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THE FDIC'S TARGETING OF REFUND ANTICIPATION LOANS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE FDIC'S TARGETING OF REFUND ANTICIPATION LOANS

Wednesday, March 16, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Sean P. Duffy [chairman of the subcommittee] presiding.

Members present: Representatives Duffy, Hultgren, Tipton, Poliquin, Hill; Green, Cleaver, Ellison, and Sinema.

Chairman DUFFY. The Subcommittee on Oversight and Investigations will come to order. Today's hearing is entitled, "The FDIC's Targeting of Refund Anticipation Loans."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of the subcommittee may participate in today's hearing for the purposes of making an opening statement and questioning our witness.

The Chair now recognizes himself for 5 minutes for an opening statement.

A year ago this month, the Oversight and Investigations Subcommittee heard testimony from the Chairman of the Federal Deposit Insurance Corporation on its role in Operation Choke Point, which was a law enforcement initiative launched by the Department of Justice to choke off legal businesses from the financial system in an effort, they say, to combat consumer fraud.

Although the FDIC has repeatedly denied that it was involved in the DOJ-named Operation Choke Point, it is clear from the investigative work of this committee and other committees that the FDIC cooperated closely with the DOJ in identifying so-called high-risk merchants and severing their ties with the financial system through its supervisory authority.

Payday lenders, gun dealers, and other perfectly legal industries were targeted by the FDIC based on the Corporation's own decision about which industries were favorable and which industries were unfavorable.

Regrettably, we are here today to learn about a separate but no less egregious effort by the FDIC to target refund anticipation loans (RALs) which, simply put, are loans based on anticipated Federal tax refunds.

A recent Inspector General report of inquiry into the FDIC's supervisory approach to refund anticipation loans reveals a troubling pattern by the FDIC officials of targeting legitimate and legal activities through abusive and unfair regulatory practices.

The I.G. uncovered this targeting when performing its audit on the FDIC's involvement in the Operation Choke Point initiative, which was released in September of 2015. Though only an executive summary of this extensive 180-page report of inquiry is being made public, I am concerned because the full report details actions of several FDIC employees who were also involved in the Operation Choke Point initiative.

According to the Inspector General, the FDIC "set in motion a series of interrelated events affecting three institutions that involved aggressive and unprecedented efforts to use the FDIC's supervisory and enforcement powers, circumvention of certain controls surrounding the exercise of enforcement power, damage to the morale of certain field examination staff, and high cost to the three impacted institutions."

In an effort to cause the three banks it supervised to exit the RAL business, the FDIC's Washington office also used "strong moral suasion" in late 2009 and early 2010.

The FDIC also used its powers to inappropriately reject underwriting plans and pressure field staff to assign lower ratings in safety and soundness examinations for at least two of the institutions, and used unprecedented examination resources to conduct an intrusive horizontal review when one bank continued offering RALs.

The Inspector General's report also found that the FDIC's legal division believed that to proceed with such enforcement remedies against the banks represented high litigation risk, but the agency proceeded anyway. All three banks ultimately, and no surprise, exited the RAL business by April of 2012.

After FDIC Chair Sheila Bair asked management to look into a complaint made by one of these targeted institutions, FDIC management did not accurately and fully describe the abusive behavior to Chairman Bair. This kind of behavior cannot and will not be tolerated by Congress and the American people who expect much more from their government and their government bureaucrats.

I am concerned that the FDIC has repeatedly demonstrated a disregard for the rule of law, for the limitations of its power, and for the financial institutions that it is supposed to serve. The work of this subcommittee is an important way to hold the Corporation accountable and to expose its behavior to ensure that it is kept in check.

That concludes my remarks. I will now recognize the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

And I thank the witness for appearing today.

I would like to note from the outset that this was not an Operation Choke Point activity. My belief is that the witness will validate this contention. While there were things that, in the opinion of the I.G., merited his attention, this was not a Choke Point activ-

ity. This is something that occurred 5 years ago. It has been resolved and disciplinary action has been taken.

I do think that there is some currency, some merit, some value, if you will, in examining this question of safety and soundness. And I say this because this is one of the reasons why the FDIC was engaged in the process.

We have loans that are anticipation loans, loans that are predicated upon a person receiving a certain amount of tax relief in terms of a refund. And unfortunately, for many of these persons, most of whom are low-income, earned-income-tax-credit folks—I will explain that at a later time if I need to—most of these loans did not materialize as expected.

Perhaps "most" is too strong, "a good many." How many is a good many? Too many did not materialize as expected, so the anticipated return was sometimes less than what was expected, which means then that the bank has an obligation that may or may not be fulfilled.

An interesting thing about the loans has to do with how they were generated. This is not a circumstance where a person comes into the bank and talks to a loan officer in the bank to acquire a loan. These loans were generated away from the bank in the office of some third person, some third party, and they were generated by persons who were tax preparers, for the most part.

These persons, in a de facto sense, became the loan officer, the loan originator, the underwriter. I am not sure it is a good practice for banks to have this kind of circumstance exist, but for our purposes today we won't go too deeply into it. It did exist.

And under these circumstances, information was acquired, but that information didn't always prove to be true and there were occasions when the loans were not honored in the sense that they weren't repaid.

So there are some safety and soundness questions here. Should banks be allowed to allow others—"others" meaning persons outside of the bank—to underwrite loans that they anticipate will be covered by a tax refund when we know that not all tax refunds as they are anticipated are fulfilled?

For example, you are scheduled to get a tax refund of X number of dollars but you have child support you haven't paid. You have other obligations that can encroach upon that refund. So you don't get the refund of X number of dollars. You get X minus some number of dollars.

And as a result we have a bank now that has a client who is required to pay this money, but it was assumed from the outset that the money would be immediately available, almost guaranteed by way of the earned income tax credit refund that a certain person might get.

So my point is this. I think that there is much to be said about the I.G's report, but there is a lot to be said also about the kind of business that was being regulated and whether the safety and soundness of the banks were in question as a result of the types of businesses with which these banks were associating themselves.

With that, Mr. Chairman, I will yield back the 2 seconds that I have.

Chairman DUFFY. The gentleman yields back his 2 seconds.

I now want to welcome our witness, Fred Gibson. Mr. Gibson is the FDIC's Acting Inspector General. Welcome. In his role, he is responsible for all facets of the Office of Inspector General's mission, which broadly is to prevent and detect waste, fraud, and abuse affecting the programs and operations of the FDIC, and to keep the Chairman of the FDIC and the Congress fully informed.

We thank him for his work and for being with us here today. He will be recognized for 5 minutes to give an oral presentation of his testimony. And without objection, his written statement will be made a part of the record.

Once the witness has finished presenting his testimony, each member of the subcommittee will have 5 minutes within which to ask questions of our witness.

Mr. Gibson, on your table, and you are well aware of this, you have three lights: the green means go; the yellow means you have a minute left; and the red means your time is up. We will try to remain true to the lights and the time, but I have a limited panel here today so we might show some generosity with the gavel.

The microphone is sensitive. Please make sure you are speaking directly into it. And so with that, Mr. Gibson, you are recognized for 5 minutes to give a presentation of your statement.

STATEMENT OF FRED W. GIBSON, JR., ACTING INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GIBSON. Chairman Duffy, Ranking Member Green, and members of the subcommittee, thank you for the invitation to speak with the Oversight and Investigations Subcommittee today regarding our report on the FDIC's supervisory treatment of refund anticipation loans or RALs.

Our work on RALs is an outgrowth of work we performed in response to an October 2014 request from 35 Members of the Congress concerning the FDIC's participation in the Department of Justice's Operation Choke Point.

During early stages of Operation Choke Point the Department of Justice attached a list of businesses, referred to as a high-risk list, to subpoena seeking information from a variety of organizations, including some financial institutions. The high-risk list, derived from an FDIC publication, was at the heart of the concern surrounding Operation Choke Point and was the starting point for our review.

In our audit, we assessed the FDIC's supervisory approach to financial institutions that conducted business with merchants on the high-risk list. We concluded that the FDIC's supervisory approach was within the broad authorities that it is granted under the FDI Act.

However, the manner in which the FDIC carried out its supervisory approach was not consistent, not always consistent with the FDIC's written policy and guidance. Payday lending in particular fell into this category.

We also concluded that the FDIC's participation, direct participation in Operation Choke Point was limited to a few communications from FDIC staff to DOJ employees at the time the DOJ's initiative was implemented.

During the course of that audit, we began to learn of the FDIC's supervisory approach to institutions offering RALs. Broadly speaking, refund anticipation loans are products offered to individuals through tax preparers that enable individuals filing returns to obtain a portion of their refund immediately.

RALs can be legally offered in most locations. Because they are short-term, high-rate loans, the FDIC considered them to have similarities to payday loans. RALs were not on the high-risk list and were not associated with DOJ's Operation Choke Point.

However, we noted that the FDIC's approach to institutions offering this product appeared to be similar to those prompting the original congressional request regarding Operation Choke Point. As a result, we decided to perform additional work regarding RALs which led to the report that we are discussing today.

This report contains information relating to open banks, supervisory matters, and information that is protected under the Privacy Act, which under the law cannot be publicly disclosed at this time. I have provided as my written statement the executive summary of the report accompanied by the executive summary of the FDIC's response in a separate letter from the Board of the FDIC.

I respectfully request that that written statement be included in the record. Thank you, Mr. Chairman, for indicating you would do so.

In summary, our review of the FDIC's supervisory approach to RALs strongly reinforced the concerns raised in our September 2015 audit. While the number of institutions offering RALs was limited, RALs were a nationwide product and the FDIC's supervisory approach affected both the product and all of the FDIC-regulated institutions offering it.

With this report, we concluded that the FDIC's decision-making process and supervisory expectations need to be more transparent. We found that the goal to eliminate RALs as a product line and the FDIC's approach in reaching that goal was not in keeping with that transparency.

Taking our two reports together we believe: that the FDIC needs to examine how the actions described in the report unfolded as they did; that they should establish more meaningful controls over the exercise of certain supervisory tools; and lastly that the FDIC should create meaningful appeal and oversight mechanisms with remedies for institutions should they be subject to abusive treatment.

The FDIC should also consider how its culture played into the events which our report details. On March 11th, I received a memo signed by each of the Directors committing to review and consider the key issues raised in our report and to provide a status update on their efforts by June 30th.

Thank you for the opportunity to present our work. I am happy to answer your questions.

[The prepared statement of Mr. Gibson can be found on page 31 of the appendix.]

Chairman DUFFY. Thank you, Mr. Gibson.

I now recognize myself for 5 minutes for questions. I just want to be clear. In regard to the refund anticipation loans and the three institutions that were subject to pressure by the FDIC, were those

institutions facing safety and soundness issues based on their participation in refund anticipation loans? Was it a safety and soundness issue for those banks?

Mr. GIBSON. The FDIC would argue that there were safety and soundness issues associated with refund anticipation loans, so from that perspective, I think the answer is yes.

Chairman DUFFY. And what was their argument?

Mr. GIBSON. I'm sorry?

Chairman DUFFY. What was their argument?

Mr. GIBSON. The argument shifted over the course of time depending upon the time that we are talking about. There were questions that the—

Chairman DUFFY. Questions that either it was a work-in-progress, an argument-in-progress, depending on—

Mr. GIBSON. I think it was. The argument shifted from various issues surrounding safety and soundness of the product, the manner in which the product was underwritten. The last issue that was raised, for example, was the loss of something called the debt indicator, an IRS tool that would enable institutions to have certain information about the borrowers.

Chairman DUFFY. Were they finding a high default rate with these loans?

Mr. GIBSON. No.

Chairman DUFFY. So to the banks' safety and soundness, do they see a real threat to the safety of the bank?

Mr. GIBSON. I think there is an argument to be made that numbers don't lie. The fact is is that the institutions never experienced a loss rate on these loans that exceeded 2 percent. In fact, in most years the loss rate on the loan was at the loans was significantly less than that. And that is true. We looked from 2007 forward to 2011, and during that period the loss rates were all less than 2 percent.

Chairman DUFFY. So the FDIC might try to make the argument of safety and soundness, but the facts showed something quite different. Is that fair to say?

Mr. GIBSON. The performance of the loans would suggest that there wasn't that much risk.

Chairman DUFFY. And you didn't see deceitful behavior, fraudulent behavior from these banks with the clients that they served or customers that they served at a high rate did you?

Mr. GIBSON. We didn't go and really examine the individual programs of the banks to make a call on something like that. But in the course of our work, we didn't become familiar with any such problem, no.

Chairman DUFFY. Did the FDIC make that argument to you that there is fraud and deceit being used by the financial institutions with their customers?

Mr. GIBSON. They never argued that there was fraud or deceit being used, to my knowledge.

Chairman DUFFY. One of my concerns is you have a product that doesn't affect the safety and soundness of the bank arguably, and it appears that the customers who are using the products know what they are getting and understand the terms of what they are getting.

And here we have the FDIC stepping in using their judgment for the free will of the American people, which gives a lot of us concern, not just in this program but also with Operation Choke Point.

The Congress uses its moral judgment as Representatives of the people. We didn't give that authority to the FDIC.

In your report, Anthony Lowe, the Regional Director of the FDIC Chicago office, and Mark Pearce, the Director of Consumer Protection, were mentioned, I think in our search, 300 times in a 180-page report. Obviously if you reviewed, and you did, the Choke Point reports by Congress, and you were involved in that as well, these are two common names that came up in Choke Point as well.

Can you describe Mr. Lowe's and Mr. Pearce's roles in the refund anticipation loan investigation that you did?

Mr. GIBSON. I am reluctant to discuss too many details for privacy concerns, but let me think about what I can say. Mr. Lowe is the Regional Director of the FDIC in the Chicago region. All three of the institutions offering refund anticipation loans were in the Chicago region and accordingly were supervised by an examination staff that Mr. Lowe supervises. Mr. Lowe directs that examination staff and is responsible for it.

Mr. Pearce was the head of the Division of Consumer Protection at the time of these events, and as such was responsible for oversight of the consumer protection side, the compliance side, as it were, of the examination function.

Both played roles in the course of this: Mr. Lowe from the standpoint of the implementation of directions that were received from headquarters in Washington; and Mr. Pearce at a higher level with respect to the policy of the FDIC concerning refund anticipation loans, as well as its implementation.

Chairman DUFFY. I am almost done here, but in the refund anticipation loans we saw with Mr. Lowe's and Mr. Pearce's involvement with the prior investigations with Choke Point, we had a chance to review the e-mail correspondence when they were targeting short-term lenders. Have these two been reprimanded? Do they still work for the FDIC? Have they been fired? What do you know about their employment status?

Mr. GIBSON. Both are still employed by the FDIC. And I cannot speak to any personnel action that may have been taken. I wouldn't know about that.

Chairman DUFFY. And we are not surprised by that. My time has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Gibson, thank you for being here. These RALs are products that have been around now for a while, and my first question is, do you see anything inherently evil with RALs, particularly those which are issued from reputable companies?

Mr. GIBSON. I don't really know that I have a position on RALs, per se. They seem to me to be a loan product that is being offered to people and that is really what they boil down to.

Mr. CLEAVER. I am thinking about that, yes, that there are some benefits. One, of course, is that the recipient of the loan which is based on anticipated refunds is able to get that refund not only

more quickly, but it would allow them to speed up some delayed attention towards financial challenges. And so, I guess I don't see them as being evil.

And my other concern and that made more impact, the FDIC, than you as the Inspector General, but that every entity providing RALs is not designed to rip them off. And so I think we may be doing a disservice if we have a conversation that would suggest that everybody who is doing it is a rip-off agent.

Now, at the same time, I do agree with your recommendations that you made, that the I.G. made. I think those are right on target. And I don't think a reputable entity would back away from that. I would think that all of the reputable institutions doing RALs would probably jump right on it and say that they can do this: better communications internally and externally; improved guidance to supervised institutions; and an enhanced appeals process, which is what you have recommended.

If that is cleaned up, and I don't know if this ends up in your purview, if those recommendations are taken do you see that as the most significant step that could be taken in terms of allowing this to be something that we live with? I don't particularly like high interest rates, even though it is a high interest rate for a short period of time. The truth of the matter is some people do in fact need that.

Mr. GIBSON. Sir, I think with respect to the recommendations that we made, the FDIC's Board indicated that they would provide us with a status update by June 30th. They indicated they would take the key issues under consideration and advise us about exactly what they were going to do in response to that.

At that point in time, we will take a look at them. And I hope that they will be responsive to the issues that we have raised and we can address it at that point in time.

Mr. CLEAVER. Do you have any idea about—my concern is "Uncle Willie's tax preparation company." Uncle Willie is an automobile body shop owner when he is not in tax season and he is a good human being, but I am just wondering how many of those kinds of things were involved in offering the RALs on behalf of, let us say, small banks, community banks?

Mr. GIBSON. The three banks that offered the RALs had different programs under which they would take a look at the folks who were offering these things. And one of the risks associated with offering these sorts of products is the risk that the person offering the product to the public isn't going to follow the law.

The banks all had mitigation programs. One bank had a fairly extensive audit program that went out and looked at a very large number of the people who were offering these in order to assure that they were complying with the law.

They made suggestions directly to the board of directors of that institution. And the board of directors, as I understand it, took action in order to remediate any of the issues that came up. So there was attention that was being paid by certainly that institution, to what was going on with the individual RAL offerors, the people who were offering the loans.

Mr. CLEAVER. Yes, but there are some of the lenders who are also banks themselves, who have a subsidiary that are actually banks, but I think those are all at another level.

I am sorry I have run over, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Thanks, Mr. Chairman. I thank you and the ranking member for this interesting hearing.

Mr. Gibson, thank you for being with us today. Do you know off the top of your head when reputation risk was added into the CAMELS rating process? My guess is sometime around the mid-2000s or so, but I just—if you might know?

Mr. GIBSON. Sir, I do not know. I don't know that CAMELS particular, that reputation risk is necessarily—it is not an individual component of CAMELS. I am not too sure if that—

Mr. HILL. No, but it was added in the exam manual sometime in 2000 that everything had reputation risk, and that boards needed to review that, particularly in new product development areas. But you agree that banks are responsible for their own product development consistent with the laws and regulations?

Mr. GIBSON. Yes, sir, I do.

Mr. HILL. And I think banks are supposed to offer products based on consumer needs, which we see in CRA. You get extra credit in community reinvestment exams if you show survey results of your consumer base, your neighborhoods. And so from surveys or word of mouth that banks get credit for doing product innovation and trying to meet consumer needs, you have seen that, I'm sure, in your work?

Mr. GIBSON. Yes, we have.

Mr. HILL. And banks have obligations for consumer compliance and for fair dealing under a number of statutes. So it always concerns me when I hear these stories of a regional office or a particular examiner kind of going rogue on taking the place of the microprudential manager of the bank about what he or she should not do in the product development arena.

And that was kind of the whole point that we were frustrated about with Operation Choke Point, because I had a lot of customers who had legitimate reasons for refund anticipation loans, such as paying off a credit card after Christmas, car downpayments, home improvement, or tuition payments for a semester.

And so when we had these sorts of activities by our regulators we are actually contradicting. We are hypocritical. We are saying that consumers want these products like overdraft protection or prepaid cards or refund anticipation loans and then we don't facilitate banks offering them.

In fact, we, through moral suasion and other ways, defeat that causing these consumers who want the product to migrate out to the unbanked, unregulated or under-regulated segments. So again, that is one of my biggest frustrations in this process.

Do you think it is fair to say that if banks do product innovation, and their board of directors reviews that product, and that they offer it and they accept the reputational risk and the financial risk with it, that generally a bank should be able to innovate, based on your work at the FDIC?

Mr. GIBSON. Sir, I think as a general proposition that it is up to the bank to mitigate the risks that are associated with the product that it offers.

As you pointed out, we create laws that establish requirements that banks are obligated to follow. And we supervise for the purpose of ensuring that they are doing so in a safe and sound manner, but ultimately, risk is the bank's job.

Mr. HILL. Right. So from your review of Mr. Lowe's work, is it fair to say that the Chicago regional office was off the reservation on pursuing this compared to the national policy directives from Washington?

Mr. GIBSON. Sir, I think with respect to the RALs, what our work shows is that the national policy informed what Mr. Lowe did. I think that the national policy directed how the RALs should be supervised. The banks offering RALs should be supervised ultimately.

Mr. HILL. But what is setting that apart from any other consumer loan product? I don't understand. If it is that we have measured loss ratio, if we are in compliance with all the lending consumer disclosure laws, and we are operating in a fair dealing manner, why is this loan or why is this product being separated out from any other consumer credit decision to finance a car or finance a new air conditioning system for a home?

Why is this being singled out? It is because of somebody's idea that it is bad. Isn't that right? Instead of a financial—

Mr. GIBSON. I really can't answer the question. And I am sorry to say that I can't because I can't point to something specific that says, this is why we are doing this with respect to RALs. The FDIC chose not to issue any guidance or policies with respect to that particular product.

Now, there is general guidance associated with kind of the type of lending here and third-party risk concerns, but there is no specific guidance on this particular product which we can turn to that answers that question.

Mr. HILL. Thank you.

Thank you, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the ranking member, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. Thank you, thank you.

Sir, I believe you will agree that the FDIC has a mandate when it comes to safety and soundness. Is this correct?

Mr. GIBSON. Absolutely.

Mr. GREEN. And I believe that their opinion is of great value when it comes to safety and soundness?

Mr. GIBSON. As do I.

Mr. GREEN. And you would probably also concur and agree that while you can give opinions about the process, the ultimate judge of safety and soundness is the FDIC.

Mr. GIBSON. I'm sorry, sir; I am having difficulty hearing you.

Mr. GREEN. Okay. While you may give an opinion about a process, the ultimate judge of safety and soundness is the FDIC.

Mr. GIBSON. Oh, absolutely. Yes, sir.

Mr. GREEN. So any opinion that you give today, and you are a wonderful person. I love you. I know your mother does. But my mother loves me, but that is just your opinion. You don't have the mandate that the FDIC has. And by the way, you have not gone so far as to say that there was not a safety and soundness issue. That is a fair statement, isn't it?

Mr. GIBSON. Sir, I didn't say that there wasn't a safety and soundness issue, but what I would point out—

Mr. GREEN. Let me just do this. I will let somebody—my time is limited and perhaps someone else—

Mr. GIBSON. That is fine.

Mr. GREEN. —will work with you. Let us talk about the quality of these loans. You did not give an opinion about the quality of the loans. I think you sort of indicated that you had no position on the quality, the quality in terms of whether or not these are good products or bad products in the main?

Mr. GIBSON. That is correct.

Mr. GREEN. So with the banks having the duty to effectively manage safety and soundness, they have to determine something with reference to quality because the banks also have one other mandate.

I think you will agree that the banks have a duty to also have a consumer protection component. Let me strike that and make it that the FDIC has this duty. The FDIC has a certain consumer protection component associated with it. Is this true?

Mr. GIBSON. That is true.

Mr. GREEN. Okay. So you have the FDIC with a consumer protection component. They have the safety and soundness component. They have a real concern, especially given how certain underwriting standards in 2008 created a crisis that had a domino impact across the globe.

Now, this is not of that magnitude, obviously, but they still have that safety and soundness concern, and they still have to deal with consumer protection issues, which is why we have to now examine the product itself because the FDIC has to give some value judgment about these products.

And clearly, some of these RALs had annual percentage rates of as much as 500 percent, some, not all, just some. Look, I agree that if you need money you have to be able to go in and get it if you need it. But I also think that we have to have some protections for consumers, especially low-income people. It is a balancing test that we have to engage in.

So with the 500 percent, with the underwriting being performed off campus away from the bank, and you couple that with the opportunity for fraud, you indicated there were some systems in place, but you did not go out and evaluate each individual underwriter, did you?

