

How states help banks exploit federal regulations

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The U.S. government had a noble intention when it conceived the Community Reinvestment Act. Yet states worked with banks to exploit the ambiguous requirements of the law to circumvent federal control and facilitate acquisitions.

The Community Reinvestment Act of 1977 was supposed to encourage lending to poor and middle-income communities. Additionally, this law gave federal banking regulators a mechanism to control bank acquisitions.

However, the ambiguous requirements of the law led to a situation where states actually helped banks circumvent federal control over acquisitions.

An article by Christopher Marquis (Harvard University), Doug Guthrie (George Washington University) and [Juan Almandoz](#) (IESE) shows how states not only helped banks sidestep this control, but also allowed banks to gain huge federal tax credits through another tax provision that was originally not intended for corporations.

The article, titled "[State Activism and the Hidden Incentives Behind Bank Acquisitions](#)," is to be published in the journal of *Social Science Research*.

Mutually beneficial

Almandoz and his coauthors use the example of the banking industry to study the interrelationships between corporations and federal and state governments.

Their research reveals how banks have been able to benefit from states' efforts to encourage economic growth within their borders.

States actively support bank consolidation within their borders because economies of scale allow larger banks to provide a much wider array of services, thus promoting local economic growth.

These states, therefore, align themselves with the interests of their local banks, especially when federal regulations represent a constraint to the banks' acquisition activity. One such example can be seen in how states exploited the ambiguities of the Community Reinvestment Act.

Community reinvestment act

In the past, banks would not lend money to individuals or businesses in certain low-income communities considered "high risk," regardless of the actual risks of the individuals or businesses applying for credit. This process is called redlining.

To encourage banks to extend credit to formerly redlined communities, Congress passed the Community Reinvestment Act (CRA) in 1977. The law required lenders to serve low and middle-income constituencies in local communities where they do business.

Banks with better community relations were rewarded with better CRA scores.

The CRA score matters most when banks seek to acquire other banks. Poor CRA ratings can be used by federal regulators to stop mergers.

However, to secure acquisition permits, banks can atone for low CRA scores by engaging in philanthropy or other activities in the communities they serve.

Role of tax credits

Starting in 1986, states seized on a new provision in the Federal Tax Code, the Low Income Housing Tax Credit (LIHTC), to help banks and other investors improve their CRA scores. The LIHTC offered a tax credit for investors in low-income housing that has much greater tax savings than a typical expense deduction.

In addition, corporations that buy the credits receive passive loss depreciation write-offs.

Needless to say, the conditions were highly favorable to banks. State agencies packaged and

sold the credits to banks, which were able to not only receive very generous tax benefits, but also use them to increase their CRA score to facilitate future mergers.

Influence of scores on acquisitions

Banks with outstanding CRA scores are less likely to make acquisitions because they wish to keep their high ratings intact and not jeopardize them by acquiring banks with lower ratings. Typically less than 10 percent of banks are rated outstanding, so the chances of finding another outstanding bank are small.

Banks with poor ratings, meanwhile, are unlikely to pursue acquisitions because of the likelihood that they will be blocked by regulators.

The banks that are most likely to make acquisitions are those with satisfactory CRA ratings because they do not have so much to lose and can still pass muster with federal regulators.

How states help companies profit

The authors found that states that do more to package and promote LIHTCs tend to have more acquisitions of their banks by other in-state banks. This, in theory, helps to strengthen local banking and keep economic resources closer to home.

In states that are less active in creating tax credits, banks are more likely to look for acquisitions beyond, rather than within, their state borders, thus diluting the banks' focus on their home state.

Although the article focused specifically on the banking industry, there are likely broader implications. Put simply, companies that face ambiguous federal regulations, and are based in states with interests aligned with theirs, may be able to use the states' interest to their own advantage.

A word of warning, though: Well-meaning regulation attempting to align social and economic goals can sometimes have undesired consequences.

As many critics have argued, by encouraging and actively helping banks and mortgage companies lend to high-risk individuals and businesses, federal and state governments set in motion a lowering of lending standards.

And as is now common knowledge, such lax lending standards in many states across the

United States would play an important role in fueling the real-estate bubble that precipitated the global financial crisis.

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