U.S. State Politics and Bank Performance

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The goal of this research is to examine the impact of politics in all 50 U.S. states on bank performance over the period of 1999-2021. Prior to this study, the impact of politics on bank performance was examined by one paper on the Federal level as it pertained to political affiliation of the U.S. president and the party in control of the Congress and by another paper that looked at politics on the state level but the time span for was limited to one year that marked the onset of the Covid pandemic. The findings of this research show that which of the two political parties controls the governorship and whether a single political party controls both the governorship and the house legislature impacts bank performance within states. Research shows that republican control of the governorship is associated with higher bank profitability, liquidity and capital adequacy but lower asset quality. Additionally, when a single party controls both the governor's mansion and the legislative majority, banks produce lower profits, and similarly to the results for the republican governors, higher levels of liquidity and capital, but lower levels of asset quality.

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1. Introduction

Political influence in the United States seems to permeate all spheres of public discourse with increasing intensity. Certainly, as it pertains to the economic activity, political undercurrents have long been believed to levy a direct impact on both macro and micro economic variables. Due to the existence of these pressures, the Federal Reserve Bank's function is designed to be mostly insulated from the executive and legislative branches of the government. The goal of this research is to examine the impact of politics on bank performance in all 50 U.S. states over the period of 1999-2021. Specifically, the paper examines whether the political party, republican or democrat, that controls the gubernatorial seat in the state and the majority in the state's legislature impacts bank performance across all U.S. states. Previous literature was able to demonstrate a relationship between bank performance and political party in charge of the White House and U.S. Congress as well as between state level political parties and bank performance during the Covid pandemic that covered a period of one year. This study takes a more extensive look at the impact of state level politics on bank performance by examining more than two decades of political influence within states on bank performance. The results show that republican governors are associated with higher profitability in banks within their respective states, however, when both the governors and majority of state legislatures belong to a single party, the level of bank profitability tends to decline. Further, banks operating in states with republican governors and with a single party in control of

the governorship and state legislature demonstrate higher levels of capital and liquidity but lower levels of asset quality.

The rest of the paper is organized as follows. Section 2 presents the literature review. Section 3 describes data and key variables. Section 4 covers methodology. Section 5 presents empirical test results. Section 6 concludes this study.

2. Literature Review

The political party influence on U.S. banks was examined by Fayman et al., (2018) and the research concluded that bank capitalization, lending and profitability was indeed impacted by the political party affiliation of the U.S. president and the party in control of the U.S. Senate and the House of Representatives. Moreover, the research shows that concentration of political power in the hands of one party leads to higher income for American banks. Fayman (2022) examined the impact of state politics on bank performance across U.S. states and found that during the four calendar quarters which marked the onset of the Covid pandemic that brought about unparalleled levels of polarization along the political party lines, banks that operated in states with republican governors or republican governors and legislatures demonstrated higher levels of profitability and liquidity. Postulating that politics influences banking likely does not require a great leap of faith. Indeed, post the Great Recession of 2008, there have been numerous calls for a greater political influence into prevention of future bank-caused financial meltdowns (Crawford (2011), Boerner (2008) and Congleton (2009)).

Besides the research mentioned above, the only other study found to look at the impact of state politics on bank performance was Almazan et al., (2010). The researchers concluded that firm location, as it related to states with republican or democratic control influenced firms' performance ratios. Additionally, there are a number of studies that look at presidential elections in order to extract evidence of political party influence on financial markets. These studies find that markets typically greet democratic winners of presidential elections with lower stock prices Niederhoffer et al., (1970), Reilly and Drzycimski (1976)) and Oehler et al., (2013)). These findings provide some credence to the believe that the republican party is viewed more variably by the business community. Nippani and Medlin (2002) and Ferri (2008) also demonstrate a similar relationship between election day results and market performance. There have been a number of studies that do not find a concrete and positive relationship between performance of financial securities and a particular political party gaining control on the federal level in Washington DC (Day and Harvey (2013), Oehler et al., (2013) and Riley and Luksetich (1980)). For every study that seems to discover a link between electoral process and political influence on financial market performance or reaches a contrary conclusion, there is research ready to rebuke those postulations with empirical evidence of their own (Coopet et al., (2006), Stangl and Jacobson (2007) and Blinder and Watson (2016)). For instance, two studies, (Showberg et al., (2007) and Day and Harvey (2013)), examined the link between which party took control of the U.S. Congress and concluded that financial markets produced positive abnormal returns if democrats took control and Oehler et

