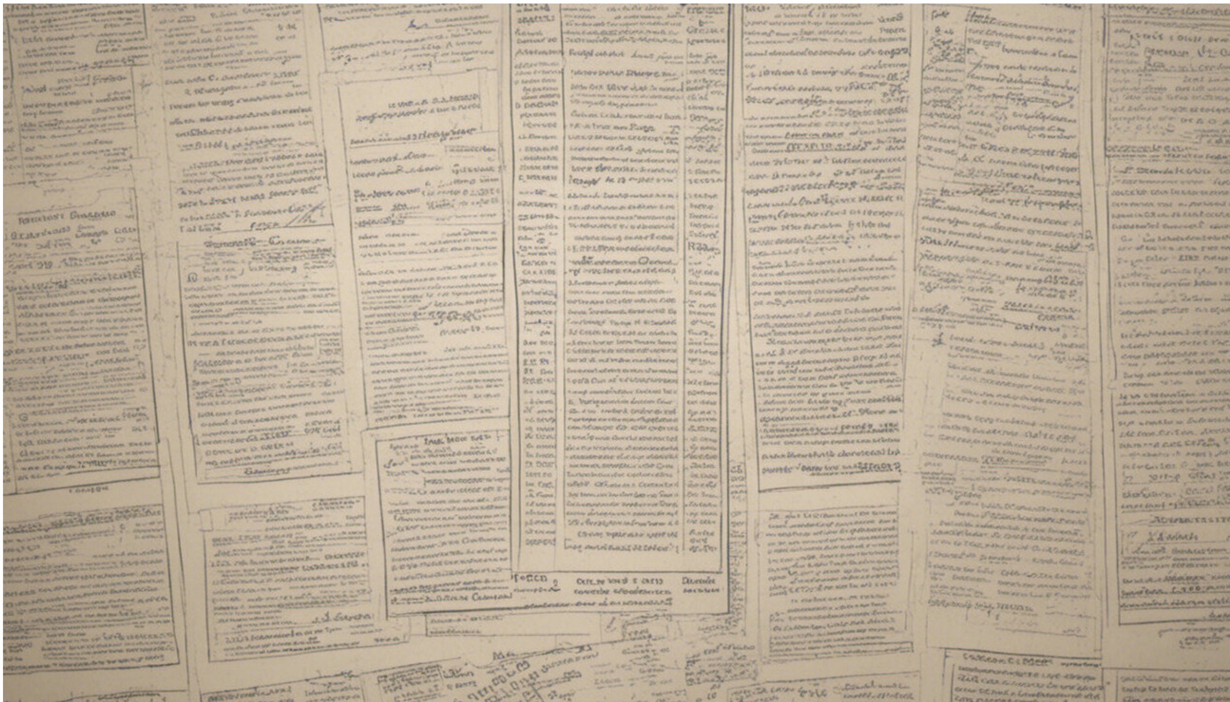
How regulations meant to increase poor, minority lending ultimately backfire

September 1 2020, by Sara Savat



Credit: AI-generated image (disclaimer)

Over the years, policymakers have enacted consumer protection laws and regulations to ensure better access to credit for low-income and minority consumers at fair lending rates. While these regulations make it illegal for financial institutions to discriminate against borrowers when making loan approval decisions, they do not guarantee equitable

outcomes.

New research from the Olin Business School at Washington University in St. Louis has exposed a significant increase in poor customer service, fraud and mis-selling—or misrepresentation of a product or service's suitability—by retail banks in low-to-moderate income areas targeted by the Community Reinvestment Act, especially those with a high minority population.

Researchers believe the regulations' quantity-based goals, meant to measure a bank's compliance, are to blame. Their findings are forthcoming in the *Journal of Financial Economics*.

"Most regulations in the U.S. and around the world primarily focus on the quantity of loans to marginalized borrowers," said Taylor Begley, assistant professor of finance and study co-author. "These goals may unintentionally encourage banks to engage in aggressive sales tactics or make loans to uninformed borrowers without proper disclosure as they seek to satisfy their regulatory requirements."

To measure the quality of the mortgage-related financial products and services, Begley and co-author Amiyatosh Purnanandam, of the University of Michigan, used Consumer Financial Protection Bureau (CFPB) data to track the incidence of consumer complaints against financial institutions.

These are typically not complaints that are easily resolved between the customer and financial institutions, otherwise they would have already been settled and not appear in the CFPB data, Begley noted.

"Mortgage products can be complex, and the transactions leave many potential borrowers at a substantial information disadvantage compared to sophisticated financial institutions," Begley said. "The complaints to

the CFPB include allegations of hidden or excessive fees, unilateral changes in contract terms after the purchase, aggressive debt collection tactics and unsatisfactory resolution of mortgage servicing issues."

The data, collected between 2012-16, included about 170,000 complaints from more than 16,000 ZIP codes. With this robust dataset, researchers were able to draw comparisons of complaint rates between Community Reinvestment Act-targeted areas and similar control areas with no such regulation pressure, as well as comparisons between areas with above- and below-average minority populations.

Overall, researchers found substantially more complaints in ZIP codes with lower education rates, lower incomes and higher minority populations. Of these variables, though, high minority status had the greatest impact on complaints—approximately two to three times more than the effect of low income or low education alone.

Even more telling: Within neighborhoods containing a below-median minority population, the complaint rates were indistinguishable between the Community Reinvestment Act-target and control areas. However, in target areas with an above-average minority population, complaint rates were about 35% higher than similar control areas.

"While banks face pressure to increase the quantity of lending in every target area, in high-minority areas they effectively have two sources of pressure for regulatory compliance—lending to low-income customers and lending to minority customers," Begley explained.

"These results show that groups that are often the intended targets of consumer protection laws experience much worse outcomes in terms of quality."

Since its formation in 2010, the CFPB has fined financial institutions

almost $10 billion to protect consumers. While it is difficult to pin down the precise economic costs of complaints for financial institutions, Begley said banks with more complaints paid significantly higher fines.

Previous research has studied the quantity of lending to low-income customers and pricing, but this study is among the first to measure the quality of these products. Begley said better understanding the quantity-quality trade-off could have broad policy implications.

"Regulations such as the Community Reinvestment Act that aim to meet the needs of low- and moderate-income neighborhoods may be successful in increasing the amount of credit extended in those areas. However, it's important to remember that the loan approval decision is only one part of the lending process," Begley said.

"Our research shows that regulators' outsize focus on the loan approval decision may come with unintended adverse consequences for consumers on other important, but more-difficult-to-regulate, dimensions, including the customer's understanding of the mortgage, whether it is a good fit for them and how lenders treat borrowers during renegotiation."

More information: Taylor A. Begley. Color and Credit: Race, Competition, and the Quality of Financial Services, *SSRN Electronic Journal* (2017). DOI: 10.2139/ssrn.2939923

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