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Ross School of Business Working Paper  
Working Paper No. 1165  
January 2012

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# Safer Ratios, Riskier Portfolios: Banks' Response to Government Aid\*

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## Abstract

We study the effect of government assistance on bank risk taking. Using hand-collected data on bank applications for government investment funds, we investigate the effect of both application approvals and denials. To distinguish banks' risk taking behavior from changes in economic conditions, we control for the volume and quality of credit demand based on micro-level data on home mortgages and corporate loans. Our difference-in-difference analysis indicates that after the bailout, bailed banks approve riskier loans and shift investment portfolios toward riskier securities. However, this shift in risk occurs mostly within the same asset class and, therefore, has little effect on the closely-monitored capitalization levels. Consequently, bailed banks appear safer according to capitalization ratios, but show a significant increase in measures of volatility and default risk.

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\* We gratefully acknowledge the financial support of the Millstein Center for Corporate Governance at Yale University. We also thank the participants at the 2011 Financial Intermediation Research Society (FIRS) annual meeting, the 2011 FDIC Banking Research Conference, the 2011 FinLawMetrics Conference at Bocconi University, and the 2012 IBEFA conference in Chicago, as well as seminar participants at the Board of Governors of the Federal Reserve System, Emory University, Hong Kong University of Science and Technology, Michigan State University, the University of Hong Kong, the University of Illinois at Urbana Champaign, the University of Michigan, and Vanderbilt University.

## 1. Introduction

The financial crisis of 2008-2009 resulted in an unprecedented liquidity shock to financial institutions in the U.S. (Gorton and Metrick, 2011) and abroad (Beltratti and Stulz, 2010). To stabilize the banking system, governments around the world initiated a wave of capital assistance to financial firms. Many economists and regulators argue that this wave altered the perception of government protection of banks (Kashyap, Rajan, and Stein, 2008) and created a precedent that will have a profound effect on the future behavior of financial institutions.<sup>1</sup> At the forefront of this debate is the effect of the bailout on bank risk taking (Flannery 2010), since risk taking, coupled with inadequate regulation (Levine 2010), is often blamed for leading to the crisis in the first place. This debate has broad policy implications, since the relation between government intervention and bank risk taking is at the core of financial system design (Song and Thakor, 2011). This paper studies whether and how the recent bailout affected risk taking in credit origination and investment activities of U.S. financial institutions.

The economic theory offers diverging predictions regarding the effect of government bailouts on bank risk taking. On the one hand, a bailout may be viewed as a signal of implicit government protection of certain financial firms, which raises the probability that a protected bank will be saved again in case of future distress.<sup>2</sup> According to this hypothesis, there is some ex-ante probability that a given bank will be bailed out in case of distress. During a liquidity shock, the bank either receives government protection or is denied government aid. If there is some consistency in the regulator's treatment of banks across time, a bank's approval for government assistance signals an increase in the probability that this bank will be protected again in case of future distress. Conversely, if a bank is denied government aid, the probability that this bank will be bailed out in the future goes down. Under this interpretation, the bailout is expected to encourage risk taking by protected banks by reducing investors' monitoring incentives (Flannery 1998) and increasing moral hazard. For example, Merton (1977) and

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<sup>1</sup> This view is summarized by the former Fed Chairman, Paul Volker, "What all this amounts to is an unintended and unanticipated extension of the official safety net...The obvious danger is that risk taking will be encouraged and efforts at prudential restraint will be resisted." (Testimony before the House Financial Services Committee on October 1, 2009).

<sup>2</sup> This view is expressed by the oversight bodies of the Troubled Asset Relief Program (see, for example, Quarterly Report to Congress of the Inspector General of the Troubled Asset Relief Program, January 30, 2010, p. 6).

more recently Ruckes (2004) theoretically show that the introduction of government guarantees in other contexts, such as deposit insurance, results in higher risk taking.

A contrasting theoretical view argues that bailouts may reduce risk taking by protected banks. In particular, a bailout raises the value of a bank charter by reducing the refinancing costs and increasing the bank's long-term probability of survival. In turn, the higher charter value, which a bank would lose in case of failure, acts as a deterrent to risk taking (Keeley 1990). Importantly, the disciplining effect of the charter value is predicted to be amplified under the conditions similar to those observed during the recent crisis. For example, when the bailout is discretionary and follows an adverse macroeconomic shock, as was the case during the financial crisis, the risk-reducing effect of the charter value is predicted to outweigh moral hazard, resulting in a lower equilibrium level of risk (Goodhart and Huang 1999; Cordella and Yeyati 2003).

A third hypothesis is that a bailout would have little effect on bank risk taking behavior. In particular, it is possible that the influence of moral hazard, investors' monitoring, and charter value would cancel each other out, thus muting any net effect on bank behavior. Similarly, it is possible that government oversight of bailed institutions, coupled with institutional restrictions on their corporate policies, would constrain a significant shift in bank behavior.

Our empirical analysis focuses on the financial crisis of 2008-2009, thus exploiting an economy-wide liquidity shock, which simultaneously affected an unusually large cross-section of firms and resulted in the biggest bailout in corporate history. In particular, we study the effect of the Capital Purchase Program (CPP), which invested \$205 billion in financial institutions. Using a hand-collected dataset on the status of bank applications for federal assistance, we are able to observe both banks' decisions to apply for bailout funds and regulators' decisions to grant assistance to specific institutions. This research setting allows us to control for the selection of bailed firms and to study the risk taking implications of both bailout approvals and bailout denials. Our risk analysis spans three channels of bank operations: (1) retail lending (mortgages), (2) corporate lending (large syndicated loans), and (3) investment activities (financial assets).

Our first set of empirical tests focuses on the retail lending market. Our data allow us to observe bank lending decisions on nearly all mortgage applications submitted in the United States in 2006-2009 and to account

for key loan characteristics, such as borrower income and demographics, loan amount, and property location. This empirical design enables us to address a critical identification issue – to distinguish supply-side changes in bank credit origination from the demand-side changes in the volume and quality of potential borrowers.

In difference-in-difference tests, we do not find a significant change in the volume of credit origination by banks that received federal capital, as compared to banks with similar financial characteristics that were not approved for federal assistance. We also do not detect a significant change in the distribution of borrowers between approved and unapproved banks. Our main finding is that after receiving federal capital, bailed banks shifted their credit origination toward riskier mortgages, as measured by the borrower’s loan-to-income ratio and the high-risk loan indicator based on the loan rate. As a result, the fraction of the riskiest mortgages in the originated credit increased for bailed banks, but declined for their non-bailed counterparts.

Our findings are qualitatively similar for large corporate loans. Our tests focus on the variation in the share of credit originated by CPP participants at the level of each syndicated loan. As with retail loans, we do not find a significant effect of federal investments on credit origination by program participants relative to their unapproved peers with similar financial condition and performance. Instead, in difference-in-difference analysis of banks granted and denied government assistance, we document a robust shift by bailed banks toward originating higher-yield, riskier loans. After receiving federal assistance, banks increase their share of credit issuance to the riskiest corporate borrowers, as measured by their credit ratings and bond yields, and reduce their share of credit issuance to safer firms. Altogether, our findings for both retail and corporate loans suggest that the bailout was associated with a shift in credit rationing rather than the volume of credit, leading to a marked increase in the riskiness of originated credit by government-supported institutions.

We find a similar increase in risk taking by government-supported banks in their investment activities. After receiving federal capital, banks significantly increased their investments in risky securities, such as equities “acquired to profit from short-term price movements”, mortgage-backed securities, and long-term corporate debt. For the average bank approved for federal assistance, the combined weight of these asset classes in the investment portfolio increased by 10.0%, displacing safer assets, such as Treasury bonds, short-term paper, and cash equivalents. The increase in the allocations to riskier assets is highly significant relative to non-recipient banks,

holds after controlling for bank fundamentals, and cannot be explained by the changes in security valuation. Using asset yields as a market measure of risk, our difference-in-difference estimates suggest that the average yield on investment portfolios of bailed banks increased by 9.4% after the bailout relative to non-bailed banks.

Overall, our analysis at the micro-level indicates a robust increase in risk taking in both lending and investment activities by bailed financial institutions, as compared to fundamentally similar banks, which were denied federal assistance. After identifying the sources of the shift in risk taking at the micro-level, we present aggregate evidence on the perceived risk of bailed and non-bailed financial institutions. We find that federal capital infusions significantly improved capitalization levels of recipient banks, with the average capital-to-assets ratio for recipients increasing from 9.9% to 10.9% after federal capital infusions. However, the reduction in leverage was more than offset by an increase in the riskiness of the asset mix of recipient banks. The net effect was a marked increase in the riskiness of bailed financial institutions following federal investments as compared to their non-bailed counterparts with similar financial characteristics. This result holds robustly whether bank risk is measured by accounting-based measures (earnings volatility and ROA volatility), market-based proxies of risk (beta and stock volatility), or the aggregate measure of distance to default (z-score). The overall effect on bank risk is also economically significant. For example, the average beta of bailed banks increased from 0.80 in 2008 to 1.01 in 2009, whereas this figure remained largely unchanged for non-bailed institutions. Similarly, the aggregate risk of bailed banks (measured by distance to default) increased by 23.7% relative to non-bailed banks.

One important consideration in interpreting our results is the selection of CPP recipients. Since the approval of program applicants is not random, it is possible that the Treasury invested in those financial institutions that were more likely to experience a significant future shock as a result of their crisis exposure or other factors. In this case, it is possible that recipient banks would have experienced an even greater increase in risk without government aid.

We address sample selection in several ways. First, we explicitly control for the declared set of financial criteria used by banking regulators for evaluating financial institutions, such as capital adequacy, asset quality, profitability, and liquidity, as well as for the bank's size and exposure to the crisis (proxied by foreclosures and non-performing loans). In addition to parametric estimation, we repeat our tests in matched samples of recipients

and non-recipients based on an array of financial variables and obtain similar results. As another test, we offer evidence from an instrumental variable approach, using banks' political connections as our instrument for government bailout decisions. Our results remain unchanged under the instrumental variable method.

Another issue important for interpreting our results is to what extent the increase in bank risk taking was the initiative of the recipient banks rather than an outcome of government intervention in the credit policies and investment activities of recipient institutions. In this respect, the institutional design of CPP offers a convenient setting, since CPP provided recipient banks with significant flexibility with respect to the deployment of government funds; most important, banks were not required to track or report the use of this capital. Consistent with this view, anecdotal evidence from bank CEOs suggests that many of them viewed capital infusions as cash windfalls (McIntire 2009). Second, to the extent that recipient banks were subject to government regulation as part of CPP, these restrictions were explicitly imposed to reduce rather than increase bank risk taking.<sup>3</sup>

Yet it is still plausible that credit origination toward riskier corporate and retail borrowers may have been part of implicit government mandates or private discussions between recipient banks and their regulators. While this conjecture is inherently difficult to test, we seek to provide evidence in this direction by collecting data on banks that applied for CPP funds, were approved for federal investment, but did not receive funds for various institutional reasons described in the empirical section. We then compare risk taking by this subset of non-recipients relative to the banks that *did* receive the money and were similar in size, financial condition, and performance at the time of CPP approval. If the shift in bank risk taking is associated with the certification of government support in case of distress (i.e. moral hazard), we would expect a similar increase in risk taking for all banks that were approved for CPP funds, regardless of whether or not they eventually received federal funds.