al., (2013) reach an opposite conclusion. Additionally, Bredthauer et al., (2015) and Homaifar et al., (1988) demonstrate that the elected president's political affiliation also impacts health care and defensive industries.

This study aims to add to previous research by providing a deeper look over an extended time period at the influence of state politics on bank performance. It is important to examine whether political discourse in gubernatorial mansions and legislative houses impacts bank performance within states.

3. Data

In this study, we use two major datasets. First, the data on all U.S. commercial banks was collected from the Federal Deposit Insurance Corporation (FDIC)[1] from 1999 through 2021, originating from the Call Reports. Banks with missing or zero values of asset, equity capital, total deposits, and bank premises & fixed assets are dropped. The Appendix defines the variables of the thirteen bank ratios we explore in this study, including the four categories: profitability, capital adequacy, liquidity, and asset quality. It also includes three control variables adopted in this study. Second, we obtained the data of each state's governor and legislature political party affiliation from 1999 through 2021 from the National Governors Association[2] and the National Conference of State Legislatures[3].

4. Methodology

Table 1 presents the descriptive statistics of the main control variables, including Total assets, Non-loan earning assets, and Fixed assets ratio. Panel A, B, and C display the statistics for all banks, banks in States with republican governors, and banks in states with democratic governors, respectively, through 1999 and 2021. All variables are winsorized at the 1% and 99% levels to mitigate the potential influence of outliers.

In our analysis, we adopt two major testing methodologies. We first conduct a series of t-tests of the thirteen key metrics in the areas defined in the Appendix to investigate whether a bank's performance is different under the influence of politics with four group settings. In the first set of t-tests, the two groups in comparison are states with republican governors versus states with democratic governors. For the second set of t-tests, we divide the banks into two groups where governors and legislatures belong to different parties where governors and legislatures belong to the same party. In the third set of t-tests, the two groups are states where governors and legislatures are democratic versus states where governors and legislatures are republican. Last, the t-tests are conducted in the states with a republican governor and a democratic legislature versus states with a democratic governor and a republican legislature.

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[1] See the website of FFIEC Central Data Repository's Public Data Distribution: https://cdr.ffiec.gov/public/.

[2] https://www.nga.org/

[3] https://www.ncsl.org/

In addition, we explore how bank performance differences are impacted by politics. If the performance ratios are significantly different among republican and democratic governors and legislatures, it is crucial to investigate whether the differences in performance are indeed driven by politics.

The model to examine the influence of politics on bank performance is based on Beck et al., (2013) and Fayman (2022):

$$Bank\ Performance_{it} = \beta_{0i} + \beta_1 GOV\ dummy_{it} + \beta_2 GOV - LEG\ dummy_{it} + \beta_3 ln(Assets)_{it} + \beta_4 Fixed\ assets\ ratio_{it} + \beta_5 Non - loan\ earning\ assets\ ratio_{it} + \varepsilon$$

where the dependent variables are the thirteen key metrics within the four categories of bank profitability, capital adequacy, liquidity, and asset quality; GOV dummy equals one for banks in states with republican governors and zero for banks in states with democratic governors; GOV-LEG dummy equals one for banks located in states where the governor and the legislature have the same party and zero when the governor and the legislature have different parties. Furthermore, to reduce the effect of potential unobserved bank-level heterogeneity, all regressions include bank fixed effects.

