8-17-2022

Race and Regulation Podcast Episode 9 - Board Diversity and Community Lending

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Podcast Transcript:

Race and Regulation Podcast

Presented by the Penn Program on Regulation

Episode 9: Board Diversity and Community Lending with Brian D. Feinstein

Released on August 17, 2022

Music: Joy Ike's "The Fall Song"

Brian D. Feinstein: When Congress passed the Federal Reserve Act in 1913, it included geographic mandates to make sure that the Central Bank wasn't dominated by New York-based bankers. I get it. Geography matters. But today, race matters too. And in the contemporary context, particularly concerning lending, I would argue that someone's race matters a lot more than which region of the country they live in. I think the laws concerning these balance requirements should reflect that reality.

Cary Coglianese: That's Brian Feinstein, an expert on financial regulation and administrative law, delivering a lecture organized by the Penn Program on Regulation at the University of Pennsylvania. I'm Cary Coglianese, the director of the Penn Program on Regulation and a professor at the University of Pennsylvania. Welcome to our podcast, "Race and Regulation."

In this series, we are talking about the most fundamental responsibility of every society: ensuring equal justice, and dignity and respect, to all people. Advancing racial justice calls for all of us to understand better the racial dimensions of regulatory systems and institutions. We're glad you can join us as we hear from Brian Feinstein, a professor at the Wharton School at the University of Pennsylvania, speaking about how regulation can promote diversity on boards of directors.

In an earlier episode in this podcast series, Chris Brummer of Georgetown Law School discussed his research showing the lack of Black political leadership in federal financial regulatory bodies. This lack of Black leadership matters, Professor Brummer argued, because policy depends ultimately on who is "in the room where it happens," to quote from the musical *Hamilton*.

Music: "The Room Where It Happens," from the original Broadway cast recording of "Hamilton."

Professor Feinstein's research sought to test the room-where-it-happens hypothesis, and see what difference diversity makes in the leadership of financial regulatory bodies. This is important not only because of the difference it makes for public policy, but also because regulations in some jurisdictions have sometimes imposed requirements on private corporate boards to have more diverse members.

BF: The project basically has its origins in two observations. The first is that African Americans' access to the financial system is considerably more precarious than that of other Americans. And the second observation, which Cary, as you highlighted, draws on research that Professor Chris Brummer presented as part of this series, is that there is a real dearth of Black financial regulators. My coauthors and I wondered if those observations are connected, and if the number of minorities in leadership positions, if it increases, whether we would see a corresponding increase in access to financial services for minority borrowers. The leadership positions that we examine here are the boards of directors of the twelve regional Federal Reserve Banks. These are entities that regulate and supervise many, but not all, commercial banks within their geographical regions.

CC: Professor Feinstein and his coauthors—Peter Conti-Brown, also of the Wharton School, and Kaleb Nygaard, of Yale—sought to investigate the effects of diversity within these regional Federal Reserve institutions. Specifically, they wanted to see if greater diversity in terms of board membership was associated with greater access to loans to members of underserved communities and communities of color.

BF: We measure access to financial services using bank scores on regulators' exams under the Community Reinvestment Act, or CRA. The CRA requires that banks lend to underserved communities, often majority-minority communities within each bank's lending area.

CC: Although private banks must meet the same CRA requirements, some do a better job than others in terms of embracing and achieving the CRA's goal of increasing equity in lending practices. On a regular basis, each bank is scored by bank examiners for how well it is doing in meeting the CRA's goals. So, what did Professor Feinstein's research reveal?

BF: We find that diversity does matter, that banks that are supervised and regulated by Federal Reserve Banks with more Black and Hispanic leaders tend to engage in greater CRA lending and greater lending to these underserved minority communities. We find there's strong evidence that as the share of Black and Hispanic leaders of the relevant regional Federal Reserve Bank increases, the propensity of regulated banks within that region to lend to underserved communities also increases.

CC: These findings suggest that the law's success in improving racial justice—in this case, the financial regulatory law known as the CRA—depends in good measure on who exactly leads the institutions charged with carrying out regulation. And this can make a real difference in the lives of the individuals that law is supposed to serve.