Mr. GIBSON. Of course not.

Mr. GREEN. Okay. So you really don't know. You really don't know what those individual underwriters were doing, do you? You don't know. Come on—

Mr. GIBSON. Do I personally know? No, of course not.

Mr. GREEN. Of course you don't. You are the I.G., and you didn't go out and examine them, so you don't know. I think that is a fair statement, isn't it?

Mr. GIBSON. It is a statement.

Mr. GREEN. Okay. Well, it is a fair statement. You weren't there. You don't know. You didn't examine them. If you want to find a clever way to say I know, tell me what that clever way is?

Mr. GIBSON. I wouldn't say that it is a clever way, but what I would point out is this. One of the institutions was to receive, based on the examination of the bank, an overall rating of two. That is a pretty good CAMELS rating, particularly if I—

Mr. GREEN. Can you do this a little bit faster because I have another question for you?

Mr. GIBSON. That is fine. I will be as quick as I can.

Mr. GREEN. Okay.

Mr. GIBSON. The point I would make is that the DCP examiners, the consumer protection examiners of the FDIC reviewed that rating for that institution that was offering RALs, and they concurred in it.

Mr. GREEN. Okay. Let us do this.

Mr. GIBSON. They didn't have a problem with giving that rating.

Mr. GREEN. I appreciate your commentary. Let us do this. Do you agree that there was not a culture at the FDIC with reference to this type of product—there was not a culture at the FDIC? There was not a culture as it relates to what they were doing in auditing these products? There was not a culture there? Do you agree with that?

Mr. GIBSON. I am not sure what you mean, sir. I'm sorry.

Mr. GREEN. Do you agree that this was not widespread, that all of the employees were involved in some sort of conspiracy to go out and put an end to these products? Do you agree with that?

Mr. GIBSON. Sir, I think that this involved a decision that was made at a headquarters level and was passed down to the field to execute. And I don't think anybody else was involved in it.

Mr. GREEN. So there is not a culture at the FDIC. And do you also agree that you have been working with the FDIC and they are going to give you some indications as to the corrective actions that have been taken?

Mr. GIBSON. Yes, they will.

Mr. GREEN. Okay.

Mr. GIBSON. I believe they will.

Mr. GREEN. And finally, and I thank you for allowing me to go over, Mr. Chairman, do you also agree that this was not, "N–O–T", not a part of Operation Choke Point?

Mr. GIBSON. Sir, Operation Choke Point was a DOJ program.

Mr. GREEN. I am going to—

Mr. GIBSON. And this wasn't part of a DOJ program, correct.

Mr. GREEN. Okay. All right. So then that is another way of saying it was N–O–T a part of Operation Choke Point, right?

Mr. GIBSON. Yes.

Mr. GREEN. Okay. Thank you.

Chairman DUFFY. The gentleman yields back the time he doesn't have.

Mr. GREEN. It is done.

Chairman DUFFY. The Chair now recognizes Mr. Poliquin, from Maine, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

Mr. Gibson, thank you very much for being here. I appreciate it. I am a business owner, and before I became State Treasurer of Maine a few years ago, and before serving in Congress, I was in the private sector my entire life.

And do you know one of the things that absolutely gives me fits is that this big, strong arm of the Federal Government, and I could extend that and say State and local government also, that continues to put pressure on our employers.

One of the things that we parents all want are better opportunities for our kids. More jobs, we want to make sure they are healthy and safe and they get a good education.

The Competitive Enterprise Institute computes that a couple of years ago, and presumably in 2015 also, the total cost to our employers in this country for Federal regulations only, Mr. Gibson, not State, just Federal regulations is $1.9 trillion—$1.9 trillion on our businesses in this country.

Now our businesses, of course, pass along these costs to the folks who buy their products or their services. So we end up paying for all this overregulation.

Now, overregulation is bad enough, and I bet I spend 25 percent of my time, Mr. Chairman, 25 percent of my time here in Congress, being here for a year, listening to business owners or folks who represent business owners with one simple request: "Get the government off my back. I know how to make money. I am an entrepreneur. I know how to take risk, invest my own savings, grow the economy. In doing that, I will hire more people and I will pay you more." That is what we want.

So now comes this Operation Choke Point or something similar to it. This is alarming. And Mr. Gibson, I am guessing as an I.G. you are also alarmed or you wouldn't be here. Now, we are in a free enterprise economy where if you have a legal business, you should be able to conduct that operation, that business legally and lawfully in this country.

But all of a sudden we see, Mr. Chairman, a few months ago we had a hearing on this that—there is a list of companies that the Justice Department didn't like, when you sell firearms legally or fireworks legally or tobacco legally or alcohol legally.

Let us go put pressure on the FDIC. Let us put pressure on the regulators to stop these businesses by choking off their credit. And now, we have a situation that I think is very concerning. It takes it to another level.

Unless I am mistaken, Mr. Gibson, and maybe you can shed light on this, and I quote from the Deputy Director of Policy at the FDIC, "Marty Gruenberg who runs the FDIC thought it was a strong document," referring to a document that was written a few years before, which is a guideline in dealing with these issues, "I thought it was a strong document."

But he stated that, "his instinct was to wait to issue a document like this until after we—i.e., the FDIC—had taken strong specific

action with one or more of our RAL lenders." He said he believes these lenders are recalcitrant and would ignore the directive.

So in other words, these are the cops showing up at your door, arresting you, and then after they do that saying now we will issue a guideline on what the heck the law is. Am I getting this wrong? What am I missing here?

Can you imagine the behavior of the Federal Government that is supposed to help our citizens in this country, help our businesses, help our families live better lives with more opportunity and more freedom? And now these regulators are saying we don't like your business, or worse, we will put pressure on you now and we will write the regulation after. What am I missing here, Mr. Gibson?

Mr. GIBSON. Sir, I believe that one of the issues that is raised by the facts that are contained in this report does relate to the transparency of the decisions that are being made by the government. I believe that the government should be able and should be willing to explain to people why it is it is doing what it is doing. And that in this particular case, the FDIC didn't achieve that end.

Mr. POLIQUIN. Let us drill down there a minute, Mr. Gibson, if you don't mind, in my remaining time. We both agree, and by the way I salute you for your work, keep digging. Absolutely keep digging. And you operate independently within FDIC and I know you have that authority and that power.

Do you think, and I think you just said you didn't, that they have not explained why they conducted themselves the way they did? Is that what I am hearing?

Mr. GIBSON. Sir, I think at the time there was no transparency really associated with the FDIC's reasons for taking the actions that it took.

Mr. POLIQUIN. And why do you think today—

Mr. GIBSON. That is what I am saying.

Mr. POLIQUIN. —they have taken those actions, sir?

Mr. GIBSON. Pardon me?

Mr. POLIQUIN. And why do you think today, they took those actions when they did? Do you have an opinion now?

Mr. GIBSON. The FDIC says that they believe that these products represented safety and soundness issues and consumer protection issues—

Mr. POLIQUIN. But does that just—

Mr. GIBSON. —and were not appropriate for that.

Mr. POLIQUIN. But does that justify putting pressure by regulators on a bank to shut this down and then afterwards issuing guidelines?

Mr. GIBSON. In my view, they should have explained why it was they felt that way.

Mr. POLIQUIN. What is next? Do you see anything coming down the road? What is next? Buying a new pair of tennis shoes even if you don't like the color? What is next?

Thank you, Mr. Chairman. I yield back my time.

Chairman DUFFY. The gentleman's time has expired. We are now going to go into a second round so that the gentleman from Maine will have another chance to continue his questioning or comments. And with that, the Chair recognizes himself for 5 minutes.

I want to follow up, Mr. Gibson, on the points that were just made by Mr. Poliquin. This is stunning to me, the fact that this individual by the name of Marty Gruenberg, in essence in an e-mail, was saying that, let us go through enforcement first and we will talk about guidance in our financial institution letter later. This individual, Marty Gruenberg, is he a low-level individual at the FDIC?

Mr. GIBSON. No, sir.

Chairman DUFFY. Who is he?

Mr. GIBSON. Mr. Gruenberg currently is the Chairman of the FDIC.

Chairman DUFFY. The Chairman of the FDIC, a-ha. The Chairman is the one who is saying let us go through an enforcement measure and let us look at guidance at a later date. Did the guidance in the form of a financial institution letter, a field letter, ever come from the FDIC?

Mr. GIBSON. Specifically with respect to this product, no, sir.

Chairman DUFFY. And so, it is no wonder that the individuals involved in this report, Anthony Lowe and Mark Pearce, are still working for the FDIC.

Frankly, they are following the directive of the Chairman of the FDIC. Their boss is in up to his armpits in the report that you provided to this committee. Yes? Is Mr. Gruenberg part of this? Did Mr. Gruenberg know what was going on?

Mr. GIBSON. Sir, that e-mail wasn't written by Mr. Gruenberg. It represents what someone believe that he said.

Chairman DUFFY. Right, but it represented a comment that Mr. Gruenberg made—

Mr. GIBSON. Yes.

Chairman DUFFY. —about holding off. And Mr. Gruenberg, as the Chair, said, let us enforce first, in essence, and we will give guidance later, right?

Mr. GIBSON. Sir, that is what he reportedly said.

Chairman DUFFY. And did they do enforcement first?

Mr. GIBSON. Yes.

Chairman DUFFY. Yes, and frankly the guidance never came, correct, because everybody got out of the business?

Mr. GIBSON. That is correct.

Chairman DUFFY. No wonder changes haven't been made at the FDIC and Mr. Gruenberg was a part of Operation Choke Point. And as Mr. Poliquin indicates, we are in a situation where we have a nanny state. Mother government will tell us what products are good and bad for us.

I think, as Mr. Cleaver indicated, we have people who find themselves in hard times, who might need to get a little money early from their tax return. They might have to get a short-term loan because their car broke down. Or the family pet got hit by a car and has to go to the vet, and they need to get short-term money.

And we are turning everyone away from an opportunity to access cash in the short term because we think we know best or they think they know best in Washington.

And if you can't turn to a bank or a short-term lender, where do you turn? You are going to turn to Uncle Vinny, not uncle, Mr.

Vinny down the street. And he is not too kind when you don't repay. And this is concerning stuff.

Let me ask you this. In regard to the banks that were involved in your investigation, was any pressure put on the banks with any downgrade of their CAMELS rating that you found?

Mr. GIBSON. Yes, sir, there was.

Chairman DUFFY. Could you explain that?

Mr. GIBSON. A downgrade of the CAMELS rating results in increased assessments. It can result in limitations on the bank's ability to engage in certain activities. In this case, the downgrade of an institution from a two to a three basically reinforced a prohibition on that institution participating in the purchase of assets of failed institutions, which was part of their business strategy.

So, changes in CAMELS ratings cause significant effects on financial institutions.

Chairman DUFFY. I think I read somewhere in your report that the FDIC was concerned there might be a high litigation cost to going after these three banks that are referenced in the report. Is that correct?

Mr. GIBSON. They did.

Chairman DUFFY. And it is fair to say that when your CAMELS rating is reduced, due pressure is applied, and people get out of the business instead of litigating it? Is that fair to say?

Mr. GIBSON. Sir, I don't know what the reasons were that people got out of the business. We didn't speak with them. But it is possible.

Chairman DUFFY. It is possible. I would just note that you look at what is taking place and the fact that last year alone 80,000 pages of new rules and regulations have come from the Federal Government.

It is hard enough to comply with the rules that are put out that people can try to read and try to comply with, but it is even harder when you have a regulatory body of our financial industry that tries to enforce first and give guidance later.

We should know what the rules are. The rules of the game should be clear. We should all be able to understand them and we should all be able to follow them. This is frightening that we have another Act by the FDIC that goes through enforcement first and guidance, if we are lucky, second.

I want to thank you again, Mr. Gibson, you and your team for the hard work they have put into this investigation, and I appreciate your willingness to testify before this committee.

Mr. GIBSON. Thank you, sir.

Chairman DUFFY. My time has expired.

And I now yield to the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

I think I sufficiently raised the issues that I needed to raise. I would like to yield the balance of my time to the ranking member.

Mr. GREEN. Thank you, Mr. Cleaver. I greatly appreciate your sharing your time with me.

Sir, with reference to the chairperson of the FDIC, is it true that the statements that were called to your attention, and we want to make sure that this is clear on the record, were statements that

we would probably call hearsay in some circumstances? Is that a fair statement?

Mr. GIBSON. Sir, that is fair.

Mr. GREEN. I'm sorry. Say that again?

Mr. GIBSON. That is fair.

Mr. GREEN. Yes, hearsay. Somebody heard it or they say that they heard it and they then repeat it. That is not the most reliable evidence. In fact, it would take some sort of exception to the hearsay rule for it to be admitted in court. Of course, we bend the rules around here, so that just about anything that we want to say gets heard.

But I want to kind of defend his reputation because I believe him to be an honorable man. And I don't think that he had a circumstance wherein he had an outcome that he desired and hence any means necessary to get to the outcome was the methodology employed. I just don't see the evidence of that as it relates to him.

Now, let us go to what I have here as intelligence. I have here an indication that in 2006, there was a report by the FDIC's Office of Inspector General. Are you associated with that office, sir?

Mr. GIBSON. Yes, I was.

Mr. GREEN. You were? All right. And how long were you there?

Mr. GIBSON. I have been there for a long time. I have been with the FDIC Office of Inspector General since the sunset of the RTC, which was 1995 or—

Mr. GREEN. So it is fair to say that you would be familiar with this report?

Mr. GIBSON. I don't know if I would be familiar with a report from—

Mr. GREEN. Okay. The style of the report is, "The Challenges and FDIC Efforts Related to Predatory Lending."

Mr. GIBSON. I am sorry, sir. I am not specifically familiar with the report at this time.

Mr. GREEN. Not specific. I don't want you to have read it in its entirety, but have you heard of such a report existing?

Mr. GIBSON. It doesn't surprise me that we did one at all.

Mr. GREEN. Okay. And would it surprise you to know that the report indicates that borrowers lose more than $25 billion annually due to predatory mortgages, payday loans, lending abuses involving overdraft loans, excessive credit card debt, and tax fund loans. Would it surprise you to know that is in the report?

Mr. GIBSON. No.

Mr. GREEN. And if this is the case, we would then focus on the refund loans and someone would conclude that predatory lending, not being a good thing, that we ought to regulate these tax refund loans. I am not saying eliminate, but I am saying that the FDIC ought to regulate them to the extent that they don't create a part of this $25 billion in predatory mortgages and other loans as well. But that shouldn't be a part of that. Don't you agree?

Mr. GIBSON. Sir, I don't know if I can comment on that.

Mr. GREEN. All right, I will accept that. Sir, I think that was a fair comment. I will accept that you won't comment on that. I will give my editorial, my commentary, and I think that we clearly expect the FDIC to deal with predatory lending. And we ought to make sure that we deal with these refund loans.

Let me give you a case in point, what we will call a case in point. A person goes in to the tax preparer. The tax preparer says, okay, I can get you this refund and I will charge you a certain amount of money because I am going to help you get a refund. The tax preparer makes a mistake or two, not intentionally, and the person does not get the amount of loan refund, well, doesn't get the amount of refund that the loan is for.

And as a result, these persons who make these loans, they sign agreements. And when they sign these agreements, there is language contained therein requiring them to have to pay for the amount that the loan was for even if the refund is a lot less. You agree with this, don't you?

Mr. GIBSON. I think so.

Mr. GREEN. Okay. I think you are thinking right. And so given that they have to pay for that loan, and given that you have a person who is getting this loan with an earned income tax credit, needed the money right away, now we have a person who doesn't have the loan. He spent that money already. And then, they have this obligation that was not expected.

That happened in these circumstances such that poor people, people who needed the money found themselves having to repay loans that they didn't expect to have to pay because of mistakes that were made in tax preparation.

I yield back.

Chairman DUFFY. The gentleman yields back.

The Chair recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. Again just, I think, to the ranking member, the FDIC exam manuals and exam process cover all consumer lending. All consumer loans have to be in compliance with the statutes and regulations. There is just nothing per se that distinguished these loans from another kind of consumer loan in the exam process.

So that is why I have been searching for the point of why they have been singled out and why this kind of a project or the Choke Point project is so off the norm from the FDIC or the DOJ's process.

With that, Mr. Chairman, I yield the balance of my time to you, sir.

Chairman DUFFY. Thank you, Mr. Hill.

I just want to be clear that, again, Mr. Gibson, the allegation wasn't being made on predatory lending, was it, in regard to your investigation?

Mr. GIBSON. Not that I am aware of.

Chairman DUFFY. And to Mr. Green's point, this was not about the FDIC regulating these loans. They were there to eliminate these loans. Is that what you found?

Mr. GIBSON. Sir, what our report found was that there was a decision that was reached that FDIC's supervised institutions should not be offering refund anticipation loans. So the goal was to get them out of refund anticipation loans. So that is the goal.

Chairman DUFFY. So you would agree that is not regulating, that is eliminating, correct?

Mr. GIBSON. It is not regulating.

Chairman DUFFY. Did you have a chance to talk to Chairman Gruenberg about this?

Mr. GIBSON. Sir, we have talked about it, yes.

Chairman DUFFY. Did he know that this elimination was taking place in regard to—

Mr. GIBSON. Sir, I did not speak with him personally or directly about that. I really don't know.

Chairman DUFFY. Did someone on your team? Did someone on your team speak with Mr. Gruenberg?

Mr. GIBSON. Mr. Gruenberg really had little recollection of these events, sir.

Chairman DUFFY. And it is my understanding that the quote that was given by the Deputy Director of Policy from the FDIC, which stated that Mr. Gruenberg thought it was a strong document, meaning to fill, but stated that his instinct was to "wait to issue a document like this until we had a strong, specific action with one or more of our RAL lenders," meaning he wanted to go through enforcement before regulation.

Did you ask Mr. Gruenberg or did your team ask Mr. Gruenberg about that e-mail?

Mr. GIBSON. Yes, sir, and he didn't recall it.

Chairman DUFFY. So he didn't deny it, per your recollection?

Mr. GIBSON. He didn't recall.

Chairman DUFFY. So he didn't deny it?

Mr. GIBSON. Not that I know of.

Chairman DUFFY. Okay. And it is also fair to say that Mr. Pearce in an e-mail said, "I want to see if we can achieve a resolution with Bank A," that was redacted, "in the next month or two then follow up with something like this in the May timeframe before institutions get going on next year's product." Then you are following up with a fill. Is that correct? That is the—

Mr. GIBSON. Sir, if it is quoted and I don't remember the specific language of the e-mail, but if it is in our report then that is exactly what the e-mail said.

Chairman DUFFY. And how many people did you interview in regard to your investigation?

Mr. GIBSON. We interviewed 25 or 26 people with respect to this and well over 100 in connection with the original audit we did in the Choke Point era.

Chairman DUFFY. So how high does this go? Who is making the decisions? Mr. Hill is a former banker who is obviously outraged by the actions of the FDIC.

Who is in control of the FDIC? Does it go to the top or is there someone below Mr. Gruenberg who is making these decisions, whether it is in regard to Choke Point or it is in regard to the current topic refund anticipation loans?

Mr. GIBSON. I think with respect to refund anticipation loans, the only answer that I can give you is that the decision was made by no one, but it was made by everyone. I can't point to a specific decision-maker because I can't find anything that identifies somebody.

The origin of the discussion in recent times, in 2008, was an e-mail from Chairman Bair or a question that Chairman Bair asked about why FDIC banks should be offering these products. It seems to have just moved forward from there.

Chairman DUFFY. But it is obvious that Mr. Gruenberg knew about the program, at least by way of some of the e-mails that you discovered. So my question is, is Mr. Gruenberg a negligent leader at the FDIC or is he complicit in all the bad behavior at the FDIC?

Because it has to be one or the other. Either he is involved and complicit or he doesn't know what is going on, and someone else is running the FDIC and he has checked out.

Mr. GIBSON. Sir, I believe that Mr. Gruenberg was generally at least aware of what was going on with respect to RALs. What I can tell you is that members of the board did most of these briefings and received information from management and in a variety of different ways each of the inside members of the board was engaged in these activities.

Chairman DUFFY. My time from Mr. Hill has expired.

The Chair now recognizes the gentleman from Minnesota, Mr. Ellison, for 5 minutes.

Mr. ELLISON. Right next door to you.

Chairman DUFFY. I know. You are my neighbor.

Mr. ELLISON. That is right. Well, anyway, thank you Mr. Chairman, and Mr. Ranking Member. I have long been critical of refund anticipation loans, RAL loans. These short-term high-cost bank loans secured by the taxpayers' expected tax refund are often predatory and expensive. I would say always, but there might be some that aren't and I just don't know about them. But all the ones I have ever seen have been bad.

I believe in many cases they violate the Equal Credit Opportunity Act (ECOA). A RAL preparer will typically charge tax preparation fees, loan administration fees, and bank fees in addition to other fees that a borrower can avoid by filing directly with the IRS. And I know your report starts in 2003 when refund anticipation loans or RALs were turning into a huge wealth-stripping problem.

Professional tax preparers, as well as thousands of small independent preparers, were brokering these deals on behalf of insured financial institutions. These 7- to 14-day loans were paid by the actual IRS refund. The RAL preparers were often able to offer these loans because they partnered with banks.

Numerous consumer groups decried this practice and urged regulators to stop the practice. And according to your report, most large banks stopped being involved with RALs. JPMorgan Chase, HSBC, and Santa Barbara Bank and Trust all stopped financing RALs.

So I guess my question is, is that right? The most well-known RAL preparers, H&R Block and Jackson-Hewitt, stopped offering RALs? Would you agree?

Mr. GIBSON. Sir, I don't really know. I am not here to talk about whether RALs are good or bad products, frankly. It is the FDIC's supervisory approach to those three institutions—

Mr. ELLISON. Okay. So did the IRS make an effort to stop RALs too by not allowing tax preparers to use its so-called debt indicator?

Mr. GIBSON. Yes. I believe they did.

Mr. ELLISON. Okay. And is it possible that the FDIC could have had a legitimate supervisory concern for the safety and soundness of institutions engaged in RALs?

Mr. GIBSON. The FDIC did have supervisory concerns with respect to the institutions offering RALs. In fact, the debt indicator

or the loss of the debt indicator is something that the FDIC mentions as a reason for that concern. What I would point out in that particular regard is that the debt indicator was one of 80 to 120 factors that were used by institutions in evaluating the loan that they were making.

Mr. ELLISON. Thank you. In looking at your report, is it true that the FDIC staff identified compliance deficiencies at the three small financial institutions that were offering RALs?

Mr. GIBSON. I'm sorry. Could you repeat that, sir?

Mr. ELLISON. So in looking at your report, is it true that FDIC staff identified compliance deficiencies at the three small financial institutions that were offering RALs?

Mr. GIBSON. I believe there were some compliance deficiencies that were identified, yes.

Mr. ELLISON. Okay. So I am looking at perhaps weak electronic return origination training, a lack of RAL program audit coverage, and even substantive violation of the ECOA? Does that ring a bell for you?

Mr. GIBSON. Sir, that could be. Yes.

Mr. ELLISON. Okay. So if the FDIC had already identified previous violations with these three institutions on notice that the agency was concerned about their performance in RALs?

Mr. GIBSON. Well, sir, all I can say on that regard, again, with respect to one institution, that institution received a CAMELS rating of two from the safety and soundness examiner during that same period of time.

The compliance examiners reviewed that examination, weighed in on it, and they concurred in a rating of two for that institution. The conclusion I would draw from that is that they weren't overly concerned about the extent of those compliance violations.

Mr. ELLISON. Okay. Thank you, and that is all I have for you today.

Chairman DUFFY. The gentleman yields back.

The Chair recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Mr. Gibson, thank you so much for being here. I appreciate you being here to testify, and I also appreciate your office looking into what appears to look very similar to the abuse of power that was uncovered by the Operation Choke Point.