On the other hand, if the risk taking at participating banks is associated with implicit government regulation, the increase in risk taking should be observed only at banks that received government funds rather than at all approved banks. Our evidence supports the former view. We find a similar increase in risk taking across all banks approved for bailout funds, regardless of whether or not they received the money and were

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<sup>3</sup> In particular, the government restricted incentive compensation at recipient banks to prevent excessive risk taking and imposed restrictions on share repurchases and dividend payments to prevent asset substitution.

subject to the subsequent government regulation. This analysis suggests that the increase in bank risk taking was attributable, at least partially, to the moral hazard hypothesis postulated in the theoretical literature and predicted as a response to the bailout in the U.S. (Kashyap, Rajan, and Stein, 2008).

Our article has several implications. First, one of the most significant recent events was a negative revision of the outlook for the long-term U.S. debt by Standard and Poor's, followed by its downgrade in August 2011 for the first time since the beginning of ratings in 1860. Among the reasons for a revised outlook cited by the rating agency were the increased riskiness of U.S. financial institutions and a higher estimated probability of future government assistance to financial firms.<sup>4</sup> Our paper identifies potential sources of the increased risk in the financial system and links them to the initial bailout policy and predictions of academic theory.

Second, earlier studies underscore the importance of bank liquidity for credit origination (Thakor 1996) and economic growth (Levine 2005). Our findings suggest an asymmetric response of financial institutions to liquidity shocks. In particular, while previous research shows that a negative shock to bank liquidity forces a cut in lending (Berger and Bouwman, 2011), we find that a positive shock to bank liquidity need not result in credit expansion, but instead may lead to a shift in credit rationing and an increase in risky investments. Finally, although bank capital requirements are used as a key instrument in bank regulation (Bernanke and Lown, 1991), we show that the strategic response of financial institutions to this mechanism erodes and, in some cases, reverses its efficacy. Specifically, government-supported banks significantly increased their risk within regulated asset classes, while, at the same time, improving their capital ratios.

The rest of the paper is organized as follows. Section 2 reviews related literature. Section 3 describes the data and presents summary statistics. Section 4 discusses the empirical design. Section 5 studies retail and corporate lending. Section 6 investigates banks' investment strategies and overall risk levels. The article concludes with summary and commentary.

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<sup>4</sup> Standard and Poor's Sovereign Credit Rating Report, "United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised To Negative", April 18, 2011, p. 4.



## 2. Related Literature

One of the most prominent features of the past decade has been an increased role of government regulation. During the financial crisis of 2008-2009, this regulation reached unprecedented scale, which was formerly seen as hardly plausible in developed economies – effective nationalization of some of the largest corporations and government assistance to more than 700 financial institutions. Since a bailout provides perhaps the cleanest, most far-reaching case of government intervention and has major policy implications, this topic has played a key role in the theoretical literature on financial regulation and financial system design.

A central issue in the models of government assistance to the private sector has been the effect of such a policy on firms' risk taking behavior. On the one hand, a number of studies show analytically that the downside protection from the government encourages risk taking by inducing moral hazard (e.g., Mailath and Mester, 1994, among many others). Yet other studies demonstrate that moral hazard can be more than offset by the disciplining effect of a bank's charter value, ultimately resulting in a lower level of risk (Goodhart and Huang 1999; Cordella and Yeyati 2003). The distinction between these views is critical for the optimal design of the government safety net, a topic recently examined in the theoretical frameworks of Gorton and Huang (2004) and Diamond and Rajan (2005, 2011). In addition, the effect of the bailout policy on risk taking is also highly relevant from the perspective of the newly-adopted financial regulation, such as the Dodd-Frank Act of 2010 and Basel III, which aims to promote financial stability and constrain risk taking by financial intuitions.

Despite the important role of this topic in the theoretical frameworks of government intervention and in policy research, the empirical evidence on bailouts has been constrained by the scarcity of such events in the Western world. As a result, previous research has mainly examined other forms of government guarantees, such as deposit insurance. The findings in this literature are mixed. Hovakimian and Kane (2000) report evidence of higher risk taking by banks in the presence of deposit insurance, while Gropp and Vesala (2004) find that explicit deposit insurance is associated with lower risk taking. In a cross-country study, Laeven and Levine (2009) find mixed evidence on the relation between government guarantees and bank risk taking and attribute the effect to the heterogeneity in banks' governance structures. Several papers use other proxies for government guarantees, such as bank size or share of government ownership, under the assumption that larger banks or banks with greater

government interest are more likely to receive federal assistance in case of distress. These studies also report mixed results. For example, De Nicolo (2001) documents a positive association between the share of government-owned banks and insolvency risk, but Barth, Caprio, and Levine (2004) find no significant relation between government ownership and bank fragility.

In contrast to studies based on indirect proxies for the likely government protection, such as bank size or ownership structure, our paper seeks to provide direct evidence on the consequences of explicit approvals and denials of government assistance to financial firms applying for federal aid. Also, our data enable us to directly observe the changes in the volume and quality of credit demand, thus distinguishing the active changes in banks' liquidity creation and risk taking after the bailout from the changes in economic conditions. Finally, our empirical setting enables us to study an unusually large cross section of firms subject to a simultaneous, unexpected liquidity shock in the world's largest and most developed financial market. This research design helps overcome the identification issues that confound empirical inference in cross-country studies, where country-level government protection is compared across nations with different legal, regulatory, and governance systems.

Our paper also contributes to the growing literature on government regulation during the recent financial crisis. Levine (2010) argues that the crisis reflected a systemic failure of government regulation. Harvey (2008) critiques the government's response to the crisis, and Diamond and Rajan (2011) evaluate various alternatives to the bailout. Veronesi and Zingales (2010) calculate the costs and benefits of government capital infusions in the largest banks and show that recipient banks received significant government subsidies. Duchin and Sosyura (forthcoming) document the role of banks' political connections in the distribution of federal capital. Li (2011) investigates the determinants of government assistance decisions and their effect on credit. Adams (2011) examines governance characteristics of banks that received government support and finds that bailed banks have weaker governance than their non-bailed peers. We refrain from the assessment of bailout alternatives or the evaluation of program governance and performance; rather, we use this research setting to study the effect of government intervention on bank risk taking.

### 3. Data and Summary Statistics

#### 3.1. Capital Purchase Program

On October 3, 2008, the Emergency Economic Stabilization Act (EESA) was signed into law. The act authorized the Troubled Asset Relief Program (TARP) – a system of federal initiatives aimed at stabilizing the U.S. financial system. On October 14, 2008, the government announced the Capital Purchase Program (CPP), which authorized the Treasury to invest up to \$250 billion in financial institutions. Initiated in October 2008 and terminated in December 2009, CPP invested \$204.9 billion in 707 financial institutions, becoming the first and largest of the 13 TARP programs.

To apply for CPP funds, a qualifying financial institution (QFI) – domestic banks, bank holding companies, savings associations, and savings and loan holding companies – submitted a short two-page application (by the deadline of November 14, 2008) to its primary federal banking regulator – the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), or the Office of Thrift Supervision (OTS). Applications of bank holding companies were submitted both to the regulator overseeing the largest bank of the holding company and to the Federal Reserve, thus granting the Fed an important role in the initial review.<sup>5</sup> If the initial review by the banking regulator was successful, the application was forwarded to the Treasury, which made the final decision on the investment.

The review of CPP applicants was based on the standard assessment system used by bank regulators – the Camels rating system, which evaluates 6 dimensions of a financial institution: *Capital adequacy*, *Asset quality*, *Management*, *Earnings*, *Liquidity*, and *Sensitivity to market risk*. The ratings in each category, which range from 1 (best) to 5 (worst), were assigned based on financial ratios and onsite examinations. In Appendix A, we provide a description of our proxies for the 6 assessment categories, along with the definitions of other variables used in our study. We use the Camels evaluation criteria as part of our controls for the selection of CPP participants.

In exchange for CPP capital, banks provided the Treasury with cumulative perpetual preferred stock, which pays quarterly dividends at an annual yield of 5 percent for the first five years and 9 percent thereafter. The

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<sup>5</sup> Adams (2010) provides a detailed discussion of bank holding companies' involvement in the decisions and governance of the Federal Reserve.

amount of the investment in preferred shares was determined by the Treasury, subject to the minimum threshold of 1 percent of firms' risk-weighted assets (RWA) and a maximum threshold of 3 percent of RWA or \$25 billion, whichever was smaller. In addition to the preferred stock, the Treasury obtained warrants for the common stock of public firms. The warrants, valid for ten years, were issued for such number of common shares that the aggregate market value of the covered common shares was equal to 15 percent of the investment in the preferred stock.

### *3.2. Sample Firms*

To construct our sample of firms, we begin with a list of all public domestically-controlled financial institutions that were eligible for CPP participation and were active as of September 30, 2008, the quarter immediately preceding the administration of CPP. This initial list includes 600 public financial institutions. We focus on public firms because the regulatory filings of public firms allow us to identify whether or not a particular firm applied for CPP funds. Public financial institutions account for the overwhelming majority (92.7 percent) of all capital invested under CPP. In particular, the 295 public recipients of CPP funds obtained \$190.1 billion under CPP, according to the data from the Treasury's Office of Financial Stability.

To identify CPP applicants and to determine the status of each application, we read quarterly filings, annual reports, and proxy statements of all CPP-eligible public financial institutions, starting at the beginning of the fourth quarter of 2008 and ending at the end of the fourth quarter of 2009. We also supplement these sources with a search of each firm's press releases for any mentioning of CPP or TARP and, in cases of missing data, we call the firm's investment relations department for verification. Using this procedure, we are able to ascertain the application status of 538 of the 600 public firms eligible for CPP (89.7 percent of all eligible public firms).

From the set of 538 firms with available data, we exclude the first wave of CPP recipients, namely the nine largest program participants announced at program initiation on October 14, 2008, thus arriving at our final sample of 529 firms. The excluded firms comprise Citigroup, JP Morgan, Bank of America, Goldman Sachs, Morgan Stanley, State Street, Bank of New York Mellon, Merrill Lynch, and Wells Fargo (including Wachovia). It has been argued that these firms constitute "too-big-to-fail" institutions. Under this argument, the approval for CPP was likely to have a less significant effect on the perceived government protection of the firms that were

already viewed as systemically important. Additionally, there is anecdotal evidence that these firms were asked to participate in CPP by the regulators to provide a signal to the market at the launch of the program.<sup>6</sup> We follow a conservative approach and exclude these firms from our sample. Our results are not sensitive to this sample restriction and remain the same if we retain these nine firms.

Of the 529 firms in our final sample, 424 firms (80.2 percent) submitted CPP applications, and the remaining 105 firms explicitly stated their decision not to apply for CPP funds. Among the 424 submitted applications, 337 applications (79.5 percent) were approved for funding. Finally, among the firms approved for funding, 286 (84.9 percent) accepted the investment, while 51 firms (15.1 percent) declined the funds. Figure 1 illustrates the partitioning of eligible firms into each of these subgroups.

Financial data on QFIs come from the quarterly Reports of Condition and Income, commonly known as call reports, which are filed by all active FDIC-insured institutions. Our sample period starts in the first quarter of 2006 and ends in the fourth quarter of 2010, the latest quarter with available call reports at the time of the analysis. Panel A of Table I provides sample-wide summary statistics for Camels variables and other characteristics for the QFIs included in our sample.