BF: About twenty percent of Black households are what's called "unbanked," meaning no member of the household possesses a basic checking or savings account. You can compare that twenty percent rate of unbanked African Americans to a rate of around four percent of white households that are unbanked. African Americans pay much higher rates for mortgages and other loans, especially auto loans. They pay higher fees for basic banking services like checking accounts, and that's when they are able to access a bank. There is a much higher proportion of African Americans that live in what are called "banking deserts," where there is no brick-and-mortar branch of a bank that is nearby. African Americans are also more likely to be foreclosed upon and sued by creditors. And all of these disparities persist when one controls for factors like income and credit score.

CC: Widespread recognition of these inequities in access to basic banking services led to the passage of the CRA.

BF: Congress passed the Community Reinvestment Act in 1977 and significantly amended it several times thereafter to help redress some of these disparities. Its passage was, you can consider it the culmination of a series of anti-discrimination laws related to housing finance. So I place, for instance, the Fair Housing Act of 1968, passed as part of the Civil Rights Act of that year, in that group, as well as the Equal Credit Opportunity Act of 1974, the Home Mortgage Disclosure Act, also of 1974. But the CRA goes further than those other laws that prohibit discrimination. CRA affirmatively compels banks to extend for-profit lending into underserved communities. The law requires that federal banking regulators, like the Federal Reserve, periodically evaluate regulated banks and assign them a score based in large part on their record of lending to these underserved communities. Poor performance on CRA exams could inhibit banks' ability to expand either by opening more branches or through merger or acquisition.

Now, formally, the law is race-neutral. It speaks of lending to underserved communities within the bank's geographic region. Nonetheless, the CRA was seen at the time, and continues to be seen, as a piece with other civil rights laws redressing some of the wrongs that were made possible by government-promoted racial redlining. Redlining is essentially the practice of curtailing credit to neighborhoods that are seen as high risk, with that supposed risk closely correlated—and erroneously correlated based on racist premises—with the prevalence of African American residents in the neighborhood. The CRA was designed to serve an anti-subordination function, to affirmatively redress that sort of race-based, discriminatory underinvestment in minority neighborhoods.

But regardless of whether one thinks the CRA works well or not, and regardless of whether one thinks the CRA should be strengthened or whether it should be weakened, study after study has shown that the law has, in fact, spurred access to credit among minority borrowers and low-income borrowers. So whatever else the CRA may accomplish, it certainly does boost credit to those populations.

Music: Joy Ike's "Time"

CC: But it does not necessarily boost credit to all underserved communities equally. And what Professor Feinstein's research indicates is that this variation corresponds with the racial composition of the overseeing regulatory body.

BF: CRA exams are administered by a patchwork of federal regulators. For purposes of this study, what is important is that the Federal Reserve regulates state-chartered banks that are members of the Federal Reserve System. So not every bank, but certainly many. JP Morgan Chase comes to mind as the largest of these banks that the Fed regulates. The group also includes what you would call the "large regional banks." So, think of Sun Trust in the South, or Bank of New York Mellon in New York, or Northern Trust and Fifth Third in the Midwest.

The Federal Reserve System has a complex structure, but for our purposes, what is important is that bank regulation and supervision, including the CRA exams, is performed at the regional level by these twelve regional Federal Reserve Banks. For instance, the Philadelphia Fed examines banks that are headquartered in eastern and central Pennsylvania, in southern New Jersey, and throughout Delaware. CRA examiners of the Philadelphia Fed are responsive to the Philly Fed's president. They are not civil servants, they don't have civil service protection, they are more akin to corporate employees, with the Philly Fed president being their CEO. And the Philly Fed president, in turn, is responsive to a nine-member board of directors, much like a corporate CEO is responsive to a board. The board selects the president, the vice president, and other senior managers, and the board also has the power to remove these folks if it chooses to do so.

Under the uncontroversial assumption that regulated banks respond to their regulator, we posit that the composition of the Reserve Bank board of directors and, thus, its supervisory priorities, will influence lending activity of regulated banks. If you are a bank executive and you think your regulator cares a lot about lending to underserved communities, you're going to care more about lending to underserved communities. And if you think it's a low priority for your regulator, it's likely to be a low priority for you as well.

