Beware of the Law of Unintended Consequences

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By Christopher Horn
Partner | Financial Services

A recent study, **Government Litigation Risk and the Decline in Low-Income Mortgage Lending**, provides further evidence that the law of unintended consequences reigns supreme, particularly in the realm of public policy. The study examined the effects of litigation brought by the Department of Justice in the early 2010s against large mortgage lenders for alleged fraud in the origination of Federal House Administration ("FHA") mortgages. The litigation resulted in a $5 billion settlement paid by 31 large FHA lenders to the Federal government.

The study found that the settlement caused large lenders to precipitously exit the FHA market, which significantly reduced low-income households' access to mortgage credit. To make matters worse, the study found no evidence that the litigation led to an improvement in underwriting standards or to a reduction in default risk for FHA loans. The authors conclude that:

"Our findings suggest that fines, while often considered an efficient form of punishment, can still have unintended consequences. In this case, large legal settlements drove large firms out of the market, and ultimately reduced borrowers' access to credit. Our results highlight the importance of considering potential unintended societal costs when disciplining firms."

The study was authored by **W. Scott Frame**, the Chief Economist and Head of Policy at the Structured Finance Association, Kristopher Gerardi of the Federal Reserve Bank of Atlanta, Erik J. Mayer of the University of Wisconsin-Madison, Finance Department, Billy Xu of the University of Rochester – Simon Business School, and Lawrence Chengzhi Zhao, of Texas Tech University – Area of Finance.