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Chapter Author(s): Luigi Zingales

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## Comment

Luigi Zingales, University of Chicago and NBER

Has lobbying by financial institutions contributed to the financial crisis? The question that Igan, Mishra, and Tressel (IMT) set themselves to address is of the highest importance. They are trying to show, in econometric terms, what Morgenson and Rosner (2011) claim to show in a narrative way in their recent book, *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon*. As the title suggests, Morgenson and Rosner claim that the lobbying power of the banking sector has weakened the regulatory environment and that this weakening is one of the main culprits of the financial crisis. Igan et al. are a bit softer in their claim, but the two theses are substantially the same.

To argue that lobbying by financial institutions contributed to/caused the financial crisis, one has to establish four results: (1) that lobbying by financial institutions distorted the policy formation process; (2) that this undue influence was crucial to create a lax regulatory environment; (3) that this lax regulatory environment caused a large number of bad loans; (4) that these bad loans were the major cause of the crisis.

Personally, I believe in all four of these logical steps, with the possible exception of the last one. Still, I am not sure this paper adds much to my conviction. It does, however, strengthen my belief that lobbying firms are generally corrupt and inefficient firms and that lobbying, at least to the extent it takes place now in the United States, is highly distortive. But let's go in order.

### Does Lobbying Distort the Policy Formation Process?

Interest groups can legally influence the policy formation process through two main channels: campaign finance contributions and lob-

bying activities in the executive and legislative branches. Igan et al. purposefully limit themselves to the second channel, since the first has received more attention in the literature. While their assessment is correct, this self-imposed restriction negatively impacts their ability to identify the distortive nature of the lobbying process. When we look at campaign contributions it is easier to identify the quid pro quo aspect (see, for example, Goldberg and Maggi 1999 and Gawande and Bandyopadhyay 2000). It is more difficult to do so when we look at pure lobbying, since this lobbying has a legitimate purpose, which is difficult to separate from the distortionary one.

According to the *American League of Lobbyists* website, “[l]obbying is a legitimate and necessary part of our democratic political process. Government decisions affect both people and organizations, and information must be provided in order to produce informed decisions. Public officials cannot make fair and informed decisions without considering information from a broad range of interested parties. All sides of an issue must be explored in order to produce equitable government policies.”<sup>1</sup> So the positive view of lobbying is that it provides necessary information for policymakers to do their job properly.

Is Igan and colleagues’ evidence inconsistent with this benign view of lobbying? Because of my role as a discussant, let me play the devil’s advocate a bit and try to see whether a coherent information-based story of lobbying is consistent with all their results. Imagine that some new lenders have a proprietary technology to better identify people who are creditworthy. Existing lenders who do not have that technology will lobby to restrict new entrants from the market. Since they cannot ban a new entry directly, they will try to do so indirectly, shutting down the market where the new lenders have the strongest comparative advantage: the market for high-risk borrowers. The newcomers will fight back. In fact, in a very optimistic view of the world, where the more efficient firms will win the lobbying battle because they have more resources to fight (Becker 1983), the new lenders will lobby more on this issue and win. Unfortunately, this technology is introduced during a real estate bubble, and when the bubble bursts, the lenders who specialized in the more risky segment of the market are hit hardest: their technology was better at detecting the idiosyncratic components of risk, but not the systematic ones. Being hit the hardest, they are also the ones that end up receiving more funds from the Troubled Asset Relief Program.

I am not claiming this is an accurate description of what happened, but only that it is a possible alternative story, which is perfectly consis-

tent with Igan and colleagues' findings. Hence their findings, while not inconsistent, do not prove that the first logical step is true.

Igan et al. acknowledge this limitation several times in their paper. Still, they could have done more to address it. At the very least, they could have cited more extensively the growing literature documenting that connections are a big part of lobbying. For example, Blanes i Vidal, Draca, and Fons-Rosen (2010) find that lobbyists who worked in a US senator's office suffer a 24% drop in revenue when that senator leaves office. Since it is hard to imagine that a lobbyist loses 24% of his ability to inform when his former boss loses his senate seat, it must be that at least one-quarter of a lobbyist's value is given by his connections. Similarly, Bertrand, Bombardini, and Trebbi (2011) show that in the issues they work on, lobbyists follow the politicians they were previously connected to, rather than sticking to the issues. Thus, it appears as if the most valuable component of their human capital is *who* they know, not *what* they know, a result hardly consistent with lobbying being mostly about information.

The second, more costly, way Igan et al. could have addressed this problem is by linking the lobbying data to the campaign contributions by the financial industry and the votes representatives and senators cast on the key pieces of legislation. This is what is done in Mian, Sufi, and Trebbi (2010).

Finally, another piece of evidence in favor of a causal link could have been obtained by looking at whether there is a correlation between the lobbying ex ante and the number of legal suits brought against these companies ex post. If lobbying is a sign of corrupt companies and not just of companies that are willing to take more risk, then this should manifest it in the frequency of illegal behavior.