CC: Professor Feinstein and his coauthors statistically analyzed the relationship between the number of Black and Hispanic leaders who serve on a regional Fed board and the CRA scores of private banks in the corresponding region. They were able to isolate this relationship from the effects of other factors that might affect lending patterns, such as differences in state regulations or in local economic conditions.

BF: I mentioned that the Philadelphia Fed conducts CRA evaluations for banks, for instance, in southern New Jersey. Well, the northern half of New Jersey is in the New York Fed's turf. So, if we compare CRA lending for banks that are in southern New Jersey to CRA lending for banks in northern New Jersey, we have managed to control, essentially, for state regulation. Going further, if we compare CRA lending for banks that are just north of that dividing line between the Philly Fed and the New York Fed, somewhere in Central New Jersey where that division is, we compare banks that are right on the northern side of that border with banks that are on the southern side of the border, you have the same economic conditions, the same workforce, and the same regional culture, as well as the same state regulation. The only difference is which Federal Reserve Bank supervises and regulates them.

So, it's not just New Jersey, there's eleven other states that are bifurcated into two Federal Reserve districts. There are some large population states in this group. Think Illinois, Pennsylvania, Missouri, Wisconsin, and so on. So, we focused on these states, and in some analyses, we focused on the border region where there is a Federal Reserve district boundary in the middle of the state – what's the lender on one side of that border doing compared to the lender on the other side? In other words, the patchwork nature of federal enforcement of the CRA allows us to make this comparison, to compare CRA lending in areas where banks are faced with a racially diverse regulator to CRA lending in areas where banks face a non-diverse regulator, and where those areas are otherwise substantially similar but for the presence or absence of minority board members.

CC: In short, by being very careful and deliberate about what comparisons they made, Feinstein and his coauthors were able, essentially, to create a series of statistical experiments.

BF: You could think of this as a treatment group and a control group.

CC: Now, having followed these standard practices in empirical research design when making their statistical comparisons, what exactly did Feinstein and his colleagues ultimately find?

BF: What we found was remarkable. For every additional African American or Hispanic director on one of these regional Federal Reserve Bank's nine-member boards, the probability that a bank within that regulator's jurisdiction receives a grade of outstanding on its CRA exam increases by about four percentage points. If you go from zero minority directors to three minority directors, that's basically the low end to the high end of the distribution, and the probability that a regulated bank gets an outstanding rating increases by almost twelve percentage points. By comparison, only approximately fourteen percent of all banks in our sample received an outstanding rating. The size of that percentage point increase is really substantial. By the way, that finding is statistically significant, it's robust to a wide variety of model specifications and robustness checks.

CC: For example, Professor Feinstein and his coauthors checked to see whether the results from his study might have stemmed merely from cultural differences that sometimes divide states, particularly between urban and rural areas. But by making some comparisons with other banks, and over time, they didn't find any evidence to support this potential cultural theory.

BF: There's another set of banks that are regulated by other regulators: the Office of Comptroller of the Currency, the FDIC, for part of our period, the Office of Thrift Supervision, and you would expect for where you increase Federal Reserve Bank diversity in those regions, you wouldn’t expect to see a connection between increasing Federal Reserve Bank diversity and better CRA scores by banks that are regulated by another agency, under my theory, if the Federal Reserve Bank diversity matters. It is just there is a culture where diversity matters and lending to underserved communities matters and those things are just so intertwined, you would perceive a correlation between increasing Federal Reserve Bank diversity and the CRA scores of non-Fed regulated banks. We don’t see that connection.

The other way we test it is in 2010, there was a change in law under which three out of the nine members of each Federal Reserve Bank board no longer played a role in the selection of the president of the Federal Reserve Bank board. Under my theory, under our hypothesis, rather, that should matter. Before 2010, those three out of nine directors, diversity among those three should matter a lot for CRA lending. But after 2010, when the connection between those three and choosing the Federal Reserve Bank president and other officers is severed, it shouldn’t matter at all. That is, in fact, what we find.

