence of political variables in each tercile by interacting tercile dummies with variables of political connections. In addition to the financial quality index, which aggregates measures of condition and performance, we also control for bank size and demographics. The dependent variable in these logit regressions is an indicator equal to 1 if a bank was approved for CPP investment. As in other specifications, we include regulator-fixed effects and cluster standard errors at the company level.

The results are presented in Table 6. The base category represents the tercile of banks with the strongest financial condition, according to the financial quality index. The interaction terms show the effects of political connections in the other two terciles. The effect of each of the four political variables is presented in the corresponding column.

For all variables of political influence, except for lobbying, the magnitude and significance of coefficients increase virtually monotonically from the top tercile to the bottom

tercile. In particular, the relation between political variables and the likelihood of CPP investment is the most pronounced for the institutions with weaker financials, which had stronger incentives to use other channels of influence.

Interpreted broadly, the evidence in this section suggests that if political ties indeed played a role in the choice of CPP investments, their effect shifted at least some capital towards less efficient, underperforming financial institutions.

5.3 Details on Congress Committees and Federal Reserve Boards

In this section we provide additional analysis of Congress committees and board memberships at the Federal Reserve to investigate the main drivers of their influence. For congressional committees, we disentangle the effects of subcommittees to understand which groups play a more important role. For board memberships at Federal Reserve Banks, we analyze how the impact of political connections varies depending on tenure and the authority level of the board seat (main office vs. a branch).

To disentangle the influence of subcommittees within the House Financial Services Committee, we assign 3 indicators, each denoting membership on the House Financial Services Committee, the Subcommittee on Financial Institutions, and the Subcommittee on Capital Markets, respectively. We then estimate the logit model for the likelihood of CPP investment, using indicators for subcommittees and controlling for financial and demographic variables. The results of estimation are presented in Columns (1) – (3) of Table 7.

The likelihood of CPP investment is positively and significantly related to representation on the Subcommittee on Capital Markets and the Subcommittee on Financial Institutions. The coefficients on both subcommittees are comparable in magnitude and significance, suggesting roughly similar effects. This finding can be explained by the fact that both committees have oversight jurisdiction over QFIs.

The effect of membership on the House Financial Services Committee is positive but not statistically significant. This result could be attributed to the fact that the Committee has 6 subcommittees, only two of which are directly involved in the regulation of the financial services industry. The other subcommittees are tasked with issues not directly related to banking, such as international trade and financial technology.

Next, we further analyze the effect of board seats held by QFI executives at Federal Reserve Banks. We introduce indicator variables to distinguish board seats at the main 12 banks from board seats at their branch offices and repeat the estimation of logit regressions, controlling for financial and demographic bank characteristics. The results, summarized in Column (4) of Table 7, show that board seats at the main banks have somewhat larger effects on the likelihood of receiving CPP capital, compared to the board seats at branch offices. This result is consistent with the greater authority of directors at the main banks.

In Column (5) of Table 7, we consider an alternative specification of board memberships, which accounts for tenure of QFI directors. The independent variable of interest is the total number of terms served by QFI's executives, who were board members at Federal Reserve Banks in 2008 and 2009. As before, we include financial and demographic controls.

The results, presented in Column (5) of Table 7, indicate that the number of terms served by QFI executives at the Federal Reserve is strongly positively related to the likelihood of CPP investment, consistent with the initial hypothesis that QFIs with more directors or with directors serving consecutive terms were more likely to be approved for CPP capital.

Conclusion

This paper provides empirical evidence on the determinants of capital allocation under the Capital Purchase Program (CPP). We consider a wide range of political, financial, and demographic indicators of qualifying financial institutions, and examine how they are related to the likelihood of receiving CPP funds. Our results highlight the importance of political connections in the choice of federal investments. Federal Reserve board members, connections with House members on finance committees, and greater representation in Congress of the financial institution's state are all positively related to the likelihood of CPP investment.

Further in-depth analysis also suggests that conditional on receiving CPP funds, an institution's investment in lobbying the Treasury and bank regulators is positively related to the amount of awarded capital. Importantly, the results in this paper also suggest that political ties play a stronger role for weaker, underperforming institutions.

