Strategically Staying Small: Regulatory Avoidance and the CRA

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Summary

- Research question
  - How do banks respond to regulatory constraint?
  - Real consequences in lending behavior and local economic outcomes
- Relevance
  - Cost of regulation
  - Intended and unintended consequences of the CRA program

Main Findings

- Introduction of an asset-based two-tiered evaluation scheme in the 1995 CRA reform
  - Significant bunching of banks right below the $250M regulatory threshold
- Bank outcomes
  - DID identification strategy; treatment group = banks falling just below the $250M regulatory threshold
  - Slower asset growth, driven by decrease in loan and cash growth; higher profitability
  - Decrease in leverage and increase in dividend payout
  - An increase in the rejection rate of LMI loans
- Local economic outcomes
  - Treatment group = counties with a larger share of small banks
  - A decline in small business growth and independent innovation

Cost of Regulatory Requirement

- Stated motivation
  - “Replace paperwork and uncertainty with greater performance, clarity, and objectivity”
- Large vs. small banks
  - Evaluation process and scope
  - Disclosure requirement on small business loan characteristics
  - Evaluation interval
- Cost of regulatory avoidance
- Trade-off

Implication

- Weaker banks have incentive to avoid the regulatory cost?
  - Lower quality
  - Lower growth potential

- Self-selection
  - Sorting outcome
  - Is it (necessarily) distortionary?

Real Effects of the Bunching Choice

- Interpretation?
  - Slower asset growth
  - Improvement in bank profitability

- Bank's lending response and local economic growth potentially more informative

- Comments and suggestions

Banks' Lending Response

- Difference in differences
- Treatment banks: those fall right below $250M in 1994
  - Possible that some choose to cross the threshold in later years?
- Control banks: above $250M in 1994 (full, < $500M, and < $350M)
  - Possible that some choose to reduce size to stay below the threshold?
- Implies an underestimate of the asset growth effect
- But also makes the parallel trend assumption harder to test

Banks’ Lending Response

- Ideal control group
  - Banking facing similar regulatory intensity but different bunching motives
  - Separate out the confounding effect from the regulatory reform shock
- Current control group
  - Large banks (>250M) and very small banks (<200M) (?)
  - However, the policy shock “increased regulatory intensity and monitoring for banks with assets greater than $250M” (page 1)
  - Suggestion: use very small banks only as the control

Banks' Lending Response

- Increase in rejection rates for CRA-targeted loans
- Could be interpreted as unintended consequence for the CRA initiative with redistributive implications
- Alternatively,
- Weaker banks' rational response by rejecting riskier loans in general
  - Not specific to CRA
- How about lending to other risky loans that are not targeted by CRA?

Local Economic Outcomes

- Analysis is done at the county level
  - Counties with higher vs. lower share of banks just below the threshold
  - Most counties (85%-90%) do not have a single treated bank
- Balancing tests: Similar growth potential?
  - Parallel trend assumption
  - How about overall employment growth?
- Back of envelope check:
  - How large is the lending response at the aggregate level (not many treated banks in the sample)
  - Does this number add up with the responses of real outcomes?

Local Average Treatment Effect

- By design

- Relevant mostly for banks
  - Close to the threshold, and
  - with limited growth potential

- The chosen cutoff point of $250M may reflect regulators' assessment of the relevant aggregate impact