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The Real Effects of Liquidity on Behavior: Evidence from Regulation and Deregulation of Credit Markets

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Purpose

The first two chapters of this dissertation examine the impact of the 1976 Community Reinvestment Act (CRA) on small business lending, and especially the 1995 reforms of this law. The CRA provides banks with incentives for lending to small businesses in low- and moderate-income neighborhoods since a bank's CRA record is considered when the bank applies for permission to expand. As such, it is important to determine if the CRA has significantly affected small business lending in these areas and whether such lending has real effects on the economy.

Overall Findings

The author presents evidence that banks with binding CRA incentives appeared to increase their small business lending by approximately 12 to 15 percent, and the number of firms holding debt increased by some 15 percent in counties with affected banks. There is also evidence that these changes in the availability of credit produce real changes in the form of payroll increases and bankruptcy decreases in the affected counties. The findings, therefore, appear consistent with a model in which targeted credit market interventions can improve efficiency, although important questions remain.

Highlights

Effects of CRA on Bank Lending

• Banks affected most by the CRA reforms did increase their small business lending, on the order of 12 to 15 percent. Moreover, CRA lending does not appear to be completely offset by decreases in non-CRA lending, either within or across banks, indicating no clear evidence of any crowding out. For the economy as a whole, CRA increased access to credit for approximately 5 percent of firms overall.

Effects of CRA on Debt Holding by Potential Borrowers

• Using Internal Revenue Service data that capture the financial structure of potential CRA borrowers, the study found that the probability of holding debt increases by approximately 7 percentage points because of CRA among affected firms relative to unaffected firms.

• Taken together, results from tests on potential borrowers suggest that CRA increases the number of firms that hold debt by 7 to 10 percentage points. Because about 60 percent of all firms are in counties

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where CRA regulations are relevant, CRA increases the total number of firms holding debt by an estimated 4 to 6 percentage points. However, the results provide no support for the hypothesis that CRA reforms successfully target firms in low- to middle-income areas.

Real Effects on County Payroll and on Bankruptcies

• The point estimate suggests that CRA increases payroll by nearly 1 percent in affected counties, although this increase is not statistically significant. Personal (nonbusiness) bankruptcies dropped by 3.6 percent. This could be driven by the improved ability of closely held businesses to stick it out, the improved ability of households to smooth adverse shocks because of increased access to credit, or some combination of both.

Scope and Methodology

By emphasizing lending performance in the targeted low- to moderate-income areas, the 1995 CRA reforms make it possible to investigate the impact of CRA regulations on small business lending by banks, specifically by large banks and banks that are most affected by CRA performance review. With variations in the applicability of the review reforms, several variables can be created for testing the hypotheses. Moreover, there are also substantial differences in the propensities to regulate by the agencies charged with enforcing CRA. Variation in "regulator toughness" also becomes an important variable in evaluating the impact.

An assessment of the impacts of these variables on potential borrowers and bank lending is presented in Chapter 1 and the effects of increased lending on real activities in Chapter 2. The author formulated models and estimated the statistical significance of the critical variables as well as the magnitude of the impacts for each variable. Data sources used include corporate tax returns from the Internal Revenue Service, small business lending information from the June issues of the Federal Reserve's call reports, bankruptcy data from the Administrative Office of the U.S. Courts, and county payroll data from *County Business Patterns* of the U.S. Bureau of Census.

Ordering Information

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