• Well recognized: government regulation of banks may be necessary even without safety nets (e.g., Calomiris and Haber book “Fragile By Design”).
  • Need is amplified by safety nets and resulting distortions in bank behavior.
• Issue: regulation often has unintended (second-order) side effects, which may even negate the first-order benefits.
  • Example: Huang and Thakor (working paper, “Political Influence on Bank Credit Allocation, Bank Capital Responses and Systemic Risk”) documents: state-chartered banks consider the political inclinations of the party in power in the governor’s mansion to adjust their capital ratios and lending practices, including CRA compliance.
Both papers in this session address this issue but in very different contexts.

Overarching research question:

How does bank regulation designed to better serve certain disadvantaged borrower groups affect the behavior of banks and their borrowers?

Overarching answer:

- Banks respond strategically to regulations, especially threshold-based regulation.
- This distorts bank behavior, with potential real effects.
- Injection of the government into the process (unavoidable with additional regulation) can even distort the behavior of borrowers.
Strategically Staying Small: Regulatory Avoidance and the CRA (Cespedes, Nickerson, and Parra)

• Research Question:
  • How do banks respond to a two-tiered regulation system with the CRA that imposes a bigger regulatory burden on banks above a size threshold than on banks below?

• Key results:
  • Banks strategically manipulate asset size to try and stay below the $250M threshold.
  • This affects their lending behavior and real outcomes in the areas in which they lend.
    1. Increased rejection of LMI loans; and
    2. The areas served by treated banks experience a decline in the county-level share of small establishments and innovation.
Strategically Staying Small: Regulatory Avoidance and the CRA (Cespedes, Nickerson, and Parra)

• Thus, regulation has unintended and undesirable real effects.
  • This aspect of CRA produces behavior that hurts the very groups it intends to serve.

• Size-based regulatory requirements are pervasive in banking.
Strategically Staying Small: Regulatory Avoidance and the CRA (Cespedes, Nickerson, and Parra)

- Paper is related to Bouwman, Hu, and Johnson (JFI, 2018 – cited) on regulatory thresholds and how banks respond to them.
  - Dodd-Frank Act: new regulatory requirements on banks with assets >$10B and >$50B.
  - That paper also documents effects on lending behavior:
    - Net regulatory costs increase across the size thresholds.
    - Below-threshold banks grow assets and loans more slowly to avoid crossing thresholds.
    - Below-threshold banks charge significantly greater loan spreads.
Strategically Staying Small: Regulatory Avoidance and the CRA (Cespedes, Nickerson, and Parra)

- Important: How to establish treatment effects?

**Tempting but wrong:**
- Treated
- Untreated

**Bouwman, Hu, and Johnson (JFI, 2018):**
- Treated $10B-$13B
- Indirectly treated $7B-$10B
- Untreated $4B-$7B

**Cespedes, Nickerson, and Parra:**
- Untreated Up to $350M
- Treated $200M-$250M
Cespedes, Nickerson, and Parra’s finding: residual real effects also means that there was no “substitution effect”:  
  • The unaffected (or non-treated banks) were not able or willing to adapt their behavior to make up for the distortion caused by the behavior of the treated banks.

In contrast, Bord, Ivashina, and Taliaferro (JFI, Oct 2021) show: effect of the 2007 real estate price collapse on small business credit supply was muted by the actions of unaffected banks.
Small Bank Financing and Funding Hesitancy in a Crisis: Evidence from the PPP (Balyuk, Prabhala, and Puri)

• Research Question:
  • How did subsidized financing under the PPP affect firms and borrowers?

• Key results:
  1. Smaller firms were less likely to gain early PPP access.
     • Effect was attenuated in small banks and small firms that had prior lending relationships with these banks.
  2. Hesitancy of small firms to join the program may have been driven by their reluctance to be subjected to more intense government regulatory scrutiny (possibly with political undertones).
Small Bank Financing and Funding Hesitancy in a Crisis: Evidence from the PPP (Balyuk, Prabhala, and Puri)

• Result (1):
  • Similar to the finding in Berger, Bouwman, Roman, Udell, and Wang (*Is a Friend in Need a Friend Indeed? How Relationship Borrowers Fare during the COVID-19 Crisis*, working paper 2021): small banks provided their small firm relationship borrowers with continuation financing at better terms during COVID-19 than non-relationship borrowers,
  • Consistent with theoretical predictions in Boot and Thakor (IER 1994).
  • Consistent with other recent evidence that relationship lending has real effects.
    • E.g., Banerjee, Gambacorta, and Sette (*The Real Effects of Relationship Lending*, JFI, 2021).
Small Bank Financing and Funding Hesitancy in a Crisis: Evidence from the PPP (Balyuk, Prabhala, and Puri)

- Result (2) is consistent with:
  - Theories of the interaction between politics and bank lending.
    - Thakor (*Politics, Credit Allocation, and Bank Capital Requirements*, JFI 2021).
  - Rational expectations:
    - Look at TARP and PPP: government changed the rules after the programs started!
      - TARP: salaries of senior executives at TARP recipients are capped at $500K.
      - SBA announced it will audit all PPP loans in excess of $2 million and may spot-check other loans.
Small Bank Financing and Funding Hesitancy in a Crisis: Evidence from the PPP (Balyuk, Prabhala, and Puri)

  - Realize: firms do not apply to the government, but to banks.
  - Small firms may be hesitant to apply for a loan because they do not have a strong relationship with their bank.
  - Banks with political connections are more likely to get PPP funding.
    - Small banks may have worse connections.
Concluding Remarks

• Two excellent papers that examine two different contexts to reiterate, based on causal evidence, that the design of bank regulation must:
  • Account for the strategic responses of both banks and borrowers and
  • Be cognizant of second-order distortions that may overshadow first-order benefits.
    • That is, bank regulation may sometimes hurt the very groups it seeks to serve.

• Policy implication:
  • New regulations should perhaps be viewed as “experiments” and there should be sufficient flexibility to modify or even eliminate regulations that are generating counterproductive effects.
    • Otherwise, there may be no end to the costly cycle of regulation ➔ bank response ➔ distortions ➔ more supervision and regulation ➔ more bank responses.