One possible interpretation of our findings is that our empirical design fails to control for important omitted or unobservable variables correlated with political connections but unrelated to attempts to influence investment decisions. Another interpretation is that political ties, at least

in some cases, affect federal investment decisions, resulting in a deviation from the declared investment focus on healthy institutions. Under the latter interpretation, the external pressures shifted at least some of the federal capital towards ailing institutions. This scenario justifies the additional requirements for accountability, disclosure, and transparency in TARP investment decisions that are advocated by the GAO and other oversight bodies of the program.

Our paper complements earlier studies on the relation between political connections and firm value (Roberts (1990), Fisman (2001), Faccio (2004)) by studying an important channel for this effect – preferential access to federal capital. Yet in this paper, we do not attempt to provide direct evidence on company value or the deployment of federal capital, given the short time horizon for making reliable conclusions. This is an interesting question for future research.

We envision several other extensions of the current work. Our analysis so far has concentrated on two dimensions of TARP investments – the choice of capital recipients and the amount of the investment. In ongoing research, we are adding a third dimension – the timing of the investment. This analysis tests whether politically-connected banks were more likely to receive capital sooner. Similarly, we are expanding our focus to include another channel of political influence – contributions to congressional campaigns.

Another interesting area for future analysis is the change in administration in the U.S. government that took effect in January 2009 as a result of the presidential and congressional elections, as well as the new appointments at the Treasury. This exogenous event provides an opportunity to capture the effect of a shift in political power on TARP investment decisions and to distill the effect of political ties, if any, from fundamental factors. This analysis is a subject of our ongoing work.

Overall, we believe that the unprecedented scale of government investment in the U.S. economy in response to the financial crisis provides a unique natural experiment for researchers in financial economics, government regulation, and social welfare. We hope that the many remaining questions about TARP programs will motivate future research in this area.

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Appendix A

Primary Banking Regulators of Qualifying Financial Institutions

The Federal Reserve is the primary regulator for bank holding companies and state-chartered banks that are members of the Federal Reserve System.²² Together, these institutions account for over 90% of QFIs in our sample and represent more than 95% of assets.

The FDIC has supervisory authority over state-chartered banks that are not members of the Federal Reserve System. These banks comprise the majority of institutions in the banking system, but most of them are held by bank holding companies, and their applications must be also submitted to the Federal Reserve.

The OCC regulates and supervises all national banks. In contrast to state banks, which are chartered by state banking departments and regulated by state banking laws, national banks are chartered by the OCC and regulated by federal banking laws. Further, unlike state banks, national banks are required to be investing members of the Federal Reserve System. National banks are typically larger than state banks, but do not need to have nationwide operations. The decision of a bank to seek federal or state charter often depends on its preference for regulatory authorities and regulating laws, since laws in some states give state banks more authority than national banks to engage in selected nonbank activities, such as real estate investments, among others.

OTS supervises savings associations (thrifts) and savings and loan holding companies. In the past, the primary operations of savings associations were limited to accepting deposits and making residential mortgage loans. However, the differences between banks and savings associations have diminished over time, and under the current law thrifts are authorized to offer largely all banking services. Savings and loan holding companies are companies that own savings associations.

²² In cases where the applying institution is a bank holding company, the application is submitted both to the regulator overseeing the largest bank of the holding company and to the Federal Reserve.

Appendix B

Oversight of the Troubled Asset Relief Program

The execution of TARP, including the allocation of CPP investments, is overseen by several monitors: The Financial Stability Oversight Board (FSOB), the Congressional Oversight Panel, and the Office of the Special Inspector General (SIGTARP), and the Comptroller General.

The FSOB, which consists of 5 members, is charged with reviewing the Treasury's actions, making recommendations to the Treasury for improvement, and preventing fraud.²³ The Board meets on a monthly basis and provides quarterly reports to Congress. The Congressional Oversight Panel consists of 5 outside experts selected by majority and minority leaders in the House of Representatives and Senate.²⁴ The Congressional Oversight Panel reviews the Treasury's management of TARP and reports to Congress every month. The Comptroller General, the director of the Government Accountability Office (GAO), is responsible for monitoring program execution, providing assessment reports to Congress every two months, and auditing the program every year. The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) was established by the Emergency Economic Stabilization Act. The Inspector General is appointed by the President and confirmed by the Senate. As of May 31, 2009, this position was held by Neil Barofsky. The task of SIGTARP is to audit and investigate the Treasury's actions, reporting to Congress every quarter.