CC: In the end, by carefully designing their research to isolate the effects of board diversity, and then by checking for other possible explanations for their results, Professor Feinstein and his colleagues have produced strong evidence that diversity in regulatory leadership can improve racial justice in the private sector.

Music: Joy Ike’s “Time”

BF: The bottom line is that we’re confident that we have observed a real and substantial effect.

CC: And this study produced more than just solid, statistically significant results. It generated important substantive implications as well.

BF: It shows that representation matters, that diversity matters. Some would argue that focusing on incremental increases in minority representation in agency leadership is mere tokenism. That it is window dressing and that it doesn’t matter for outcomes. That is not the case, at least not here. Even adding small numbers of non-white directors who are never in the majority on a board, and usually not even close, that still influences outcomes.

CC: And as Professor Feinstein acknowledges, his study shows only one way that diversity can make a difference.

BF: Our measure may just be capturing a floor, not a ceiling, regarding how it matters. Diverse decision-makers can improve outcomes in subtle and perhaps immeasurable ways, and there are real advantages to descriptive representation that likewise defy quantitative measurement and lie outside of the scope of our more narrow findings.

CC: The study also holds important implications for board diversity in the private sector—that is, on corporate boards.

BF: So I think the conclusions from this study may be portable to the corporate context. Given the similarities between Federal Reserve Bank boards of directors and corporate boards of directors, maybe some of these lessons translate. The Federal Reserve Bank boards of directors do look a lot like corporate boards, as I alluded to earlier. These are part-time positions. Members tend to be a mix of business people, folks from NGOs, and civic leaders. The Federal Reserve Banks are public-private partnerships. So, there is a private sector element here. Some people doubt the ability of part-time corporate boards to meaningfully influence large complex organizations. But our findings call that critique into question. If diversity on Federal Reserve Bank boards matters, and these Federal Reserve Bank boards have so many characteristics in common with corporate boards, it seems reasonable to wonder, and perhaps even to assume, that diversity in a wide variety of leadership settings may matter as well.

CC: Professor Feinstein's research also raises some important questions about how best to address racial injustice through regulation: Is it just a matter of getting the law right—say, of tinkering more with rules such as those in the Community Reinvestment Act? Or do we need to think harder about the leadership and management of regulatory organizations? Professor Feinstein acknowledges that both the law and regulatory leadership are important.

BF: You really do need law as a foundation and diverse people building upon that.

CC: Still, he notes there's good reason to give greater attention to the people who implement and enforce the law—to focusing on who is "in the room where it happens."

BF: The Community Reinvestment Act is a law that grants a lot of discretion to on-the-ground examiners. The original CRA, as passed in 1977, was one page long. Today, it's a bit longer, but really what one might call guidance or a delegation of pretty substantial discretion to agents in the federal regulatory agencies that regulate financial institutions. Given that granted discretion, you really do see this wide divergence in outcomes based on personnel. I think if one wants to see greater lending to underserved communities, one would be wise to focus on increasing diversity in these Federal Reserve Banks, rather than legal changes. The CRA has been tinkered with many, many times over the past forty-some years. It looks like the prospects for strengthening it are rather dim these days. By contrast, we seem to be in a moment right now in American history where many people are recognizing that diverse personnel can matter. So I think as a strategic matter, if you have to focus on legal change or personnel change, the wind will be in your sails if you focus on personnel change.

Music: Joy Ike's "Walk"

CC: Thank you for listening to this episode of "Race and Regulation." We hope you have learned more about the implications of board diversity for racial justice.

This podcast has been adapted from a lecture delivered by Professor Brian Feinstein in 2022. He spoke as part of the Penn Program on Regulation's lecture series on race and regulation, co-sponsored by the Office on Equity and Inclusion at the University of Pennsylvania Carey Law School.

I'm Cary Coglianese, the director of the Penn Program on Regulation. For more about our program and free public events, visit us at pennreg.org. You can also find other episodes in our Race and Regulation series wherever you get your podcasts.

This podcast was produced by Patty McMahon, with help from Andy Coopersmith, our program's managing director. Our music is by Philadelphia-based artist, Joy Ike.