Do Financial Consumers Discipline Bad Lenders? The Role of Disclosure Awareness

Mark J. Flannery
K. Philip Wang
Cathy Zhang

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Regulatory Missions

- **Safety and soundness of financial institutions**
  - Markets penalize lenders for excessive risk-taking
  - A large body of literature has examined this issue (e.g., Flannery and Sorescu 1996 JF; Martinez Peria and Schmukler 2001 JF; Hett and Schmidt 2017 JFE)

- **Financial consumer protection**
  - Markets penalize lenders for harming consumers’ interests
  - Limited research on this issue
  - Regulatory oversight did not prevent predatory lending prior to the 2008 financial crisis
  - Predatory lending still persists today (Benzarti 2023 RES)

Research Questions

- (Market monitoring) Do financial consumers penalize lenders for engaging in unscrupulous practices?

- (Market influence) If they do, how do lenders change their behavior in response to consumer discipline?

Setting

CFPB and state regulators' enforcement actions that specifically target illegal lending practices

- e.g., deceptive ads; overcharging borrowers; failure to mediate in good faith during foreclosure; using tactics to mislead borrowers

- Most credible signals of unscrupulous lending
- Easily accessible to consumers via "Consumer Access"

Data

Sample period: 2011-2019

1. **NMLS**: Enforcement actions and alternative lender names
2. **HMDA**: Loan applications
3. **Fannie, Freddie, Ginnie database**: loan-level interest rates and controls (e.g., FICO, LTV)
4. **CFPB complaint database**: lender-state level complaints
5. **Factiva**: media coverage of enforcement actions.
6. **American Community Survey** (ACS) by Census: census tract-level income, education, and minority percentage.

Example

LYC Mortgage, LLC

NMLS ID: 1443

Street Address: 20 Southwest Park
Westwood, MA 02090

Mailing Address: 20 Southwest Park
Westwood, MA 02090

Phone: 781-237-2525-16
Toll-Free Number: Not provided
Fax: 781-237-5522

Website: www.lycmortgage.com
Email: rlee@lyccpa.com

Other Trade Names ?: BuyUSDA.com
Prior Other Trade Names ?: None
Prior Legal Names ?: None
Sponsored MLOs ?: 1

Fiscal Year End: 12/31 | Formed in: Massachusetts, United States | Date Formed: 03/15/2004 | Stock Symbol: None | Business Structure: Limited Liability Company

Regulatory Actions ?: Yes

Branch Locations ?

(0 Active, 1 Inactive) View All Branches ▸

State Licenses/Registrations

(Displaying 3 Active of 8 Total) [+] View All

Regulator ?	Lic/Reg Name	Authorized to Conduct Business ?	Consumer Complaint ?	[+] View All Details
California - DFPI	Financing Law License	Yes	Submit to Regulator	[+] View Details
Massachusetts	Mortgage Broker License	Yes	Submit to Regulator	[+] View Details
South Carolina-BFI	Mortgage Lender / Servicer License	Yes	Submit to Regulator	[+] View Details

Regulatory Actions ?

While some state and federal agencies may add actions taken in previous years against a licensee, the majority are adding only new actions from 2012 or later. To view complete information regarding regulatory actions posted by the agency, click any regulator link.

Regulator ?	Action Type ?	Date of Action	Multi-state Action ID ?	Docket Number	Associated Document(s)
Connecticut	Order - Consent	03/19/2013	N/A	None	Final Order
Connecticut	Notice	12/11/2012	N/A	None	Initial Order
Texas - SML	Order - Order to Take Affirmative Action	09/16/2015	N/A	158142	Final Order

"Market Discipline"

In capital markets (bond, equity, deposit), investors can:

- Sell shares → Price drop
- Require a higher cost of capital → Price drop

In financial consumer markets, consumers can:

- Stay away from the bad lenders → Fewer loan applications
- Require better loan terms → Lower interest rates

Do Financial Consumers Discipline Bad Lenders?

Borrowers on average do not reduce loan applications to sanctioned lenders.

Borrowers do not receive lower interest rates from sanctioned lenders.

Borrower Inaction

Borrower Inaction

- Stand contrast with prior literature on enforcement actions (e.g., accounting fraud, banks' unsound practice)
- Challenge practitioners' claim that consumers deter unscrupulous lending.
  - Doug Duncan, then chief economist at the Mortgage Bankers Association, stated that "market discipline in this [mortgage] industry is swift, can be severe, and is more effective in changing lending practices than any potential changes in regulation"
- Imply that the regulators who aim to help consumers with disclosure did not achieve their goal.

Borrower Inaction

- Borrower Unsophistication?
- Lack of Lender Choices?
- Disclosure Unawareness?

- **Borrower Unsophistication**
  - Even most educated borrowers do not react to enforcement actions.
- **Lack of Lender Choices**
  - Even borrowers in areas with most lenders nearby do not react to enforcement actions.
  - Even least risky borrowers do not react to enforcement actions.
- **Disclosure Unawareness**
  - Borrowers do react to enforcements with high media coverage
    - Loan applications to sanctioned lenders drop by 18.8%
    - Interest rates decrease by 5.8 bps.

Do Sanctioned Lenders Subsequently Change Behavior?

Do Sanctioned Lenders Subsequently Improve Service Quality?

Do Sanctioned Lenders Attempt to Hide Their Identities by Adopting Alternative Names?

- **Do they subsequently improve service quality?**
  - Enforcements with high media coverage: Subsequent complaints drop by 9.5%.
  - Enforcements with no/low media coverage: No effect

- **Do they subsequently adopt more alternative names?**
  - Enforcements with high media coverage: No effect
  - Enforcements with no/low media coverage: Lenders adopted 8.5% to 10.3% more alternative names (“doing business as”).

Banks versus Non-banks

- Borrowers react to sanctioned banks but not to nonbanks.
- Sanctioned banks improve service quality, but sanctioned nonbanks do not.

Why?

  - Banks' enforcements receive significantly more media coverage.

- Many studies on mortgage lending limit their sample to banks only, doing so can lead to biased inferences.
  - Banks nowadays account for only 1/3 of mortgage originations

Policy Implications

- Consumers tend to passively absorb disclosures rather than actively search for it.
- Easy-to-understand disclosures could still prove ineffective if consumers are not aware of them. Regulators should take consumer awareness into account when designing new disclosures in the future.
- Some U.S. legislators recently proposed to roll back regulation on financial consumer protection. Borrower inaction raise questions about financial consumers' ability to protect themselves and suggest that consumers may be more exposed to predatory lending when there is less regulation in place.