²³ FSOB members include the Chairman of the Board of the Federal Reserve, Secretary of the Treasury, Director of the Federal Housing Finance Agency, Chairman of the Securities and Exchange Commission, and Secretary of the Department of Housing.

²⁴ As of May 31, 2009, members of the Congressional Oversight Panel include representatives from the banking sector, law, politics, and the academia.

Appendix C

Financial Conditions of the Capital Purchase Program

Redemption of Capital

Preferred shares acquired by the Treasury can be redeemed by the QFI at the issue price. During the first three years of investment life, preferred stock may be redeemed by the QFI by issuing common or preferred stock for cash in the amount of not less than 25% of the issue price of preferred shares acquired by the Treasury. After the first three years of investment, preferred shares may be redeemed in whole or in part at QFIs' discretion. As of May 15, 2009, 15 banks redeemed their preferred shares from the Treasury for a total amount of \$1.3 billion. In each case, QFIs redeemed 100% of preferred shares.

Participation Terms for "S" Corporations and Mutual Organizations

The terms of program participation for "S" corporations and mutual organizations are similar in spirit to those described in this section, with some modifications that accommodate the structure of these institutions.²⁵ For example, in cases of "S" corporations, the Treasury invests in senior debentures, rather than preferred stock. These debentures pay an annual coupon of 7.7% for the first 5 years and 13.8% thereafter, and thus have an after-tax cost of 5% and 9%, respectively, under the assumption of a 35% tax rate. The Treasury also receives warrants to purchase additional debentures, which are also exercised immediately.

Restrictions on Participating Institutions

During the first three years of Treasury's ownership of preferred stock or warrants, participating banks are prohibited from increasing dividends on their common shares, or repurchasing common stock or preferred shares junior to Treasury's investment. Participating institutions must also impose certain restrictions on their executive compensation.²⁶

²⁵ Additional details on the financial terms of the program for "S" corporations and mutual organizations can be obtained from the program term sheets for these institutions at <http://www.financialstability.gov/roadtostability/CPAppdocs.html>

²⁶ In short, participating banks are prohibited from making golden parachute payments, deducting for tax purposes compensation exceeding \$500,000 per executive, and employing compensation schemes that encourage "unnecessary and excessive risks" to the value of the institution. Banks are also required to claw back any incentive compensation paid to executives based on earnings that were subsequently restated.

Appendix D

Boards of Directors at Federal Reserve Banks

Each of the 12 Federal Reserve banks has its own board of directors, which consists of 9 members appointed for 3-year staggered terms, with a maximum service tenure of two consecutive terms. Three board members in each bank are classified as Class A directors and represent the member banks in the district. Class A directors usually comprise senior executives at member institutions and are the primary focus of our analysis.

Another three directors, Class B directors, are chosen to represent the public in the respective Federal Reserve District. These directors include representatives from the industry, agriculture, non-profit organizations, and the academia. Both class A and class B directors are elected by member banks. In this election, all member banks of the Federal Reserve district are divided into three categories by the amount of capital: large, medium, and small. Each category of banks elects one class A and one class B director.

Class C directors comprise 3 members appointed by the Federal Reserve Board of Governors to represent the interests of labor, industry, and agriculture. Two of the Class C directors are appointed to serve as chairman and deputy chairman of the board by the Federal Reserve Board of Governors. Both class B and class C directors cannot be employees or directors at any bank.

Among the 12 main banks in the Federal Reserve System, 11 banks also have additional branches located in the main cities of the district. The number of branches ranges from 1 to 4 per district, depending on its size. Branches of Federal Reserve Banks have their own boards of directors.

In the majority of branches, boards consist of 7 members serving 3-year terms with a maximum service limit of two consecutive terms. In a typical branch board, four directors are appointed by the Reserve Bank and three are appointed by the Board of Governors, which also designates the board's chairman. Members of the branch board usually include 1-2 executives of member banks, with the remaining directors representing the industry, agriculture, non-profit sector, and academia.

Appendix E

Variable Definitions

1. CPP Variables

CPP = an indicator equal to 1 if the financial institution was approved for CPP funds.