The average (median) QFI has book assets of \$2.2 billion (\$147.6 million). The Camels variable Capital Adequacy, which reflects a bank's Tier 1 risk-based capital ratio, shows that the vast majority of banks are well capitalized. For example, the 50<sup>th</sup> percentile of the Tier 1 ratio in our sample is 10.7 percent, nearly double the threshold of 6 percent stipulated by the FDIC's definition of a well-capitalized institution. The variable Asset Quality captures loan defaults and shows the inverse of the ratio of net losses on loans to the average amount of outstanding loans and leases. The variable Earnings, measured as the return on assets (ROA), shows that the average (median) bank in our sample has a quarterly ROA of 0.19 (0.55) percent, consistent with the typical profitability indicators of banking institutions characterized by a large asset base. To proxy for a firm's exposure to the financial crisis, we use the ratio of foreclosed assets to the total value of loans and leases. This ratio for the average (median) bank in our sample was 0.39 (0.15) percent.

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<sup>6</sup> Solomon, Deborah and David Enrich, "Devil Is in Bailout's Details", *The Wall Street Journal*, October 15, 2008.

### 3.3. Loan Data

We obtain loan application data from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry. This dataset covers approximately 90 percent of mortgage lending in the U.S. (Dell’Ariccia, Igan, and Laeven, 2009), with the exception of mortgage applications submitted to the smallest banks (assets under \$37 million) located in rural areas.<sup>7</sup> The unique feature of these data is the coverage of both approved and denied mortgages, which enables us to study bank lending decisions at the level of each application. This attribute is important for our empirical tests, since it will allow us to distinguish the changes in credit origination driven by loan demand (the number of applications and their quality) from those driven by credit rationing of financial institutions.

At the level of each application, we are able to observe the characteristics of the borrower (e.g., income, gender, and race), the features of the loan (e.g., loan amount, loan type, and property location), and the decision of the bank on the loan application (e.g., loan originated, application denied, application withdrawn, etc.). While banks are not required to disclose applicants’ credit scores or to provide the interest rate for every mortgage, they must report the interest rate spread on loans with an APR of at least 300 (500) basis points above the Treasury of comparable maturity for first-lien (subordinate-lien) loans.<sup>8</sup> Previous research has shown that the rate spread indicator in HMDA data serves as a close proxy for subprime mortgages.<sup>9</sup> The borrower and loan characteristics enable us to study the changes in banks’ credit rationing across riskier and safer loans. Finally, the HMDA data provide the location of the property underlying each mortgage application. This location is reported by the U.S. census tract (median population of 4,066 residents), an area “designed to be homogeneous with respect to population characteristics, economic status, and living conditions”.<sup>10</sup> This level of data granularity allows us to

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<sup>7</sup> According to the Home Mortgage Disclosure Act of 1975, most depository institutions must disclose data on applications for home mortgage loans, home improvement loans, and loan refinancing. A depository institution is required to report if it has any office or branch located in any metropolitan statistical area (MSAs) and meets the minimum threshold of asset size. For the year 2008, this reporting threshold was established at \$37 million.

<sup>8</sup> For loan applications received on or after October 1, 2009 banks are now required to report the actual rate spread between the APR and the Average Prime Offer Rate if it is at least 150 basis points for first liens or 350 basis points for subordinate liens.

<sup>9</sup> Dell’Ariccia, Igan, and Laeven (2009) show that the classification of subprime loans based on the credit rate spread ensures a correlation of approximately 80% with the classification derived from the list of subprime lenders developed by the U.S. Department of Housing and Urban Development (HUD).

<sup>10</sup> Tract definition from the U.S. Census Bureau, Geographic Areas Reference Manual, p. 10-1. <http://www.census.gov/geo/www/GARM/Ch10GARM.pdf>

focus on the differences in lending decisions by different banks within the same small region, while controlling for the conditions specific to the local housing market.

To construct our sample of mortgage applications, we aggregate financial institutions in HMDA at the level of the bank holding company and match them to our list of QFIs. Among the 529 QFIs in our sample, 508 institutions (which account for 97% of bank assets) reported their mortgage activity under HMDA in 2006-2009. Next, we limit our analysis to applications that were either denied or approved, thus excluding observations with ambiguous statuses, such as incomplete files and withdrawn applications. Since the focus of our analysis is on credit origination, we restrict our sample to new loans rather than refinancing and purchases of existing loans. We also exclude loans that were sold in the same calendar year they were originated because these loans have a comparatively smaller effect on the risk of the originating QFI. Finally, we drop observations with missing data.

Panel B of Table I provides summary statistics for our sample of mortgage applications. Approximately 62.2% of applications are approved, and the average amount of the loan is \$166,000. The data show significant variation in the loan-to-income ratio, a measure commonly used in the mortgage industry as an indicator of loan risk.<sup>11</sup> This ratio in our sample ranges from 0.75 in the 25<sup>th</sup> percentile to 2.7 in the 75<sup>th</sup> percentile. About 9.7 percent of mortgages have an APR spread over Treasuries of at least 300 basis points, indicating high-risk loans.

To control for temporal dynamics in loan demand within each housing market, we also collect data on macroeconomic variables that influence the demand for mortgages. For each census tract, we obtain data on the dynamics of home vacancies and the number of housing units from the U.S. Postal Service. To control for the changes in the demographic drivers of housing demand, we collect county-level data on per capita income, population, and unemployment from the Bureau of Economic Analysis. We supplement these data with the quarterly index of home prices by Metropolitan Statistical Area (MSA) from the Federal Housing Finance Agency.

In addition to the analysis of retail lending, we also collect data on corporate credit facilities from DealScan. This dataset covers large corporate loans, the vast majority of which are syndicated, i.e. originated by

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<sup>11</sup> For example, the loan-to-income ratio is used by regulators in the assessment of mortgage risk in determining its eligibility for federal loan modification programs, such as the Federal Home Affordable Modification Program (HAMP).

one or several banks in a syndicate. DealScan reports loans at origination, allowing us to focus on the issuance of new corporate credit and to avoid contamination from the drawdowns of previously-made financial commitments. Each unit of observation is a newly-issued credit facility, which provides such information as the originating bank(s), date of origination, loan amount, interest rate, and the corporate borrower.

According to DealScan, between 2006 and 2009, 179 QFIs in our sample originated \$3.5 trillion in corporate credit. The average (median) loan amount during our sample period is \$582 (\$300) million. Borrowers of these credit facilities are typically large firms. As shown in Panel B of Table I, over our sample period, the average fraction of CPP recipients in the total number of lenders per loan is 67.3 percent. The breakdown of the newly-issued credit between CPP recipients and nonrecipients at the loan level allows us to control for the changes in investment opportunities of industrial firms. As a result, this data feature enables us to identify the effect of CPP, if any, on industrial firms' access to credit, as proxied by the share of loans originated by CPP recipients in the firm's funding mix.

#### **4. Empirical Methodology**

The objective of our empirical design is to identify the treatment effect of CPP capital infusions on the risk taking behavior in the financial sector. To isolate this effect, we would like to control for several issues that may confound empirical inference: (1) selection of CPP recipients; (2) changes in economic conditions; (3) changes in the distribution of credit demand between bailed and non-bailed banks. In this section, we discuss each of the potential issues and describe our empirical approach to addressing them.

##### *4.1. Selection*

Since the selection of CPP recipients is not random, we would like to control for the possibility that approved banks were selected on attributes correlated with subsequent risk. For example, if government assistance was provided to better-capitalized or more profitable banks, which were more likely to survive the crisis (according to the declared objective to assist healthier banks), these banks may have been better positioned to increase their risk



after receiving federal capital. Under such a scenario, the subsequent increase in risk taking by bailed banks could be explained by the selection of CPP recipients rather than by government intervention.

Several features of our data enable us to account for the selection of recipient firms. A typical issue in most studies on various forms of government regulation is that the researcher can observe only the set of firms selected for government intervention, thus making it difficult to distinguish those that were denied government assistance (negative treatment effect) from those that did not request it (outside the selection group). In contrast, our data enable us to identify both applicants and non-applicants for government funds, to observe the selection of approved and denied firms, and to document the subsequent effect of both positive and negative treatment. Second, the set of criteria used by the government in its various forms of financial intervention in the private sector is typically unknown to the researcher. In contrast, our research design focuses on a systematic and structured government assistance program with a unified decision framework, a homogenous set of eligible firms, and a known set of declared selection criteria.

To account for the selection of CPP recipients, we explicitly control for the Camels measures of financial condition and performance, bank size, and crisis exposure in our tests. Furthermore, to accommodate various functional forms of the relation between the Camels measures and the approval for government funds, we repeat all of our tests in subsamples matched on these variables. Specifically, we construct a subsample of CPP recipients matched on their approval propensity to other CPP applicants that were not approved for government funds. Since our sample consists of 337 firms that were approved for CPP and 87 firms that were not approved, we start with the sample of 87 unapproved firms, and match each of them to the approved firm with the closest approval propensity score.

The propensity scores are estimated from a probit regression of the approval decision on a host of bank-level variables, which include capital adequacy, asset quality, management quality, earnings, liquidity, sensitivity to market risk, foreclosures, and size. This procedure results in a matched sample of 174 firms, whose summary statistics are shown in Panel C of Table I. The two groups of matched firms are statistically indistinguishable at conventional significance levels on each of the Camels measures, crisis exposure (foreclosures), and size.

In addition to the declared decision criteria, it is possible that the regulators used other, perhaps less tangible or unobservable criteria in the selection of recipient firms. To control for these characteristics in the selection of recipient firms, our robustness tests include specifications with bank fixed effects, which capture all time-invariant observable and unobservable bank-level characteristics. Finally, as an additional robustness test, we also present evidence from an instrumental variable approach, using banks' political connections as an instrument for the selection of recipient firms. Our conclusions are very similar across the specifications with matched samples, fixed effects, and the instrumental variable.

#### *4.2. Economic Conditions*

The financial crisis was characterized by a rapid change in economic conditions and a significant variation in them across various parts of the United States. In this environment, a change in bank's risk may be induced by the worsening macroeconomic conditions in the regions where a bank has significant exposure.

To account for the dynamics in the economy-wide conditions, we adopt the difference-in-difference methodology as our main specification, thus controlling for the shocks common to the entire financial sector. To capture the heterogeneity in economic conditions at the regional level, we construct specifications with regional fixed effects, where each region is defined at the level of one U.S. Census Tract. This analysis compares credit rationing by approved and unapproved CPP applicants on loan applications submitted within the same census tract, thus controlling for the differential effect of the crisis at a highly refined unit of geographic analysis. Finally, we also account for the time-variant changes in economic conditions at the regional level by controlling for such variables as the home vacancy rate, per capita income, and regional housing price index.

#### *4.3. Demand for Credit*

It is possible that federal capital infusions were associated with changes in the distribution of credit demand and the quality of borrowers between approved and unapproved CPP applicants. Under one scenario, banks may have been approved for federal funds because of the expected increase in credit demand in their markets. Under another

scenario, federal capital infusions may have changed borrowers' perception of credit availability across banks, leading them to apply for credit at banks that received additional capital from the government.

As discussed earlier, our empirical tests distinguish supply-side changes in bank credit origination from the demand-side changes in the volume and quality of potential borrowers. At the retail level, we observe the incoming mortgage applications and study banks' credit rationing across borrowers of various levels of risk. We also explicitly test for systematic differences in the volume of credit demand across recipient and nonrecipient banks. At the corporate level, we use the share of credit originated by CPP recipients via credit facilities issued to corporate borrowers of various risk.

## **5. Lending**

### *5.1. Retail Lending*

In this subsection, we study the effect of CPP on credit rationing across mortgage borrowers with different risk characteristics. We use two proxies for borrower risk in home mortgages. The first proxy is the loan-to-income ratio. The second proxy is the interest rate spread on loans with an APR of at least 300 (500) basis points above the Treasury of comparable maturity for first-lien (subordinate-lien) loans.

