



Who's Holding the Bag?

Regulatory Compliance Pressure and Bank Risk-Shifting

Lamont Black

and

John Hackney





Banks face regulatory compliance pressure.
How do they **manage** it?





Community Reinvestment Act (CRA)

- The CRA Act of 1977 encourages banks to meet the credit needs of their communities
- Assessment areas are determined by branch locations, ATMs, and banking activity
- Banks undergo regular on-site *exams* to determine CRA compliance
- We focus on the *small business lending test*





CRA Exam Cycle

- Banks undergo a CRA exam on a regular schedule
 - Large banks about every 2 years
 - Small banks about every 4 to 6 years
- But, the lending test is typically only 1 or 2 years
- There are “dark” periods in small bank CRA compliance





Do small banks “cram” for the CRA exam?





Our Analysis

- **Hypothesis:** Small banks “cram” in the year of their exam by making more CRA loans
- **Data:** CRA loan data (<\$100K; \$100-250K; \$250K-1M)
- **Test:** We compare the small business lending of banks undergoing a CRA exam to that of non-exam banks in the *same county and year*
- **Result:** Small banks increase smallest loans (<\$100K) by 19% during CRA exam years





Next Question

- *How* do small banks “cram” for the exam?
- We look at the Small Business Administration (SBA) 7(a) program
- Many small banks make SBA loans
- SBA guarantees up to 85% of the loan balance





**Does SBA lending
provide a means to achieve
CRA compliance?**





Our Analysis

- **Hypothesis:** Small banks increase SBA loans to increase CRA loans
- **Data:** Loan-level SBA 7(a)
- **Test:** We compare the SBA lending (volume and share) of banks undergoing a CRA exam to that of non-exam banks in the *same county and year*
- **Result:** CRA “cramming” loans are more likely to be SBA





What are the pros and cons of **CRA + SBA ?**





Pros & Cons of CRA+SBA

- SBA loans granted in the quarter of a CRA exam announcement are *more likely to default* – risk-shifting to the government
- CRA-induced lending leads to short-term *increases* in small business employment but long-term *declines*





Learning from Bankers/Examiners

Does all this sound plausible?

We would welcome input from you
or your CRA or SBA officers!

lblack6@depaul.edu