CPP amount = amount of capital received by a financial institution from the CPP, scaled by the institution's tier-1 capital.

2. Political Connections

Congress finance committee member = average of a set of indicators equal to 1 if the financial institution's Congress representatives in 2008 or 2009 were members of either the Financial Services Committee, the Capital Markets sub-committee, or the Financial Institutions sub-committee.

Federal Reserve board member = an indicator equal 1 if the financial institution had executives that are also Federal Reserve directors in 2008 or 2009.

Lobbying amount = total amount of money invested in lobbying the Treasury and the banking regulators (FED, OTS, FDIC, and OCC) from the beginning of 2008 through the first quarter of 2009. Attention is restricted to Banking, Finance, and Bankruptcy issues.

State congress representatives = the number of Congress representatives in the state where the financial institution is headquartered, scaled by the total number of financial institutions headquartered in the state.

Congress financial services committee member = the average of 2 indicators equal 1 if the company's Congress representatives in 2008 or 2009 were members of the Financial Services Committee.

Congress capital markets sub-committee member = the average of 2 indicators equal 1 if the company's Congress representatives in 2008 or 2009 were members of the Congress Capital Markets sub-committee.

Congress financial institutions sub-committee member = the average of 2 indicators equal 1 if the company's Congress representatives in 2008 or 2009 were members of the Financial Institutions sub-committee, respectively.

Federal Reserve board member, main office = an indicator equal 1 if the company had executives that are also Federal Reserve directors in one of the 12 main offices in 2008 or 2009.

Federal Reserve board member, branch = an indicator equal 1 if the company had executives that are also Federal Reserve directors in any of the branch offices in 2008 or 2009.

Federal Reserve board member, number of terms = total number of terms served by company executives that are Federal Reserve board members in 2008 or 2009.

3. Financial Variables

Capital adequacy = tier 1 risk-based capital ratio, defined as tier 1 capital divided by risk weighted assets.

Capital adequacy refers to the amount of a bank's capital relative to the risk profile of its assets. Broadly, this criterion evaluates the extent to which a bank can absorb potential losses. Tier 1 capital comprises the more liquid subset of bank's capital, whose largest components include common stock, paid-in-surplus, retained earnings, and non-cumulative perpetual preferred stock. To compute the amount of risk-adjusted assets in the denominator of the ratio, all assets are divided into risk classes (defined by bank regulators), and less risky assets are assigned smaller weights, thus contributing less to the denominator of the ratio. The intuition behind this approach is that banks holding riskier assets require a greater amount of capital to remain well-capitalized.

In the robustness section, we also test an alternative specification of capital adequacy – the total risk-based capital ratio, determined as a ratio of total capital to risk-weighted assets.

Asset quality = the negative of noncurrent loans and leases, scaled by total loans and leases.

Asset quality evaluates the overall condition of a bank's portfolio and is typically evaluated by a fraction of non-performing assets and assets in default. Non-current loans and leases are loans that are past due for at least 90 days, or are no longer accruing interest, including non-performing real-estate mortgages. A higher proportion of non-performing assets indicates lower asset quality. For ease of interpretation, this ratio is included with a negative sign so that greater values of this proxy reflect higher asset quality.

In the robustness section, we also test an alternative measure – the ratio of loan and lease allowance to total loans. This ratio (also included with a negative sign) measures the adequacy of the allowance created by the bank to absorb losses on non-performing loans.

Management quality = the negative of the number of corrective actions that were taken against bank executives by the corresponding banking regulator (FED, OTS, FDIC, and OCC) between 2006 and 2009.

In our sample, we have a total of 1,681 orders issued to 961 QFIs. The most frequent enforcement actions include prohibitions from further participation in banking activities²⁷, orders to cease and desist²⁸, and orders to pay civil money penalty.²⁹ To avoid subjectivity, we do not attempt to assess the severity of each corrective action but rather use the total number of enforcement orders issued to a QFI over the 3-year period.

²⁷ These orders prohibit bank managers convicted of unlawful activities or unsound banking practices from involvement in any insured depository institution without prior regulatory approval.

²⁸ Cease-and-desist orders are issued when a regulator determines that a bank has engaged in “an unsafe or unsound banking practice or a violation of law”. These orders require banks to take corrective actions specified by the banking regulator.