Table 1 : Descriptive Statistics

Panel A: All Banks					
	Mean	**Std. Dev.**	**Median**	**10th Pctl.**	**90th Pctl.**
Total assets	803509	3120559	144426	34442	965477
Non-loan earning assets	0.27	0.16	0.25	0.09	0.49
Fixed assets ratio	0.02	0.01	0.01	0.00	0.03
Panel B: Banks in Republican Governor States					
	Mean	**Std. Dev.**	**Median**	**10th Pctl.**	**90th Pctl.**
Total assets	701243	2759349	143339	34101	886304
Non-loan earning assets	0.28	0.16	0.25	0.10	0.50
Fixed assets ratio	0.02	0.01	0.01	0.00	0.03
Panel C: Banks in Democratic Governor States					
	Mean	**Std. Dev.**	**Median**	**10th Pctl.**	**90th Pctl.**
Total assets	953478	3579758	146230	34940	1105546
Non-loan earning assets	0.27	0.15	0.24	0.09	0.48
Fixed assets ratio	0.02	0.01	0.02	0.00	0.03

Note: This table provides summary statistics on the control variables, including Total Assets, Non-loan earning assets, and Fixed assets ratio. Panel A, Panel B, and Panel C present mean value, median value, standard deviation, 10th and 90th percentile values for all banks, banks in republican governor states, and banks in democratic governor states.

5. Empirical Results

5.1 T-test results

The goal of this research is to examine the impact of politics in all 50 U.S. states on bank performance over the period of 1999-2021. In this section, the univariate results presented in Tables 2-5 are discussed. From the results, it is apparent that the political affiliation of the governor and the majority of the state legislature impacts bank profitability, capitalization, liquidity and asset quality. In particular, banks tend to produce higher ROE, net interest margin and profit margin when their states are governed by a republican. Further, banks located in states during periods that coincide with control by democratic governors demonstrate higher loan ratio as well as deposit ratio and loans to assets, while banks in states with republican governors demonstrate higher capital ratios and cash to assets. As evident from univariate tests, the results are similar banks from states where republicans control both the governor's mansion as well as the legislative house.

Table 2 : T-Tests

	D-GOV N	D-GOV Mean	R-GOV N	R-GOV Mean	Diff
A: Profitability Variables					
ROE (Return on equity)	238,929	0.048	353,594	0.05	-0.003***
Net interest margin	235,758	0.024	349,000	0.02	-0.001***
Profit margin	238,869	0.134	353,514	0.15	-0.013***
B: Capital Adequacy					
Capital ratio	238,943	0.112	353,691	0.11	-0.002***
Loan ratio	238,829	6.334	353,607	6.10	0.232***
Deposit ratio	237,901	8.208	352,541	8.18	0.028***
C: Liquidity					
Loans to assets ratio	238,830	0.634	353,607	0.62	0.017***
Cash to total assets	247,041	0.073	362,487	0.08	-0.003***
Liquidity ratio	240,547	0.286	351,240	0.30	-0.012***
Deposits to liabilities	236,932	0.930	351,225	0.94	-0.008***
D: Asset Quality					
Expenses to revenue	238,362	7.132	352,802	7.06	0.072***
Loan loss allowance to total loans	237,954	0.015	352,316	0.02	-0.001***
Non-interest expense ratio	238,922	0.019	353,571	0.02	-0.001***

Note: This table provides key metrics in the areas of bank profitability, capital adequacy, liquidity, and asset quality between two groups. The two groups are banks located in states with republican governors versus banks located in states with democratic governors respectively. ***, **, and * indicate significance at the 1%, 5%, and 10% levels respectively.

