Who’s Holding the Bag?
Regulatory Compliance Pressure and Bank Risk-Shifting

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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!

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