We begin by presenting univariate evidence on the changes in the approval rates for home mortgages between CPP recipients and non-recipients before and after government capital assistance. Since our data on mortgage applications are provided by calendar year, we define the period before CPP as 2006-2008 and the period after CPP as 2009. While each CPP recipient received its federal investment on a different date, nearly all investments in our sample (89.9% by capital amount) were announced in October-December 2008. Therefore, for simplicity and standardization, we define the period beginning in January 2009 as the period "After CPP". Our results are not sensitive to this definition and remain qualitatively unchanged if we use just the year 2008 as the before period and the year 2009 as the after period. As another check for the validity of the data-imposed cutoffs at the end of the calendar year, we repeat the analysis after excluding banks that received CPP capital in the late 2008 or after the first two months of 2009, and obtain similar results.

We divide our sample of mortgage applications into equal quintiles based on the loan-to-income ratio of the borrower. The ranking of quintiles is such that quintile 1 represents safer borrowers (lower loan-to-income ratio), and quintile 5 corresponds to riskier applicants. To illustrate, the average loan-to-income ratio for quintile 1 is 0.40, which would be observed, for example, for a borrower with an annual income of \$200,000 taking on a mortgage of \$80,000. In contrast, the average loan-to-income ratio for quintile 5 is 4.3, corresponding to an applicant with an income of \$22,000 wishing to borrow \$94,600.

Table II presents the results of univariate difference-in-difference comparisons in mortgage loan approval rates across the five loan-to-income quintiles. The results indicate that recipient banks tightened their approval rates for the safer borrowers after CPP and increased the approval rates for the riskier borrowers. For example, the approval rates for recipients dropped from 74.1% to 63.3% in quintile 1, but increased from 48.4% to 53.0% in quintile 5. A similar trend emerges after controlling for the change in approval rates of non-recipients. This is evident from the difference-in-difference estimates reported in the last column. Compared to non-recipients (i.e. banks that applied for CPP but were denied government funds), recipient firms cut their approval rates by 15.1% in quintile 1, compared to an increase of 2.5% in quintile 5 after CPP. These estimates are all significantly different from zero at the 1 percent level.

The reported univariate results suggest that after CPP capital infusions, program participants tilted their credit origination toward higher-risk loans by tightening credit standards for the relatively safer borrowers and slightly loosening them for riskier borrowers. This pattern would be consistent with a strategy aimed at originating high-yield assets, while improving bank capitalization ratios, since the key capitalization ratios do not distinguish between prime and subprime mortgages.<sup>12</sup> Note that in 2009, our “After CPP period”, interest rates on prime mortgages were at their historic lows, thus offering a relatively low return on the bank capital. For example, the average interest rate on a fixed-rate 30-year prime mortgage in 2009 was 5.03%, nearly identical to the 5%

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<sup>12</sup> For example, consider a closely monitored capitalization ratio, Tier-1 risk-based capital, which is commonly used as a measure of bank capital adequacy. The ratio is computed by dividing bank’s capital by the risk-weighted bank assets (all assets are divided into risk classes, with safer assets assigned lower weights). The intuition is that banks holding riskier assets require a greater amount of capital to remain well capitalized. According to regulatory requirements, all mortgages are assigned the same weight of 0.5. Under this methodology, a prime and a subprime mortgage of equal notional amounts would have the same effect on the ratio, despite the significant difference in the perceived risk of the borrower.

dividend yield that banks were paying on the capital provided by CPP.<sup>13</sup> Overall, one explanation for the observed evidence is that banks tightened credit origination for the low-yield mortgages to improve their capital position, while, at the same time, taking on more risk in the subprime market to increase the yield on their assets.

After providing suggestive evidence, we proceed with more formal tests of the effect of federal capital assistance on bank credit rationing and report our results in Table III. The unit of observation in our analysis is a mortgage application submitted to a QFI during our sample period of 2006-2009. The dependent variable in these tests is an indicator equal to 1 if the mortgage application is approved and 0 otherwise. The main independent variable of interest is the interaction term of the dummy *After CPP* (which takes on the value of 1 in 2009 and 0 otherwise) and the dummy *CPP Recipient* (which takes on the value of 1 for approved CPP applicants and 0 for unapproved applicants). The coefficient on this variable captures the effect of federal assistance, if any, on loan approval rates of participating banks. We estimate the regressions separately in each loan-to-income quintile.

To capture the effect of CPP capital assistance, we would like to control for those bank characteristics that are correlated with CPP investments and may also influence a bank's credit origination. Therefore, our set of independent variables includes controls for the following bank characteristics: size (the natural logarithm of book assets), the Camels measures of banks' financial condition and performance used by banking regulators, and a proxy for bank's exposure to the crisis (foreclosures).

Since our focus is on the bank lending decisions, we would also like to control for the variation in the quality of mortgage applications received by each bank. First, we include housing market fixed effects to compare lending decisions within the same census tract. While the small size of the so-defined housing market should reduce borrower heterogeneity, it is possible that some banks attract stronger or weaker applicants within each market. Therefore, as a second control, we include borrower-level characteristics that affect loan approval, such as loan-to-income ratio as well as the fixed effects for borrower gender, race, and ethnicity. To control for time-variant determinants of loan demand, we also include changes in the demographics of the local housing market:

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<sup>13</sup> Data on mortgage rates are from the Federal Home Loan Mortgage Corporation's (Freddie Mac) Weekly Primary Mortgage Market Survey (PMMS). The annual rate reflects a national average and is derived by averaging the weekly rates reported in PMMS in 2009.

index of the regional housing prices, home vacancy rates, population size, median income, and fraction of minority population. For brevity, we do not report the regression coefficients on these controls.

In Panel A, we present the results for our full sample of approved and unapproved CPP applicants. In Panel B, we provide evidence from the matched samples of approved and unapproved CPP applicants, constructed as discussed in the previous section.

The empirical results, summarized in Table III, show a significant decline (increase) in loan approval rates of participating banks for safer (riskier) borrowers relative to nonparticipating banks. These results hold both in the full sample and in the matched sample and are statistically significant at the 1 percent level. In particular, the coefficient on the interaction term *After CPP x CPP Recipient* is negative and statistically significant at the 1 percent level in the lowest loan-to-income quintile in both Panels A and B. Conversely, it is positive and statistically significant at the 1 percent level for borrowers in the two highest loan-to-income quintiles across both Panels. This evidence suggests that compared to nonrecipients, CPP recipients tightened approval rates for the safest borrowers and increased approval rates for the riskiest borrowers, consistent with the univariate evidence reported earlier.

We do not detect a significant effect of CPP on the overall volume of credit origination by participating banks. The left-hand side column in both Panels of Table III reports the regression estimates for all mortgage applications in our sample. In both panels, the coefficient on the interaction term *After CPP x CPP Recipient* is insignificant, indicating that CPP capital infusions did not have a material effect on the overall loan approval rates across all categories of borrowers.

The last column in both Panels of Table III corresponds to an alternative measure of borrower risk, the subprime mortgage rate spread. Here, however, the analysis is restricted to approved mortgage applications, since the spread is not reported for unapproved applications. To identify differences in borrower risk, we compare between the fraction of CPP recipients in the total originations of risky loans (defined as loans with an interest rate spread of at least 300 (500) basis points above the Treasury) before and after CPP. Thus, the dependent variable in these regressions is the CPP recipient indicator. In both panels, the coefficient on the *After CPP*

dummy is positive and statistically significant at the 1 percent level, suggesting that the fraction of CPP recipients in the origination of risky loans has increased after CPP.

## 5.2. Robustness

Our analysis so far has controlled for observable characteristics of bank condition and performance. In Panel A of Table IV, we reestimate our base specification of mortgage application approvals after adding bank fixed effects, which capture all time-invariant bank characteristics. We find similar results. In particular, the coefficient on the interaction term *After CPP x CPP Recipient* is negative and statistically significant at the 5 percent level in the lowest loan-to-income quintile. Conversely, it is positive and statistically significant at the 1 percent level for borrowers in the highest loan-to-income quintile. These estimates suggest that compared to nonrecipients, CPP recipients cut approval rates for the safest borrowers and increased approval rates the riskiest borrowers.

Another possible concern is that our results are driven by FDIC-facilitated acquisitions. This could be the case, for example, if CPP recipients were asked by the FDIC to acquire distressed institutions, whose lending practices were riskier compared to the average bank. In that case, our findings that CPP recipients increased lending to riskier borrowers may simply reflect the acquisition of riskier lenders. To control for this possibility, we collect data on the FDIC-facilitated acquisitions in 2006-2009 by our sample firms from the FDIC online directory, and exclude the 63 institutions that took part in such transactions from our sample. Panel B of Table IV reports the results of our tests reestimated in this subsample. Our results remain unchanged, indicating that our evidence cannot be explained by regulator-facilitated deals.

We also consider the possibility that the tilt of CPP banks toward riskier, higher-yield mortgages in loan origination after government capital infusions is related to an implicit government mandate or regulators' intervention in bank operations. To evaluate the hypothesis of government intervention into bank credit rationing, we collect data on financial institutions that were approved for CPP funds but did not receive federal investments. To identify these banks, we search QFIs' press releases, proxy statements, financial reports (8K and 10Q), and news announcements in Factiva for any mentionings of CPP. We identify 51 banks that were approved for CPP funds but did not receive the actual capital investment. We then read these press releases and news articles to

understand the reasons for the bank's decision to decline CPP funds. Among the common reasons, banks mentioned additional restrictions placed on participating institutions, the stigma associated with CPP participation, and the value of losing tax benefits on executive compensation.

Panel C of Table IV compares between the mortgage approval rates of firms that were approved for CPP and received government funds and firms that were approved for CPP but did not receive government assistance. As in previous specifications, the coefficient of interest is the interaction term *After CPP x CPP Recipient*, which captures the marginal effect of CPP on the change in loan approval rates between approved firms that received government funds and approved firms that did not receive capital. To the extent that our results are capturing an implicit government requirement to increase lending to riskier borrowers, the coefficient on the interaction term should be positive for the riskier borrower quintiles. The results in Panel C, however, suggest that there is no significant difference between approved firms that received government capital and approved firms that did not receive government capital. Therefore, our results are unlikely to be driven by the regulator involvement rather than the approval for government funds. This interpretation would be consistent with the increase in moral hazard in response to the certification of government support in case of distress.

In Panel D of Table IV, we estimate a selection model based on the Instrumental Variable (IV) approach, where banks' political connectedness serves as an instrument for CPP approval. Duchin and Sosyura (forthcoming) show that banks' political connections influenced the distribution of CPP capital (instrument inclusion restriction). In particular, banks headquartered in the election districts of Congress representatives that served on the House Financial Services Committee, banks connected to Treasury, Congress, and banking regulators via boards of directors, banks that lobbied Treasury, Congress and banking regulators on the issues of banking, finance, or bankruptcy in 2008-2009, and banks that made political campaign contributions to the House Financial Services Committee in the 2008 election cycle were more likely to receive CPP funds. Following Duchin and Sosyura (forthcoming), we construct an index of political connectedness by calculating the firm's percentile ranking in our sample on each of the four measures of political influence and then finding the mean of these rankings to derive an aggregate political connections index, normalized to lie between 0 and 1.