### **Was Lobbying Crucial in Creating a Lax Regulatory Environment?**

Even if I believe that lobbying can and often is distortionary, it is not fair to blame it for all that goes wrong. In other words, the relevant question is whether the regulatory environment would have been significantly different without the lobbying of the financial industry.

Consider the antipredatory law in Georgia, which was designed to protect subprime lenders. As Morgenson and Rosner (2011) describe, what killed the law in Georgia was not lobbying but Standard & Poors, who announced that it would not allow mortgage loans that originated in Georgia into any mortgage-backed securities pool it rated. The reason was that the Georgia law created a liability for any institution that

participated in a securitization containing a loan that might be considered predatory. Even Morgenson and Rosner (2011) admit that the lobbyists had only to circulate the S&P press release to overturn the law. This is a clear case where lobbyists' effort might have been inframarginal. The same happened in New Jersey.

The same is also true for the mandatory counseling pilot program introduced in Illinois in September 2006 and terminated only 20 weeks later. An Illinois law firm described the reasons for this premature termination as follows:

The Program came under fire from community organizations and civic leaders, who raised serious concerns that certain individuals were being wrongly targeted, based solely on race. In addition, the initial implementation of HB 4050 resulted in fewer mortgage loans being made in certain zip codes targeted by the Program. A report from the University of Illinois demonstrated that housing sales in the targeted zip codes dropped nearly 50 percent, while those in non-targeted zip codes declined only 20 percent. As a result, Governor Blagojevich suspended the initial Program Jan. 19, 2007.<sup>2</sup>

Was this program killed by lobbyists? According to the Counseling Agencies that participated to the pilot program, it was very successful. "More than half of the borrowers referred for File Review could not afford the loan they were being given by their mortgage broker/loan originator and 9% of the file reviews showed indicia of fraud."<sup>3</sup> Nevertheless, the program was very unpopular. Agarwal et al. (2010) show that in the ten treated zip codes, the legislation caused a 65% drop in the number of mortgage applications, a 35% decline in the number of active lenders, about 47% decline in the number of originated purchase-related mortgages, and 77% decline in the number of originated refinancing mortgages. The reduction in the supply of credit was so extreme, that the program was terminated by popular demand. Mortgage brokers, especially those specialized in subprime mortgages, celebrated the demise of the program. I am quite confident that they also lobbied against it. Are they responsible for its demise? No. The real estate bubble was like a party gone wild, where borrowers were demanding the change to take crazy loans as drunks demand booze. Are just the bartenders responsible if too much alcohol was served? No. The customers have their fair share of responsibility. Furthermore, in a democracy it is difficult for a regulator to lean against the popular consensus. And the customers, not only the bartenders, wanted the party to continue.

In sum, I do not doubt that lobbyists pushed for the party to continue, but would the party have ended much earlier if they did not? I doubt it.

## Did This Lax Regulatory Environment Cause the Large Number of Bad Loans?

At some level the response to this question is obvious. If regulation had rigidly enforced a down payment of 50% and a total debt-to-income ratio below 2%, very few loans would have defaulted and even the one that defaulted would not have caused many losses. Yet, such rigid guidelines would have reduced dramatically the number of loans available. Furthermore, even before the subprime bubble the lending standards were much lower than this. The down payment was below 20% and in computing the ratio of annual income to mortgage costs, most lenders used a lower teaser rate, rather than an actual rate.

Thus, the more relevant (and difficult to answer) question is whether the subprime bubble was caused by a relaxation of lending standards below what was common in the United States before. To answer this question, it is useful to distinguish between a macro effect, where we take into consideration the effect that a relaxation of lending standards has on the equilibrium prices of houses, and a micro effect, where prices are exogenously determined.

From a macro point of view, Mian and Sufi (2009) show that the greater availability of credit has contributed to the rise in real estate prices, especially in the subprime areas. They focus on securitization, not relaxation of the lending standards. Keys et al. (2010) show the existence of a connection between securitization and relaxation in lending standards. This relaxation, however, is not caused by reduced regulation, but by the incentive of the underwriter. While it is possible that a more aggressive regulatory stance could have reduced the relaxation of these standards, there is no evidence either in Igan et al. or in Keys et al. (2010) that this is the case. In fact, Keys et al. (2009), who look at the relation between regulatory tightness and lending standards, find that more regulated entities do not relax their lending standards less.

From a micro point of view, the existence of a connection between relaxed regulation and bad loans have been convincingly shown by Jiang, Nelson, and Vytlačil (2010) and Rajan, Seru, and Vig (2010). By looking at one large underwriter Jiang et al. (2010) show that low documentation loans perform significantly worse than full doc loans by the same underwriter, even accounting for all observables. They also find that, unlike for full doc loans, borrower's information for low documentation loans does not predict default well, suggesting it is either inaccurately recorded or intentionally falsified.