²⁹ These orders require banking organizations to pay fines for engaging in unsafe banking practices, violations of law, or incompliance with orders of banking regulators.

Earnings = return on assets (ROA), measured as the ratio of the annualized net income in the trailing quarter to average total assets. For robustness, we also measure Earnings using net interest income to earning assets

Liquidity = total cash divided by total deposits. For robustness, we also measure Liquidity using the negative of the non-core dependence ratio, defined as non-core deposits divided by long-term assets.³⁰

Sensitivity to market risk = the sensitivity to interest rate risk, defined as the ratio of the absolute difference (gap) between short-term assets and short-term liabilities to earning assets.

The primary focus of risk analysis by bank regulators is on interest rate risk. The gap between short term assets and liabilities approximates the net amount of assets or liabilities that need to be repriced within one year, impacting earnings. A greater absolute value of the gap reflects higher interest rate risk.

Foreclosures = total value of foreclosed assets divided by net loans and leases.

Quality index = the company's average ranking on Capital adequacy, Asset quality, Management quality, Earnings, Liquidity, and Sensitivity to market risk (CAMELS), normalized to lie between 0 and 1.

4. Demographic Variables

Size = the natural logarithm of total assets, defined as all assets owned by the bank holding company including cash, loans, securities, bank premises and other assets. This total does not include off-balance-sheet accounts.

Age = age (in years) of the oldest bank owned by the bank holding company as of September 30, 2008.

Number of employees = total number of employees of the bank or the holding company as of September 30, 2008.

³⁰ Non-core deposits represent the more volatile funds, such as brokered deposits, CDs in excess of 100,000 and deposits by foreign institutions. These sources are most sensitive to changes in interest rates and market conditions. Since a greater reliance on non-core funds indicates lower liquidity, we take the negative of the non-core dependence ratio.

Table 1**Summary Statistics**

This table reports summary statistics for the sample, which consists of all FDIC-insured, active financial institutions as of September 30, 2008. We exclude non-US banks and banks that declined to apply to CPP. CPP investment is an indicator that equals 1 if the company received CPP funds or was approved and later declined the funds, and 0 otherwise. Congress finance committee member is the average of a set of indicators equal to 1 if the company's Congress representatives in 2008 or 2009 were members of the Financial Services Committee, the Capital Markets sub-committee, or the Financial Institutions sub-committee, respectively. Federal Reserve board member is an indicator that equals 1 if the company had executives that are also Federal Reserve directors in 2008 or 2009. Lobbying amount is the total amount of lobbying expenditures from the beginning of 2008 through the first quarter of 2009 spent on lobbying the Treasury and the banking regulators (FED, OTS, FDIC, and OCC) on the issues of Banking and Finance. State Congress representatives is the number of Congress representatives for the company's state, scaled by the number of banks headquartered in the state. Capital adequacy is Tier 1 risk-based capital ratio. Asset quality is the negative of noncurrent loans and leases, scaled by total loans and leases. Management quality is the negative of the number of corrective actions that were taken against bank executives by the corresponding banking regulator (FED, OTS, FDIC, and OCC) between 2006 and 2009. Earnings is return on assets (ROA). Liquidity is measured by the cash to deposits ratio. Sensitivity to market risk is the sensitivity to interest rate risk, defined as the ratio of the absolute difference (gap) between short-term assets and short-term liabilities to earning assets. Foreclosure is the total value of foreclosed assets scaled by net loans and leases. Age is the age of the oldest bank owned by the bank holding company in years as of 2009. Assets is all assets owned by the bank holding company including cash, loans, securities, bank premises and other assets, but excluding off-balance-sheet accounts.

Panel B shows the correlation matrix for political, financial, and demographic variables.