I respect that the names of some of the affected institutions will and need to remain anonymous for the purposes of your report and for this investigation, but I also understand that they may have been in my district or at least in Illinois given the role of the FDIC's Chicago Regional Director.

In late 2009, the FDIC contended that Bank A had expanded its RAL program while operating under a 2009 cease-and-desist order. This perceived expansion prompted M. Anthony Lowe, the FDIC Chicago Regional Director since 1985, to send a letter to the institution's board of directors dated September 30, 2009, expressing concern about the bank's RAL products and requesting a plan for discontinuing this type of lending.

In separate letters, both dated February 3, 2010, Mr. Lowe notified the boards of the two remaining institutions that RALs were

unacceptable for the banks and that plans should be developed for the expeditious exit of those lines of business.

The FDIC OIG determined that the FDIC's letter to all three institutions were coordinated through the Washington office, including the then Division of Supervision and Consumer Protection and the legal division. And there was discussion of a global approach at the FDIC to deal with the RAL products as well.

Notably the OIG found that, "The verbiage included text from letters that had been sent to banks engaged in payday lending" as covered in the OIG September 2015 audit on Operation Choke Point.

The specific language is as follows, "We find that RALs are costly and offer limited utility for consumers as compared to traditional loan products. They also carry a high degree of risk to an institution, including third-party reputational compliance and legal exposures. These risks may expose the bank to individual and class actions by borrowers and local regulatory authorities. Consequently, we find RALs unacceptable for the bank."

All three banks considered in this report of inquiry are located in the Chicago region. Is that correct?

Mr. GIBSON. They were located in the region—yes. They were located in the region, sir.

Mr. HULTGREN. And the Chicago Regional Director supervising these banks is Anthony Lowe. Is that correct?

Mr. GIBSON. Yes, sir, it is.

Mr. HULTGREN. This is the same Anthony Lowe who was mentioned in your September 2015 Operation Choke Point audit, is that right?

Mr. GIBSON. Yes, sir, it is.

Mr. HULTGREN. And Mr. Lowe was responsible for sending several letters to banks asking them to stop their payday lending businesses. Isn't that correct?

Mr. GIBSON. Mr. Lowe sent some letters, sir.

Mr. HULTGREN. Actually, in an informal interview with the committee staff on June 2, 2015, Mr. Lowe indicated that there may even be a letter template floating around the FDIC's Washington office for such letters. Would that surprise you?

Mr. GIBSON. Sir, I don't know whether there was or there wasn't. I don't remember seeing a template, per se.

Mr. HULTGREN. Okay. Let me move on. On December 17, 2014 FDIC Chairman Martin Gruenberg requested that the FDIC OIG "conduct a fact-finding review of the actions of FDIC staff." That is "in regards to the Operation Choke Point initiative."

His request was prompted by concerns raised by Congressman Luetkemeyer in a December 10, 2014, letter which asks that the role of the five FDIC officials and others as appropriate be examined.

The FDIC OIG addressed the roles of the five individuals in its audit report Number AUID15–008, dated September 2015, entitled, and I quote—"The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions That Conducted Business With Merchants Associated With High Risk Activities."

In that audit, the FDIC OIG committed to conduct additional work on the role of the FDIC staff with respect to the agency's supervisory approach to financial institutions that offered RALs.

The FDIC's OIG's more recent report of inquiry reveals that two of the five officials referenced by the Congressman—Mark Pearce, Director, Division of Depositor and Consumer Protection; and M. Anthony Lowe, Chicago Regional Director—as well as others at the agency played key roles in forcing banks to exit the RALs business.

What was the impetus from the OIG's report of inquiry into refund anticipation loans?

Mr. GIBSON. Sir, as we were doing the work with respect to Operation Choke Point, we became aware of the FDIC's approach to refund anticipation loans. There were some similarities in that approach and it struck us that there were concerns that were similar to the concerns that were raised in the letter from 35 Members of Congress that triggered our original work.

So we elected to continue to conduct work with respect to RALs even though they were a product that wasn't really directly involved in the DOJ's Operation Choke Point.

Mr. HULTGREN. Okay. Did the OIG determine any overlap in the FDIC officials involved in targeting refund anticipation loans and working with DOJ in carrying out Operation Choke Point?

Mr. GIBSON. No, sir. I don't believe so.

Mr. HULTGREN. Okay. I see my time has expired.

I yield back the balance of my time. Thank you, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the ranking member, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. Let us talk some more about Mr. Gruenberg. These activities that occurred, did they occur prior to 2011?

Mr. GIBSON. Yes, some of them did.

Mr. GREEN. Okay. And is it true that Mr. Gruenberg became Chair in 2011, if you know?

Mr. GIBSON. Yes, it is.

Mr. GREEN. And as a result, it would be inappropriate and misleading to imply that Mr. Gruenberg was Chair when these activities took place?

Mr. GIBSON. Mr. Gruenberg was the Vice Chairman. That is correct.

Mr. GREEN. He was not the Chair?

Mr. GIBSON. No, he was not.

Mr. GREEN. He was not the Chair. He was there, but he was not the Chair?

Mr. GIBSON. No, he was not.

Mr. GREEN. And it seems as though we were trying to imply that as Chairman, he had knowledge of these things. He was a Vice Chair. He was there, but he was not the Chair. As a matter of fact, there was another person who was Chair, who, of course is obviously no longer there, Ms. Bair. Is that a fair statement?

Mr. GIBSON. That is correct.

Mr. GREEN. And is it also true that Mr. Gruenberg was the person who asked for the investigation?

Mr. GIBSON. Yes, sir, Mr. Gruenberg had asked us to conduct investigative work. That is true.

Mr. GREEN. Yes.

Mr. GIBSON. Yes, sir.

Mr. GREEN. Yes, it is true. It is true. It is okay to just say it is true because it is. He is the person who caused you to come over to perform the investigation because he requested it. True?

Mr. GIBSON. He requested the investigation.

Mr. GREEN. So that is true? Do you have a problem saying it is true, sir?

Mr. GIBSON. I don't have a problem with saying—

Mr. GREEN. Okay. Is it true that he is the person who asked for the investigation?

Mr. GIBSON. Sir, I don't know that I accept the premise of all of your questions.

Mr. GREEN. Okay.

Mr. GIBSON. That is why—

Mr. GREEN. Did he ask for an investigation—

Mr. GIBSON. —on that project.

Mr. GREEN. Pardon me? Did he ask for an investigation?

Mr. GIBSON. He did.

Mr. GREEN. And did he ask for the investigation as it related to Operation Choke Point?

Mr. GIBSON. He did.

Mr. GREEN. And is it true that when you got there, you decided that you were going to expand the investigation into this other area, but he was the reason that you arrived because he asked for the investigation into Operation Choke Point?

Mr. GIBSON. Yes.

Mr. GREEN. Okay. And by the way, you did not do an audit. You did a review.

Mr. GIBSON. That is correct, sir.

Mr. GREEN. Okay. Now, let us go to something else with reference to elimination versus regulation. The product still exists, doesn't it? RALs?

Mr. GIBSON. As far as I know, it does. Insofar as I know, it does. FDIC-supervised institutions don't offer it.

Mr. GREEN. Yes. And they were in the business of protecting banks, but they don't have jurisdiction over many other institutions that have the opportunity to present this product to the public. Is that a fair statement? Other institutions do this now. There are other institutions that are doing it. Banks don't.

Mr. GIBSON. I assume that there are, yes, but—

Mr. GREEN. Okay. The FDIC—

Mr. GIBSON. —I am not aware of the industry—

Mr. GREEN. And well, you are not aware, but let us do it this way since I have to get this answer on the record for my own purposes. You agree that this product still exists but not with FDIC institutions, right?

Mr. GIBSON. I believe that is true. Yes.

Mr. GREEN. Okay. So the FDIC, while it did, as my colleagues have indicated, deal with the product as it related to them, the FDIC could not eliminate this product so there are others that are doing it.

It is just the FDIC, the entity in charge of safety and soundness, has a duty to protect consumers. This entity decided that it wasn't in the best interests of the banks to do this, and it moved to eliminate this as a product within these three institutions. Is that a fair statement?

Mr. GIBSON. Apparently so.

Mr. GREEN. Okay. Now, final comment to you, sir, is this. Look, I appreciate your testimony here today. I really do. And after we finish, I am going to come down and shake your hand and offer you lunch. But I do want you to know that Mr. Gruenberg is not the source of this, and I don't want you to get caught up in some sort of implication that Mr. Gruenberg was the genesis of this and that this, all of this was emanating from him. He was a really bad manager, because that is just not the case.

He did what he could when he found out about things, the Choke Point circumstance he called to your attention, and also he has taken a corrective action once you have called it to his attention. He is going to be reporting to you again in June.

So I am just a person who wants to see people treated fairly, and I think Mr. Gruenberg has not been treated fairly today. And I am going to stand up for him.

I yield back.

Chairman DUFFY. The gentleman yields back. Hopefully, he is paying for lunch when he offers that to you, Mr. Gibson.

[laughter]

Chairman DUFFY. The Chair now recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. And thank you, Mr. Gibson, for continuing to be here. I appreciate it very much.

We all know in any organization that the bad behavior of that organization starts at the top if there is bad behavior. How long has Mr. Gruenberg been at the FDIC, sir?

Mr. GIBSON. Sir, he was appointed as Vice Chairman of the Board of Directors. I am not sure what year that was honestly. It was a number of years before he became the Chairman of the FDIC.

Mr. POLIQUIN. And how do you become a chairman of a major regulator like this in Washington? How did he become the Chairman?

Mr. GIBSON. Sir, you are appointed by the President and—

Mr. POLIQUIN. And how long is Mr. Gruenberg's term appointed by the President?

Mr. GIBSON. Pardon me?

Mr. POLIQUIN. How long does Mr. Gruenberg's term last?

Mr. GIBSON. Sir, I may have to get back to you on that, but I believe it is 5 years. I could be wrong, but—

Mr. POLIQUIN. Okay. And how long have you been the I.G. at the FDIC?

Mr. GIBSON. Sir, I have been the acting I.G. at the FDIC for almost 3 years now.

Mr. POLIQUIN. Okay. So your time has overlapped with that of Mr. Gruenberg's. Is that correct?

Mr. GIBSON. Yes, it is.

Mr. POLIQUIN. Okay, fine. If I am not mistaken, Mr. Gruenberg was in a position of extreme authority at the FDIC during Operation Choke Point, is that correct?

Mr. GIBSON. Sir, he was either the Vice Chairman or the Chairman, but I am not sure—

Mr. POLIQUIN. Okay. How many Chairmen—

Mr. GIBSON. —what the timeframe of Operation—

Mr. POLIQUIN. How many Chairmen do you have at the FDIC?

Mr. GIBSON. We have one.

Mr. POLIQUIN. And how many Vice Chairmen do you have?

Mr. GIBSON. We have one.

Mr. POLIQUIN. Okay. So he was either the top banana or the number two guy, right?

Mr. GIBSON. That is correct.

Mr. POLIQUIN. Okay, fine. You must associate with Mr. Gruenberg professionally and maybe otherwise with other I.G.s in this town embedded in other major regulators like the FDIC. Do you know who your counterparts are?

Mr. GIBSON. I know who my counterparts are, yes, sir.

Mr. POLIQUIN. Okay. Do you think that the behavior of Operation Choke Point where Mr. Gruenberg was there and was in a position of authority and did nothing to stop it when it was exposed in their coordinated work with Justice? Do you find this unusual for other government agencies here in Washington?

Mr. GIBSON. Sir, what I would point out is that our audit found that the FDIC had minimal direct involvement with Operation Choke Point. And in fact, the FDIC's communications with DOJ at the time Operation Choke Point initiated ceased because Chairman or Vice Chairman Gruenberg—I believe he may have been the Chairman at the time—basically indicated that the FDIC shouldn't participate in those.

Now, I can't really speak to the rest of your question. I am not sure that I can associate that with the heads of other agencies.

Mr. POLIQUIN. Do you recall the genesis of Operation Choke Point, Mr. Gibson?

Mr. GIBSON. Yes, sir. I think I do.

Mr. POLIQUIN. Could you tell us a little bit about it?

Mr. GIBSON. Operation Choke Point was a program that was initiated by the Department of Justice.

Mr. POLIQUIN. Who was the head banana at the Department of Justice at that time?

Mr. GIBSON. Sir, I believe Eric Holder was the Attorney General at the time.

Mr. POLIQUIN. Mr. Holder was the Attorney General at the time? And how long was Mr. Holder's term?

Mr. GIBSON. Sir, I don't know that he had a term.

Mr. POLIQUIN. Okay, but he was appointed by whom?

Mr. GIBSON. He was appointed by President Obama.

Mr. POLIQUIN. Okay, so what you are telling me is in some shape or form it is the Administration that is responsible for appointing all of these regulators, either top people—

Mr. GIBSON. Yes, sir.

Mr. POLIQUIN. —or those who eventually become the top people. This behavior with respect to Choke Point using Federal regulators

to force banking regulators to choke off credit to legally operating businesses has been conducted recently over the last 7 years. Is that correct?

Mr. GIBSON. Sir, I believe Operation Choke Point was conducted during that timeframe.

Mr. POLIQUIN. Okay, fine. And how long have you been in this town, Mr. Gibson?

Mr. GIBSON. Longer than I care to admit.

[laughter]

Mr. POLIQUIN. Okay. That is a fair statement. Do you find that this sort of behavior has happened throughout different parts of this Federal Government for the last 7 years? Is it unique to this period of time?

Mr. GIBSON. Sir, I am genuinely not sure how to answer that question. I don't know that I would accept the premise that things are necessarily different now than they were prior to that period of time.

Mr. POLIQUIN. And do you find in the last 7 years, Mr. Gibson, that there has been an unusual amount of activity by the Federal Government to put burdensome regulations on legally run businesses—

Mr. GIBSON. Sir—

Mr. POLIQUIN. —that we haven't seen in the past?

Mr. GIBSON. I honestly don't have an empirical basis on which I can make an assessment about that.

Mr. POLIQUIN. How can we find out that information?

Mr. GIBSON. That is a good question.

Mr. POLIQUIN. And to whom do we go?

Mr. GIBSON. Sir, I am sure there are studies that are done which address that.

Mr. POLIQUIN. Another study. We don't—okay.

Mr. GIBSON. I—

Mr. POLIQUIN. Can you cite any of those studies?

Mr. GIBSON. I'm sorry?

Mr. POLIQUIN. Could you cite any of those studies for our committee now?

Mr. GIBSON. No, I am afraid I can't. I am only—

Mr. POLIQUIN. And where we might go to find out—

Mr. GIBSON. In terms of burdensome regulation, none. I am not an expert on that subject.

Mr. POLIQUIN. Where might we go to find out if such studies existed?

Mr. GIBSON. Sir, I think the Congressional Research Service would be a place to start.

Mr. POLIQUIN. Okay. Thank you very much.

Thank you, Mr. Chairman. I yield back my time.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the gentleman from Texas for 5 seconds.

Mr. GREEN. Thank you, Mr. Chairman.

I referenced earlier an I.G. report, and at this time I would like to place that report in the record if there are no objections. It is styled, "Challenges and FDIC Efforts Related to Predatory Lending."

Chairman DUFFY. Without objection, it is so ordered, and your 5 seconds has expired as well.

I want to thank Mr. Gibson, you and your team, for your work and your testimony today. We are grateful for that.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place his responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, I note without further objection, this hearing is adjourned.

Mr. GIBSON. Thank you, sir.

Chairman DUFFY. Thank you.

[Whereupon, at 3:30 p.m., the hearing was adjourned.]

A P P E N D I X

March 16, 2016

CONGRESSWOMAN JOYCE BEATTY (OH-03)
STATEMENT FOR THE RECORD
FINANCIAL SERVICES COMMITTEE, OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE
MARCH 16, 2016

Thank you Mr. Chairman and Ranking Member Green.

I would like to thank Acting Federal Insurance Deposit Corporation Inspector General Gibson for stepping up in his role at the agency while we impatiently await a FDIC Inspector General to receive a simple up or down vote in committee or by the full Senate.

On October 23rd, 2014, President Obama nominated Jay Lerner to the position of Federal Deposit Insurance Corporation Inspector General – 17 months ago in OCTOBER 2014.

While Mr. Lerner finally received a confirmation hearing in September of 2015 from the Senate Banking Committee– almost a full year after his nomination was sent to the committee, to date he still has not received a up or down vote.

Like so many of President Obama's nominees, he has been held up by Senate Republicans.

If House Republicans are really serious about oversight and culture change at our administrative agencies then they should pressure their fellow Republican colleagues in the Senate to fulfill their constitutional duties to advise and consent.

They should pressure Senate Republicans to hold hearings and vote on the President's nominees.

Without this pressure, it is difficult to take House Republican rhetoric attacking senior leadership at the FDIC seriously today when they will not even commit as a party to confirm or hold a vote on a FDIC Inspector General.



Testimony

Before the Committee on Financial Services,
Subcommittee on Oversight and Investigations
U.S. House of Representatives

Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel

Statement of Fred W. Gibson, Jr.
Acting Inspector General
Federal Deposit Insurance Corporation

March 16, 2016

Statement of Fred W. Gibson, Jr.
Acting Inspector General, Federal Deposit Insurance Corporation
March 16, 2016

House Committee on Financial Services
Subcommittee on Oversight and Investigations

Chairman Duffy, Ranking Member Green, and Members of the Subcommittee:

I appreciate the opportunity to appear before you today to present the results of our work on the *FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel*. (Report No. OIG-16-001.)

I am submitting for the record the Office of Inspector General's Executive Summary of this report. Our Executive Summary explains why and how we conducted this work and what we learned as a result. It also raises matters for the FDIC's consideration.

Along with our Executive Summary, I am including two sets of comments from the FDIC. The first comments were received following issuance of our draft report. They are signed by the Director of the Division of Risk Management Supervision and the FDIC General Counsel and reflect the signatories' summary of the lengthier set of written comments they provided to us at that time. I received the second set of comments on the final report from the Members of the Board of Directors of the FDIC on March 11, 2016. As noted in our Executive Summary, we had requested that the Corporation advise us within 60 days from the date of our final report on the steps it would take to address the matters raised for its consideration. The Board of Directors' response outlines initial steps and indicates the Board will update our office on its progress by June 30, 2016. My office will continue to monitor the Corporation's efforts going forward.

I appreciate the Subcommittee's interest in our work and will be pleased to answer any questions you and other Members may have.

Why and How We Conducted This Inquiry

On December 17, 2014, Chairman Gruenberg requested that the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) conduct a "fact-finding review of the actions of FDIC staff" in the Department of Justice's Operation Choke Point. The Chairman's request was prompted by concerns raised by a letter from a member of Congress, dated December 10, 2014, asking that the role of five FDIC officials, and others as appropriate, be examined. Our office addressed the actions of the five FDIC officials in connection with Operation Choke Point in the OIG's September 2015 Report, *The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions that Conducted Business with Merchants Associated with High-Risk Activities* (AUD-15-008) (the Audit).

In that report, the OIG indicated that it would conduct further work on the role of FDIC staff with respect to the Corporation's supervisory approach to financial institutions that offered a credit product known as a refund anticipation loan (RAL). A RAL is a particular type of loan product, typically offered through a national or local tax preparation company in conjunction with the filing of a taxpayer's income tax return.[1] Although tax preparation firms were not specifically associated with Operation Choke Point, and RALs are financial products offered by banks and not a line of business related to Operation Choke Point, information we identified in the course of the Audit raised sufficient concern to cause us to also review the FDIC's supervisory approach to institutions offering RALs and the roles of FDIC personnel in that process.

This report describes our work and findings. It is based on interviews with knowledgeable individuals and an extensive review and analysis of FDIC internal emails, correspondence, supervisory materials, and other documents.

What We Learned

The FDIC had a lengthy supervisory relationship with institutions offering RALs, dating to the 1980s. In January 2008, the then-FDIC Chairman, Sheila Bair, asked why FDIC-regulated institutions would be allowed to offer RALs.[2] Shortly thereafter, the FDIC began to try to cause banks it supervised, which are the focus of this review, to exit the business line. In late December 2010, the Office of the Comptroller of the Currency (OCC) required an institution it supervised to exit RALs effective with the 2011 tax season. During this time period, the Internal Revenue Service also withdrew access to an underwriting

[1] The tax preparer, sometimes referred to as an electronic refund originator (ERO), works in cooperation with the financial institution to advance a portion of the tax refund claimed by individuals in the form of a loan. Typically the loan amount would include the tax return preparation cost, other fees and a finance charge.

[2] The Chairman's question was raised in the context of an incoming letter from a number of consumer advocacy groups. This letter, together with similar correspondence in 2009, expressed concern that RALs harmed consumers.

tool it formerly provided to tax preparers and banks that had been used to mitigate certain risks associated with RALs. Ultimately, the FDIC caused all three of its supervised institutions that then continued to facilitate RALs to exit the business in 2011 and 2012.

RALs were, and remain, legal activities, but ultimately were seen by the FDIC as risky to the banks and potentially harmful to consumers.[3] As discussed in our report, the FDIC's articulated rationale for requiring banks to exit RALs morphed over time. The decision to cause FDIC-supervised banks to exit RALs was implemented by certain Division Directors, the Chicago Regional Director, and their subordinates, and supported by each of the FDIC's Inside Directors. The basis for this decision was not fully transparent because the FDIC chose not to issue formal guidance on RALs, applying more generic guidance applicable to broader areas of supervisory concern. Yet the decision set in motion a series of interrelated events affecting three institutions that involved aggressive and unprecedented efforts to use the FDIC's supervisory and enforcement powers, circumvention of certain controls surrounding the exercise of enforcement power, damage to the morale of certain field examination staff, and high costs to the three impacted institutions.

The Washington Office pressured field staff to assign lower ratings in the 2010 Safety and Soundness examinations for two institutions that had RAL programs. The Washington Office also required changing related examination report narratives. In one instance a ratings downgrade appeared to be predetermined before the examination began. In another case, the downgrade further limited an institution from pursuing a strategy of acquiring failed institutions. The institution's desire to do so was then leveraged by the FDIC in its negotiations regarding the institution's exit from RALs. Although the examiners in the field did not agree with lowering the ratings of the two institutions, the FDIC did not document these disagreements in one instance, and only partially documented the disagreement in another, in contravention of its policy and a recommendation in a prior OIG report.

The absence of significant examination-based evidence of harm caused by RAL programs could have caused FDIC management to reconsider its initial assessment that these programs posed significant risk to the institutions offering them. However, lack of such evidence did not change the FDIC's supervisory approach. The FDIC's actions also ultimately resulted in large insurance assessment increases, reputational damage to the banks, as well as litigation and other costs for the banks that tried to remain in the RAL business.

[3] The FDIC's current and historical policy is that it will not criticize, discourage, or prohibit banks that have appropriate controls in place from doing business with customers who are operating consistent with federal and state law. The FDIC applies this policy to services offered to bank customers, i.e., depositors or borrowers. Because RALs are offered through EROs and are third-party relationships, the FDIC does not believe this policy applies.

The Washington Office also used a cursory analysis of underwriting plans that two banks submitted to show their mitigation of perceived risk to reject those plans. In fact, when the initial review suggested these underwriting plans could effectively mitigate certain risks, the Washington Office narrowed and repeated its request to solicit a different outcome. It appears that the decision to reject the plans had been made before the review was complete. The alleged insufficiency of the underwriting plans also formed the basis for an enforcement action against one of the banks.