Additionally, when looking at banks in states where the parties of the governor and the legislature do not match, banks tend to produce higher ROE and net interest margin while demonstrating higher loan and loans to assets ratios. However, banks in states where governors and majority of legislature belong to the same party, produce higher profit margin, capital ratio as well as cash to assets, liquidity ratio, deposits to liabilities, expenses to revenue and loan loss allowance. The final set of univariate tests compares banks in states with republican governors and democratic legislatures versus banks in states with democratic governors and legislatures dominated by republicans. It is evident that in such cases, banks in states with republican governors produce higher ROE and profit margin while banks in states with democratic governors produce higher net interest margins.

Table 3 : **T-Tests**

	GOV≠ LEG N	GOV≠ LEG Mean	GOV= LEG N	GOV= LEG Mean	Diff
A: Profitability Variables					
ROE (Return on equity)	250,807	0.051	323,067	0.05	0.003***
Net interest margin	247,442	0.024	318,667	0.02	0.004***
Profit margin	250,720	0.139	323,014	0.14	-0.002***
B: Capital Adequacy					
Capital ratio	250,847	0.112	323,138	0.11	0.001***
Loan ratio	250,735	6.297	323,052	6.12	0.181***
Deposit ratio	249,777	8.184	322,016	8.22	-0.038***
C: Liquidity					
Loans to assets ratio	250,736	0.632	323,052	0.62	0.015***
Cash to total assets	259,623	0.068	331,256	0.08	-0.012***
Liquidity ratio	249,512	0.285	323,626	0.30	-0.015***
Deposits to liabilities	249,163	0.929	320,345	0.94	-0.010***
D: Asset Quality					
Expenses to revenue	250,203	7.057	322,318	7.13	-0.075***
Loan loss allowance to total loans	249,714	0.015	321,927	0.02	0.005***
Non-interest expense ratio	250,784	0.019	323,060	0.02	0.001*

Note: This table provides key metrics in the areas of bank profitability, capital adequacy, liquidity, and asset quality between two groups. The two groups are banks located in states where governors and legislature belong to different parties versus banks located in states where governors and legislature belong to the same party. ***, **, and * indicate significance at the 1%, 5%, and 10% levels respectively.

Table 4 : T-Tests

	D GOV+LEG N	D GOV+LEG Mean	R GOV+LEG N	R GOV+LEG Mean	Diff
A: Profitability Variables					
ROE (Return on equity)	104,911	0.043	218,156	0.05	-0.008***
Net interest margin	103,001	0.023	215,666	0.02	-0.001***
Profit margin	104,883	0.118	218,131	0.15	-0.033***
B: Capital Adequacy					
Capital ratio	104,916	0.112	218,222	0.11	-0.002***
Loan ratio	104,844	6.308	218,208	6.02	0.283***
Deposit ratio	104,284	8.249	217,732	8.21	0.039***
C: Liquidity					
Loans to assets ratio	104,844	0.629	218,208	0.61	0.017***
Cash to total assets	110,898	0.076	220,358	0.08	-0.006***
Liquidity ratio	106,384	0.290	217,242	0.30	-0.014***
Deposits to liabilities	103,586	0.929	216,759	0.94	-0.016***
D: Asset Quality					
Expenses to revenue	104,629	7.704	217,689	6.86	0.848***
Loan loss allowance to total loans	104,302	0.015	217,625	0.02	-0.001***
Non-interest expense ratio	104,904	0.018	218,156	0.02	-0.001***

Note: This table provides key metrics in the areas of bank profitability, capital adequacy, liquidity, and asset quality between two groups. The two groups are banks located in states where governors and legislature are democratic versus banks located in states where governors and legislature are republican. ***, **, and * indicate significance at the 1%, 5%, and 10% levels respectively.