Panel A: Summary Statistics

Variable	Mean	25th percentile	Median	75th percentile	Standard deviation
Political Variables					
Congress finance committee member	0.033	0.000	0.000	0.000	0.085
Federal reserve board member	0.011	0.000	0.000	0.000	0.106
Lobbying Amount, \$Thousands	2,167	200	637	4,520	2,406
State Congress representatives	0.06	0.031	0.048	0.074	0.047
CPP					
CPP investment indicator	0.089	0.000	0.000	0.000	0.285
CPP amount (\$Thousands), recipients	318,000	5,000	12,000	38,000	2,010,000
Financial Variables					
Capital adequacy (%)	18.416	10.763	13.423	18.628	24.211
Asset quality (%)	-1.828	-2.263	-1.022	-0.309	2.901
Management quality	-0.231	0.000	0.000	0.000	1.623
Earnings (%)	0.465	0.142	0.702	1.169	3.876
Liquidity (%)	8.247	2.587	3.872	6.623	74.465
Sensitivity to market risk (%)	13.649	2.981	8.465	18.332	33.637
Demographic Variables					
Age	71	25	81	106	44
Size, Assets in \$Thousands	1,700,000	66,408	144,000	335,000	36,600,000

Panel B: Correlation Matrix

Variable	Congress finance committee member	Federal reserve board member	Lobbying Amount	State congress reps	Capital adequacy	Asset quality	Management quality	Earnings	Liquidity	Sensitivity to market risk	Age	Size
Congress finance committee member	1.000											
Federal reserve board member	0.024	1.000										
Lobbying Amount	0.010	0.057	1.000									
State congress representatives	0.059	0.025	0.041	1.000								
Capital adequacy	0.008	-0.030	-0.008	0.052	1.000							
Asset quality	-0.022	-0.002	0.004	-0.032	0.096	1.000						
Management quality	-0.034	-0.178	-0.265	-0.048	0.038	0.095	1.000					
Earnings	-0.026	0.004	0.004	-0.116	0.183	0.116	0.026	1.000				
Liquidity	0.007	0.023	0.023	0.012	0.237	0.010	-0.159	0.099	1.000			
Sensitivity to market risk	0.013	-0.001	-0.006	0.045	0.122	0.039	0.008	0.022	0.144	1.000		
Age	-0.060	0.022	-0.003	-0.283	-0.077	0.091	-0.027	0.101	-0.028	0.021	1.000	
Size	0.067	0.197	0.155	0.237	-0.260	-0.085	-0.262	-0.008	-0.028	-0.024	-0.011	1.000

Table 2**Non Parametric Evidence**

The table presents difference-in-means estimates of the likelihood of receiving CPP funds. The sample consists of all FDIC-insured, active financial institutions as of September 30, 2008. We exclude non-US banks and banks that declined to apply to CPP. The quality index is the company's average ranking on Capital adequacy, Asset quality, Management quality, Earnings, Liquidity, and Sensitivity to market risk (Camels), normalized to lie between 0 and 1. See Table 1 for all other variable definitions.

Sort Variable	Low	High	High Minus Low	t-statistic
Political Variables				
Congress finance committee member	0.088	0.113	0.025	2.381
Federal reserve board member	0.085	0.470	0.385	12.380
Lobbying Amount	0.087	0.410	0.323	7.086
State congress representatives	0.035	0.089	0.054	2.402
Financial Variables				
Capital adequacy	0.154	0.025	-0.129	19.808
Asset quality	0.104	0.074	-0.029	4.378
Management quality	0.117	0.085	-0.032	3.241
Earnings	0.116	0.062	-0.055	8.202
Liquidity	0.115	0.063	-0.052	7.785
Sensitivity to market risk	0.093	0.085	-0.008	1.240
Foreclosures	0.073	0.105	0.033	4.868
Quality index	0.147	0.031	-0.116	17.684
Demographic Variables				
Age	0.113	0.065	-0.047	7.123
Number of employees	0.030	0.148	0.118	18.028
Size	0.025	0.153	0.127	19.533

Table 4
Robustness

This table presents estimates from logit regressions explaining the likelihood of CPP investment. The dependent variable is an indicator equal to 1 if the financial institution was approved for CPP funds. The sample consists of all FDIC-insured, active financial institutions as of September 30, 2008. We exclude non-US banks and banks that declined to apply to CPP. Variable definitions in Table 1 correspond to all columns but (5) and (6). In column (5), Capital adequacy is total risk-based capital ratio, Asset quality is the opposite of net losses to average total loans and leases, Earnings is noninterest income to earning assets, and Liquidity is the opposite of the non-core dependence ratio, defined as non-core deposits divided by long-term assets. In column (6), Capital adequacy is the tier 1 leverage capital ratio, Asset quality is the opposite of loan and lease allowance to total loans, Earnings is net interest income to earning assets, and Liquidity is core deposits to asset growth. All regressions include regulator fixed effects. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the company level. Significance levels are indicated: * = 10%, ** = 5%, *** = 1%.