While the FDIC's Legal Division believed the pursuit of an enforcement remedy against the banks presented "high litigation risk," the FDIC chose to pursue such remedies. Members of the Board, including the then-Chairman of the Case Review Committee, were involved in drafting the language of a proposed enforcement order and in advising management on the development of supervisory support for the enforcement case. The FDIC also attempted to strengthen its case by pursuing a compliance-based rationale. To that end, in early 2011 the FDIC employed extraordinary examination resources in an attempt to identify compliance violations that would require the bank to exit RALs. This examination effort, in the form of a "horizontal review," involved deploying an unprecedented 400 examiners to examine 250 tax preparers throughout the country and the remaining bank offering RALs. The horizontal review was used as leverage in negotiations to get the final bank to exit RALs. Ultimately, the results of the horizontal review were used for little else.

The FDIC also employed what it termed "strong moral suasion" to persuade each of the banks to stop offering RALs. What began as persuasion degenerated into meetings and telephone calls where banks were abusively threatened by an FDIC attorney. In one instance, non-public supervisory information was disclosed about one bank to another as a ploy to undercut the latter's negotiating position to continue its RAL program.

When one institution questioned the FDIC's tactics and behavior of its personnel in a letter to then-Chairman Bair and the other FDIC Board members, the then-Chairman asked FDIC management to look into the complaint. FDIC management looked into the complaint but did not accurately and fully describe the abusive behavior. Nevertheless, the behavior was widely known internally and, in effect, condoned. Other complaints from the banks languished and ultimately were not addressed or investigated independently. Ratings appeals that included these complaints were not considered because they were voided by the FDIC's filing of formal enforcement actions. These complaints were eventually subsumed by settlement processes that, in the case of one bank, appeared to trade improved ratings and the right to purchase failing institutions for an agreement to exit RALs permanently.

Conclusion and Matters for Consideration

The facts developed by this review strongly reinforce the concerns and issues raised in the OIG's earlier Audit. In our view, the FDIC must candidly consider its leadership practices, its process and procedures,

and the conduct of multiple individuals who made and implemented the decision to require banks to exit RALs. While we acknowledge that the events described in our report surrounding RALs involved only three of the FDIC's many supervised institutions, the severity of the events warrants such consideration. The FDIC needs to ask how the actions described in our report could unfold as they did, in light of the FDIC's stated core values of integrity, accountability, and fairness. Further, the Corporation must address how it can avoid similar occurrences in the future.

In December 2015, in response to concerns raised in the Audit, the FDIC removed the term "moral suasion" from its guidance. We appreciate the central importance of informal discussions and persuasion to the supervisory process; however, we believe more needs to be done to subject the use of moral suasion, and its equivalents, to meaningful scrutiny and oversight, and to create equitable remedies for institutions should they be subject to abusive treatment.

Because our work is in the nature of a review, and not an audit conducted in accordance with government auditing standards, we are not making formal recommendations. However, we request that the FDIC report to us, 60 days from the date of our final report, on the steps it will take to address the matters raised for its consideration.

The Corporation's Response

The OIG transmitted a draft copy of this report to the FDIC on January 21, 2016. We asked the Corporation to review the draft and identify any factual inaccuracies they believed existed in the report. We met with staff from the FDIC, on February 10, 2016, to consider whether any factual clarifications were appropriate, reviewed the documentation they provided, and subsequently made some clarifications to the report. The Corporation also requested that we include its response to our report herewith. We have provided the FDIC's full response at Appendix 9. The FDIC's response has not changed our overall view of the facts.

FDIC Summary Comments on the Draft Report

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision
Legal Division

DATE: February 17, 2016

MEMORANDUM TO: Fred W. Gibson, Jr.
Acting Inspector General

FROM: Doreen R. Eberley /S/
Director, Division of Risk Management Supervision

Charles Yi /S/
General Counsel

SUBJECT: Response to the Draft Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel

Thank you for the opportunity to review and respond to the Draft Report of Inquiry (Draft Report) into *The FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel*, prepared by the FDIC's Office of Inspector General (OIG). We believe that the supervision and enforcement activities discussed in the Draft Report were supported by the supervisory record and handled in accordance with FDIC policy. These activities occurred more than five years ago with respect to the three banks that offered refund anticipation loans (RALs).

EXECUTIVE SUMMARY

In August 2015, the FDIC Office of Inspector General (OIG) determined to conduct a review of the role of FDIC staff with respect to the FDIC's supervisory approach to three institutions that offered refund anticipation loans, or RALs. The findings were presented to FDIC in a Draft Report on January 21, 2016 (Draft Report). The Draft Report presented the OIG's view of the FDIC's handling of its supervisory responsibilities with respect to these three financial institutions that offered RALs between five and eight years ago.

We believe that the supervision and enforcement activities identified by the OIG were supported by the supervisory record and handled in accordance with FDIC Policy.

Summary of FDIC Response

- RALs, as described in a GAO report[1], are short-term, high-interest bank loans that are advertised and brokered by both national chain and local tax preparation companies. RALs carry a heightened level of credit, fraud, third-party, and compliance risk because

[1] United States Government Accountability Office Report, GAO-08-800R Refund Anticipation Loans (June 5, 2008) (stating "the annual percentage rate on RALs can be over 500 percent").

they are not offered by bank loan officers, but by several hundred to several thousand storefront tax preparers (also referred to as electronic refund originators (EROs)).

- FDIC must provide strong oversight to ensure that the financial institutions it supervises are offering the product in a safe and sound manner and in compliance with applicable guidance and laws.
- FDIC issued relevant guidance for banks making RALs. In response to an OIG audit, FDIC issued a Supervisory Policy on Predatory Lending. Further, to describe its expectations for banks making loans through third-parties, FDIC issued Guidance on Managing Third-Party Risks.
- Supervisory issues were identified by field compliance examiners as early as 2004, including substantive violations of the Equal Credit Opportunity Act, weak ERO training, and a lack of RAL program audit coverage.
- One community bank grew its RAL program rapidly, nearly doubling the number of EROs through which it originated tax products between 2001 and 2004 to more than 5,600, and then nearly doubling that number again by 2011 to more than 11,000. By comparison, one of the three largest banks in the country at that time originated tax products through 13,000 EROs.
- Supervisory concerns increased through 2008 and 2009, as the management of two banks did not follow regulatory recommendations and directions, including provisions of enforcement actions.
- One of the three RAL banks moved its origination business to an affiliate without prior notice to the FDIC, effectively removing the RAL origination activity from FDIC supervision.
- The exit of large national banks and a thrift from the RAL business raised additional concerns, because similar prior exits had led to the business moving to the much smaller FDIC-supervised community banks.
- All three RAL banks conceded that the loss of the Internal Revenue Service (IRS) Debt Indicator would result in increased credit risk to the bank. The Debt Indicator was a key underwriting tool, supplied by the IRS, and used by the banks to predict the likelihood that a valid tax refund would be offset by other debt. Two of the three banks were unable to fully mitigate the risk created by the loss of the Debt Indicator, and neither substituted credit underwriting based on borrower ability to repay. The third bank may have had an acceptable underwriting substitute, but had such deficient controls and oversight that its RAL program was otherwise not safe and sound.
- The combination of risks outlined above caused the FDIC to ask the banks to exit the RAL business. All three banks declined.
- When poor practices of bank managements were not fully factored into examination ratings for two banks, Washington senior management provided direction to regional management, consistent with policy.
- Two banks were properly downgraded in the 2010 examination cycle based on well-defined weaknesses.
- The banks continued to decline to exit the poorly managed RAL programs.

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- Senior FDIC management recommended enforcement actions based on the supervisory records of the institutions.
- Senior FDIC management appropriately briefed the FDIC Chairman and other Board members on the supervisory actions being taken.
- While some members of the Legal Division raised concerns about litigation risk, the supervisory records supported approval of the enforcement cases, and supervision and legal officials ultimately approved them.
- The recommendations for enforcement action were reviewed by the FDIC's Case Review Committee (CRC), consistent with the FDIC Bylaws and the CRC governing documents.
- One of the final enforcement actions described violations of law by one of the RAL banks because of its efforts to impede examination activities.
- Settlement of the approved enforcement actions addressed the supervisory issues and was handled consistently with FDIC policy. It is not unusual for institutions that cannot engage in expansionary activities because of their condition to take steps to remedy regulatory concerns in order to regain the ability to expand.

We look forward to reviewing the details of the final report and will provide actions to be taken in response within the 60-day timeframe specified by the OIG.

Introduction

We reviewed the materials relied upon by the OIG, which included select email communications between FDIC employees, one former employee's personal notes, draft reports of examination, and information from interviews that OIG staff conducted with select past and current FDIC personnel. Having reviewed relevant materials, we believe that the supervision and enforcement activities that occurred with respect to the three banks discussed in the Draft Report were supported by the supervisory record and handled in accordance with FDIC policy. Nonetheless, the Draft Report did identify areas where better communication, both internally and externally, could have improved understanding of the agency's supervisory expectations and bases for action. Additionally, the Draft Report describes at least one instance in which a former employee – new to the FDIC at the time[2] – communicated with external parties in an overly aggressive manner. The FDIC does not condone such conduct, that type of conduct is not consistent with FDIC policy, and steps were taken to address the conduct at the time.

Risks of Refund Anticipation Loans

RALs are short-term, high-interest bank loans that are advertised and brokered by both national chain and local tax preparation companies. By their very nature, RALs carry a heightened level of credit, fraud, third-party, and compliance risk. Financial institutions must execute strong oversight of the storefront tax preparers (also referred to as electronic refund originators (EROs)) that originate RALs because banks are responsible for the actions of their third-party agents. Similarly, supervisory authorities must provide strong oversight to ensure

[2] The employee left the agency later that same year.

that financial institutions are offering the product in a safe and sound manner and in compliance with applicable guidance and laws. Fewer than 10 financial institutions have ever offered RALs.

FDIC Took an Incremental Approach to Supervising Banks that Offered RALs

The Draft Report suggests that actions taken by the FDIC represented a sharp and rapid escalation in oversight of the institutions with RAL programs. The supervisory record, however, indicates that concerns were raised about risk management oversight of the RAL programs at the institutions for a number of years.

The FDIC first developed supervisory concerns with the risk management practices and oversight provided by the board and senior management of two institutions in 2004. FDIC had concerns with another RAL lender at the time that was not reviewed by the OIG. That lender exited the business in 2006 when its tax preparation partner wanted to offer a product the bank deemed too risky.

Between 2004 and 2009, the two institutions were subject to annual risk management examinations and two compliance examinations. The examinations identified repeated weaknesses in risk management practices. Both banks' RAL programs experienced heavier than normal losses in 2007. Examinations in 2008 showed continuing weaknesses in risk management practices and board and senior management oversight, and both institutions' compliance ratings were downgraded to less-than-satisfactory levels. Examinations in 2009 showed continued weaknesses in risk management practices and oversight, and both institutions were downgraded to an unsatisfactory level for compliance and "Needs to Improve" for CRA.

By December 2009, FDIC continued to have a variety of concerns with the RAL programs of both institutions. One of the institutions had moved the RAL business to an affiliate for the 2009 tax season and was not in compliance with a February 2009 Cease and Desist Order requiring enhancement of its program oversight. Later, that institution entered into contracts to expand its ERO lender base without the required prior notice to the FDIC.

Another institution was operating under a Memorandum of Understanding (MOU) requiring it to improve its oversight, audit, and internal controls over its RAL business. The bank's management was not in compliance with those provisions of the MOU.

Given identified risk management weaknesses and concerns about one institution's continued expansion, in December 2009, FDIC directed the institution to deliver a plan to exit the RAL business. Based on similar concerns with another bank's risk-management weaknesses, and reports that the Internal Revenue Service was contemplating discontinuance of its Debt Indicator, a key underwriting tool for RAL lending, FDIC sent similar letters to two other banks in February 2010, requesting that they develop and submit plans to exit the RAL business.

The letters sent to all three of the banks expressed concern about the utility of the product to the consumer given high fees. This concern was consistent with the FDIC's Supervisory

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Policy on Predatory Lending, which stated that signs of predatory lending included, among others, the lack of a fair exchange of value. All three institutions declined the request that they develop a plan to exit the business.

FDIC had Operative Guidance for Banks Engaged in RALs

The Draft Report suggests that the FDIC did not have guidance that was applicable to RALs. In fact, the FDIC has well-established guidance for the supervision of banks that offer RALs, stemming from longstanding guidance governing predatory lending as well as guidance for banks engaged in third-party lending arrangements.

In June 2006, the OIG's Audits and Evaluations staff issued OIG Report 06-011, *Challenges and FDIC Efforts Related to Predatory Lending*. The Report recommended that FDIC issue a policy on predatory lending, and FDIC complied. The Policy, which was issued in January 2007, states, "[s]igns of predatory lending include the lack of a fair exchange of value or loan pricing that reaches beyond the risk that a borrower represents or other customary standards."[3] Further, FDIC issued FIL-44-2008, *Guidance for Managing Third-Party Risk*, in June 2008. Both pieces of guidance were relevant to the banks engaged in the RAL business.

Headquarters Management Properly Oversaw Regional Offices

The Draft Report suggested that decisions by FDIC officials to change draft ratings assigned by examiners were improper and unfounded. However, such oversight is appropriate and the review of the examination documents suggests the changes had a strong supervisory basis.

In 2010, FDIC headquarters instructed the Chicago Regional Office to consider bank practices, not just their current financial conditions, in assigning ratings to two banks with identified weaknesses in their RAL programs. This instruction was consistent with interagency rating guidelines. The instruction was also consistent with the concept of forward-looking supervision that the FDIC had emphasized in response to OIG recommendations following Material Loss Reviews of failed banks.

Forward-looking supervision encourages examiners to consider the fact that even financially strong institutions can experience stress in cases in which risks are not properly monitored, measured, and managed. Further, examiners are encouraged to take proactive and progressive action to encourage banks to adopt preemptive measures to address risks before their profitability and viability is impacted.

[3] See https://www.fdic.gov/news/news/financial/2007/fil07006.html, FDIC Financial Institution Letter 6-2007, FDIC's Supervisory Policy on Predatory Lending, January 22, 2007.

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The ratings for the two banks were fully supported by the weaknesses identified in both banks' risk management practices and board and senior management oversight of their RAL businesses.

Supervisory Practices were Appropriate and Risk-Focused, Consistent with Longstanding Policy

During 2010, FDIC's concerns about the safety and soundness of RAL programs grew. OCC and OTS had each directed a large institution to exit the RAL business, and an additional large financial institution exited the RAL lending business on its own. The FDIC was concerned that the activities would migrate to the three FDIC supervised community banks, two of which had documented weaknesses in the oversight of their existing RAL programs. Further, the IRS announced in August it would discontinue the Debt Indicator (DI) before the 2011 tax season; the DI had proven to be a key tool for reducing credit risk in RALs. In November 2010, the institutions were asked to outline their plans for mitigating the resulting increase in credit risk following the loss of the tool. All three institutions conceded that the loss of the DI would result in increased risk to their banks. Despite these concerns, all three institutions continued to decline to exit the business. Finally, in December 2010, OCC directed the final national bank making RALs to exit the business before the 2011 tax season.

In response to these concerns, as well as the ongoing compliance issues that were being identified by 2010 risk-management examinations, the FDIC planned to conduct unannounced horizontal reviews of EROs during the 2011 tax season. These types of reviews were not a novel supervisory tool for the FDIC; in fact third-party agents of one of the institutions had previously been the subject of a horizontal review in 2004 that covered two additional FDIC-supervised institutions.

The 2011 horizontal review ultimately only covered EROs of one of the banks. The review confirmed that the institution had violated law by interfering with the FDIC's review of the EROs during the 2009 compliance examination and during the 2011 horizontal review by coaching ERO staff and providing scripted answers. The review identified a number of additional violations of consumer laws and unsafe and unsound practices, violations of a Consent Order, and violations of Treasury regulations for allowing third-party vendors to transfer up to 4,300 bank accounts for Social Security recipients without the customers' knowledge or consent.

FDIC's Enforcement Actions Were Legally Supported

Contrary to what the Draft Report suggests, the presence of litigation risk does not mean an enforcement action has no legal basis. While some in the Legal Division – in particular the Deputy General Counsel, Supervision Branch (DGC) – believed that enforcement action against one institution presented litigation risk, the General Counsel and the DGC both approved the enforcement actions taken by the FDIC. Their own actions demonstrated their belief that the enforcement action was legally supportable.

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The decision to pursue an enforcement action against the bank despite the presence of litigation risk is consistent with guidance offered by the OIG. In a 2014 report on enforcement actions, the OIG noted that legal officials need to ensure that their risk appetite aligns with that of the agency head and should clearly communicate the legal risks of pursuing a particular enforcement action, but the agency head or senior official with delegated authority should set the level of litigation risk that the agency is willing to assume.

Moreover it is important to note that experienced enforcement counsel and subject matter experts in the Legal Division reviewed and responded to the concerns raised by the Chicago Regional Counsel in a series of memoranda.

Communications Between FDIC Board Members and Staff Were Appropriate

The Draft Report suggests that discussions between staff and FDIC Board members on the RAL programs were unusual and inappropriate. However, as discussed below, such discussions are expected and appropriate. No member of the FDIC Board directed FDIC staff to order any banks to discontinue offering RAL products or to take any action that was not supported by supervisory findings.

The FDIC bylaws set forth the organizational structure of the FDIC and the foundation for communications and exercise of authority of both the FDIC Board and its Officers. The FDIC Board has overall responsibility for managing the FDIC, while day-to-day responsibility for managing the FDIC and supervising its Officers is delegated to the FDIC Chairman. FDIC Officers have a duty to keep the Chairman informed of their actions as well as other Board members as appropriate, and they meet this duty through regular briefings of the Chairman and updates to other Board members about the ongoing activities in their organizations.

Case Review Committee Acted Consistently With Existing Guidelines

Contrary to the suggestion in the Draft Report, the Case Review Committee (CRC) acted consistently with existing guidelines in connection with the issuance of the Notice of Charges against an institution in February 2011. The CRC is a standing committee of the FDIC Board of Directors that is responsible for overseeing enforcement matters. Its voting members consist of one internal FDIC Board member who serves as the CRC Chairman and one special assistant or deputy to each of the other four FDIC Board members.

First, the Notice of Charges sought a Cease & Desist Order (C&D) which does not require CRC approval under governing documents. Authority to issue C&D Orders was delegated to staff and therefore the CRC was not required to vote on the C&D Order.

Second, CRC governing documents provide for staff to consult with the CRC Chairman if a proposed enforcement action may affect FDIC policy, attract unusual attention or publicity, or involve an issue of first impression. Under such circumstances, the CRC Chairman may, in his or her discretion, determine whether review and approval by the CRC would be desirable, in

which case the matter would be heard by the CRC. Thus, the Notice of Charges did not require a CRC vote.

Finally, CRC governing documents provide that the CRC Chairman is expected to take an active role in the enforcement process and to meet regularly with senior supervision and legal enforcement personnel to review enforcement activities and matters. As such, it was wholly permissible and appropriate for the CRC Chairman to engage with staff in active debate over a matter affecting the FDIC.

Settlement Discussions Were Handled Properly

The FDIC acted consistently with outstanding agency policy when conducting settlement discussions. In the case referenced by the OIG, the bank was prevented from participating in failed bank acquisitions by two issues: an outstanding enforcement action and compliance and risk-management problems stemming from its RAL program. Once the bank settled its enforcement action and agreed to exit the RALs business, there was no reason to prevent the bank from qualifying for the "failed bank bid list." To do otherwise could have been arbitrary and unduly punitive.

Conclusion

The FDIC had longstanding supervisory histories with respect to RALs. To differing degrees, the institutions engaged in the RAL business had a record of supervisory deficiencies identified by examination staff in both risk management and compliance stemming from their RAL programs. These issues formed the basis for the examination and enforcement actions described in the report. Nonetheless, the Draft Report did identify areas where better communication, both internally and externally, could have improved understanding of the agency's supervisory expectations and bases for action. Additionally, the Draft Report describes at least one instance in which a former employee – new to the FDIC at the time[4] – communicated with external parties in an overly aggressive manner. The FDIC does not condone such conduct, that type of conduct is not consistent with FDIC policy, and steps were taken to address the conduct at the time.

We look forward to reviewing the details of the final report and will provide actions to be taken in response within the 60-day timeframe specified by the OIG.

[4] The employee left the agency later that same year.

FDIC Board of Directors
Comments on the Final Report

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Board of Directors

March 11, 2016

TO: Fred W. Gibson
Acting Inspector General

FROM: Martin J. Gruenberg /S/
Chairman

Thomas M. Hoenig /S/
Vice Chairman

Thomas J. Curry /S/
Director (Comptroller of the Currency)

Richard Cordray /S/
Director (Director of the Consumer Finance Protection Bureau)

SUBJECT: Response to Office of Inspector General Report No. OIG-16-001

Thank you for the opportunity to review and respond to the final Report of Inquiry (Final Report) into *The FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel*, prepared by the FDIC's Office of Inspector General (OIG). While the FDIC's response to the Draft Report of Inquiry on February 17, 2016, addressed the factual record, this response addresses the matters raised by the OIG for consideration.

FDIC Board Review of Policy Matters Raised in the Final Report

The OIG requested that FDIC consider the issues contained in the Final Report and apprise the OIG of any actions FDIC will take as a result. In response, the FDIC Board of Directors (FDIC Board or Board) will undertake a review of the key issues raised in the Final Report for consideration. As a starting point, the FDIC Board reiterates its commitment to the Mission, Vision, and Corporate Values of the FDIC. Additionally, the FDIC Board commits to review and consider the following matters:

- the clarity and sufficiency of parameters applied to the use of moral suasion, or its equivalents;
- the adequacy of existing vehicles for examiners and other employees to report what they believe to be inappropriate actions or direction;
- the effectiveness and timeliness of avenues of redress available to banks that believe supervisory powers are not used appropriately; and
- the governance and procedures of the Board and its committees.

Interim Actions in Response to the Final Report

In addition to this Board-level review, the FDIC has identified a number of interim actions that may be taken now to be responsive to the OIG's concerns and further strengthen the FDIC's supervision programs.

Issuance of Internal Guidance Regarding Communication with Bankers

To further reinforce expectations that communication with bankers be clear and balanced, the Division of Risk Management Supervision (RMS) will issue a Regional Director Memorandum (RD Memo) *Best Practices: Communication and Coordination with Bank Management in Carrying Out Forward-Looking, Risk-Based Supervision.* The RD Memo will:

- set forth communication expectations and best practices for each stage of the supervisory cycle: pre-examination planning, on-site examination activity, post-examination report review, and the period between examinations;
- reinforce the importance of communicating matters involving policy or recommendations in writing on FDIC letterhead or through a report of examination and documenting all such communications in FDIC records; and
- provide expanded instructions for report of examination content and style, the focus of which will be that fact-based, diplomatic and objective language is ordinarily more effective than criticism in achieving corrective action or adoption of recommended improvements.

Enhancement of Appeals Processes

The FDIC agrees that banks should have meaningful avenues of redress if they believe supervisory powers are not used appropriately, including when the appeals process is not available. The Supervision Appeals Review Committee (SARC) guidelines were amended in 2008, after notice and comment, to modify the supervisory determinations eligible for appeal and align the FDIC's appeal procedures with those of the other federal banking agencies. Prior to 2008, the FDIC was the only federal banking agency that expressly allowed review of determinations that underlie formal enforcement actions, which are subject to a separate due process.

The FDIC Board will review and reconsider the changes made in 2008 to the SARC eligibility requirements as part of the Board-level review of the clarity and appropriateness of the roles and responsibilities of existing Board committees and the effectiveness and timeliness of avenues of redress available to banks that believe supervisory powers are not used appropriately. Additionally, RMS and the Division of Depositor and Consumer Protection (DCP) will develop a process for the review of appeals that are received but are deemed ineligible for the formal review process to ensure that any matters in the appeal that require FDIC management's attention, including employee behavior, are addressed. The process will require that such reviews be completed in a timely manner, similar to that afforded those appeals eligible for the formal process.