5.2 Regression results

To further delve into the data, this study employs the Beck et al., (2013) model to analyze the significance of state politics on bank profitability, capital adequacy liquidity and asset quality variables. From Panel A of Table 6, it is evident that banks produce higher profits, as measured by ROE, net interest margin and profit margin when they operate in states with republican governors. Interestingly, banks in states controlled by governors and legislatures dominated by one party produce lower ROE, net interest margins and profit margins. As demonstrated in Panel B of Table 6, banks in states with republican governors tend to hold more capital to total assets, lower levels of loans to total equity and lower levels of deposits to equity capital. When both the gubernatorial seats and the majority of seats in state legislatures are occupied by a single party, the results for capital adequacy are similar to the results produced by the models that examines the impact of the governors' political affiliation on capital adequacy. That is, when the governor and majority of state legislature belong to a single party, the capital ratios tend to be higher, but the loan and deposit ratios are lower than when states' governorship and legislature are under mixed political control.

Table 5 : T-Tests

	R GOV D LEG N	R GOV D LEG Mean	D GOV R LEG N	D GOV R LEG Mean	Diff
A: Profitability Variables					
ROE (Return on equity)	76,964	0.053	83,534	0.05	0.006***
Net interest margin	76,546	0.024	82,327	0.02	-0.001***
Profit margin	76,949	0.153	83,491	0.12	0.035***
B: Capital Adequacy					
Capital ratio	76,970	0.112	83,536	0.11	-0.002***
Loan ratio	76,953	6.290	83,480	6.23	0.059***
Deposit ratio	76,838	8.183	83,115	8.16	0.028**
C: Liquidity					
Loans to assets ratio	76,954	0.634	83,480	0.63	0.006***
Cash to total assets	76,854	0.069	86,070	0.07	0.003***
Liquidity ratio	76,618	0.286	83,301	0.28	0.004***
Deposits to liabilities	76,717	0.934	82,787	0.93	0.004***
D: Asset Quality					
Expenses to revenue	76,796	6.703	83,302	7.87	-1.169***
Loan loss allowance to total loans	76,800	0.015	82,940	0.02	0.005
Non-interest expense ratio	76,964	0.018	83,517	0.02	-0.001***

Note: This table provides key metrics in the areas of bank profitability, capital adequacy, liquidity, and asset quality between two groups. The two groups are banks located in states with republican governors and democratic legislatures versus banks located in states with democratic governors and republican legislatures. ***, **, and * indicate significance at the 1%, 5%, and 10% levels respectively.

Further, Panel C in Table 6 presents regression models that analyze the impact governor's political affiliation and whether a single party control the governorship and the house legislature on bank liquidity. The results of the fixed effects regression models suggest that banks operating in states with republican governors produce lower loans to assets ratios but hold higher levels of cash to total assets, demonstrate higher liquidity ratios and deposits to liabilities. The results are identical for the models that examine a single party control of the gubernatorial mansion and states' legislature and show that when banks operate in states with governors and majority legislators belonging to the same party demonstrate higher liquidity levels than banks that operate in states with mixed political leadership. Finally, Panel D of Table 6 presents the results of regression models that analyze the impact of state political control on asset quality of banks in their respective states. The results of the models show that when states are controlled by republican governors, banks produce higher expenses to revenue, higher loan loss allowance to total loans and higher non-interest expense ratio. These results indicate lower asset quality is associated with republican

governors. The results remain the same for the three asset quality ratios when examined relative to the GOV-LEG variable. That is, banks tend to demonstrate lower asset quality when their states are controlled by governors and state legislatures which are located underneath the same political umbrella.

