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Bank Supervision and Managerial Control Systems: The Case of Minority Lending

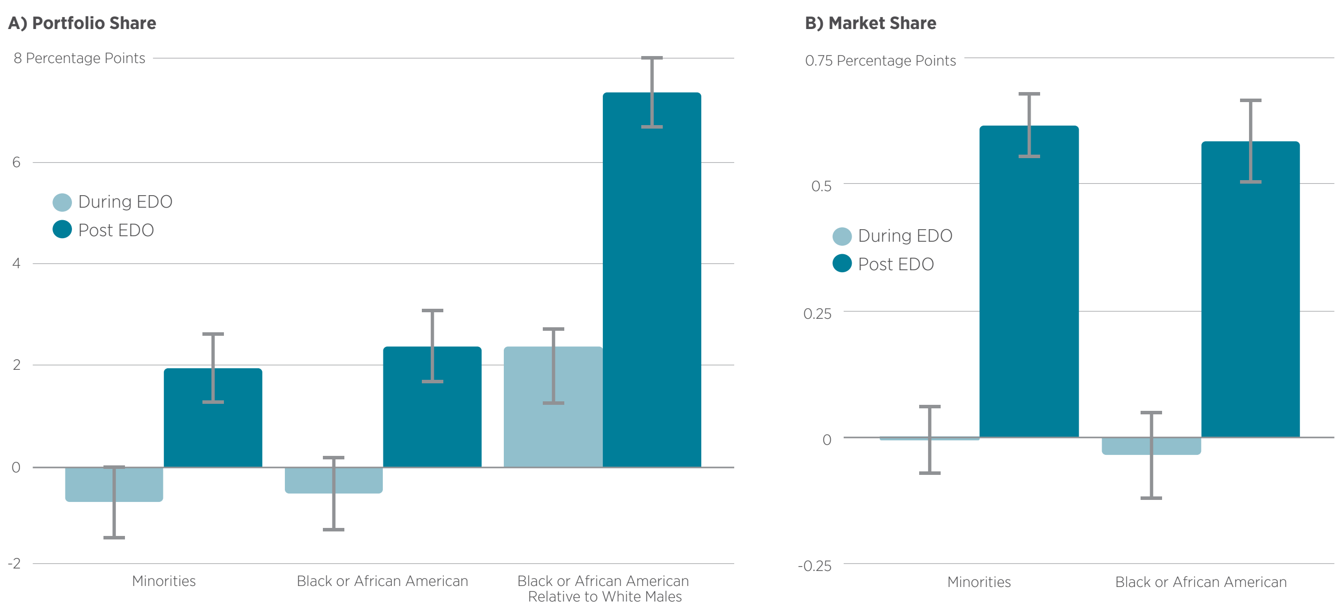
Based on BFI Working Paper 2023-16, "Bank Supervision and Managerial Control Systems: The Case of Minority Lending," by Byeongchan An, University of Utah; Robert Bushman, University of North Carolina; Anya Kleymenova, Federal Reserve Board; and Rimmy E. Tomy, Chicago Booth

Relative to white borrowers, mortgage lending to minority borrowers significantly increases following the resolution of enforcement decisions and orders (EDOs); this effect increases with the strictness of bank supervision and severity of the EDO.

One important effect of bank supervision is its effect on credit supply. Do certain supervisory practices influence loan supply? How do supervisory regime shifts, say, to more rigorous practices, affect credit supply? For example, recent research finds that internal lending practices among banks following a supervisory regime shift exhibit a pronounced increase in the amount and type of complex lending, such as lending to small businesses.

This work extends this literature by investigating how US banks' mortgage lending to minority borrowers, relative to white borrowers, changes following the resolution of severe enforcement decisions and orders (EDOs). EDOs are issued against financial institutions for unsafe or unsound practices; breaches of fiduciary duty; and violations of laws, rules, or regulations. The intuition for this study is similar to that described in the example above: Just as rigorous supervisory practices have been shown to

Figure 1 • Percentage Point Change in Banks' Share of Residential Mortgage Loans Relative to the Pre-EDO Period



increase small business lending, stricter bank supervision should also lead to loans for other complex borrowers, such as minority borrowers whose credit risk is more challenging to evaluate.

Regarding racial disparities in mortgage lending, the authors are particularly interested in which administrative controls, in the form of loan and internal governance policies and adherence to such policies, serve as mechanisms through which EDOs transmit their effect on lending outcomes. Recent research finds some support for this mechanism, showing that racial disparities can derive from the biases of individual loan officers and limitations on the scope of borrowers' information used in the lending decision.

To what degree, then, do post-EDO bank management policies address these issues and lead to better outcomes? The answer is important because banks' credit allocation decisions are crucial and have critical socio-economic implications. To this point, though, our understanding of the impact of administrative controls on banks' lending decisions is limited. This paper addresses this gap by examining the extent to which EDO banks' minority lending changes in the five years following the resolution of the EDO, to find the following:

- EDO banks significantly increase their mortgage lending to minority borrowers relative to white borrowers following the termination of an enforcement order. Specifically, the share of residential mortgage lending to minority borrowers in EDO banks' total residential mortgage portfolio, measured at the county level, increases by 2% to 7% after EDO termination.
- EDO banks increase their market shares of mortgage lending to minorities relative to all banks in a given county following EDO termination. Relative to the pre-EDO period, EDO banks' market share of mortgage lending to minorities increases by 0.58%–0.62%. On average, EDO banks' market share of lending to minorities in the residential mortgage market is 0.41%, making the increase economically significant.
- Increases in minority lending are significantly higher for EDOs that specify revisions of loan policies and or implement more formal internal governance procedures in counties with a higher proportion of subprime borrowers.
- Regarding the effect of supervisory enforcement, the authors find that the increase in minority lending is greater for banks with stricter regulators.
- Banks with more severe EDOs or with low CRA ratings expand their minority lending more after exiting EDOs.
- On the question of how corrective actions directly influence loan approval decisions, the authors find that mortgage loan denial is 9.6% more likely for minority borrowers relative to white borrowers prior to an EDO. However, following EDO termination, the likelihood of denial decreases by five percentage points for minority borrowers.
- Finally, regarding specific loan denial reasons, relative to the pre-EDO period, the rejection of minority loan applications due to borrower credit history is 3.4% less likely following EDO termination.

Bottom line: Supervisory enforcement matters. The authors' finding that banks increase lending to minority borrowers relative to white borrowers following the resolution of EDOs, has important implications for policymakers. Specifically, this work reveals that proper bank administrative controls are critical to enhancing access to mortgage credit for minority borrowers.

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