Issuance of External Guidance Regarding Expectations for Communication and Handling of Disagreements

RMS and DCP will update and reissue Financial Institution Letter (FIL) 13-2011, *Reminder on FDIC Examination Findings*. This FIL:

- reinforces FDIC's expectations for communications between FDIC and bankers;
- encourages banks to provide feedback on supervisory programs and to seek clarity on FDIC findings and recommendations as necessary;
- encourages institutions with concerns about examination findings to discuss those concerns with the examiner-in-charge or to contact field office or regional office personnel;
- provides an avenue for institutions to appeal examination findings through a formal appeals process; and
- provides a confidential, neutral and independent sounding board through the FDIC Office of the Ombudsman.

Issuance of Industry Guidance on Lending Through Third Parties

In response to the findings of the Final Report and prior OIG audits, the FDIC has begun developing guidance to address the risks associated with banks making loans through third parties as well as risk management practices that would be expected of banks engaging in these activities to mitigate the risks. This new guidance will supplement and expand on the guidance contained in FIL-44-2008, *Guidance for Managing Third-Party Risk*, and will specifically address the risks associated with banks making loans through rent-a-charter relationships, agent relationships, and other third-party relationships. FDIC staff will present the guidance to the FDIC's Board of Directors for consideration. As new products and delivery channels emerge, the FDIC commits to fully consider whether the issuance of specific regulatory guidance is warranted.

Independent Review

The FDIC has hired outside counsel to conduct an independent review of the Final Report and supporting materials to advise whether there is a basis for personnel action or changes to personnel policies.

Next Steps

We appreciate the opportunity to provide a response to the Final Report. The FDIC will provide a status update of the efforts outlined above by June 30, 2016.

Office of Inspector General

June 2006
Report No. 06-011

Challenges and FDIC Efforts Related to Predatory Lending

AUDIT REPORT

Office of Audits

OIG

Office of Audits

Report No. 06-011
June 2006

Challenges and FDIC Efforts Related to Predatory Lending

Background and Purpose of Audit

Predatory lending typically involves imposing unfair and abusive loan terms on borrowers, and statistics show that borrowers lose more than $25 billion annually due to predatory practices. Predatory lending can be detrimental to consumers and increases the financial and reputation risk for financial institutions. Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeat refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan.

The FDIC is responsible for evaluating FDIC-supervised financial institutions' compliance with federal consumer protection laws and regulations, including several that address predatory lending. To evaluate compliance, the FDIC conducts examinations of institutional practices regarding fair lending, privacy, and other consumer protection laws.

The objective of this audit was to determine the challenges faced and the efforts taken by the FDIC to identify, assess, and address the risks posed to FDIC-supervised financial institutions and consumers from predatory lending practices. We also gained an understanding of the efforts taken by the other federal banking regulators to address predatory lending.

To view the full report, go to www.fdicig.gov/2006reports.asp

Results of Audit

The FDIC faces significant challenges associated with identifying, assessing, and addressing the risks posed to FDIC-supervised institutions and consumers by predatory lending. Specifically, (1) each loan transaction must be viewed in its totality to determine whether it may be predatory; (2) FDIC-supervised institutions can have direct or indirect involvement in predatory lending; and (3) nontraditional mortgages and other loan products are now available that contain terms that may be viewed as appropriate for some borrowers, but predatory for others. Further, the FDIC must ensure that its efforts to combat predatory lending do not limit consumer access to legitimate sources of credit.

FDIC guidance issued to examiners, FDIC-supervised financial institutions, and consumers addresses predatory lending. However, the guidance does not formally articulate a supervisory approach to address predatory lending and was not issued for the explicit purpose of identifying, assessing, and addressing the risks that such lending practices pose to institutions and consumers. Further, certain characteristics potentially indicative of predatory lending were not covered. The lack of an articulated supervisory approach and gaps in coverage could result in increased risk that predatory lending practices occur, are not detected, and harm institutions and consumers.

Recommendations and Management Response

The report recommends that the FDIC describe in policy its overall approach to addressing predatory lending and review existing examiner, financial institution, and consumer guidance and determine whether additional guidance is needed to address the risks associated with predatory lending. Additionally, the report identifies for the FDIC's consideration other federal banking regulatory agencies' actions to identify, assess, and address predatory lending.

FDIC management agreed with the recommendations. The FDIC will develop an overall supervisory approach to predatory lending that will include a review of existing supervisory policies and practices. Based on that review, the Corporation will also develop additional guidance to address predatory lending, if necessary.

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Table 2: Analysis of Reputational Risk for FRB-Supervised Financial Institutions 17

ACRONYMS

AMTPA	Alternative Mortgage Transaction Parity Act
ANPR	Advance Notice of Proposed Rulemaking
ARM	Adjustable Rate Mortgage
CRA	Community Reinvestment Act
CRC	Consumer Response Center
DSC	Division of Supervision and Consumer Protection
ECOA	Equal Credit Opportunity Act
ED	Examination Documentation
FCRA	Fair Credit Reporting Act
FDCPA	Fair Debt Collection Practices Act
FFIEC	Federal Financial Institutions Examination Council
FHA	Fair Housing Act
FIL	Financial Institution Letter
FRB	Federal Reserve Board
FTC	Federal Trade Commission
GAO	Government Accountability Office
GLBA	Gramm-Leach-Bliley Act
HOEPA	Home Ownership and Equity Protection Act
HUD	Department of Housing and Urban Development
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
RESPA	Real Estate Settlement Procedures Act
ROE	Report of Examination
TILA	Truth in Lending Act

FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: June 7, 2006

MEMORANDUM TO: Sandra L. Thompson, Acting Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Challenges and FDIC Efforts Related to Predatory Lending*
(Report No. 06-011)

This report presents the results of the subject FDIC Office of Inspector General's (OIG) audit. Although there is no universally accepted definition, predatory lending typically involves imposing unfair and abusive loan terms on borrowers, often through aggressive sales tactics; taking advantage of borrowers' lack of understanding of complicated transactions; and outright deception. The objective of this audit was to determine the challenges faced and efforts taken by the FDIC to identify, assess, and address the risks posed to institutions and consumers from predatory lending. Also, we gained an understanding of the efforts taken to address predatory lending by the Office of Thrift Supervision (OTS), Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Trade Commission (FTC), and Department of Housing and Urban Development (HUD). Appendix I of this report discusses our objective, scope, and methodology in detail.

BACKGROUND

According to the Center for Responsible Lending, which is a research and policy organization whose main components include legislative and policy advocacy, borrowers lose more than $25 billion annually due to predatory mortgages, payday loans, and lending abuses involving overdraft loans, excessive credit card debt, and tax refund loans. Predatory lending can be detrimental not only to consumers but also to financial institutions because such practices could (1) lead to a high volume of foreclosures, which are costly to the mortgage holder; (2) undermine the reputation of financial institutions and the public's trust in the financial services industry; and (3) subject institutions that engage in or unintentionally support predatory lending to the risk of costly litigation.

Within the FDIC, the Division of Supervision and Consumer Protection (DSC) has primary responsibility for dealing with issues related to predatory lending. DSC addresses predatory lending and the effect that such lending might have on institutions and consumers as part of its safety and soundness and compliance examinations. For example, DSC examiners evaluate an institution's compliance with various consumer protection, fair lending, and privacy laws,

including the following that address predatory, unfair, abusive, or deceptive acts or practices. (See Appendix II for more details.)

- Equal Credit Opportunity Act (ECOA)
- Fair Credit Reporting Act (FCRA)
- Fair Debt Collection Practices Act (FDCPA)
- Fair Housing Act (FHA)
- Federal Trade Commission Act (FTC Act)
- Home Ownership and Equity Protection Act (HOEPA)
- Real Estate Settlement Procedures Act (RESPA)
- Truth in Lending Act (TILA)

DSC has issued guidance to examiners, financial institutions, and consumers regarding issues related to predatory, unfair, abusive, or deceptive acts or practices. Further, the FDIC's national Consumer Response Center (CRC), established in July 2002, receives, investigates, and responds to complaints involving FDIC-supervised institutions and answers inquiries from consumers about consumer protection laws and banking practices. For the period January 1, 2003 through November 7, 2005, CRC identified 23 possible predatory lending complaints and inquiries. In response, CRC investigated or referred complaints to the responsible federal banking regulator as deemed appropriate, or otherwise disposed of the complaints. More specifically:

- eight complaints were investigated by the FDIC, and no evidence was found that the financial institution violated a consumer protection law or regulation;
- seven complaints were referred to other agencies because those circumstances did not involve FDIC-supervised institutions;
- four inquiries were information requests from consumers about payday or predatory lending;
- two complaints were investigated by the FDIC, and the Corporation did not intervene due to litigation between the consumer and the financial institution; and
- two complaints were not investigated by the FDIC because the consumer did not provide enough information about the nature of the complaint.

RESULTS OF AUDIT

Overall, we found that the FDIC faces significant challenges associated with identifying, assessing, and addressing the risks posed to FDIC-supervised institutions and consumers by predatory lending. Specifically, (1) each loan transaction must be viewed in its totality to determine whether it may be predatory; (2) FDIC-supervised institutions can have direct or indirect involvement in predatory lending; and (3) nontraditional mortgages and other loan products are now available that contain terms that may be viewed as appropriate for some

borrowers but predatory for others. Further, the FDIC must ensure that its efforts to combat predatory lending do not limit consumer access to legitimate sources of credit.

FDIC guidance issued to examiners, FDIC-supervised financial institutions, and consumers addresses predatory lending. However, the guidance does not formally articulate a supervisory approach to address predatory lending and was not issued for the explicit purpose of identifying, assessing, and addressing the risks that such lending practices pose to institutions and consumers. Further, certain characteristics potentially indicative of predatory lending were not covered. The lack of an articulated supervisory approach and gaps in coverage could result in increased risk that predatory lending practices occur, are not detected, and harm institutions and consumers. Therefore, the FDIC needs to clarify for examiners and institutions its overall approach to addressing predatory lending and enhance guidance to bring increased attention to associated characteristics.

Additionally, this report identifies for the FDIC's consideration other federal banking regulatory agencies' actions to identify, assess, and address predatory lending.

CHALLENGES RELATED TO PREDATORY LENDING

The following discusses in detail significant challenges that the FDIC faces with respect to combating predatory lending.

Transactions Must be Viewed in Totality

Identifying or recognizing predatory lending in a specific loan transaction can be a challenge because each loan transaction must be viewed in its totality, including the associated marketing practices, terms of the agreement, various parties involved in the loan transaction, and financial sophistication of the parties involved. As a result, there is no simple "checklist" to follow in identifying predatory lending.

Additionally, borrowers can be susceptible to predatory lending practices in several phases of the loan transaction as described below.

- Marketing Phase. Lenders may employ aggressive marketing techniques that target specific borrowers or communities.

- Loan Underwriting Phase. Lenders may require borrowers to pay additional fees or accept additional and unnecessary services or products in order to receive a loan.

- Loan Execution Phase. Lenders may suggest refinancing, or "flipping" a loan (at an additional fee) without economic gain for the borrower.

When used in an unfair, abusive, or deceptive manner and depending on the circumstances faced by the specific borrower and the borrower's financial sophistication, the activities could, in fact, be predatory.

Direct or Indirect Institutional Involvement

A financial institution's involvement in predatory lending is not always obvious because such involvement may be direct or indirect. Direct involvement might involve a financial institution extending predatory loans to borrowers or using a network of loan brokers that have access to subprime lenders. A financial institution's indirect involvement in the predatory lending process—knowingly or unknowingly—may result from acquiring or forming subsidiaries that specialize in subprime lending, lending to subprime lenders, servicing loans, investing in asset-backed securities, or participating in the securitization process. Accordingly, determining an institution's involvement in predatory lending is difficult for FDIC examiners.

Variety of Loan Products

The fixed-rate mortgage is now just one of an array of loan products. Such loan products include: (1) no-money-down loans; (2) adjustable rate mortgages (ARM) with negative amortization and interest-only options; and (3) Option-ARMs, which give borrowers increased options in repaying the mortgage. Regulatory experience with nontraditional mortgage lending programs has shown that prudent management of these programs requires increased attention to product development, underwriting, compliance, and risk-management functions. Further, although these loan products may be appropriate for certain consumers, the federal regulatory agencies are concerned that these products and practices are being offered to some borrowers who may not otherwise qualify for traditional fixed-rate or ARM loans and may not fully understand the associated risks.

Maintaining Consumer Access to Credit

It has been widely recognized that there is a close relationship between predatory lending—which is detrimental to the consumer—and subprime lending—which has a legitimate place in the financial services industry, in that subprime lending serves the market of borrowers whose credit histories would not permit them to qualify for a conventional "prime" loan. This challenge is evidenced in testimony by the Comptroller of the Currency before the Committee on Banking and Financial Services, U.S. House of Representatives, May 24, 2000:

> While we clearly need to address real abuses that exist, particularly in connection with home-secured loans, we also need to preserve and encourage consumer access to credit, meaningful consumer choice, and competition in the provision of financial services to low- and moderate-income families. Determining how to draw the line between predatory and legitimate credit practices in a way that will both combat abuses and advance these other objectives is a major challenge.

Further, as many as 12 million households either have no relationship with traditional financial institutions or depend on "fringe lenders," such as pawnshops, payday lenders, and rent-to-own stores, for their credit needs. Such fringe lenders, which remain largely unregulated, frequently

charge excessively high fees and can expose borrowers to predatory, unfair, abusive, or deceptive acts or practices.[1]

Thus, in combating predatory lending, the FDIC's challenge lies in preventing the unintended consequence of limiting consumer access to legitimate credit sources.

FDIC EFFORTS TO ADDRESS PREDATORY LENDING CHALLENGES

The FDIC has taken action to address significant challenges related to predatory lending by providing guidance in various forms to examiners, FDIC-supervised institutions, and consumers. However, the guidance does not formally articulate the Corporation's overall supervisory approach for addressing predatory lending and is contained in multiple policies, procedures, and memoranda. Generally, this guidance was not issued for the explicit purpose of addressing predatory lending. In addition, the guidance covers many, but not all, of the characteristics often associated with predatory lending. Consequently, predatory lending may not receive sufficient attention, which increases the risk that such practices could occur, may not be detected, and may harm institutions and borrowers.

FDIC Guidance Related to Predatory Lending

The FDIC has provided guidance related to predatory lending to examiners in safety and soundness and compliance examination policies and procedures and Regional Directors Memoranda and to institutions the FDIC supervises in financial institution letters (FIL).[2] The FDIC has also provided guidance to consumers on predatory lending through its adult education program—*Money Smart*—and the *FDIC Consumer News* publication. However, we found that the FDIC's guidance did not articulate the overall supervisory approach for identifying, assessing, and addressing predatory lending and either varied or did not explicitly cover some predatory lending characteristics, depending on the source of the guidance.

Numerous lending characteristics, when considered either individually or in combination, could indicate whether predatory lending has occurred. Our research identified 21 characteristics that are potentially associated with predatory lending. Some of these characteristics are not prohibited by law, but may be predatory if they are determined to be associated with unfair, abusive, or deceptive lending practices. Table 1 shows the characteristics identified by our research and indicates whether there is some coverage in established FDIC guidance.

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[1] FDIC Banking Review, 2005, Volume 17, No. 1, *Limited-Purpose Banks: Their Specialties, Performance, and Prospects.*

[2] FILs may announce new regulations, special alerts concerning entities operating illegally as financial institutions, new FDIC publications, or a variety of other matters.

Table 1: OIG Analysis of Coverage for Characteristics Potentially Associated With Predatory Lending[a]

Characteristic	Examination Guidance[b]		FILs	*Money Smart*
	Safety and Soundness	Compliance		
The "✓" indicates that guidance included some coverage of the characteristic.				
Abusive Collection Practices	✓	✓	✓	✓
Balloon Payments With Unrealistic Repayment Terms		✓	✓	✓
Encouragement of Default in Connection With Refinancing				
Equity Stripping Associated With Repeat Refinancing and Excessive Fees			✓	✓
Excessive Fees not Justified by the Costs of Services Provided and the Credit and Interest Rate Risks Involved	✓	✓	✓	✓
Excessive Interest Rates That May Involve "Steering" a Borrower to a Higher-Cost Loan	✓	✓	✓	✓
Fraud, Deception, and Abuse	✓	✓	✓	✓
High Loan-to-Value Ratio That May Negatively Impact a Borrower's Ability to Avoid Unaffordable Debt	✓		✓	✓
Lending Without Regard to Ability to Repay	✓	✓	✓	✓
Loan Flipping Without Economic Gain for the Borrower, Resulting in Equity Stripping	✓	✓	✓	✓
Mandatory Arbitration Clauses			✓	
Payday Lending	✓	✓	✓	✓
Pre-payment Penalties That May Trap Borrowers in High-Cost Loans		✓	✓	✓
Refinancing of Special Mortgages Without Economic Gain for the Borrower, Resulting in Equity Stripping				
Refinancing Unsecured Debt Without Economic Gain for the Borrower, Resulting in Equity Stripping				
Repetitive Refinancing Without Economic Gain for the Borrower, Resulting in Equity Stripping		✓	✓	✓
Single-Premium Credit Insurance That is Added to the Total Loan Amount and Increases the Total Interest Paid		✓	✓	✓
Spurious Open-End Loans		✓	✓	
Steering Borrowers Who Qualify for Lower-Cost Loans to Higher-Cost Financing			✓	
Subprime Lending Within Which Predatory Lending Generally Occurs[c]	✓	✓	✓	✓
Yield-Spread Premiums With Incentives to Steer Borrowers into Higher-Cost Loans		✓	✓	

Source: OIG review of DSC guidance provided to examiners, FDIC-supervised financial institutions, and consumers.

[a] Appendix III provides details on the characteristics that may be predatory if they are determined to be associated with unfair, abusive, or deceptive lending practices.

[b] Examination guidance includes examination policies, procedures, and Regional Directors Memoranda.

[c] According to the DSC *Risk Management Manual of Examination Policies*, there is not a universal definition of a subprime loan in the industry, but subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers.

Coverage of the lending characteristics in Table 1 can vary depending on their nature, and certain characteristics may appropriately lend themselves to being covered under one type of examination (e.g., safety and soundness or compliance) in comparison to another. As a result, we fully recognize that there may be legitimate reasons why certain characteristics may not be included in a particular form of guidance. However, three of the characteristics were not explicitly covered by any of the guidance—specifically, (1) encouragement of default, (2) refinancing of special mortgages, and (3) refinancing unsecured debt.

There may be other lending characteristics associated with predatory lending practices that are not included in Table 1. Further, we recognize that defining lending practices that constitute predatory lending is not easy and that consideration must be given to the context in which lending practices occur. Some lending practices may be abusive in the context of high-cost loans; others may be unacceptable in all contexts; and others, not necessarily abusive for all high-cost borrowers, may be abusive for a particular borrower due to deception. We discuss, in detail, coverage of the characteristics by the various forms of FDIC guidance in the following sections of the report.

Guidance to FDIC Examiners

The FDIC conducts and provides guidance on examinations to determine the safety and soundness of financial institutions and whether institutions are complying with consumer protection laws and regulations. DSC's examination guidance does not articulate the FDIC's overall supervisory approach for addressing predatory lending. Further, the FDIC's safety and soundness examination and compliance examination guidance addresses many, but not all of the potentially predatory lending characteristics that our research identified.

Safety and Soundness Examination Guidance

We found that DSC's safety and soundness examination guidance covered the following characteristics.

Subprime Lending Examination Documentation (ED) Module

- Abusive collection practices.
- Excessive fees not justified by the costs of services provided and the credit and interest rate risks involved.
- Excessive interest rates that may involve "steering" a borrower to a higher-cost loan.
- Fraud, deception, and abuse.
- Lending without regard to ability to repay.
- Loan flipping without economic gain for the borrower, resulting in equity stripping.

- Subprime lending within which predatory lending generally occurs.

Residential Real Estate Lending ED Module

- High loan-to-value ratio that may negatively impact a borrower's ability to avoid unaffordable debt.

Payday Lending Guidance

- Payday lending (a particular type of subprime lending) guidance also includes guidance on lending without regard to the ability to repay and information on various consumer protection laws, including the TILA, ECOA, FCRA, FDCPA, and FTC Act.[3]

As of September 30, 2005, the FDIC reported 91 (about 2 percent) of the 5,257 FDIC-supervised institutions as subprime lenders based on aggregate credit exposure in subprime loans equal to or greater than 25 percent or more of Tier 1 capital. As a result, use of the *Subprime Lending ED Module* and coverage of the seven characteristics noted above could be limited to a small number of FDIC-supervised institutions.

In addition to the subprime, residential real estate, and payday lending guidance, we found that the *Mortgage Banking ED Module* does not specifically reference any of the characteristics but does contain the following step in the *Internal Controls* section of the segment entitled, *Core Analysis Procedures*, as shown below:

> Evaluate the bank's process for ensuring compliance with predatory lending laws, including:
>
> - the strategy for handling loans originated and serviced in various jurisdictions;
> - procedures to confirm compliance with predatory lending laws and regulations; and
> - risk controls that are in place to prevent predatory servicing practices.

The extent to which examiners would perform this step depends upon whether the financial institution being examined is classified as a mortgage banker. As of September 2005, the FDIC classified 376 (about 7 percent) of its supervised institutions as mortgage bankers, which are defined as institutions that deal in mortgages with brokers originating loans and then selling them to investors. Further, although the module directs examiners to evaluate the bank's procedures for confirming compliance with predatory lending laws and regulations, the module does not specify the laws and regulations the examiners should use to make the evaluation. However, DSC officials stated that the ED modules resulted from an interagency effort by the FDIC,

[3] The FDIC's subprime lending and payday lending guidance also provides information on the FDIC's expectations for prudent risk-management practices for those lending activities. At the time the FDIC released its payday lending guidance in March 2005, the Corporation reported that 12 FDIC-supervised institutions were engaging in payday lending.

Federal Reserve Board, and Conference of State Bank Supervisors and that because those procedures are used by state examiners and federal examiners, it is not practical for the module to document every applicable state and federal law and regulation. In addition, DSC officials stated that ED modules are an examination tool that focuses on risk management practices and guides examiners to establish the appropriate examination scope. In addition, the modules:

- incorporate questions and points of consideration into examination procedures to specifically address a bank's risk management strategies for each of its major business activities and
- direct examiners to consider areas of potential risk and associated risk control practices to facilitate an effective supervisory program.

Further, DSC officials stated that the Subprime Lending and Mortgage Banking ED Modules are supplemental modules or reference modules to be used in conjunction with core ED modules. Examiners are not required to duplicate efforts already addressed in core procedures or elsewhere, since ultimately, the conclusions will be brought forward to the Core Analysis Decision Factors.

The safety and soundness examination guidance did not cover the following characteristics:

- balloon payments with unrealistic repayment terms;
- encouragement of default in connection with refinancing;
- equity stripping associated with repeat refinancing and excessive fees;
- mandatory arbitration clauses;
- pre-payment penalties that may trap borrowers in high-cost loans;
- refinancing of special mortgages without economic gain for the borrower, resulting in equity stripping;
- refinancing unsecured debt without economic gain for the borrower, resulting in equity stripping;
- repetitive refinancing without economic gain for the borrower, resulting in equity stripping;
- single-premium credit insurance that is added to the total loan amount and increases the total interest paid;
- spurious open-end loans;
- steering of borrowers who qualify for lower-cost loans to higher-cost financing; and

- yield-spread premiums with incentives to steer borrowers into higher-cost loans.