Table 6 Regressions

	GOV dummy	GOV-LEG dummy	Ln (Assets)	Fixed assets ratio	Non-loan earning assets ratio	Con.	Adjusted R^2
Panel A: Profitability Variables							
ROE	0.002***	-0.004***	0.002***	-0.073***	-1.031***	0.070***	0.338
Net interest margin	0.001***	0.001***	-0.002***	-0.021***	-0.017***	0.049***	0.129
Profit margin	0.012***	-0.007***	0.084***	-0.147***	-4.166***	-0.752***	0.467
Panel B: Capital Adequacy							
Capital ratio	0.001***	0.002***	-0.014***	0.021***	0.387***	0.264***	0.636
Loan ratio	-0.091***	-0.083***	0.365***	-7.585***	-13.416***	4.258***	0.750
Deposit ratio	-0.021***	-0.053***	0.284***	0.12***	-11.504***	5.025***	0.604
Panel C: Liquidity							
Loans to assets ratio	-0.004***	-0.003***	0.03***	-0.807***	-0.868***	0.506***	0.910
Cash to total assets	0.001***	0.006***	0.018***	0.19***	-0.03***	-0.197***	0.549
Liquidity ratio	0.006***	0.001***	-0.005***	0.841***	-0.497***	0.129***	0.932
Deposits to liabilities	0.006***	0.005***	-0.002***	0.035***	0.057***	0.942***	0.684
Panel D: Asset Quality							
Expenses to revenue	0.086***	0.35***	-2.041***	4.154***	62.773***	29.139***	0.496
Loan loss allowance to total loans	0.001***	0.001***	0.001***	0.017***	0.023***	0.007***	0.521
Non-interest expense ratio	0.001***	0.001***	-0.002***	-0.003***	0.143***	0.044***	0.322

Note: This table displays the output of fixed effects panel regression models that examine areas of profitability, capital adequacy, liquidity, and asset quality in each panel respectively. The independent variables are GOV dummy that is equal to 1 for banks in states with a republican governor and 0 for banks in states with a democratic governor, GOV-LEG dummy that is equal to 1 for banks located in states where the governor and the legislature have the same party and 0 when the governor and the legislature have different parties, Natural log of total assets, Fixed assets ratio and Non-loan earning assets ratio. ***, **, and * indicate significance at the 1%, 5%, and 10% levels respectively.

6. Conclusion

This study examines the impact of political control in all 50 states on performance of banks conducting business within those states for all banks during 1999-2021. In particular, the study looks at the influence of political affiliation of

governors and the impact on banks performance when both the governorship and the states' legislatures are controlled by a single political party. The results show that banks which operate in states controlled by republican governors produce higher levels of profitability. Interestingly, when both the governor and the majority of state legislature belong to a single party, the level of bank profitability tends to decline. Additionally, banks that operate in states with republican governors and a single party control over both the governorship and the legislature show higher levels of capital and higher levels of liquidity. However, results also indicate the republican governors and single party control in states are associated with lower asset quality. These results are significant because this study establishes that state politics do indeed impact bank performance within states. These results may be pertinent to political leaders as they reflect on how their decisions impact banks as well state and federal regulators and banks operating within those states.

Appendix : Variable Definitions

A: Profitability Variables	
ROE (Return on equity)	Total income/total equity capital (%)
Net interest margin	(Interest income - Interest expense)/earning assets) (%)
Profit margin	Net income/(non-interest income + interest income) (%)
B: Capital Adequacy	
Capital ratio	Total equity capital/total assets (%)
Loan ratio	Total loans/total equity capital (%)
Deposit ratio	Total deposits/total equity capital (%)
C: Liquidity	
Loans to assets ratio	Total loans/total assets (%)
Cash to total assets	Cash + balances due from institutions to total assets (%)
Liquidity ratio	(Cash +securities)/total assets (%)
Deposits to liabilities	Total deposits/total liabilities (%)
D: Asset Quality	
Expenses to revenue	Non-interest expense/non-interest revenue (%)
Loan loss allowance to total loans	Loan loss allowance/total loans (%)
Non-interest expense ratio	Non-interest expense/total assets (%)
E: Control Variables	
ln (total assets)	Natural log of total assets
Non-loan earning assets ratio	Non-loan earning assets/total assets (%)
Fixed assets ratio	Fixed assets/total assets (%)

Note: This table displays definitions of key metrics in the areas of bank profitability, capital adequacy, liquidity, and asset quality that were analyzed in this research

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