

Government Litigation Risk and the Decline in Low-Income Mortgage Lending

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Overview

- ▶ **Research question:** effects of government litigation on credit distribution
- ▶ **Efficiency** of litigation → guidance on government decisions
 - ▶ An important setting: **FHA mortgage market**
- ▶ Empirical approach
 - ▶ Diff-in-diff comparing high-litigation-risk lenders vs low-litigation-risk lenders
 - ▶ Pre/post the 2012 litigation wave
- ▶ Main findings
 - ▶ **Ex-ante:** No evidence that banks engage in worse lending practices based on default outcomes → Unfair selection
 - ▶ **Ex-post:** FHA loan volume & low-income lending ↓, service quality ↓, no change in underwriting standards or delinquency rates, interest rates ↑
- ▶ **Government litigation efficiency remains questionable:** highlights the **costs** of litigation

Discussion

- ▶ Important discussion: How should the government hold financial institutions accountable?
- ▶ Clear, careful, and well-structured analysis
- ▶ My comments
 - ▶ Alleged fraud?
 - ▶ Alternative stories
 - ▶ Interpretation of the decline in service quality
 - ▶ (Un)intended consequences of government litigation

Comment 1: Alleged fraud?

- ▶ “Bank lenders actually had *lower* early default rates on their FHA loans originated **from 2004 through 2010** as compared to other lenders”
- ▶ Is 2004–2010 an appropriate sample period to examine differences in early default rates?

“Wells Fargo, ..., engaged in a regular practice of reckless origination and underwriting of its retail FHA loans over the course of more than four years, from May 2001 through October 2005.”

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- ▶ What else can be used to show the “unfair” selection of litigated lenders?
 - ▶ Conditional on comparable FHA market activity and financial profiles, what is the relative likelihood of litigation for banks versus shadow banks?

Comment 2: Understanding the decline in FHA loan volume

- ▶ Loan volume = $\#(\text{Appl}) \times P(\text{FHA}|\text{Appl}) \times P(\text{Approval}|\text{FHA}, \text{Appl})$
- ▶ This paper: no significant change in FHA approval rates at the **county** level
 - ▶ Footnote 22: "... the fact that lenders exiting the FHA market typically did so by no longer taking FHA mortgage applications, rather than by taking and rejecting applications"
- ▶ **Story 1:** Keling consults Wells Fargo about FHA loans, but they inform her that such products are unavailable. She makes no further inquiries with other lenders

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- ▶ **Story 3:** Keling finds the current housing price too high. She decides to continue renting her 400 sq ft studio

Comment 2: Understanding the decline in FHA loan volume

- ▶ Exiting the FHA market
 - ▶ Show approval rate results by loan type at the lender-county level
 - ▶ Do banks close their branches?
 - ▶ Do banks lay off loan officers who specialize in FHA lending?
- ▶ Steering borrowers from FHA loans to conventional loans
 - ▶ Does the share of conventional loan applications increase among litigated lenders?
 - ▶ Experiment: Given comparable borrower characteristics, does choosing an FHA mortgage yield better outcomes than a conventional loan?
- ▶ Change in loan demand
 - ▶ Check the propensity to apply by borrower type at the county level

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$$\text{Misconduct Rate}_c = \sum_I \underbrace{\frac{\#Mortgages_{I,c}}{\sum_I \#Mortgages_{I,c}}}_{\text{Mkt share}} \times \underbrace{\frac{\#LO_I^{w.M}}{\#LO_I}}_{\text{Avg Misconduct}}$$

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 - ▶ **Yes:** Large banks reallocate their good loan officers upon exit; bad lenders expand; customers are more likely to encounter less capable loan officers

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- ▶ Suggestions
 - ▶ Check the employment history of mortgage loan officers, doable with NMLS data!
 - ▶ Use alternative measure of service quality, e.g. # CFPB complaints, customer reviews

Comment 4: (Un)intended consequences of government litigation

- ▶ Litigation vs. regulation: Litigation does not guarantee deterrence

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- ▶ Discussion on the benefits of government litigation

Conclusion

- ▶ Important discussion about the efficiency of litigation
- ▶ Well-executed and well-written
- ▶ Good luck!