For our purposes, an important observation is that political connectedness has been shown to affect CPP approval, but a priori, it is unlikely to directly affect loan approval rates and investment portfolios of banks. Under this premise, political connectedness is a plausible instrument for CPP approval. Our IV estimations are performed in two stages. In the first stage, CPP approval is regressed on the excluded instrument (political connections index) and a set of independent bank-level control variables included in the second stage regressions. The predicted approval propensity from the first stage is then used in the second-stage regressions. In the first-stage regression, the political connectedness variable is found to have a positive and statistically significant effect on CPP approval. Accordingly, the likelihood ratio in the first stage model is highly significant (p-values lower than 0.001), confirming the strength of the instrument.<sup>14</sup> To complement the likelihood ratio test, we also consider Shea's (1997) partial R-square from the first-stage regressions. The R-square exceeds the suggested (rule of thumb) hurdle of 10%, with an average value of 13.9%. These statistics suggest that our instrument is relevant in explaining the variation of our model's potentially endogenous regressors.

Panel D of Table IV shows that our results remain very similar under the IV approach, and all the qualitative conclusions hold under this selection model.

### *5.3. Credit Demand*

In our analysis so far, we have controlled for credit demand to capture the supply-side effect of bank credit rationing. In this section, we provide direct evidence on the effect of government assistance on the distribution of borrowers across credit institutions. We test this effect within the same framework as in our previous tests, except now the dependent variable is one of the proxies for loan demand from retail borrowers of different risk categories. As before, we control for bank-level measures of financial condition and performance (Camels), bank size, and foreclosures.

Panel A of Table V reports the regression results for the number of loans requested by borrowers each year. Specifically, the dependent variable (and the unit of analysis) is the natural logarithm of the total number of applications received by a bank from each loan-to-income quintile each year. This design reduces our sample size

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<sup>14</sup> Formally, this is the Chi-Square test of the significance of the instrument, which is similar to the F-test in the OLS regression.

compared to Tables III and IV. The regression results indicate that there are no significant differences in the demand for loans between approved and unapproved banks. The coefficient on the interaction term *After CPP x CPP Recipient* is never statistically significant, suggesting that CPP approval did not have a significant effect on the volume of credit demand across the different risk categories.

Panel B of Table V examines whether CPP had an effect on the loan amounts requested by the borrowers. The dependent variable is the natural logarithm of the total dollar amount of loan applications received by a bank from each loan-to-income quintile each year. The regression results indicate that, as in Panel A, there are no significant differences between approved and unapproved banks. The coefficient on the interaction term *After CPP x CPP Recipient* is not statistically significant (except for quintile 2 where it is significant at the 10 percent level), suggesting that CPP approval did not have a material effect on the amount of credit demanded across the different risk categories.

Overall, the results indicate that CPP capital infusions did not have a material effect on the distribution of credit demand across financial institutions. These findings suggest that the decrease in approval rates for safer borrowers and the increase in approval rates for riskier borrowers, observed for CPP recipients compared to nonrecipients, are likely driven by credit rationing (or the supply of credit) rather than changes in the demand for loans.

#### *5.4. Corporate Lending*

So far, our analysis has concentrated on retail lending. We proceed by studying the effect of CPP on the origination of corporate credit. To study the effect of CPP on the supply of credit, our tests focus on the variation in the share of credit originated by CPP recipients at the loan level. Specifically, the dependent variable in the regressions is the number of lenders that were approved for CPP divided by the total number of lenders per syndicated loan. We use the number of CPP recipients rather than their dollar share in the overall loan amount because this information is missing from Dealscan in the vast majority of the cases. The unit of observation is a loan facility.

We regress the fraction of CPP recipients per syndicated loan on the *After CPP* dummy, a measure of the borrowing firm's credit risk, and the interaction term *After CPP x Borrower risk*. The main independent variable of interest is the interaction term. It captures the marginal impact of CPP capital infusions on the fraction of loans extended to riskier borrowers by approved banks relative to unapproved banks. We use two measures of borrower credit risk. The first measure is *bond yield*, calculated as the average spread between the yield on the firm's outstanding bond issues and the yield on Treasuries with the closest maturity over the month preceding the loan. The data on bond yields are gathered from TRACE. The second measure of risk is the firm's credit rating, calculated as the average credit rating of a company's bond issues in the year preceding the loan. We collect credit ratings data from Mergent's FISD ratings dataset. The regressions include borrower fixed effects to control for time-invariant borrower characteristics that may affect the demand for loans.

Table VI summarizes these results. We first consider the evidence on *bond yields*. The interaction term *After CPP x Bond yields* is positive and statistically significant at the 1 percent level across all specifications. These findings indicate that the fraction of CPP recipients in loans to riskier borrowers (with higher bond yields) has increased after CPP compared to nonrecipients. The effects are also economically significant. For instance, based on the *Full sample* model, an increase of one standard deviation in bond yields corresponds to an increase of 8.9% in the fraction of CPP recipients for the average loan. The results are similar for credit ratings, albeit statistically insignificant without controlling for the selection of CPP recipients. Specifically, the interaction term *After CPP x Credit ratings* is negative across all specifications and statistically significant at the 1 percent level in the *Matched sample* model. These estimates imply that the fraction of CPP recipients in loans to borrowers with lower credit ratings has increased after CPP compared to nonrecipients.

In summary, the evidence in this subsection suggests that CPP capital investments had a significant effect on the risk profile of corporate lending. These results echo the impact of CPP investments on mortgage approval rates of riskier borrowers. These findings are consistent across various measures of credit risk and are robust to controlling for loan demand. Taken together, our retail and corporate lending results indicate that within lending categories, CPP recipients tilted their portfolios towards riskier borrowers. Our evidence also suggests that government assistance had little effect on the overall supply of credit.

## **6. Investments and Overall Risk**

### *6.1. Investments*

The evidence so far suggests that CPP participants increased the risk of their loan portfolios after they were approved for CPP funds. If this strategy reflects a general increase in risk taking by CPP banks, we are likely to observe a similar tilt toward higher-risk assets in banks' investments in securities after CPP capital provisions. The advantage of analyzing banks' portfolio investments is that the risk of financial assets is often more transparent and can be estimated based on market information.

In our analysis of banks' investments we study whether CPP participants increased their allocations to risky securities relative to other assets after they were approved for CPP funds. We study both the aggregate measures such as total investment in securities and average interest yield, as well as the breakdown of securities into safer and riskier assets. Specifically, to provide a simple and transparent classification, we define equities, corporate debt, and mortgage-backed securities as "riskier securities". Conversely, we label Treasuries and state-insured securities as "lower-risk securities".

Table VII shows the results of difference-in-difference tests of investments in all securities, riskier securities, and lower-risk securities between approved and unapproved CPP applicants. We first consider the evidence in Panel A. The results show that CPP participants significantly increased their allocation to investment securities after receiving federal capital. For the average CPP participant, the total weight of investment securities in bank assets increased by 5.3% after CPP relative to non-recipient banks. More importantly, the increase in the allocation to investment securities at CPP participants was primarily driven by higher allocations to riskier securities, which increased at CPP banks by 6.2% after CPP relative to nonrecipients. In contrast, CPP participants reduced their investment in lower-risk securities by 6.9% relative to nonrecipients banks.

Our results offer additional detail on the interest yields and maturities of financial portfolios of CPP participants relative to unapproved QFIs. The results suggest that CPP banks shifted their portfolios toward higher-yield securities after CPP, as compared to CPP applicants that were not approved for federal capital. In particular, the average interest yield on investment portfolios of CPP banks increased by 9.4% after CPP relative

to unapproved CPP applicants.<sup>15</sup> Similar conclusions about the increased risk of CPP banks emerge from the analysis of the average maturity of debt assets, suggesting an increase in allocations to bonds with longer maturity and a higher exposure to interest rate risk.

The results in Panel B are qualitatively similar with different point estimates. For example, the total weight of investment securities in bank assets increased after CPP by 12.7% for approved relative to unapproved banks. Further, similar to Panel A, the increase in the allocation to investment securities at CPP participants was primarily driven by higher allocations to riskier securities.

Overall, the analysis of banks' investment portfolios suggests that CPP participants actively increased their risk exposure after being approved for federal capital. In particular, CPP recipients invested capital in riskier asset classes, tilted portfolios to higher-yielding securities, and engaged in more speculative trading, compared to nonrecipient banks with similar financial characteristics.

## 6.2. *Bank-level Risk*

In this section, we study whether the observed changes in the bank loan origination and investment strategy influenced the overall risk of financial institutions. To measure bank risk, we use both accounting and market-based measures: earnings volatility, leverage, z-score, market beta, and stock return volatility.

In a broad sense, the two primary sources of bank risk include asset composition and leverage. We measure the former risk source by the standard deviation of ROA and the standard deviation of earnings and the latter source by the ratio of equity capital to total assets. Following the literature (e.g., Laeven and Levine, 2009) we also aggregate these two sources of risk into a composite z-score, a measure of a bank's distance to insolvency. The z-score is computed as the sum of ROA and the capital asset ratio scaled by the standard deviation of asset returns. Under the assumption of normally distributed bank profits, this measure approximates the inverse of the default probability, with higher z-scores corresponding to a lower probability of default.<sup>16</sup>

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<sup>15</sup> For consistency, all changes in investment weights and yields are reported in percent (rather than in percentage points). For example, an increase in the yield from 6% to 6.6% is an increase of 10%.

<sup>16</sup> The intuition for this result was first developed in Roy (1952). For a more recent discussion of the relation between z-score and bank default, see Laeven and Levine (2009).

In addition to accounting-based measures, we also use market-based risk proxies – market beta and stock return volatility. To compute betas, we assume the market model, with the CRSP value-weighted index used as the market proxy. To match the data frequency of other risk measures, which are based on quarterly accounting data, we estimate betas for each calendar quarter, using daily returns. Our results are also similar if we use market betas from a two-factor model, which is often assumed to describe the return generating process for financial institutions.<sup>17</sup> The results are also robust to using longer estimation horizons. Similarly, to compute stock return volatility, we estimate the volatility of daily returns for each calendar quarter.

Table VIII provides evidence from panel regressions of bank risk. The dependent variables include ROA volatility, leverage, z-score (measured as the natural logarithm), market beta, and stock return volatility. The independent variables include dummies *After CPP* and *CPP Recipient*, their interaction terms, and a set of controls including the Camels variables, foreclosures, and size.

The results in Table VIII show that CPP banks significantly increased their asset risk, as proxied by ROA volatility and earnings volatility. This conclusion is consistent with the increase in the riskiness of the loan portfolios and investment assets of CPP participants reported earlier. Regression results for the capital-to-assets ratio suggest that CPP banks significantly reduced leverage after federal infusions. For the average CPP recipient, the capital-to-assets ratio increased from 9.9% in the third quarter of 2008 (last quarter before CPP) to 10.9% in the first quarter of 2009. This result is consistent with a significant inflow of new capital from CPP, combined with a lack of increase in credit origination relative to non-CPP participants.

One possible explanation for the increase in asset risk and a simultaneous decline in leverage could be a strategic response from financial institutions to federal capital requirements, for example, if the banks followed a strategy designed to increase the profitability of assets (and hence their risk), while, at the same time achieving better capitalization levels monitored by the program’s oversight bodies. The net effect of this strategy is an

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<sup>17</sup> The two-factor model for financial institutions is based on the market risk and the interest rate risk, with the latter factor approximated by daily changes in the Treasury rate (e.g., Flannery and James 1984, Sweeney and Warga 1986, Saunders, Strock and Travlos, 1990; Bhattacharyya and Purnanandam, 2010).

increase in the probability of bank distress, as shown by the significant coefficient on the interaction term *After CPP x CPP Recipient* in columns that use the z-score as the dependent variable.