Description	Exclude top 25% capital adequacy	Exclude top 25% quality index	Exclude top 1% size	Exclude NY	Different Controls	Different Controls
Model Number	(1)	(2)	(3)	(4)	(5)	(6)
Congress finance committee member	1.503*** [3.085]	1.618*** [3.273]	1.267*** [2.614]	1.724*** [3.499]	1.426*** [3.047]	1.259*** [2.699]
Federal reserve board member	0.796*** [2.706]	0.829*** [2.774]	0.731** [2.330]	0.800*** [2.739]	0.820*** [2.845]	0.774*** [2.677]
Lobby Amount	0.120 [0.128]	-0.077 [0.076]	0.561 [0.460]	0.399 [0.284]	0.385 [0.412]	-0.014 [0.015]
State congress representatives	5.896*** [6.283]	5.923*** [6.256]	5.824*** [6.273]	6.622*** [6.902]	5.948*** [6.715]	6.508*** [7.310]
Capital adequacy	-0.165*** [7.405]	-0.117*** [7.113]	-0.137*** [8.990]	-0.132*** [8.790]	-0.115*** [8.229]	-0.078*** [4.698]
Asset quality	0.219*** [6.591]	0.237*** [7.233]	0.206*** [6.343]	0.248*** [7.505]	0.000 [0.147]	0.267*** [3.268]
Management quality	0.104*** [4.202]	0.110*** [4.314]	0.441*** [4.363]	0.102*** [4.915]	0.074*** [3.885]	0.086*** [4.095]
Earnings	-0.049 [1.231]	-0.086** [2.551]	-0.159*** [4.545]	-0.148*** [4.284]	-0.077* [1.900]	-0.042 [0.763]
Liquidity	0.003 [1.519]	0.004 [1.473]	-0.027** [2.058]	0.003*** [3.093]	0.000 [1.220]	0.000 [1.344]
Sensitivity to market risk	-0.006 [1.327]	-0.013*** [2.951]	-0.008* [1.905]	-0.009** [2.036]	-0.007* [1.721]	-0.015*** [3.708]
Foreclosures	-0.002** [2.504]	-0.002*** [3.069]	-0.002*** [2.864]	-0.002*** [2.848]	-0.004*** [5.497]	-0.003*** [4.137]
Bank age	-0.007*** [5.623]	-0.007*** [5.572]	-0.008*** [6.293]	-0.007*** [5.806]	-0.007*** [6.421]	-0.009*** [7.736]
Number of employees	0.581*** [6.959]	0.584*** [6.868]	0.469*** [5.027]	0.494*** [5.114]	0.576*** [6.549]	0.557*** [6.471]
Size	0.273*** [3.536]	0.266*** [3.393]	0.389*** [4.401]	0.349*** [3.971]	0.258*** [3.290]	0.352*** [4.411]
Regulating agency F.E?	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R ²	0.240	0.258	0.258	0.275	0.263	0.249
N_obs	5,441	5,441	7,182	7,082	7,255	7,255

Table 6
Political Connections and Financial Strength

This table presents estimates from logit regressions explaining the likelihood of CPP investment. The dependent variable is an indicator equal to 1 if the financial institution was approved for CPP funds. The sample consists of all FDIC-insured, active financial institutions as of September 30, 2008. We exclude non-US banks and banks that declined to apply to CPP. The quality index is the company's average ranking on Capital adequacy, Asset quality, Management quality, Earnings, Liquidity, and Sensitivity to market risk (Camels), normalized to lie between 0 and 1. See Table 1 for all variable definitions. All regressions include regulator fixed effects. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the company level. Significance levels are indicated: * = 10%, ** = 5%, *** = 1%.