Lacking coverage of certain characteristics could be significant because predatory lending may cause safety and soundness problems. For example:

- **Balloon Payments With Unrealistic Repayment Terms.** A financial institution may structure loans with initial low monthly payments but include a balloon payment that the borrower cannot afford in an attempt to trap the borrower into refinancing and paying additional fees at the end of the loan term. However, if the borrower is unable to restructure the loan and the collateral value declines, the institution is left without adequate sources of repayment for the loan. Higher loan losses could lead to safety and soundness concerns.

- **Refinancing Unsecured Debt Without Economic Gain for the Borrower, Resulting in Equity Stripping.** A financial institution that engages in refinancing unsecured debt, using a borrower's home as collateral, may eventually incur higher loan losses. Borrowers may continue to incur additional unsecured debt and may default on the loan. If a borrower defaults, the institution is dependent upon the collateral for any recovery on the loan. The bank would absorb foreclosure costs and any decline in collateral value. An institution that makes a loan to a consumer based predominantly on the liquidation value of the borrower's collateral, rather than on determination of the borrower's repayment ability, may be engaging in a fundamentally unsafe and unsound banking practice. This practice increases not only the risk to the bank that the loan will default but also the bank's potential loss exposure upon default.

Compliance Examination Guidance

Compliance examination procedures include guidance for examiner use in determining compliance with a number of consumer protection laws and regulations, including HOEPA, TILA, RESPA, and the FTC Act. Examiners use these procedures if the examiner decides, through the risk-focused compliance examination process, to test the bank's compliance with a particular law or regulation. Noncompliance can result in civil liability and negative publicity as well as the FDIC's imposition of formal or informal actions to correct noncompliance. Further, it is important to note that the FDIC can rely on the FTC Act as authority for issuing enforcement actions against financial institutions for unfair, abusive, and deceptive acts or practices, which could include any or all of the characteristics potentially associated with predatory lending that our research identified.

The FDIC's compliance examination procedures include reference to many of the characteristics that we identified in conducting the audit but do not cover the following:

- encouragement of default in connection with refinancing;

- equity stripping associated with repeat refinancing and excessive fees;

- high loan-to-value ratio that may negatively impact a borrower's ability to avoid unaffordable debt;
- mandatory arbitration clauses;
- refinancing of special mortgages without economic gain for the borrower, resulting in equity stripping;
- refinancing unsecured debt without economic gain for the borrower, resulting in equity stripping; and
- steering of borrowers who qualify for lower-cost loans to higher-cost financing.

Further, of those characteristics, neither the compliance nor safety and soundness examination guidance covered: (1) encouragement of default in connection with refinancing; (2) equity stripping associated with repeat refinancing and excessive fees; (3) mandatory arbitration clauses; (4) refinancing of special mortgages without economic gain for the borrower, resulting in equity stripping; (5) refinancing unsecured debt without economic gain for the borrower, resulting in equity stripping; and (6) steering of borrowers who qualify for lower-cost loans to higher-cost financing. These characteristics could cause detrimental consequences such as defaults and foreclosures to borrowers. Although we did not identify specific coverage of the seven characteristics in compliance examination guidance, as noted earlier, those characteristics could indicate noncompliance with the FTC Act if the loan was made in an unfair, abusive, or deceptive manner.

On June 17, 2005, the FDIC issued examination guidance entitled, *Procedures for Determining Compliance With the Prohibition on Unfair and Deceptive Acts or Practices found in Section 5 of the Federal Trade Commission Act*. The purpose of that guidance is to strengthen the FDIC's ability to apply Section 5 of the FTC Act, which prohibits such acts or practices. In addition, although examination guidance states that most banking organizations do not engage in unfair or deceptive acts or practices, advances in banking technology and changes in the lending organizational structure have contributed to financial institutions' participating in non-banking activities and provided the ability to structure complex financial products and sophisticated marketing methods. The pace and complexity of these advances have increased the potential risk for consumer harm. However, the examination guidance does not specifically address predatory lending practices.

Guidance to FDIC-Supervised Institutions

The FILs issued to FDIC-supervised institutions include information on all of the characteristics that we identified except for the following:

- encouragement of default in connection with refinancing;
- refinancing of special mortgages without economic gain for the borrower, resulting in equity stripping; and

- refinancing unsecured debt without economic gain for the borrower, resulting in equity stripping.

Encouragement of default may influence a borrower to breach an existing loan to subsequently refinance all or part of a loan, which could result in higher loan balances and additional interest and fees. In addition, encouraging a borrower to use equity in a residence as collateral to refinance unsecured debt, such as credit card debt, could jeopardize the borrower's equity in the residence and could, ultimately, result in the borrower losing the residence. Refinancing special mortgages could also negatively affect terms that may have been favorable to the borrower, leaving the borrower with loan terms that do not provide a tangible economic benefit.

Enhancing the FILs to cover these characteristics would help to ensure that financial institutions protect consumers by avoiding these practices, when appropriate.

Consumer Education

The FDIC has included information related to predatory lending in its adult education program—*Money Smart*—and its *FDIC Consumer News* publication. *Money Smart* includes information on many of the characteristics that we identified but does not include coverage of the following:

- encouragement of default in connection with refinancing;
- mandatory arbitration clauses;
- refinancing of special mortgages without economic gain for the borrower, resulting in equity stripping;
- refinancing unsecured debt without economic gain for the borrower, resulting in equity stripping;
- spurious open-end loans;
- steering of borrowers who qualify for lower-cost loans to higher-cost financing; and
- yield-spread premiums with incentives to steer borrowers into higher-cost loans.

The FDIC created *Money Smart* as a training program to help adults outside the financial mainstream enhance their financial management skills and create positive banking relationships. Ten comprehensive modules comprise the *Money Smart* curriculum and cover basic financial topics to help consumers understand banking basics. The modules include information on bank services, credit, budgeting, savings, credit cards, loans, and homeownership. The program also provides information in the following areas to assist consumers in avoiding predatory lending:

- loan payment decisions,
- loan rejection,

- predatory lending and TILA,
- predatory loan offers,
- predatory lending tactics, and
- what to do if consumers believe they are victims of a predatory loan.

Information on predatory lending also addresses mortgage loans, credit cards, and installment loans. The program is available through the Internet, classroom instruction, or CD-ROM and is available in multiple languages, including Spanish, Korean, Chinese, Vietnamese, and Russian.

The *FDIC Consumer News* provides practical guidance on how to become a smarter, safer user of financial services. The Summer 2002 edition of the *FDIC Consumer News* article entitled, *High-Cost "Predatory" Home Loans: How to Avoid the Traps*, advised consumers that:

> . . . something is robbing homeowners of money and putting many of these same families at risk of *losing* their homes. . . . There is no clear-cut definition of a predatory loan, but many experts agree that it is the result of a company misleading, tricking and sometimes coercing someone of taking out a home loan (typically a home equity loan or mortgage refinancing) at excessive costs and without regard to the homeowner's ability to repay. Victims who have trouble repaying a predatory loan often face harassing collection tactics or are encouraged to refinance the loan at even higher fees.

The publication also acknowledged some of the consumer protection laws, including TILA and HOEPA.

FDIC guidance to consumers could be enhanced to provide coverage on the seven characteristics not already addressed to make consumers better aware of the potential negative effects of predatory lending.

Conclusion and Recommendations

FDIC officials have stated that federally insured depository institutions have a good record of avoiding involvement in predatory lending practices. Those financial institutions, which are banks, thrifts, or credit unions, are subject to federal and state oversight and supervision, unlike most subprime lenders. Further, financial institutions' regulatory agencies have stated that their monitoring and examination activities have revealed little evidence of predatory lending practices by federally regulated depository institutions. However, as consumers enjoy more access to credit from a wider variety of sources, opportunities have expanded for predatory lending. Education is one way to help people achieve financial literacy and avoid abusive loans, but supervision and oversight should also play an important role in preventing predatory lending practices.

The FDIC has recognized the importance of its role in this regard by establishing a strategic goal to ensure that consumers' rights are protected and by responding to consumer complaints and inquiries related to predatory lending. The FDIC has also taken steps to provide guidance to its examiners, FDIC-supervised financial institutions, and consumers on many of the characteristics related to predatory lending. However, the Corporation could bring more attention to combating

predatory lending by establishing and articulating its overall supervisory approach for identifying, assessing, and addressing the risks associated with predatory lending and ensuring that characteristics of predatory lending are addressed in examiner, institution, and consumer guidance.

We recommend that the Director, DSC:

(1) Describe in policy the FDIC's overall supervisory approach to predatory lending.

(2) Review existing examiner, financial institution, and consumer guidance and determine whether additional guidance is needed to address the risks associated with predatory lending.

ISSUES FOR CONSIDERATION

The FDIC and some members of the Federal Financial Institutions Examination Council (FFIEC)[4] have addressed predatory lending in various ways. These include jointly issued guidance, performance measurement, consumer information on predatory lending, and assessment of risk associated with predatory lending. Appendix IV contains supplemental information from some of the other federal banking regulatory agencies regarding their efforts related to predatory lending.

Jointly Issued Guidance

The FFIEC members have jointly issued guidance to examiners, financial institutions, and consumers on supervisory and consumer issues related to some predatory lending characteristics. For example, the FFIEC issued guidance and examination procedures on subprime lending in January 2001 and on fair lending in August 2004. Further, the FFIEC members issued guidance to consumers entitled, *Putting Your Home on the Loan Line is Risky Business*.[5] The brochure provides information on the following:

- Groups targeted by abusive lenders or contractors—homeowners with low incomes or credit problems and the elderly.

- Steps consumers can take to protect themselves, including:

    - considering multiple options for sources of credit;
    - contacting several lenders for possible credit;

[4] The FFIEC, which consists of all federal financial institution regulatory agencies, is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the FDIC, OTS, OCC, FRB, and National Credit Union Administration (NCUA). The FFIEC makes recommendations to promote uniformity in the supervision of financial institutions. The scope of our audit did not include the NCUA.

[5] The following agencies also participated in the issuance of the consumer brochure: HUD, Department of Justice, Federal Housing Finance Board, FTC, and Office of Federal Housing Enterprise Oversight.

- comparison shopping for loan terms, conditions, payment options, points, fees, and penalties; and
- understanding consumer rights and cancellation options.

- Contact information for federal banking regulatory agencies, the Department of Justice, HUD, Federal Housing Finance Board, and Office of Federal Housing Enterprise Oversight.

In addition, in March 2004, the FDIC and FRB jointly published guidance for state-chartered institutions on unfair or deceptive acts or practices prohibited by Section 5 of the FTC Act. This guidance explains how institutions could avoid engaging in practices that might be viewed as unfair or deceptive.

Individual Regulatory Guidance

The individual members of the FFIEC have issued guidance to their examiners and supervised institutions.

Office of Thrift Supervision Guidance

OTS has issued examination-scoping guidance and a *Strategic Plan* that specifically addresses predatory lending. The OTS Examination Scope Worksheet, which examiners use to determine whether a specific issue should be included in the examination scope, includes a line item for an assessment of predatory lending issues. Further, the OTS *Strategic Plan* includes a performance goal to maintain a thrift industry that effectively complies with consumer protection laws. As stated in the plan, one of the strategies OTS uses for achieving performance is to "conduct examinations with a top-down, risk focused approach that promotes comprehensive compliance management including the establishment of adequate internal controls to ensure regulatory compliance and to avoid predatory practices."

Office of the Comptroller of the Currency Guidance

OCC has issued industry guidance addressing predatory lending.

- In February 2003, OCC issued two advisory letters related to predatory lending to the national banks and operating subsidiaries it supervises. The advisory letters:

  - describe loan attributes that are often considered predatory and establish standards for policies and procedures for monitoring loan transactions to avoid making, brokering, or purchasing loans with such attributes;

  - state OCC's position that predatory lending will affect a national bank's Community Reinvestment Act (CRA) rating;[6] and

[6] On July 19, 2005, the federal banking agencies approved CRA final rules, effective September 1, 2005. Those rules include clarification on when discrimination or other illegal credit practices by a bank or its affiliate will adversely affect an evaluation of the bank's CRA performance.

- clarify ways in which predatory lending practices can create legal, safety and soundness, and reputational risks for national banks.

- In January 2004, OCC issued a rule adopting anti-predatory lending standards that expressly prohibit national banks from (1) making consumer and mortgage loans based predominantly on the bank's realization of the foreclosure value of the borrower's collateral, without regard for the borrower's ability to repay, and (2) engaging in unfair and deceptive practices within the meaning of Section 5 of the FTC Act.

- In September 2004, OCC issued an advisory letter alerting national banks regarding OCC's concerns about certain credit card marketing and account management practices. These practices may entail unfair or deceptive acts or practices and may expose a bank to compliance and reputational risks.

- In February 2005, OCC issued guidelines on national bank residential mortgage lending standards to further the OCC's goal of ensuring that national banks do not become involved in predatory, abusive, unfair, or deceptive residential mortgage lending practices. The guidelines are enforceable pursuant to the process provided in Section 39 of the FDI Act and Part 30 of OCC regulations. The new guidelines incorporated key elements of the OCC's February 2003 advisory letters.

Federal Reserve Board Guidance

The FRB has issued examination guidance on assessing financial institutions' risks related to predatory lending. FRB's *Risk-Focused Consumer Compliance Supervision Program*, dated December 2003, states that FRB examiners evaluate consumer compliance risks during specialized consumer compliance examinations. The consumer compliance risk profile incorporates an assessment of operational, legal, and reputational risks arising from a bank's consumer compliance activities.

In evaluating reputational risk during safety and soundness examinations, examiners are to determine whether the bank's risk is "low," "moderate," or "high" in accordance with FRB guidance. In addition, examiners assign a trend indicator of "increasing," "stable," or "decreasing." The risk assessment considers the (1) level of inherent risk involved in each of the bank's significant business activities and (2) strength of risk management systems in place to control the level of risk in these activities. Table 2 on the next page shows that FRB examiners consider the level of reputational risk specifically related to predatory lending for FRB-supervised financial institutions.

Table 2: Analysis of Reputational Risk for FRB-Supervised Financial Institutions

Reputational Risk		
Low	**Moderate**	**High**
Business strategy and/or bank products unlikely to raise concern regarding predatory lending and/or unfair and deceptive acts or practices.	Business strategy and/or bank products may raise concern regarding predatory lending and/or unfair and deceptive acts or practices.	Business strategy and/or bank products likely to raise serious concern regarding predatory lending and/or unfair and deceptive acts or practices.

Source: FRB *Risk-Focused Consumer Compliance Supervision Program*, dated December 2003.

Conclusion

It is not our intention to conclude on whether one agency's approach to addressing predatory lending is better than another. We recognize that the OCC and OTS supervisory approaches to predatory lending are based, in large part, on their authority to charter and supervise institutions whose operations are largely defined and bound by federal statutes and regulations. Unlike the OCC and OTS, the FDIC is not a chartering authority and shares regulatory oversight of the institutions it supervises with the appropriate state supervisor that can address predatory lending through applicable state and local laws and regulations. Nevertheless, the FDIC should consider the merits of the other federal banking regulatory agencies in establishing the Corporation's supervisory approach to this important issue. Additional information on OTS and OCC predatory lending efforts is in Appendix IV.

CORPORATION COMMENTS AND OIG EVALUATION

A draft of this report was issued on February 24, 2006. On June 1, 2006, the Acting Director, DSC, provided a written response to the draft report. The DSC response is presented in its entirety in Appendix V. A summary of management's response to the recommendations is in Appendix VI.

In its response to recommendations 1 and 2, DSC stated that it agreed with the recommendations and would develop an overall supervisory approach to predatory lending that will include a review of existing supervisory policies and practices. Based on that review, DSC will also develop additional enhanced guidance to address predatory lending, if necessary. DSC agreed to complete these actions by December 31, 2006. These agreed-upon actions meet the intent of our recommendations, which will remain open for reporting purposes until we have determined that the actions have been completed and are effective.

In addition to addressing the recommendations in the draft report, DSC's response provided an overview of its past and ongoing efforts to address predatory lending, including (1) examination guidance and training, (2) enforcement policy, (3) speeches and testimony, and (4) financial education.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The overall objective of this audit was to determine the challenges faced and efforts taken by the FDIC to identify, assess, and address the risks posed to institutions and consumers from predatory lending. As part of this objective, we contacted other federal regulators to determine the policies, procedures, and guidance the banking regulators, FTC, and HUD had issued to address these risks. We performed our audit from April 2005 through January 2006 in accordance with generally accepted government auditing standards.

Scope and Methodology

To achieve the objective, we interviewed FDIC officials in:

- DSC's headquarters in Washington, D.C., responsible for conducting safety and soundness and compliance examinations of FDIC-supervised financial institutions.
- DSC's Kansas City Regional Office, CRC, responsible for investigating consumer complaints about FDIC-supervised institutions and for responding to consumer inquiries about consumer laws and regulations and banking practices. We obtained information on policies and procedures related to consumer complaints and inquiries and statistics on the number of complaints and inquiries received since 2003 that related to predatory lending.
- The Office of Ombudsman, which acts as a liaison for the banking industry and the general public, to facilitate the resolution of problems and complaints in a fair, impartial, and timely manner.

In addition, we reviewed:

- Prior audit reports and various articles related to predatory and subprime lending.
- FDIC regulations and DSC policies and procedures manuals, including related examination procedures for safety and soundness and compliance examinations; and FILs used to provide guidance and announce new regulations and special alerts to FDIC-supervised institutions.
- Literature and the training modules for, and performance measures related to, the FDIC's *Money Smart* program.
- The FDIC's *2005-2010 Strategic Plan*, *2005 Annual Performance Plan*, and the FDIC/DSC 2004 Business Line Objectives to determine whether the Corporation had developed performance measures related to consumer protection, in general, and predatory lending, in particular.

- Information obtained during interviews with other federal banking regulatory agencies, FTC, and HUD and those agencies' respective Web sites on:

    - examination policies and procedures and
    - information provided to examiners, financial institutions, and consumers.

During the audit, we coordinated with the other FDIC OIG Office of Audits directorates, Office of Investigations, and Office of Counsel and GAO to determine whether there were prior or ongoing audits, studies, or investigations related to predatory lending. Regarding congressional issues or interests related to predatory lending, we coordinated with the FDIC OIG Office of Management and Congressional Relations. We did not consider any pending legislation that might relate to predatory lending.

We gathered data on the federal banking regulatory agencies' policies and procedures related to predatory lending, including examination guidance and information provided to FDIC-insured financial institutions; policies and procedures for handling consumer complaints; policies and procedures related to cited violations and enforcement and/or supervisory actions; and training. We coordinated this aspect of our review through the respective federal agency Inspector General organizations.[7]

In addition, we reviewed congressional testimony related to predatory lending and reports issued by GAO, HUD and Treasury, OCC, Freddie Mac, the Center for Responsible Lending, and the FDIC on payday and subprime lending and identified a set of 21 characteristics sometimes associated with predatory, unfair, abusive, and deceptive acts or practices. Because there is no specific definition for predatory lending, we used those characteristics in reviewing DSC policies, examination procedures (safety and soundness and compliance), FILs, and Regional Directors Memoranda to develop a matrix on the extent of coverage the FDIC's guidance provides on those characteristics. Appendix III provides a list of the characteristics and their definitions.

Compliance With Laws and Regulations

We reviewed the DSC *Compliance Examination Manual* and compliance examination procedures to identify guidance for examiners on consumer protection laws that relate to predatory and subprime lending. We identified the following laws related to predatory and subprime lending.

- Equal Credit Opportunity Act,
- Fair Credit Reporting Act,
- Fair Debt Collection Practices Act,
- Fair Housing Act,
- Federal Trade Commission Act,

[7] We coordinated meetings with FRB and FTC program officials through their respective Offices of Inspector General. Our contact with HUD, OCC, and OTS was limited to meetings with their OIG officials and review of information obtained from their agency Web sites.

- Home Ownership and Equity Protection Act,
- Real Estate Settlement Procedures Act, and
- Truth in Lending Act.

Appendix II provides details on the requirements of each law. During this audit, we did not contact any state regulatory agencies to determine their efforts to identify, assess, and address predatory lending or financial institutions' compliance with state laws regarding predatory lending. We also did not determine whether the FDIC reviews its supervised financial institutions for compliance with state predatory lending laws.

DSC officials provided a sample of reports of examination (ROEs) that included instances in which DSC cited financial institutions for noncompliance with some consumer protection laws. We reviewed those ROEs solely to familiarize ourselves with how DSC addresses noncompliance with consumer protection laws. We did not review the ROEs or any applicable examination work papers to determine the extent of coverage of predatory lending characteristics during safety and soundness or compliance examinations.

In April 1975, the FDIC complied with the FTC Act in establishing a separate office to receive and respond to complaints about financial institutions that it supervises. In addition, effective July 1, 2002, the FDIC centralized its consumer affairs function with the establishment of the CRC within DSC. The CRC receives, investigates, and responds to complaints involving FDIC-supervised institutions and answers inquiries from consumers about consumer protection laws and banking practices. We did not identify any instances of FDIC noncompliance with pertinent laws and regulations.

Reliance on Computer-based Data, Government Performance and Results Act, Fraud and Illegal Acts, and Internal Control

Validity and Reliability of Data from Computer-based Systems

We did not use any computer-based data for evaluative purposes. Although we obtained information from DSC's automated Specialized Tracking and Reporting System (STARS) on the number and type of consumer complaints and inquiries regarding predatory lending, we did not rely on this information to achieve our audit objective. Accordingly, we did not conduct any independent testing of computer data.

Performance Measures

The Government Performance and Results Act of 1993 directs Executive Branch agencies to develop a strategic plan, align agency programs and activities with concrete missions and goals, manage and measure results to justify appropriations and authorizations, and design budgets that

reflect strategic missions. In fulfilling its primary supervisory responsibilities, the FDIC pursues two strategic goals:

- FDIC-supervised institutions are safe and sound, and
- consumers' rights are protected, and FDIC-supervised institutions invest in their communities.

The FDIC's Strategic Plan is implemented through the Corporation's *Annual Performance Plan.* The annual plan identifies performance goals, indicators, and targets for each strategic objective. In reviewing the FDIC's *Strategic Plan* and *Annual Performance Plan*, we did not identify any strategies or performance goals directly related to predatory lending.

Fraud and Illegal Acts

The objective of this audit did not lend itself to testing for fraud and illegal acts. Accordingly, the survey and audit programs did not include specific audit steps to test for fraud and illegal acts. However, we were alert to situations or transactions that could have been indicative of fraud or illegal acts, and no such acts came to our attention.

Internal Controls Reviewed

During the audit, we gained an understanding of relevant control activities related to examinations by reviewing DSC policies and procedures as presented in *DSC's Compliance Examination Manual*, *Risk Management Manual of Examination Policies*, safety and soundness examination documentation modules, and Regional Director Memoranda.

Summary of Prior Audit Coverage

GAO Audit

In January 2004, GAO issued Audit Report GAO-04-280 entitled, *Federal and State Agencies Face Challenges in Combating Predatory Lending.* Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate, requested that GAO evaluate issues related to predatory home mortgage lending. GAO's report discusses (1) federal laws related to predatory lending and federal agencies' efforts to enforce them; (2) actions taken by states to address predatory lending; (3) the secondary market's role in facilitating or inhibiting predatory lending; (4) ways in which consumer education, mortgage counseling, and loan disclosures may deter predatory lending; and (5) the relationship between predatory lending activities and elderly consumers.

APPENDIX I

FDIC OIG Audits

The FDIC OIG conducted three previous audits related to fair lending, subprime lending, and consumer protection but has not conducted any previous audits specifically related to predatory lending.

On March 26, 2002, the OIG issued Audit Report 02-009, *The Division of Compliance and Consumer Affairs' Risk-Scoping Process for Fair Lending Examinations*, on the fair lending examination risk-scoping process as conducted by the Division of Compliance and Consumer Affairs.[8] The audit focused on the FDIC's application of the *FFIEC Interagency Fair Lending Examination Procedures* and did not directly relate to the scope of our audit.