Compared to CPP applicants that were not approved for federal funds, CPP recipients increased their exposure to systemic risk after federal capital infusions, as indicated by the positive and significant coefficient on the interaction term in the specifications that use the market beta as the dependent variable. This effect is also economically important, indicating an increase in beta from 0.80 to 1.01 for CPP participants after federal capital infusions. In contrast, non-participating banks experienced no changes in systemic risk over the same period.

In summary, we find that CPP investments are associated with a shift in credit origination toward riskier borrowers and with capital reallocations to risky securities by participating banks. This strategy is associated with an increase in systemic risk and the probability of distress of CPP participants. This evidence suggests that at least some CPP participants responded to the bailout by increasing their risk taking and that this effect appears to outweigh the disciplining role of government monitoring and the regulatory constraints on incentive compensation of CPP participants.

## **Conclusion**

This paper has investigated the effect of government assistance on risk taking of financial institutions. While we do not find a significant effect of the program on the aggregate amount of originated credit, our results suggest a considerable impact of government assistance on the risk of originated loans. After being approved for federal funds, program participants issue riskier loans and increase capital allocations to riskier, higher-yield financial securities, as compared to banks that were not approved for federal funds. A fraction of new capital inflows is also used to build cash reserves. Although the cash reserves reduce leverage and improve capitalization ratios, the net effect is a significant increase in systemic risk and the probability of distress due to the higher risk of bank assets.

The evidence in our paper is broadly consistent with the theories that predict an increase in risk taking incentives in response to government protection. From a policy perspective, our findings show that any capital provisions should establish clear investment guidelines and provide mechanisms for tracking the deployment of capital by recipient institutions in order to limit the unintended consequences of government aid.

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## Appendix A: Variable Definitions

### A.1. Bank-level variables

#### *CAMELS*

*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 noncumulative 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.

*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 nonperforming assets and assets in default. Noncurrent loans and leases are loans that are past due for at least ninety days or are no longer accruing interest, including nonperforming real-estate mortgages. A higher proportion of nonperforming 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.

*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).

*Earnings* = return on assets (ROA), measured as the ratio of the annualized net income in the trailing quarter to average total assets.

*Liquidity* = cash divided by deposits.

*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.

#### *Other Variables*

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

*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.

*Political connections index* = a firm's average percentile rank in our sample on each of the following four measures of political connections: *House financial services subcommittee* (an indicator equal to 1 if the House member representing the voting district of a firm's headquarters served on the Capital Markets Subcommittee or the Financial Institutions Subcommittee of the House Financial Services Committee in 2008 or 2009), *Connected board member* (an indicator equal to 1 if a firm's board of directors in 2008 or 2009 included a director with simultaneous or former work experience at the banking regulators (Federal Reserve, FDIC, OTS, and OCC), Treasury or Congress), *Lobbying* (an indicator equal to 1 if the firm engaged in lobbying activity targeted at the banking regulators, Treasury, or Congress on the issues of banking, financial institutions, or bankruptcy from the first quarter of 2008 to the first quarter of 2009, inclusive), and *Contributions* (an indicator equal to 1 if the bank made political contributions by its sponsored political action committee(s) to the members of the Capital Markets Subcommittee and the Financial Institutions Subcommittee of the House Financial Services Committee in the 2008 congressional election campaign). The index is scaled to range from 0 (low) to 1 (high).

## A.2. CPP Variables

*CPP recipient* = an indicator equal to 1 if the financial institution applied and was approved for CPP and 0 if it applied and was not approved. In the IV specification (Panel D of Table IV), this variable is the predicted value from a probit regression of CPP approval on the political connections index and a set of independent bank-level control variables (Camels, foreclosures, and size).

*After CPP* = an indicator equal to 1 after January 1, 2009.

## A.3. Risk

*The Subprime spread indicator* is reported by HMDA and equals 1 if the annual percentage rate on the mortgage loan exceeds the rate on the Treasury securities of comparable maturity by at least three percentage points.

*Bond yield* = the average spread between a company's outstanding bond issues and treasury yields with the closest maturity over the month preceding the loan. Data on bonds' yields is gathered from TRACE.

*Credit rating* = the average credit rating of a company's bond issues in the year preceding the loan. Data on credit ratings are gathered from Mergent's FISD ratings dataset.

*Standard deviation of ROA* = For each quarter, the standard deviation of ROA is calculated as the quarterly standard deviation over the previous 4 quarters. ROA is net operating income as a percent of average assets.

*Standard deviation of earnings* = For each quarter, the standard deviation of earnings is calculated as the quarterly standard deviation over the previous 4 quarters. Earnings are net operating income as a percent of average assets.

*Capital asset ratio* = Average total equity divided by average assets.

*Z-score* = ROA plus capital asset ratio divided by the standard deviation of ROA.

*Beta* = Betas are computed assuming the market model, with the CRSP value-weighted index used as the market proxy. Betas are calculated for each calendar quarter using daily returns.

*Stock return volatility* = the volatility of daily returns for each calendar quarter.

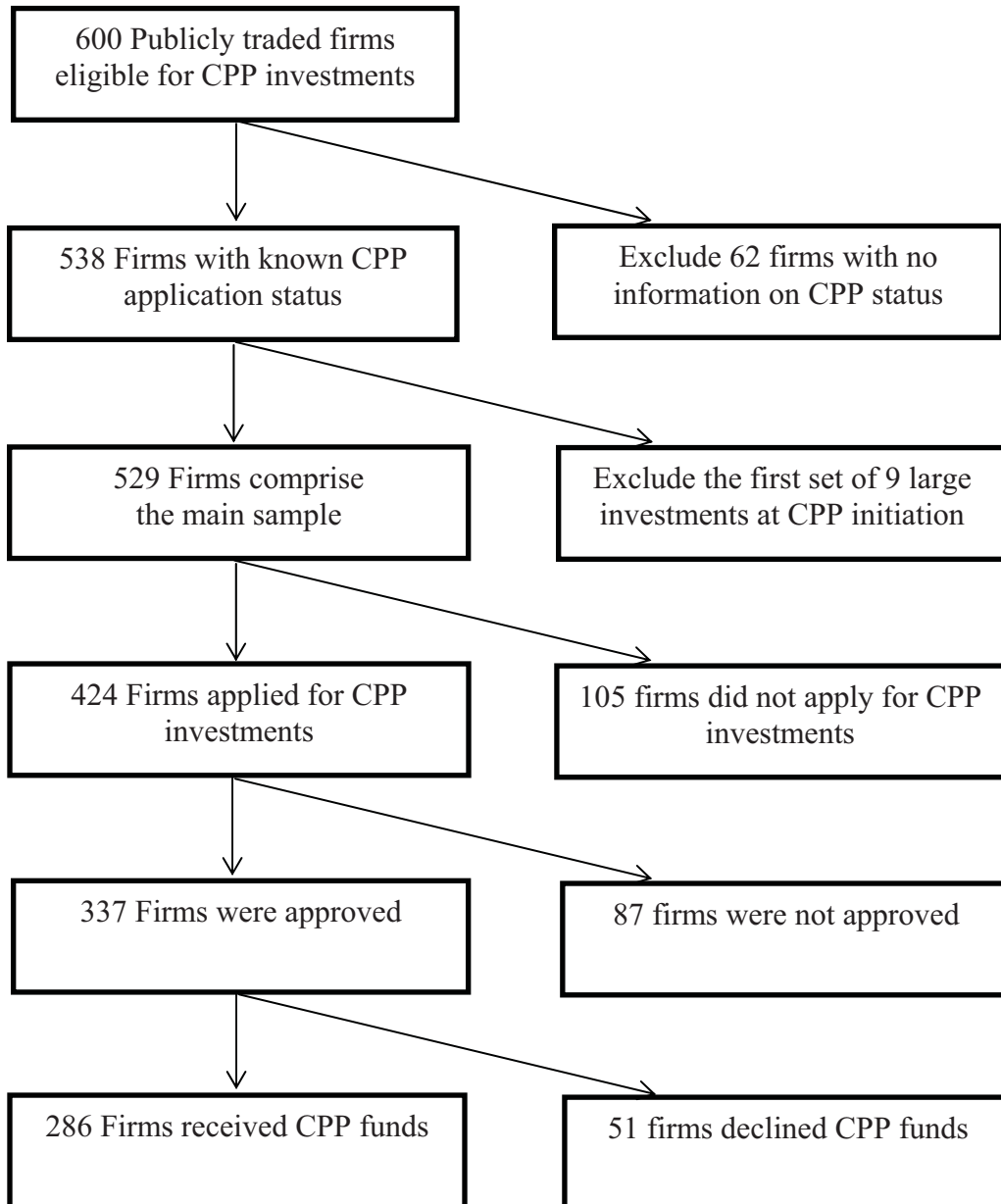
## A.4. Investments

*Lower-risk securities* = U.S. Treasury securities and securities issued by states & political subdivisions.

*Riskier securities* = Equity securities, trading account (securities and other assets acquired with the intent to resell in order to profit from short-term price movements), corporate bonds, and Mortgage-backed securities.

*Long-term debt securities* = Debt securities with maturities greater than 5 years.

**Figure 1**  
**Sample Firms and their Investment Applications**



**TABLE I**  
**Summary Statistics**

This table reports summary statistics for the data used in the analysis. The sample consists of 529 publicly-traded financial firms eligible for participation in the Capital Purchase Program (CPP) with available data on program application status. The sample excludes the nine CPP investments in the largest banks announced at program initiation. Panel A reports bank-level data. *CPP application indicator* is dummy variable equal to 1 if the firm applied for CPP funds. *CPP approval indicator* is a dummy equal to 1 if the firm was approved (conditional on applying) for CPP funds. *CPP investment indicator* is a dummy equal to 1 if the firm received (conditional on being approved for) CPP funds. The financial condition variables correspond to the Camels measures of banks' financial condition and performance used by banking regulators, augmented with exposure to the crisis (foreclosures). *Capital adequacy* is the tier-1 risk-based capital ratio, defined as tier-1 capital divided by risk-weighted assets. *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 disciplinary orders issued to a firm's management by the firm's banking regulator in 2006-2009. *Earnings* is return on assets (ROA), measured as the ratio of the annualized net income in the trailing quarter to average total assets. *Liquidity* is cash divided by deposits. *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. *Foreclosures* is the value of foreclosed assets divided by net loans and leases. Panel B reports loan-level data. The mortgage application data are from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry. *Application approval* is an indicator equal to 1 if the mortgage application was approved. *Loan to income ratio* is the loan amount divided by the applicant's annual income. *Rate spread indicator* is a dummy equal to 1 if the annual percentage rate on the mortgage loan exceeds the rate on the Treasury securities of comparable maturity by at least three percentage points. The corporate loan data are gathered from DealScan. *Number of CPP recipients per loan* is the number of loan arrangers that were approved for CPP. *Fraction of CPP recipients in the total number of lenders per loan* is the number of loan arrangers that were approved for CPP divided by the total number of loan arrangers. Panel C compares between the propensity score-matched samples of CPP recipients and non-recipients.