Similarly, Rajan et al. (2010), who look at lenders representing more than 90% of the subprime mortgages, find that low doc loans performed worse than full doc loans. They also find that observable information for low doc fails to predict defaults—more so for borrowers for whom “soft” information might be important.

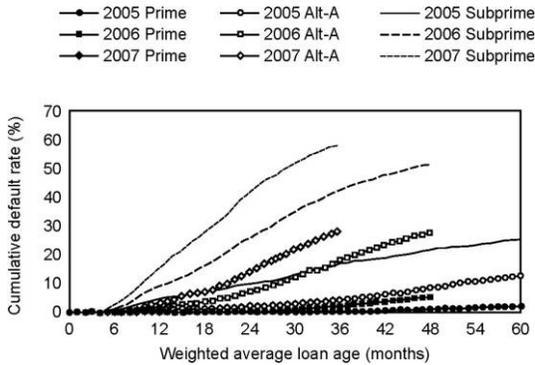
In sum, while logically one could argue that prohibiting low doc loans would have reduced the number of bad loans, there is no evidence that a more lax regulatory environment leads to a higher number of bad loans.

### **Were These Bad Loans the Major Cause of the Crisis?**

Paradoxically, the weakest link in the logical argument is the connection between the bad loans and the overall financial crisis. I say “paradoxically” because this link is a foregone conclusion in most of the popular discussion. Nevertheless, we need to distinguish between the effect of the real estate bubble and the marginal effect due to the bad loans. As before, if all loans required 50% down, even the bursting of a real estate bubble would not have had very dramatic effects. Thus, the crucial dimension to establish this link is the interpretation of the word bad. If by “bad” we mean fraudulent, I posit that the link is far from clear. In the Jiang et al. (2010) paper, for instance, the difference in default between low doc and full doc loans was only 5 to 8 percentage points. Yet the increment in default rates during the crisis was much, much higher.

As figure 1 shows, the difference in cumulative default rates across various default vintages was enormous. After 24 months the 2005 subprime vintage had only 10% of cumulative default, versus almost 30% for 2006 and more than 40% for 2007. The large surge in defaults in 2006–2007 was present also in the full doc loans, albeit the difference between low and full doc defaults increased (see Rajan et al. 2011). Thus, the main cause of the increase in defaults seems to be a macro factor, not a micro one.

We arrive at the same conclusion if we analyze the result of the Illinois experiment. The mandatory counseling pilot program that decreased by 47% the number of purchase-related mortgages and by 77% the refinancing was able to reduce the ex post default rates only by 3 to 4 percentage points. Even with the most aggressive counseling and eradication of liar loans, regulation could have reduced mortgage default rates by less than a third. Fraudulent loans are terrible and people



**Fig. 1.** Overall cumulative defaults (active plus closed defaults) by first-quarter vintage and product type.

Source: Standard & Poor, "U.S. Residential Mortgage Default Index: Defaults Are Waning But Cumulative Default Rates Remain Extremely High for Recent Vintages," May 24, 2010.

who consciously underwrote them should be prosecuted. Still, it is far from clear that they were the main cause of the crisis.

## Conclusions

Before the development of modern medicine, every time there was an epidemic a few people were unjustly accused of spreading the disease and ended up lynched or executed in the public square. These killings did not prevent future epidemics, but they did calm public anxiety and fulfilled the desire of public authorities who wanted to be seen as proactive. Economics is not as developed as modern medicine, but fortunately is not as primitive as premodern medicine. With sufficient data we do have methods to identify the potential causes of a phenomenon. Most of the time, the limits are imposed by the data availability, not by our methodology.

The Financial Crisis Inquiry Commission, nominated by Congress, was supposed to collect the necessary data and analyze it so as to provide an accurate report of what happened. Unfortunately, it wasted its time in political squabbles and provided no data. Thus, three years after the crisis we are still wondering should take the most blame.

As with most big trends, the crisis was probably the combination and the interaction of several factors: a very lenient monetary policy, very lax lending standards, and heavy lobbying to keep the previous two in place. Igan et al. do an excellent job in showing how these phenomena

are correlated. More micro data are needed to try to tease out the casual link.

## Endnotes

For acknowledgments, sources of research support, and disclosure of the author's material financial relationships, if any, please see <http://www.nber.org/chapters/c12418.ack>.

1. <http://www.alldc.org/publicresources/lobbying.cfm>
2. [http://www.reedsmith.com/library/search\\_library.cfm?FaArea1=CustomWidgets.content\\_view\\_1&cit\\_id=14695](http://www.reedsmith.com/library/search_library.cfm?FaArea1=CustomWidgets.content_view_1&cit_id=14695)
3. <http://www.nlihc.org/doc/repository/IL-Findings.pdf>

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