On March 18, 2003, the FDIC OIG issued Audit Report 03-019, *The Division of Supervision and Consumer Protection's Examination Assessment of Subprime Lending*, in which the OIG concluded that:

- DSC had taken reasonable steps to ensure that institutions (1) effectively manage risks associated with subprime lending programs and price loans based on risk, (2) establish adequate allowance levels to cover loan and lease losses, and (3) maintain capital levels that reflect the additional inherent risks associated with subprime lending.

- Interagency policies and procedures for examinations of subprime banks provided examiners with the necessary guidance to identify and assess the condition of subprime loan programs in insured institutions, and the examiners adequately implemented this guidance. The procedures specifically addressed the management of risk associated with subprime lending programs, stressed the need for banks' risk management programs to address loan pricing, and set forth the requirements for calculating and maintaining adequate allowances for loan and lease losses and capital levels.

- FDIC examiners conducted pre-examination planning that included steps to look for indications of subprime lending programs and generally followed the interagency subprime lending examination procedures involving examinations of capital levels during onsite examinations. In addition, DSC maintained a quarterly database to assist in monitoring the condition of FDIC-insured institutions with subprime lending programs. Further, examiners noted that institutions had implemented corrective actions as a result of DSC examination findings related to the banks' subprime lending activities, including requirements for maintaining adequate levels of capital and adequate allowances to cover loan and lease losses.

The OIG reported that existing guidance may not have been sufficient for ensuring that models used by banks to estimate the creditworthiness of credit applicants made correct predictions. As a result, there was a potential for a lack of consistency in onsite examinations of banks with subprime lending programs, particularly with regard to allowances for losses and capital-level

[8] Effective June 30, 2002, the FDIC's Division of Supervision and Division of Compliance and Consumer Affairs merged to form the new DSC.

calculations. Also, in order for lenders to appropriately stratify the additional default risk and price the subprime products accordingly, constant monitoring and testing of credit scoring models were required to ensure that projected results were in line with actual performance. The FDIC agreed with the OIG's observations and planned to offer additional training for a select group of specialists on custom credit scoring.

On September 23, 2005, the FDIC OIG issued Audit Report 05-038 entitled, *Division of Supervision and Consumer Protection's Risk-Focused Compliance Examination Process.* The OIG concluded that DSC examiners generally complied with the policies and procedures related to risk-scoping compliance examinations and that the Risk Profile and Scoping Memorandums prepared by examiners provided an adequate basis for planned examination coverage. The examiners (1) reviewed bank policies, procedures, disclosures, and forms for compliance with consumer protection laws and regulations for each examination reviewed and (2) planned for transaction testing or spot checks in all compliance areas over the course of two consecutive examinations – a period of 2 to 6 years, depending on an institution's size and ratings. Additionally, examiners conducted transaction testing or spot checks in those areas for which apparent violations had been found at previous compliance examinations. However, the OIG found that examination documentation did not always show the transaction testing or spot checks conducted during the onsite portion of the examinations, including testing to ensure the reliability of the institutions' compliance review functions. Examiners also did not always document whether the examination reviewed all the compliance areas in the planned scope of review. As a result, DSC could not assure that the extent of testing was appropriate except for those areas in which examiners had identified violations and included them in ROEs. We recommended that DSC clarify and reinforce requirements that examiners adequately document the scope of the work performed, including transaction testing and spot checks of the reliability of the institutions' compliance review functions, during the onsite portion of compliance examinations.

DSC concurred with the recommendation and issued Regional Directors Memorandum No. 2005-035, *DSC's June 2003 Revised Compliance Examination*, which included guidance on:

- documenting changes in the scope of an examination,
- documenting spot checks of regulations,
- providing cross-checks to additional information available in *Examiner Summaries*, and
- providing descriptions of examination procedures used to conduct the examination.

We also reviewed the joint HUD and Treasury predatory lending report, *Curbing Predatory Home Mortgage Lending*, dated June 2000. The report proposed a four-point plan to address predatory lending practices—(1) improving consumer literacy and disclosures, (2) prohibiting harmful sales practices in the mortgage market, (3) restricting abusive terms and conditions on high-cost loans, and (4) improving market structure as it relates to CRA credit to banks and thrifts.

APPENDIX II

CONSUMER PROTECTION LAWS

Equal Credit Opportunity Act (ECOA) – ECOA prohibits discrimination based on race, color, religion, national origin, sex, marital status, and age in any aspect of a credit transaction. The FRB issued Regulation B, which describes lending acts and practices that are specifically prohibited, permitted, or required under ECOA.

Fair Credit Reporting Act (FCRA) – FCRA requires that consumer reporting agencies adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner that is fair and equitable to the consumer with regard to confidentiality, accuracy, relevancy, and proper utilization of information. On July 19, 2000, the FFIEC issued revised examination procedures to incorporate changes made to the FCRA as a result of the Gramm-Leach-Bliley Act (GLBA).[9]

Fair Debt Collection Practices Act (FDCPA) – FDCPA protects reputable debt collectors from unfair competition and encourages consistent state action to protect consumers from abuses in debt collection. On September 5, 1997, the FFIEC issued revised guidance to incorporate changes made to the FDCPA by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). EGRPRA amended the FDCPA by requiring debt collectors to inform debtors that they are attempting to collect a debt and that any information obtained could be used for that purpose.

Fair Housing Act (FHA) – The FHA prohibits discrimination based on race, color, religion, national origin, sex, familial status, and handicap in residential real-estate-related transactions, including making loans to buy, build, repair, or improve a dwelling. Lenders may not discriminate in mortgage lending based on any of the prohibited factors.

Federal Trade Commission Act (FTC Act) – The FTC Act authorizes the FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. On March 11, 2004, the FDIC and FRB issued standards that will be considered by the agencies as they carry out their responsibility to enforce the prohibitions against unfair or deceptive trade practices described in the FTC Act as they apply to acts and practices of state-chartered banks.

Home Ownership and Equity Protection Act (HOEPA) – Congress enacted HOEPA in response to evidence of abusive mortgage lending, particularly lending that involves excessive interest rates and fees. HOEPA identifies a class of high-cost mortgage loans and requires that consumers who enter into these transactions be provided with additional disclosures intended to facilitate comparison with other loan products. HOEPA restricts the use of certain loan terms associated with abusive lending and authorizes FRB to issue regulations that prohibit specific types of mortgage lending practices found to be abusive. On December 20, 2001, FRB amended

[9] In addition to reforming the financial services industry, GLBA addressed concerns relating to consumer financial privacy. Title V of the GLBA established major privacy provisions under Subtitles A and B. Subtitle A provides a mechanism to protect the confidentiality of a consumer's nonpublic personal information. Subtitle B prohibits "pretext calling," which is a deceptive practice used to obtain information on the financial assets of consumers. Criminal penalties and regulatory and administrative enforcement mechanisms are established to help prevent this practice.

the provisions of Regulation Z that implement HOEPA. The amendments restrict certain unfair practices and strengthen HOEPA's prohibition against extending credit without regard to a borrower's ability to repay it.

Real Estate Settlement Procedures Act (RESPA) – RESPA requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures regarding the nature and costs of the real estate settlement process. The Act also protects borrowers against certain abusive practices, such as kickbacks, and places limitations upon the use of escrow accounts. HUD promulgated Regulation X, which implements RESPA.

Truth in Lending Act (TILA) – TILA requires meaningful disclosure of credit and leasing terms so that consumers will be able to more readily compare terms in different credit and lease transactions. TILA also protects the consumer against inaccurate and unfair credit billing, credit card, and leasing transactions. FRB issued Regulation Z, which implements TILA. The regulation requires accurate disclosure of true cost and terms of credit. The regulation also regulates certain credit card practices, provides for fair and timely resolution of credit billing disputes, and requires that a maximum interest rate be stated in variable rate contracts secured by the consumer's dwelling.

APPENDIX III

CHARACTERISTICS POTENTIALLY ASSOCIATED WITH PREDATORY LENDING

Characteristic	Definition of Characteristic
Abusive Collection Practices	Attempting to collect debt through harassment or abuse, improper communication, false or misleading representations, or furnishing deceptive forms.
Balloon Payments	Loans with balloon payments are structured so that monthly payments are lower, but one large payment (the balloon payment) is due when the loan matures. Predatory loans may contain a balloon payment with unrealistic repayment terms, which the borrower is unlikely to be able to afford, resulting in foreclosure or refinancing with additional high costs and fees. Sometimes, lenders market a low monthly payment without adequate disclosure of the balloon payment. Balloon payments disguise the true, higher-than-expected cost of the loan.
Encouragement of Default	Encouraging a borrower to breach a contract and default on an existing loan prior to and in connection with the consummation of a loan that refinances all or part of the existing loan.
Equity Stripping	Repeat financings where the equity is depleted as a result of financing excessive fees.
Excessive Fees	Abusive loans may include fees that greatly exceed the amounts justified by the costs of the services provided and the credit and interest rate risks involved. Lenders may add these fees to the loan amounts rather than requiring payment up front, so the borrowers may not know the exact amount of the fees they are paying.
Excessive Interest Rates	Mortgage interest rates can legitimately vary based on the characteristics of borrowers (such as creditworthiness) and of the loans themselves. However, in some cases, lenders may charge interest rates that far exceed what would be justified by any risk-based pricing calculation, or lenders may "steer" a borrower with an excellent credit record to a higher-rate loan intended for borrowers with poor credit histories.
Fraud, Deception, and Abuse	Predatory lenders may perpetrate outright fraud through actions such as inflating property appraisals and doctoring loan applications and settlement documents. Unscrupulous lenders often prey on certain groups—the elderly, minorities, and individuals with lower incomes and less education, with deceptive or high-pressure sales tactics.
High Loan-to-Value Ratio	These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.
Lending Without Regard to Ability to Repay	Loans may be made without regard to a borrower's ability to repay the loan. In these cases, the loans are approved based on the value of the asset (the home) that is used as collateral. In particularly egregious cases, monthly loan payments have equaled or exceeded the borrower's total monthly income. Such lending can quickly lead to foreclosure of the property.
Loan Flipping	Mortgage originators may refinance borrowers' loans repeatedly in a short period of time without any economic gain for the borrower. With each successive refinancing, these originators charge high fees that are folded into the loan balance and "strip" borrowers' equity in their homes.
Mandatory Arbitration Clauses	Mandatory arbitration clauses limit homeowners' choices for dispute resolution, thereby preventing victims of predatory lending practices from suing for damages.

Characteristic	Definition of Characteristic
Payday Lending	Payday loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the total costs can rapidly exceed the amount borrowed.
Pre-payment Penalties	Penalties for prepaying a loan are not necessarily abusive, but predatory lenders may use them to trap borrowers in high-cost loans.
Refinancing of Special Mortgages	Special subsidized mortgages that contain terms favorable to the borrower are refinanced with a loan that does not provide a tangible economic benefit to the borrower relative to the refinanced loan.
Refinancing Unsecured Debt	The process of using an individual's home as collateral to refinance unsecured debt such as credit cards or medical debts. This process can be disadvantageous because creditors of unsecured debt can rarely take a borrower's property for nonpayment. However, creditors who refinance unsecured debt using a home as collateral can take the home for nonpayment.
Repetitive Refinancing	Repeatedly refinancing a loan within a short period of time and charging high points and fees with each refinancing. The repeated refinancing has the effect of stripping the homeowner's equity from the home by increasing the amount borrowed in each refinancing without providing any benefit to the borrower.
Single-Premium Credit Insurance	Credit insurance is a loan product that repays the lender should the borrower die or become disabled. In the case of single-premium credit insurance, the borrower pays the total premium upfront rather than on a monthly basis because it is added to the amount financed in the loan. The process of adding the full premium to the amount of the loan unnecessarily raises the amount of interest borrowers pay. Therefore, single-premium credit insurance is generally considered inherently abusive.
Spurious Open-End Loans	The lender is allowed to avoid the more comprehensive disclosures required by closed-end credit and thereby avoid any chance of the homeowner asserting the right of rescission, avoiding the restrictions under the HOEPA, regardless of the cost of the loan.
Steering	The process of referring borrowers who qualify for lower-cost financing to high-cost lenders. Subprime lenders will charge prime borrowers who meet conventional underwriting standards higher rates than necessary.
Subprime Lending	Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. Such borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, predatory mortgage lending occurs in the subprime market.
Yield-Spread Premiums	The payment a mortgage broker receives from a lender based on the difference between the actual interest rate on the loan and the rate the lender would have accepted on the loan given the risks and costs involved. The higher the actual loan rate compared with the acceptable loan rate, the higher the yield-spread premium. Yield-spread premiums provide incentives for mortgage brokers to steer borrowers into higher-cost loans.

Source: OIG review of congressional testimony related to predatory lending and reports issued by GAO, HUD and Treasury, OCC, Freddie Mac, the Center for Responsible Lending, National Consumer Law Center, and the FDIC on payday and subprime lending.

APPENDIX IV

INFORMATION PROVIDED BY OTHER FEDERAL REGULATORY AGENCIES

This appendix contains chronological information related to actions taken by OTS and OCC to address predatory lending. The appendix includes (1) information discussed in detail in our report in the section entitled, *Issues for Consideration*, and (2) supplemental information provided by OCC and OTS that was not included in our review of the agencies' efforts to address predatory lending and, therefore, was not verified during the audit. (The supplemental information is excerpted and shown in italics below.)

OTS

OTS has issued examination-scoping guidance and a *Strategic Plan* that specifically addresses predatory lending. The OTS Examination Scope Worksheet, which examiners use to determine whether a specific issue should be included in the examination scope, includes a line item for an assessment of predatory lending issues. Further, the OTS *Strategic Plan* includes a performance goal to maintain a thrift industry that effectively complies with consumer protection laws. As stated in the plan, one of the strategies OTS uses for achieving performance is to "conduct examinations with a top-down, risk focused approach that promotes comprehensive compliance management including the establishment of adequate internal controls to ensure regulatory compliance and to avoid predatory practices."

> *OTS received numerous comments from financial institutions and other interested parties when OTS issued an ANPR [Advance Notice of Proposed Rulemaking] on "Responsible Alternative Mortgage Lending" in April 2000. (65 Fed. Reg. 17811 (April 5, 2000)). OTS's rule, created during a high interest rate environment when many state laws prohibited ARMS, granted state-chartered thrifts and non-depository institutions preemption under the Alternative Mortgage Transaction Parity Act from state laws on alternative mortgages. Over the years, this preemption frustrated the states from enforcing consumer protections relating to prepayment penalties and late charges. OTS addressed the issue in September 2002 in its final rulemaking on the Alternative Mortgage Transaction Parity Act (AMTPA).*
>
> *In addition, OTS has taken a number of affirmative steps to stop or prevent institutions from offering loans with predatory characteristics. These actions include directing institutions (and requiring them through normal and formal enforcement actions) to close certain types of lending programs and directing certain institutions to divest their thrift charters. OTS also makes referrals concerning possible Equal Credit Opportunity Act violations by mortgage brokers and others to the Federal Trade Commission and Department of Justice, and discrimination complaints to Department of Justice and the Department of Housing and Urban Development.*

In addition to the interagency guidance noted previously, OTS has issued guidance on title loan programs and payday lending[10] in CEO [Chief Executive Officer] Letters 131 and 132. This guidance states that OTS will closely review the activities of savings associations engaged in title loan programs and payday lending to ensure that they are following prudent, non-abusive lending practices.

OCC

The OCC conducts risk-based consumer compliance reviews that require examiners to determine the quantity of risk inherent in the bank's products and services associated with consumer protection laws and regulations, including those addressing predatory lending and unfair or deceptive acts or practices. Consumer complaint data are reviewed and analyzed for early warning indicators of potential unfair, deceptive, abusive, and predatory practices. Examiners also evaluate the adequacy of the financial institution's risk management practices used to identify, measure, monitor, and control the institution's compliance and reputation risk. If the quantity of risk is high and exposes the institution to significant risk or the compliance management system is inadequate to address the quantity of risk identified, examiners may expand their review to ensure the institution is in compliance with applicable laws and regulations.

In December 2004, OCC issued revised risk-based Retail Lending Examination Procedures. Minimum examination procedures are used in all banks, and they may indicate the need for more extensive review of all or parts of a bank's retail lending activities. As part of the minimum examination procedures, examiners determine whether the bank's lending activities include indicators of predatory lending, such as whether underwriting policies provide appropriate guidance on assessing that the borrower's capacity to repay the loan is based on a consideration of the borrower's income, financial resources, and debt service obligations, and whether the bank's policies and procedures provide adequate guidance to avoid discriminatory, unfair, deceptive, predatory, and abusive lending practices. If examiners determine that supplemental examination procedures are necessary, those procedures include assessments that identify predatory lending practices.

- *In July 2000, the OCC issued an advisory letter addressing abusive lending practices. The advisory letter identified a number of practices that may indicate that an institution may be engaging in abusive lending and violations of fair lending statutes and other consumer protection provisions.*

- *In November 2000, the OCC issued an advisory letter alerting national banks to concerns raised by title lending arrangements with third parties. Such arrangements raise significant consumer protection concerns, because of the high cost of the loan, and may involve abusive lending and collection practices.*

[10] A title loan is a short-term consumer loan made to an individual secured by clear title to the borrower's vehicle. Payday loans are small-dollar, short-term loans that borrowers promise to repay out of their next paycheck.

- *Also in November 2000, the OCC issued an advisory letter to ensure that any national bank that engages in payday lending does so in a safe and sound manner and does not engage in abusive practices that would increase the compliance, legal, and reputational risks associated with payday lending and could harm the bank's customers.*

- *In March 2002, the OCC issued an advisory to inform national banks and their operating subsidiaries about the risks present in engaging in lending and marketing practices that may constitute unfair or deceptive acts or practices, and to help national banks to avoid being placed in jeopardy of penalties, judgments, and harm to their reputations that can result from such practices.*

- In February 2003, OCC issued two advisory letters related to predatory lending to the national banks and operating subsidiaries it supervises, as discussed earlier in this report.

- In January 2004, OCC issued a rule adopting anti-predatory lending standards that expressly prohibit national banks from making consumer and mortgage loans based predominantly on the foreclosure value of the borrower's collateral and engaging in unfair and deceptive practices, as discussed earlier in this report.

- *In April 2004, the OCC issued an advisory letter intended to help national banks identify risks that are presented by secured credit cards and to provide guidance on how to address such risks, so that national banks that elect to offer secured credit cards do so in a safe and sound manner that treats customers fairly and promotes responsible credit access.*

- In September 2004, OCC issued an advisory letter alerting national banks regarding OCC's concerns about certain credit card marketing and account management practices, as discussed earlier in this report.

- In February 2005, OCC issued guidelines for national bank residential mortgage lending standards to further the OCC's goal of ensuring that national banks do not become involved in predatory, abusive, unfair, or deceptive residential mortgage lending practices, as discussed earlier in this report.

The OCC has used its 12 U.S.C. [United States Code] *§ 1818 enforcement authority to bring actions against national banks that have engaged in unfair or deceptive acts or practices. These enforcement actions include two predatory mortgage lending cases and several cases involving credit card issuers that engaged in unfair or deceptive acts or practices. The enforcement actions have resulted in over $300 million in relief for consumers.*

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

DATE: June 1, 2006

TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Sandra L. Thompson [Electronically produced version; original signed by Sandra L. Thompson]
Acting Director

CONCUR: John F. Bovenzi [Electronically produced version; original signed by John F. Bovenzi]
Deputy to the Chairman and Chief Operating Officer

SUBJECT: Draft Report Entitled *Challenges and FDIC Efforts Related to Predatory Lending* (Assignment No. 2005-023)

This memorandum represents the Division of Supervision and Consumer Protection (DSC) response to the draft report entitled, *Challenges and FDIC Efforts Related to Predatory Lending*. (Assignment No.2005-023) ("Draft Report") prepared by the FDIC's Office of Inspector General (OIG). The objective of the OIG audit, started on March 2, 2005, was to determine challenges faced and efforts undertaken by the FDIC to identify, assess, and address the risks posed to institutions and consumers by predatory lending. The OIG also reviewed the efforts taken by the other federal banking regulators to address predatory lending.

The Draft Report recognizes the significant supervisory challenges attendant to predatory lending and identifies certain characteristics that are potentially indicative of predatory lending activities. The Draft Report recommends that the FDIC 1) clarify its overall approach to predatory lending, and 2) review existing guidance to identify gaps in examiner coverage of predatory lending. DSC agrees with these recommendations and will develop an overall supervisory approach to predatory lending that will include a review of existing supervisory policies and practices. DSC will also review existing examiner guidance and, if necessary, develop additional guidance to address predatory lending. These actions will be completed by year-end.

Overview

The FDIC ensures that the 5,000 banks under its supervision engage in safe and sound lending, adhere to consumer protection laws, and invest in their communities. Predatory lending often involves both borrower deception and poor underwriting standards. The FDIC thus views predatory lending as a major consumer protection challenge and a significant safety and soundness concern. FDIC efforts to address predatory lending have been in place formally since 1999 and include: examiner guidance in both the risk management and compliance disciplines; enforcement policy; public policy advancement through speeches and testimony; and active financial education and other outreach activities.

APPENDIX V

Examination Guidance and Training

Predatory lending is most often associated with abusive lending practices in the subprime mortgage market. In 2001, the banking agencies jointly issued *Expanded Examination Guidance for Subprime Lending Programs*. The expanded guidance, which supplements previous subprime lending examination guidance issued in 1999, was developed to strengthen the examination and supervision of institutions with significant subprime lending programs. Moreover, this expanded examination guidance formed the basis of an interagency predatory lending examination strategy for risk management and compliance examinations. The FDIC took a leadership role to ensure the examination guidance distinguished between well-managed and responsible subprime lending programs and subprime lending programs that involved predatory practices. The examination guidance provides a useful overview of the issue of predatory lending in the subprime mortgage market and reflects the approach of the agencies to the issue. It states, in part:

> The term subprime is often misused to refer to certain "predatory" or "abusive" lending practices. The Agencies have previously expressed their support for lending practices designed to responsibly service customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals. However, the Agencies also recognize that some forms of subprime lending may be abusive or predatory. Some such lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value. This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure/repossession to pressure the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:
>
> - Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
> - Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
> - Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.
>
> Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the Report of Examination as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to their Agency's respective consumer compliance/fair lending specialists for additional review.

2

APPENDIX V

In addition to the 2001 guidance, the FDIC has issued guidance on matters related to predatory lending, whether or not labeled as such.[1] In 2004, to make certain that the industry understood our concerns, the FDIC and Federal Reserve Board jointly issued detailed guidance about how to avoid unfair or deceptive practices. And, in June 2005, the FDIC issued examination procedures intended to ensure that FDIC examiners have the tools necessary to evaluate compliance with the FTC Act.

The FDIC has also recently worked closely with the other financial regulatory agencies to develop guidance for banks about non-traditional mortgage products. As the Draft Report recognizes, these products pose a supervisory challenge because they, "...may contain terms that are appropriate for some borrowers but predatory to others".[2] The proposed guidance addresses both safety and soundness and consumer protection concerns.

Both compliance and risk management examiners at the FDIC have received training in the last several years on issues and activities associated with predatory lending. The training highlighted issues raised by consumer organizations, findings by several government studies, and unfair and deceptive practices found by the federal banking agencies. As a result of this training, examiners have a heightened awareness of predatory lending concerns and are prepared to address them by applying both consumer protection laws and safety and soundness standards. Additionally, in 2002, the FDIC established a Fair Lending Examination Specialist Program that assigned an expert Fair Lending Examination Specialist to each Regional and Area Office to assist compliance examiners in conducting fair lending examinations. These examinations include consideration of discriminatory lending and certain predatory lending activities, such as discriminatory pricing and steering.