**Panel A: Bank-level data**

Variable	Mean	25th percentile	Median	75th percentile	Standard deviation
<b>CPP</b>					
CPP application indicator	0.802	1.000	1.000	1.000	0.399
CPP approval indicator (if applied)	0.795	1.000	1.000	1.000	0.404
CPP investment indicator	0.849	0.000	1.000	1.000	0.359
<b>Bank size</b>					
Total assets (\$000)	2,167,517	67,963	147,636	344,765	41,900,000
Assets in financial securities (\$000)	349,912	8,952	23,610	60,849	6,080,917
<b>Financial condition</b>					
Capital adequacy (%)	12.750	9.690	10.657	12.644	9.008
Asset quality (%)	-0.071	-0.061	-0.007	0.000	0.245
Management quality	-0.314	-1.000	0.000	0.000	0.464
Earnings (%)	0.194	0.040	0.547	0.867	1.900
Liquidity (%)	3.914	2.272	3.030	4.202	3.877
Sensitivity to market risk (%)	14.588	5.382	10.900	19.670	12.485
Foreclosures (%)	0.390	0.034	0.148	0.410	1.078

**Panel B: Loan-level data**

<b>Variable</b>	<b>Mean</b>	<b>25th percentile</b>	<b>Median</b>	<b>75th percentile</b>	<b>Standard deviation</b>
<b>Mortgage application data</b>					
Application approval indicator	0.622	0.000	1.000	1.000	0.485
Loan to income ratio	1.915	0.750	1.703	2.708	1.473
Rate spread indicator	0.097	0.000	0.000	0.000	0.296
Loan amount (\$000)	165.8	51.0	110.0	220.0	156.2
Applicant income (\$000 per year)	99.6	43.0	71.0	123.0	81.8
<b>Corporate loan data</b>					
Loan amount (\$000)	582,000	135,000	300,000	675,000	918,000
Number of CPP recipients per loan	2.766	1.000	2.000	4.000	1.631
Fraction of CPP recipients in the total number of lenders per loan	0.673	0.376	0.601	0.854	0.184

**Panel C: Matched Samples**

<b>Variable</b>	<b>Unapproved</b>	<b>Approved</b>	<b>Difference</b>	<b>t-statistic</b>
Capital adequacy (%)	11.548	12.893	1.344	1.092
Asset quality (%)	-0.052	-0.046	0.006	0.304
Management quality (%)	-0.310	-0.276	0.034	0.497
Earnings (%)	-0.921	-0.786	0.135	0.336
Liquidity (%)	4.061	3.856	-0.206	0.326
Sensitivity to market risk (%)	11.508	9.878	-1.630	1.194
Foreclosures (%)	0.315	0.298	-0.017	0.312
Size (log assets)	13.922	13.610	-0.312	1.631

**TABLE II**

**Univariate Evidence on Application Approval Rates and Loan Risk**

This table reports difference-in-differences mean estimates of the likelihood of mortgage application approval by CPP recipients and non-recipients across borrowers of various risk. The quintiles are sorted on the borrower's loan-to-income ratio and on the frequency of approved high-risk mortgages (mortgages with a rate spread indicator equal to 1). *Loan application approval* is an indicator equal to 1 if the mortgage application was approved and 0 if it was denied. *Before CPP* denotes the period 2006-2008, and *After CPP* denotes 2009. *CPP recipients (non-recipients)* are banks that applied for CPP funds and were approved for (denied) government capital. *Loan-to-income ratio* is the loan amount divided by the applicant's annual income. The individual loan application data come from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry and cover the period 2006-2009. The sample consists of 529 publicly-traded financial firms eligible for participation in CPP with available data on program application status. The sample excludes the first nine CPP investments in the largest banks announced at program initiation. T-statistics are reported in parentheses. The difference-in-difference (DD) estimate is printed in bold.

Loan-to-income ratio rank	Before CPP			After CPP			Diff-in-diff (t-statistic)
	Non-recipients	Recipients	Difference (t-statistic)	Non-recipients	Recipients	Difference (t-statistic)	
<b>Lowest (safe)</b>	0.788	0.741	-0.047 (9.330)	0.832	0.633	-0.199 (12.164)	<b>-0.151</b> <b>(9.520)</b>
<b>2</b>	0.679	0.570	-0.109 (22.033)	0.707	0.462	-0.245 (15.175)	<b>-0.136</b> <b>(8.100)</b>
<b>3</b>	0.651	0.530	-0.121 (35.724)	0.716	0.528	-0.188 (12.902)	<b>-0.067</b> <b>(4.230)</b>
<b>4</b>	0.649	0.533	-0.117 (24.951)	0.705	0.567	-0.138 (9.498)	<b>-0.022</b> <b>(3.410)</b>
<b>Highest (risky)</b>	0.526	0.484	-0.042 (9.275)	0.547	0.530	-0.017 (1.199)	<b>0.025</b> <b>(3.660)</b>

**TABLE III**  
**Regression Evidence on Mortgage Application Approval Rates and Loan Risk**

This table reports regression estimates of the relation between CPP capital infusions and bank approval rates on mortgage applications across borrowers of different risk. The dependent variable is an indicator equal to 1 if a loan was approved, except in the last column, where the dependent variable is the CPP recipient indicator. *CPP recipient* is an indicator equal to 1 if the bank applied for CPP funds and was approved, and 0 if it applied but was not approved. In Panel B, for each bank that applied and was not approved for CPP, we match the closest approved bank on propensity scores estimated from a probit regression, which predicts the likelihood of CPP approval based on the Camels variables, foreclosures, and size. All variables are defined in Appendix A. The individual loan application data come from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry and cover the period 2006-2009. *After CPP* is an indicator that equals 1 in 2009 and 0 in 2006-2008. All regressions include bank level controls, demographic controls, housing market controls, borrower fixed effects (gender, race, ethnicity), and tract fixed effects, which are not shown to conserve space. *Bank level controls* include the Camels variables, foreclosures, and size. *Demographic controls* include the median family income, population size, and the percentage of minority population. *Housing market controls* include regional housing prices and vacancy rates. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the census tract level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

**Panel A: Full Sample**

Sample	Overall sample	Loan-to-income ratio rank				Rate spread indicator=1	
		Low	2	3	4		High
Dependent variable		Application approval indicator				CPP recipient	
After CPP	0.217*** [5.773]	0.261*** [6.618]	0.198*** [4.594]	0.130*** [3.485]	0.152*** [3.178]	0.168** [2.566]	0.085*** [7.141]
CPP recipient	-0.130*** [5.766]	-0.067** [2.076]	-0.120*** [4.217]	-0.156*** [6.475]	-0.151*** [6.126]	-0.158*** [4.958]	
After CPP x CPP recipient	-0.020 [0.588]	-0.240*** [6.135]	-0.040 [0.937]	0.078 [1.292]	0.105*** [2.911]	0.124*** [2.875]	
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,650,136	290,635	284,780	311,141	328,953	366,923	94,504
R-Squared	0.107	0.082	0.092	0.120	0.139	0.130	0.235



**Panel B: Matched Sample**

Sample	Overall sample	Loan-to-income ratio rank				Rate spread indicator=1	
		Low	2	3	4		High
Dependent variable		Application approval indicator				CPP recipient	
After CPP	0.030 [1.059]	0.045* [1.790]	0.011 [0.353]	-0.024 [0.826]	0.006 [0.207]	-0.051 [1.149]	0.196*** [2.841]
CPP recipient	-0.072*** [2.803]	0.013 [0.449]	-0.046 [1.401]	-0.110*** [3.979]	-0.112*** [4.324]	-0.065** [2.164]	
After CPP x CPP recipient	0.058 [1.623]	-0.123*** [3.808]	0.019 [0.436]	0.076 [1.148]	0.109*** [2.938]	0.175*** [3.835]	
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	120,417	22,534	17,705	19,085	21,229	28,297	9,202
R-Squared	0.226	0.142	0.209	0.256	0.270	0.249	0.461

**TABLE IV**  
**Robustness**

This table reports regression estimates of the relation between CPP capital infusions and bank approval rates on mortgage applications across borrowers of different risk. The dependent variable is an indicator variable equal to 1 if a loan was approved, except in the last column, where the dependent variable is the CPP recipient indicator. Panel A augments the regressions with bank fixed effects. Panel B excludes banks that were part of FDIC-facilitated acquisitions of financial institutions. In both panels, *CPP recipient* is an indicator equal to 1 if the bank applied for CPP funds and was approved, and 0 if it applied and was not approved. In Panel C, *CPP recipient* is an indicator that equals 1 if a bank was approved for CPP and received capital, and 0 if a bank was approved for CPP but subsequently did not receive capital. Each approved bank that did not receive capital is matched to its closest approved counterpart that received capital. Matching is based on the propensity to decline federal capital conditional on approval from a probit model in which the independent variables include the Camels variables, foreclosures, and size. In Panel D, *CPP recipient* is the predicted likelihood that a bank is approved for CPP funds, conditional on applying, from a probit regression of CPP approval on a bank's political connections index. *After CPP* is an indicator that equals 1 in 2009 and 0 in 2006-2008. All variables are defined in Appendix A. The individual loan application data come from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry and cover the period 2006-2009. All regressions include bank level controls, demographic controls, housing market controls, borrower fixed effects (gender, race, ethnicity), and tract fixed effects, which are not shown to conserve space. *Bank level controls* include the Camels variables, foreclosures, and size. *Demographic controls* include the median family income, population size, and the percentage of minority population. *Housing market controls* include regional housing prices and vacancy rates. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the census tract level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

**Panel A: Bank Fixed Effects**

Risk Measure	Overall sample	Loan-to-income ratio rank				
		Low	2	3	4	High
After CPP	0.092** [2.432]	0.142*** [2.736]	0.093** [2.203]	0.040 [1.213]	0.070* [1.869]	0.103** [2.008]
After CPP x CPP recipient	0.059 [1.265]	-0.107** [2.315]	0.032 [0.675]	0.111*** [2.648]	0.141*** [2.675]	0.155** [2.428]
Bank fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,910,402	335,205	359,491	371,049	369,382	396,943
R-Squared	0.162	0.128	0.159	0.171	0.183	0.274

**Panel B: Excluding FDIC-facilitated Acquisitions**

Risk Measure	Overall sample	Loan-to-income ratio rank				Rate spread indicator=1	
		Low	2	3	4		High
Dependent variable		Application approval indicator				CPP recipient	
After CPP	0.177*** [5.009]	0.200*** [5.697]	0.138*** [3.535]	0.115*** [3.013]	0.128** [2.384]	0.107* [1.758]	0.029*** [6.851]
CPP recipient	-0.115*** [4.626]	-0.107*** [3.146]	-0.131*** [4.524]	-0.118*** [4.441]	-0.119*** [4.258]	-0.121*** [3.364]	
After CPP x CPP recipient	0.019 [0.590]	-0.164*** [4.786]	0.036 [0.937]	0.119*** [3.066]	0.148*** [3.010]	0.128** [2.255]	
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,380,127	242,121	232,523	262,982	278,038	314,910	73,854
R-Squared	0.120	0.080	0.097	0.139	0.161	0.145	0.417

**Panel C: Distinguishing Bank Decisions from Government Intervention**

Risk Measure	Overall sample	Loan-to-income ratio rank				Rate spread indicator=1	
		Low	2	3	4		High
Dependent variable		Application approval indicator				CPP recipient	
After CPP	0.149*** [7.714]	0.056*** [2.602]	0.095*** [5.308]	0.152*** [6.988]	0.158*** [5.986]	0.204*** [7.602]	-0.039 [0.857]
CPP recipient	-0.062*** [2.658]	-0.090*** [2.665]	-0.098*** [3.530]	-0.069*** [3.017]	-0.053* [1.829]	-0.040 [0.852]	
After CPP x CPP recipient	0.035 [1.249]	-0.001 [0.035]	-0.063 [1.495]	0.024 [0.529]	0.029 [0.624]	0.014 [0.375]	
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	32,269	4,490	5,708	6,940	5,943	5,474	1,996
R-Squared	0.257	0.305	0.296	0.285	0.311	0.299	0.748