Explanatory Variable (var)	Congress finance committee member	Federal Reserve board member	Lobbying Amount	State congress representatives
Model Number	(1)	(2)	(3)	(4)
var	-3.021* [1.716]	-0.908 [0.788]	1.022 [0.430]	-3.953* [1.702]
var x medium quality index	4.237** [2.221]	1.304 [1.009]	-6.984 [1.425]	10.087*** [4.668]
var x low quality index	5.090*** [2.744]	2.028* [1.679]	-0.357 [0.099]	10.596*** [4.292]
Quality index	-1.257*** [3.658]	-1.509*** [4.605]	-1.558*** [4.762]	-0.439 [0.928]
Age	-0.009*** [7.967]	-0.009*** [8.195]	-0.009*** [8.175]	-0.008*** [6.784]
Number of employees	0.452*** [5.597]	0.428*** [5.317]	0.437*** [5.289]	0.439*** [5.508]
Size	0.436*** [6.060]	0.440*** [6.116]	0.453*** [6.058]	0.419*** [5.875]
Regulating agency F.E?	Yes	Yes	Yes	Yes
Pseudo R ²	0.218	0.217	0.216	0.228
N_obs	7,255	7,255	7,255	7,255

Table 7**Congress Committees and Federal Reserve Boards: Details**

This table presents estimates from logit regressions explaining the likelihood of CPP investment. The dependent variable is an indicator equal to 1 if the financial institution was approved for CPP funds. The sample consists of all FDIC-insured, active financial institutions as of September 30, 2008. We exclude non-US banks and banks that declined to apply to CPP. House Financial Services Committee member is the average of 2 indicators equal to 1 if the company's Congress representatives in 2008 or 2009 were members of the Financial Services Committee. House Financial Institutions Subcommittee member and House Capital Markets Subcommittee member are defined analogously with respect to the Capital Markets Subcommittee and the Financial Institutions Subcommittee, respectively. Federal Reserve board member, main office is an indicator that equals 1 if the company had executives that were also Federal Reserve directors in one of the 12 main offices in 2008 or 2009. Federal Reserve board member, branch is defined analogously with respect to directors in the branch offices of Federal Reserve Banks. Federal Reserve board member, number of terms is the total number of terms served by company executives that are Federal Reserve board members in 2008 or 2009. See Table 1 for all other variable definitions. All regressions include regulator fixed effects. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the company level. Significance levels are indicated: * = 10%, ** = 5%, *** = 1%.

Model Number	(1)	(2)	(3)	(4)	(5)
House Financial Services Committee member	0.384 [0.989]				
House Financial Institutions sub-committee member		0.885** [2.004]			
House Capital Markets sub-committee member			0.947** [2.233]		
Federal Reserve board member, main office				0.827** [2.374]	
Federal Reserve board member, branch				0.774** [2.420]	
Federal Reserve board member, number of terms					0.502*** [3.492]
Capital adequacy	-0.125*** [8.754]	-0.125*** [8.791]	-0.125*** [8.765]	-0.125*** [8.764]	-0.126*** [8.806]
Asset quality	0.226*** [7.091]	0.226*** [7.095]	0.227*** [7.120]	0.225*** [7.021]	0.227*** [7.053]
Management quality	0.092*** [4.749]	0.094*** [4.795]	0.090*** [4.663]	0.100*** [5.164]	0.110*** [5.651]
Earnings	-0.161*** [4.725]	-0.161*** [4.731]	-0.159*** [4.684]	-0.162*** [4.763]	-0.163*** [4.793]
Liquidity	0.002*** [2.932]	0.002*** [2.948]	0.002*** [2.916]	0.002*** [3.204]	0.003*** [4.045]
Sensitivity to market risk	-0.005 [1.317]	-0.005 [1.312]	-0.006 [1.443]	-0.005 [1.209]	-0.005 [1.261]
Foreclosures	-0.003*** [3.351]	-0.003*** [3.367]	-0.003*** [3.294]	-0.003*** [3.325]	-0.003*** [3.361]
Age	-0.009*** [8.012]	-0.009*** [7.889]	-0.009*** [7.979]	-0.009*** [8.072]	-0.009*** [8.069]
Number of employees	0.528*** [6.462]	0.536*** [6.562]	0.530*** [6.482]	0.513*** [6.272]	0.511*** [6.255]
Size	0.385*** [5.202]	0.376*** [5.078]	0.384*** [5.188]	0.374*** [5.031]	0.377*** [5.079]
Regulating agency F.E?	Yes	Yes	Yes	Yes	Yes
R ²	0.266	0.266	0.267	0.268	0.268
N_obs	7,255	7,255	7,255	7,255	7,255