Enforcement Policy

The FDIC has vigorously enforced existing consumer protection and fair lending laws and regulations, including the Home Ownership and Equity Protection Act of 1994, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Fair Housing Act, the Equal Credit Opportunity Act, the Community Reinvestment Act, and the Federal Trade Commission Act (FTC Act). These authorities provide the FDIC with a range of tools to address predatory lending practices.

The Draft Report states there is no universally accepted definition of predatory lending.[3] In a report issued in June 2000, HUD and the Treasury Department explained that "... the predatory nature of many loans typically is not the result of a single term or characteristic, but a

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[1] See, e.g., Interagency *Guidelines for Subprime Lending*, published by the FDIC through FIL -20-99, and Interagency *Expanded Guidance for Subprime Lending Programs*, published by the FDIC through Financial Institution Letter (FIL) 9-2001.

[2] Draft Report at p. 3.

[3] Draft Report at p.1.

3

series of characteristics that in combination impose substantial hardship on the borrower". [4] We agree with the Draft Report that identifying or recognizing predatory lending in a specific loan transaction can be a challenge because each loan transaction must be viewed in its totality, including the associated marketing practices, terms of the agreement, various parties involved in the loan transaction, and financial sophistication of the parties involved. As a result, there is no simple "checklist" to follow in identifying predatory lending.[5]

In view of this challenge, we agree with the Draft Report that Section 5 of the FTC Act is an important tool to use where otherwise lawful loan features are included in transactions in an unfair and deceptive way. These features include balloon payments, high loan to value loans, prepayment penalties, mandatory arbitration clauses, high cost ancillary products such as single-premium life insurance, and high cost fees financed into the loan. While subprime lending is a legal activity, some consumers accept subprime products because they have been misled about whether they qualify for products with prime rates and terms or about the features of the subprime loans. As the Draft Report states:

> [T]he FDIC can rely on the FTC Act as authority for issuing enforcement actions against financial institutions for unfair, abusive, and deceptive acts or practices, which could include any or all of the characteristics potentially associated with predatory lending that our [OIG] research identified during this audit.[6]

Although the FDIC to date has not identified violations involving unfair or deceptive practices in mortgage lending by FDIC supervised institutions, we have taken enforcement action against institutions that violated the FTC Act in a different context involving other credit products. OIG staff reviewed compliance examination reports that documented our action.[7] The FDIC is prepared to extend enforcement of the FTC Act to mortgage lending.

Public Policy: Speeches & Testimony

The FDIC has also made its concerns about predatory lending known in numerous speeches and testimony by FDIC officials since 2000. These include speeches before forums sponsored by the National Association of Affordable Lenders, the National Congress for Community and Economic Development, America's Community Bankers and others, and testimony before Congress. These public statements of policy addressed the different types of predatory practices discussed in the Draft Report, in addition to others, and laid out strategies to identify and prevent predatory lending. The collected speeches and testimony provided guidance not only to the industry, but also communicated the FDIC perspective on predatory lending to examiners as well.

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[4] See "The National Predatory Lending Task Force, Curbing Predatory Home Mortgage Lending: A Joint Report, U.S. Department of Housing and Urban Development and U.S. Department of Treasury" (June 2000). (HUD/Treasury Report).

[5] Draft Report at p. 3.

[6] Draft Report at p. 11 (emphasis added).

[7] Id. at p.21.

APPENDIX V

Financial Education

In addition to our supervisory programs, the FDIC's ongoing public awareness and education initiatives play an important part in combating predatory practices and complement our supervisory programs. As acknowledged in the Draft Report, the FDIC has long recognized the value of consumer education as an additional tool in combating predatory lending abuses. The FDIC's award-winning *Money Smart* financial education program and the *FDIC Consumer News* play an important role in the FDIC's efforts to provide helpful free information to the public, financial institutions and our examination staff.

The FDIC's financial education program is primarily focused on helping low- and moderate-income adults develop money-management skills. Two versions are available for free– one for classroom use (in English, Spanish, Chinese, Korean, Vietnamese, and Russian), the other for computer-based, self-paced learning (in English and Spanish). Classes are offered through an extensive network of *Money Smart* "partners," including financial institutions, non-profit organizations and government agencies. Since 2001, about 495,000 people have taken *Money Smart* classes and 95,000 new banking relationships have been established.

In addition, FDIC Community Affairs staff have hosted or participated in numerous anti-predatory lending conferences and forums that promote the use of *Money Smart* and other means to prevent predatory lending or correct its effects on low and moderate-income individuals and others.

Conclusion

In summary, predatory lending harms individuals and communities and raises risk management and consumer compliance concerns for financial institutions. Predatory loans can have a negative impact on a bank's Community Reinvestment Act evaluation. The loans may violate fair lending laws and other consumer protection laws, resulting in legal or regulatory action. Questionable loan underwriting and the risk of litigation raise additional safety and soundness concerns. For these reasons, the FDIC maintains a strong supervisory strategy developed over several years to combat predatory lending in the financial system through vigorous safety and soundness and compliance examination and enforcement, industry outreach and adult financial education programs. The development of an articulated overall supervisory approach to predatory lending, based on a review of existing supervisory polices and practices that address predatory lending, as recommended by the OIG Draft Report, will enhance the FDIC's efforts in this area. We will complete this task by year-end.

5

OIG Recommendation

"Describe in policy the FDIC's overall supervisory approach to predatory lending."

DSC Response

The FDIC agrees that it will be beneficial to articulate an overall supervisory approach as stated above to address any predatory lending practices that FDIC examiners may find. By year-end, DSC will develop a formal policy statement describing its approach to combating predatory lending.

OIG Recommendation

"Review existing examiner, financial institution, and consumer guidance and determine whether additional guidance is needed to address predatory lending."

DSC Response

The Draft Report suggests that we consider the approaches of the other agencies. The supervisory approaches of the OCC and OTS to predatory lending are based, in large part, on their authority under the National Bank Act and Home Owners Loan Act to supervise institutions pursuant to federal law. The FDIC has worked closely with state supervisors to take action to address activities that violate state anti-predatory lending laws. As explained above, the FDIC has also required banks subject to its supervision to correct unfair and deceptive acts or practices under the FTC Act and disengage from unsafe or unsound lending practices.

The Federal Reserve Board, which also works with state authorities, mentions predatory lending as a potential risk to be considered when evaluating reputation risk during examinations. FDIC examiners undertake a similar risk assessment, although the guidance does not use the phrase "predatory lending." Under the FTC Act examination guidance issued in June 2005, FDIC compliance examiners must consider the risks for unfair or deceptive acts or practices when they develop a risk profile for an institution. To assess this risk, examiners evaluate: consumer complaints received by the bank or the FDIC; whether the bank's product lines are high risk; the quality of the bank's compliance management system; and the bank's past performance.

We will carefully review any overall supervisory strategy in use by the other agencies with an eye to enhancing the FDIC's strategy as the OIG suggests. By year-end, DSC will complete the recommended review and determine whether any new or enhanced policy or guidance is necessary in light of the strategy statement developed in response to Recommendation 1.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	DSC will develop an overall supervisory approach to predatory lending that will include a review of existing supervisory policies and practices.	December 31, 2006	NA	Yes	Open
2	DSC will review existing predatory lending guidance and, if necessary, develop additional guidance to address predatory lending.	December 31, 2006	NA	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Once the OIG determines that the agreed-upon corrective actions have been completed and are effective, the recommendation can be closed.

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Statement for the Record of
Chi Chi Wu, National Consumer Law Center
to the Subcommittee on Oversight and Investigations
of the U.S. House of Representatives Committee on Financial Services
regarding "The FDIC's Targeting of Refund Anticipation Loans"
March 16, 2016

Chairman Hensarling, Ranking Member Waters, and Members of the Committee on Financial Services:

Thank you for the opportunity to submit a written statement regarding the hearing entitled "The FDIC's Targeting of Refund Anticipation Loans." The National Consumer Law Center (NCLC)[1] has considerable expertise and interest on the issue of refund anticipation loans (RALs), refund anticipation checks (RACs), other tax-time financial products, and taxpayer consumer protection.[2] We offer our testimony here on behalf of our low-income clients, as well as the Consumer Federation of America.[3]

We believe the FDIC had good reason to be concerned about the RALs offered by its supervisee banks, and should continue to closely supervise these same banks regarding their current tax refund-related offerings. The FDIC's actions during the 2011 to 2012 time period were measured, appropriate, and necessary to protect both consumers and the safety and soundness of banks. In particular:

- RALs made by FDIC-supervised banks and other banks subjected taxpayers to triple-digit interest rates, skimmed billions from their refunds, and put them at risk of unmanageable debt. The FDIC protected taxpayers by stopping RAL abuses.

- RALs presented a significant risk to the safety and soundness of banks, because of the massive levels of errors and fraud from paid tax preparers that still continue to this day. The FDIC was entirely justified in getting its supervisee banks to stop making these loans

[1] Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has worked for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the U.S. through its expertise in policy analysis and advocacy, publications, litigation, expert witness services, and training.
[2] NCLC and the Consumer Federation of America have jointly authored annual reports on RALs, RACs and tax-time financial products since 2002. NCLC has also authored a number of other reports on tax-time consumer issues. The annual RAL reports and other tax-consumer issue reports are available at www.nclc.org/issues/taxes.html.
[3] The Consumer Federation of America is an association of more than 250 nonprofit consumer groups that was established in 1968 to advance the consumer interest through research, advocacy and education. www.consumerfed.org

in 2011-2012. Its examination of tax preparers acting as bank agents uncovered widespread egregious legal violations.

- The need for FDIC oversight of RAL lending banks and tax preparers continues to this day. This year, FDIC-supervised banks are offering RALs that are allegedly "no fee" to the consumer, but present a risk of consumer abuse. Refund anticipation checks represent a disguised loan of the tax preparation fee, with triple digit annual percentage rates (APRs).

FDIC Actions Stopped RAL Abuse of Taxpayers

From about the mid-1990s until 2012, a handful of banks (including three FDIC-supervised banks) made tens of millions of RALs that drained billions of dollars from the refunds of hard-working taxpayers. These RALs were one- to two-week loans made by banks and offered by tax preparers, without underwriting for ability to pay and secured by the taxpayer's refund.[4] These RALs were extremely expensive: with fees from $30 to nearly $140, the APRs for RALs ranged from 50% to 500%. RALs also collectively drained billions from taxpayer refunds. From 2002 to 2012, RALs collectively skimmed over ***$9.6 billion*** from the refunds of tens of million American taxpayers.[5]

RALs targeted low-income taxpayers, especially recipients of the Earned Income Tax Credit (EITC). In 2010, over 90% of taxpayers who applied for a RAL were low-income, and nearly two-thirds (66%) were EITC recipients. Yet EITC recipients made up only 20% of individual taxpayers in that year.

RALs also presented significant financial risks to taxpayers. If a refund is denied because of a preparer's error or for any other reasons, the taxpayer would end up on the hook for the loan. This imposed a substantial hardship, because the taxpayer usually had not budgeted to repay this loan. The taxpayer might be subjected to debt collection harassment, a damaged credit rating, or even have next year's refund grabbed to pay off the loan.

RALs Pose a Safety & Soundness to Banks

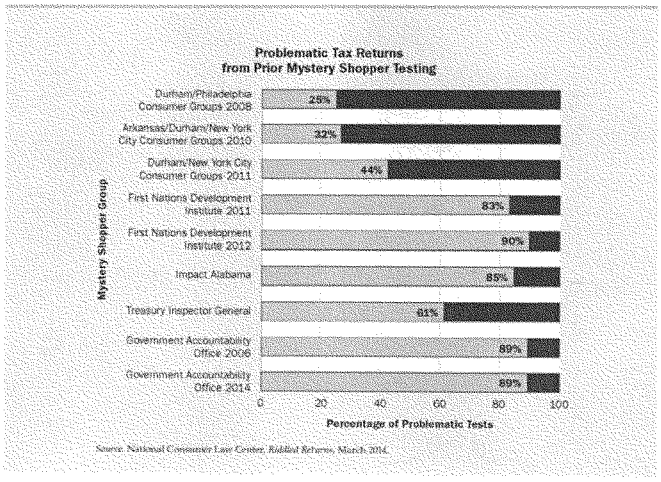
The harms of RALs are not limited to their impact on consumers. RALs present significant safety and soundness risks because the high levels of fraud and errors by tax preparers, who act as bank agents when they offer a RAL. In fact, concerns over RALs and tax fraud were

[4] A product related to RALs is the refund anticipation check (RAC). With RACs, the bank opens a temporary bank account into which the IRS direct deposits the refund check. After the refund is deposited, the bank issues the consumer a check, direct deposit or prepaid card with the refund proceeds minus the RAC fee, tax preparation fee, and any add on junk fees. The bank then closes the temporary account.

[5] The data in this section is derived from the annual reports of the National Consumer Law Center and Consumer Federation of America on RALs, RACs, and other tax-time consumer issues. These reports are all available at www.nclc.org/issues/taxes.html#ral .

significant enough for the Internal Revenue Service (IRS) to open a rulemaking proceeding regarding the issue in 2008.[6]

A startling fact about the tax preparation industry is that, in all but four states, paid tax preparers are not required to meet any minimum educational, competency, or training standards. The lack of competency standards has allowed errors and fraud by tax preparers to flourish. As the chart below shows, mystery shopper tests of tax preparers by the Government Accountability Office, the Treasury Inspector General for Tax Administration, and consumer groups have found high levels of errors, fraud and other abuses.[7] Fraud has a direct impact on the safety and soundness of RALs, because the accuracy of the tax return is critical in determining whether the loan should be made, whether it will be repaid, and whether a subsequent IRS audit could result in problems for the bank.



Law enforcement actions have similarly uncovered massive fraud schemes, including the U.S. Department of Justice (USDOJ) action in April 2007 against five Jackson Hewitt franchisees that falsely claiming $70 million in tax refunds.[8]

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[6] 73 Fed. Reg. 1131 (Jan. 7, 2008)(asking whether IRS should develop rules restricting the sharing of tax return information to market RALs, RACs, and other financial products). For more on how RALs promote tax fraud, *see* Chi Chi Wu, National Consumer Law Center, RALs, Tax Fraud, and Fringe Preparers (Feb. 2009).

[7] This chart is based on the rounds of mystery shopper testing discussed in Chi Chi Wu, National Consumer Law Center, Riddled Returns: How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do (November 2013), *available at* www.nclc.org/issues/riddled-returns.html.

[8] *See* Complaint, United States v. Smart Tax of Georgia, Inc., 1:07CV-0747 (N.D. Ga. Apr. 2, 2007); Complaint, United States v. Smart Tax Inc., 07C-1802 (N.D. Ill. Apr. 2, 2007); Complaint, United States v. Sofar, Inc., Civ. No.

In addition to errors and fraud, the role of the tax preparer in making RALs was critical because they acted as the bank's agent when making a RAL. Tax preparers solicited customers for the loans, explained (or failed to explain) the loan terms to consumers, processed loan documentation, obtained the consumer's signature, retained the loan documents on file, and even printed RAL checks. They determined the size of the loan and purported to ensure its soundness, through their work in preparing the tax return. In short, tax preparers did everything but make the ultimate approval decision and fund the loan. Given that these preparers were not – and still are not -- supervised by anyone else, it was appropriate and necessary for the FDIC to examine them, including when the FDIC conducted visitations of 250 tax preparers that offered RALs made by Republic Bank & Trust. These visitations were critically important because they found that Republic had failed to properly train and monitor its tax preparers, resulting in multiple legal violations including:[9]

- Truth-in-Lending Act (TILA) - The FDIC found that copies of the written disclosures required by TILA were regularly absent from loan files. In addition, nearly 88% of the tax preparers that FDIC investigators called failed to make an oral disclosure of the annual percentage rate (APR) when requested.
- Gramm-Leach-Bliley Act - Tax preparers did not have proper physical and electronic safeguards for the protection of confidential consumer information, such as shredders or locked dumpsters. Half of the tax preparer offices had no alarm system, even though the stores had bank checks inside.
- Federal Trade Commission Act - The FDIC alleged that Republic engaged in unfair and deceptive actions, such as implying that customers would receive the full amount of their refunds minus fees in one or two days by getting a RAL, despite the fact that the RAL amounts were limited by Republic to $1,500.
- Equal Credit Opportunity Act (ECOA) - The FDIC found tax preparers refused to process a RAL application when only one spouse applied for the loan, in violation of the ECOA.

Nearly half (46.5 percent) of tax preparers who made Republic RALs were in violation of at least three different laws. The FDIC found that Republic failed to properly train tax preparers to comply with consumer protection laws. In particular, Republic tested preparers' knowledge of consumer laws by giving them an online quiz that permitted the preparers to keep guessing until they passed the test. In addition, the FDIC alleged that Republic attempted to interfere with its investigation by setting up an Internet webpage of Frequently Asked Questions to coach tax preparers during the day when the FDIC tested the preparers.

The high levels of errors and fraud, combined with these multiple legal violations, by themselves would have justified the FDIC's actions in 2011 and 2012 to encourage its supervisee banks to stop making RALs. However, there was an additional critical factor. The FDIC's actions were

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2:07-cv-11460 (E.D. Mich. Apr. 2, 2007); Complaint, United States v. Smart Tax of North Carolina, Inc., Civ. No. 5:07-cv-00125-FL (E.D.N.C. Apr. 2, 2007).

[9] Amended Notice of Charges for an Order to Cease and Desist, In the Matter of Republic Bank & Trust Co., FDIC-10-079b and FDIC-10-216k, May 3, 2011.

also based upon the termination of the Debt Indicator by the IRS in August 2010.[10] The Debt Indicator was an IRS-provided service that helped tax preparers and banks make RALs by notifying them if the borrower's refund would be intercepted by the government for certain debts. Without the Debt Indicator, a RAL could go unpaid, harming both the bank and the taxpayer. It was entirely appropriate for the FDIC to warn its banks of the safety and soundness risks of making RALs without the Debt Indicator.

It is also important to note that the FDIC was not alone in prompting its supervisee banks to leave the RAL market. The Office of Comptroller of Currency (OCC) had forced two of its banks (Pacific Capital Bancorp and HSBC) to stop making RALs.[11] The OCC's actions were actually stronger, in that it issued regulatory directives prohibiting those two banks from making RALs.

Need For Vigorous FDIC Supervision of RAL Lending Continues to Today

The FDIC's close supervision of RAL lending banks was not only appropriate back in 2011 and 2012, it needs to continue. There is a new generation of RALs -- "advances" that supposedly do not impose a charge on the consumer for the loan. Two of the lenders for these "no fee" RALs are FDIC supervised banks – Republic Bank & Trust and River City Bank.

These "no-fee" RALs could present risks to consumers. Even though there is supposedly no charge to the consumer, Republic Bank & Trust charges the tax preparer a $35 fee for its "no fee" RAL.[12] Preparers might pass along this fee, or charge even more, by padding their tax preparation fees or by charging separate "add-on" junk fees.[13] Tax preparation fees are extremely non-transparent, and can be high.[14] Few consumers can get a firm price estimate before having their refund prepared, so hidden fees can be hard to avoid. Because it can conduct examinations, the FDIC is perhaps the only entity that could detect if preparers are passing along the $35 fee to consumers without their knowledge.

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[10] Press Release, Internal Revenue Service, IRS Removes Debt Indicator for 2011 Tax Filing Season (Aug. 5, 2010), *available at* www.irs.gov/newsroom/article/0,,id=226310,00.html.

[11] *See* Press Release, H&R Block, *HSBC Terminates Agreement to Provide RALs at Direction of OCC* (Dec. 24, 2010); Press Release, *Pacific Capital Bancorp Announces Planned Sale of Refund Anticipation Loan and Refund Transfer Businesses* (Dec. 24, 2009).

[12] Republic Bank & Trust, Easy Advance, at https://www.republicrefund.com/Products/EasyAdvance.aspx (visited Mar. 11, 2016).

[13] For example, there is a similar "no fee" RAL available from Santa Barbara Tax Products Group (SBTPG). One of the software providers called "service bureaus" that offers the SBTPG "no fee" RAL is Gannon Service Bureau. Gannon offers to provide software with lower upfront costs to the preparer, but the preparer then charges an additional $44 "service bureau" fee. Gannon makes it very clear that preparers can hide fees by stating "We charge a small $44 service bureau fee that is deducted directly from the taxpayer's return for each bank product you file. With our free bank products, we're confident that even after this fee, your clients will save an average of $20 to $60 per return.... This is money you can stick directly into your own pocket by increasing your own prep fee $20 to $60 per return, while keeping the overall cost to the client the same as last year." Gannon Service Bureau, www.gannonservicebureau.com (visited Mar. 11, 2016).

[14] *See* David Rothstein, Policy Matters Ohio, Improving Tax Preparation with a Model Fee Disclosure Box, June 2013, *available at* www.policymattersohio.org/wp-content/uploads/2013/06/FeeDisclosure_Jun2013.pdf.

River City Bank offers a "no-fee" RAL but does not charge the tax preparer. However, if a taxpayer obtains a refund anticipation check, she will pay more. River City offers several RAC programs. If a preparer offers "no fee" RALs, then River City will charge the taxpayer $39.95 for the RAC. But if a tax preparer does not offer the "no-fee" RAL, it has the option of offering RACs for a lower fee, either $29.95 or $34.95. This price different could be a hidden finance charge for this supposedly "no fee" RAL.[15]

It is also important to note that the FDIC must continue to closely monitor RAL lending because the fraud and error issues continue as well. Last year, mystery shopper testing by consumer advocacy groups in Florida and North Carolina found inaccuracies in 27 out of the 29 tax returns prepared by paid tax preparers.[16] And just last month, the USDOJ filed an enforcement action seeking to bar a Liberty Tax Service franchise in South Carolina from preparing tax returns, alleging that the franchise deliberately prepared fraudulent returns and inflated federal tax refunds by giving taxpayers income from fictional jobs and claiming children that didn't exist.[17]

Finally, the FDIC needs to continue to examine banks like Republic Bank and River City Bank when they offer refund anticipation checks (RACs). While the banks claim otherwise, RACs increasingly represent nothing more than a disguised loan of the tax preparation fee. When taxpayers obtain a RAC simply because they cannot afford the price of tax preparation upfront, they are essentially paying to defer payment of the tax preparation fee—which is a loan. If a taxpayer pays $35 to defer payment of a $350 tax preparation fee for three weeks, the APR would be equivalent to 174%. At least two court decisions have held that a RAC constitutes a loan of the tax preparation fee, and thus RAC fees are finance charges under the Truth in Lending Act.[18]

Conclusion

The FDIC did the right thing in 2011-2012 by prompting its supervisee banks to stop making RALs. Its actions were justified, and it should continue to closely supervise these same banks regarding their current tax refund-related offerings.

[15] River City Bank, Product > Pricing, at www.rcbtaxdivision.com/pricing.aspx?mnu=3 (visited Mar. 11, 2016)
[16] Chi Chi Wu, Alice Vickers, Amelia O'Rourke-Owens, Peter Skillern, and Cara Williams, National Consumer Law Center, Florida Alliance for Consumer Protection, Reinvestment Partners, Prepared in Error: Mystery Shoppers in Florida and North Carolina Uncover Serious Tax Preparer Problems (Apr. 2015).
[17] Complaint for Permanent Injunction and Other Relief, United States v. Haynes, Case No. 3:16-cv-00373-MG (D.S.C. Feb. 8, 2016).
[18] United States v. ITS Fin., LLC, 2013 WL 5947222 (S.D. Ohio Nov. 6, 2013); People v. JTH Tax, Inc., 212 Cal. App. 4th 1219, 151 Cal. Rptr. 3d 728 (2013).

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