**Panel D: Instrumental Variable Analysis**

Risk Measure	Overall sample	Loan-to-income ratio rank				Rate spread indicator=1	
		Low	2	3	4		High
Dependent variable		Application approval indicator				CPP recipient	
After CPP	0.354*** [7.107]	0.479*** [6.338]	0.404*** [5.784]	0.109** [2.155]	0.196*** [3.443]	0.284*** [3.613]	0.040*** [10.597]
CPP recipient	0.177** [2.500]	-0.076 [1.123]	0.040 [0.583]	0.162** [1.975]	0.200** [2.058]	0.251** [2.523]	
After CPP x CPP recipient	-0.262*** [4.734]	-0.477*** [5.487]	-0.363*** [4.765]	0.004 [0.075]	0.060 [0.931]	0.136*** [3.573]	
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Demographic controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Housing market controls?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Borrower fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tract fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	698,955	124,488	110,676	125,807	135,133	147,963	55,977
R-Squared	0.118	0.086	0.110	0.151	0.156	0.143	0.538

**TABLE V****Government Assistance and the Distribution of Loan Demand**

This table studies the relation between CPP capital infusions in financial institutions and the demand for mortgages across banks. The results are presented across different borrower risk categories. In Panel A, the dependent variable is the natural logarithm of the total number of mortgage applications received by a bank from each loan-to-income borrower quintile in each year. In Panel B, the dependent variable is the natural logarithm of the total dollar amount of mortgage applications received by a bank from each loan-to-income borrower quintile in each year. The individual loan application data come from the Home Mortgage Disclosure Act (HMDA) Loan Application Registry and cover the period 2006-2009. *After CPP* is an indicator that equals 1 in 2009 and 0 in 2006-2008. All regressions include *Bank level controls*, which comprise the Camels variables, foreclosures, and size. All variables are defined in Appendix A. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the bank level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

**Panel A: Number of Loan Applications**

Risk Measure	Overall sample	Loan-to-income ratio rank				
		Low	2	3	4	High
Dependent variable		Annual number of loan applications				
After CPP	-0.469*** [4.085]	-0.472*** [2.819]	-0.568*** [3.631]	-0.475*** [2.993]	-0.320* [1.913]	-0.469*** [2.913]
CPP recipient	0.143 [1.195]	0.316** [2.072]	0.173 [1.111]	0.078 [0.474]	-0.003 [0.018]	0.052 [0.371]
After CPP x CPP recipient	0.138 [1.325]	0.157 [0.992]	0.204 [1.436]	0.187 [1.333]	0.066 [0.440]	0.084 [0.571]
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	6,429	1,021	1,076	1,106	1,065	1,074
R-Squared	0.429	0.368	0.423	0.476	0.454	0.516

**Panel B: Amount of Loan Applications**

Risk Measure	Overall sample	Loan-to-income ratio rank				
		Low	2	3	4	High
Dependent variable		Annual total amount of loan applications				
After CPP	-0.509*** [4.776]	-0.610*** [3.534]	-0.601*** [4.039]	-0.442*** [2.738]	-0.258 [1.640]	-0.554*** [3.530]
CPP recipient	0.057 [0.521]	0.251* [1.821]	0.036 [0.260]	0.047 [0.280]	-0.034 [0.214]	-0.029 [0.203]
After CPP x CPP recipient	0.132 [1.352]	0.254 [1.516]	0.236* [1.719]	0.083 [0.584]	-0.031 [0.214]	0.150 [1.042]
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	6,429	1,021	1,076	1,106	1,065	1,074
R-Squared	0.434	0.429	0.500	0.543	0.498	0.520

**TABLE VI**  
**Regression Evidence on Corporate Lending and Risk**

This table reports regression estimates of the relation between CPP capital infusions and corporate lending of CPP banks. The dependent variable is the ratio of the number of lenders classified as CPP recipients to the total number of lenders per syndicated loan. *CPP recipient* is an indicator that equals 1 if the bank applied for CPP funds and was approved, and 0 if it applied and was not approved. In the matched sample, each bank that was not approved for CPP is matched to the closest approved bank on propensity scores obtained from a probit regression estimating the likelihood of CPP approval. *After CPP* is an indicator that equals 1 in 2009-2010 and 0 in 2006-2008. Data on corporate loans are gathered from Dealscan and cover the period 2006-2010. We employ two measures of borrowers' risk. *Bond yield* is the average spread between the yield on a company's outstanding bond issues and the average yield on Treasury bonds with the closest maturity over the month preceding the loan. *Credit rating* is the average credit rating of a company's bond issues in the year preceding the loan. Data on bonds' yields are gathered from TRACE. Credit ratings are obtained from Mergent's FISD ratings dataset. All variables are defined in Appendix A. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the borrower level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

Risk measure	Bond yields		Credit ratings	
	Full sample	Matched sample	Full sample	Matched sample
After CPP	0.023*** [3.284]	0.084 [0.247]	0.107 [0.774]	0.119 [0.885]
Risk	0.008*** [5.751]	0.062** [2.770]	0.007 [1.479]	0.000 [0.742]
After CPP x Risk	0.005*** [2.801]	0.006*** [2.622]	-0.009 [1.087]	-0.011*** [3.638]
Borrower fixed effects?	Yes	Yes	Yes	Yes
Observations	2,021	1,072	937	926
R-Squared	0.847	0.971	0.815	0.866

**TABLE VII**  
**Regression Evidence on Banks' Investment Securities**

This table reports regressions explaining banks' securities holdings as a fraction of assets or as a fraction of different security classes. *Total interest income on securities/assets* is measured in percentage points. *Lower-risk securities* include U.S. Treasuries and securities issued by states & political subdivisions. *Riskier securities* include equity securities, trading account (securities and other assets acquired with the intent to resell in order to profit from short-term price movements), corporate bonds, and mortgage-backed securities. *Long term debt securities* include fixed-income instruments with maturities exceeding 5 years. Quarterly data on banks is gathered from Call Reports and cover the period 2006-2010. *CPP recipient* is an indicator that equals 1 if the bank applied for CPP funds and was approved, and 0 if it applied and was not approved. In Panel B, each bank that was not approved is matched to the closest approved bank on propensity scores obtained from a probit regression estimating the likelihood of CPP approval. *After CPP* is an indicator equal to 1 in 2009-2010 and 0 in 2006-2008. All regressions include *Bank level controls*, which comprise the Camels variables, foreclosures, and size. All variables are defined in Appendix A. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the bank level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

**Panel A: Full Sample**

Dependent variable	Total securities/assets	Total interest income on securities/assets	Lower-risk securities/total securities	Riskier securities/total securities	Long-term debt securities/total debt securities
After CPP	0.005 [0.708]	-0.135*** [5.635]	-0.013 [1.316]	0.127*** [7.561]	0.037*** [2.732]
CPP recipient	-0.001 [0.283]	-0.030* [1.806]	-0.003 [0.454]	-0.003 [0.270]	0.040*** [4.322]
After CPP x CPP recipient	0.009*** [3.139]	0.041*** [3.566]	-0.011** [2.017]	0.037** [1.962]	0.008*** [3.519]
Bank level controls?	Yes	Yes	Yes	Yes	Yes
Observations	7,329	7,329	7,273	7,273	7,261
R-Squared	0.067	0.081	0.054	0.083	0.069

**Panel B: Matched Sample**

Dependent variable	Total securities/assets	Total interest income on securities/assets	Lower-risk securities/total securities	Riskier securities/total securities	Long-term debt securities/total debt securities
After CPP	0.005 [1.172]	-0.135*** [4.740]	-0.013** [2.187]	0.127*** [5.576]	0.037*** [3.835]
CPP recipient	-0.018*** [7.829]	-0.077*** [3.082]	-0.034*** [22.301]	-0.005 [1.051]	0.013 [1.513]
After CPP x CPP recipient	0.020*** [4.398]	0.058*** [3.480]	-0.006 [1.229]	0.024** [2.254]	0.008 [0.769]
Bank level controls?	Yes	Yes	Yes	Yes	Yes
Observations	2,850	2,850	2,810	2,810	2,799
R-Squared	0.045	0.045	0.060	0.069	0.070



**TABLE VIII**  
**Regression Evidence on Overall Bank Risk**

This table reports results from regressions estimating bank-level risk based on accounting and market proxies. Quarterly data on banks are gathered from Call Reports and cover the period 2006-2010. *CPP recipient* is an indicator that equals to 1 if the bank applied for CPP funds and was approved, and 0 if it applied and was not approved. In Panel B, each bank that was not approved is matched to the closest approved bank on propensity scores obtained from a probit regression estimating the likelihood of CPP approval. *After CPP* is an indicator equal to 1 in 2009-2010 and 0 in 2006-2008. *ROA* is net operating income as a percent of average assets. *Earnings* is net operating income as a percent of average assets. For each quarter, the standard deviation of ROA and earnings is calculated as the quarterly standard deviation over the previous 4 quarters. *Capital asset ratio* is average total equity divided by average assets. *Z-score* is the natural logarithm of the sum of ROA and capital asset ratio divided by the standard deviation of ROA. To compute betas, we assume the market model, with the CRSP value-weighted index used as the market proxy. Betas are calculated for each calendar quarter using daily returns. Stock return volatility is calculated as the volatility of daily returns for each calendar quarter. All regressions include *Bank level controls*, which comprise the Camels variables, foreclosures, and size. All variables are defined in Appendix A. The t-statistics (in brackets) are based on standard errors that are heteroskedasticity consistent and clustered at the bank level. \*\*\*, \*\*, or \* indicates that the coefficient estimate is significant at the 1%, 5%, or 10% level, respectively.

**Panel A: Full Sample**

Risk Measure	Z-Score	Standard deviation of ROA	Standard deviation of earnings	Capital asset ratio	Beta	Stock return volatility
Model	(1)	(2)	(3)	(4)	(5)	(6)
After CPP	-0.664*** [3.699]	0.001 [0.688]	0.002 [0.897]	-0.020*** [6.918]	0.131** [2.342]	0.040*** [9.702]
CPP recipient	0.471*** [4.126]	-0.001 [0.652]	-0.001 [0.640]	0.004 [1.156]	0.020 [0.349]	-0.005*** [2.798]
After CPP x CPP recipient	-0.265** [2.378]	0.003*** [3.460]	0.003*** [3.439]	0.019*** [6.093]	0.087** [1.989]	0.021*** [4.855]
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	7,122	7,178	7,178	7,185	5,632	5,632
R-squared	0.276	0.409	0.410	0.135	0.395	0.185

**Panel B: Matched Sample**

Risk Measure	Z-Score	Standard deviation of ROA	Standard deviation of earnings	Capital asset ratio	Beta	Stock return volatility
Model	(1)	(2)	(3)	(4)	(5)	(6)
After CPP	-0.594*** [3.325]	0.001 [0.425]	0.001 [0.576]	-0.020*** [6.968]	0.115** [2.053]	0.037*** [9.401]
CPP recipient	0.215* [1.694]	-0.001 [0.546]	-0.001 [0.680]	0.006 [1.438]	0.076 [1.295]	-0.006*** [2.859]
After CPP x CPP recipient	-0.281** [2.259]	0.007*** [3.305]	0.007*** [3.386]	0.018*** [3.215]	0.045* [1.868]	0.011** [2.368]
Bank level controls?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,229	2,274	2,274	2,279	1,751	1,751
R-squared	0.394	0.485	0.484	0.357	0.401	0.219