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Federal Reserve Board Memo from Dolores Smith and Glenn Loney re Compliance Inspection

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Glenn Loney

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From: Regina B Watson on 08/31/2000 04:12 PM

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Subject: DCCA Committee Meeting--Sept. 5, 1:00 pm, Special Library

A DCCA Committee meeting is planned for Tuesday, September 5, 1:00 pm, in the Special Library to discuss

1) HOEPA/HMDA reforms; and 2) Examination of nonbank subs. Attached is background material for Item #2.



2stepProposalFinal.doc

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE: August 31, 2000
TO: Governor Edward Gramlich
FROM: Dolores Smith and Glenn Loney
SUBJECT: Compliance Inspections of Nonbank Subsidiaries of Bank Holding Companies

Introduction

This memorandum responds to your request that we develop a possible approach to determining whether predatory lending may be occurring at nonbank subsidiaries of bank holding companies (nonbank subsidiaries). We recommend that, as a first step, the System undertake a pilot program to carry out targeted inspections for predatory lending practices at a limited number of selected nonbank subsidiaries. The knowledge gained through this project would be used to assess whether nonbank subsidiaries are engaging in such practices, to test examination and inspection methodologies,¹ and generally to determine the likely impact, including costs, should the Board decide to undertake inspections of nonbank subsidiaries on an ongoing basis.

Overview of Recommended Pilot Program

Staff recommends a pilot program in which the System performs a limited number of inspections of nonbank subsidiaries to gauge the existence and extent of predatory lending practices at these institutions and to develop information that would be useful to the Board in determining whether a permanent oversight program is in order and what its elements should be. The initial reviews would be conducted over the next two years. Staff will identify factors thought to be predictive of an institution's potential for predatory lending to be validated during the inspections. A System inspection team would be constituted, examination procedures would be developed, and six to eight nonbank subsidiaries would be selected for inspection. Our goal would be to have the inspections begin within six months of Board approval, and continue through to the end of the twenty-four month period. The findings of

these inspections would be shared with the institution and appropriate federal and state agencies.

Background

Predatory Lending

Predatory lending, in common parlance, refers to harmful lending practices that go beyond the bounds of fair and responsible lending. There is, however, no particular legal definition of the term and the concept has been argued to cover many different actions in a number of different contexts. Some predatory lending practices violate one or more fair lending or consumer compliance laws and regulations. Some do not. Predatory lending practices can involve, among other things,

- ◆ lending based on the assets of the borrower rather than the borrower's ability to repay an obligation,
- ◆ inducing a consumer to refinance a loan repeatedly while adding additional points and fees each time ("flipping"),
- ◆ building in loan terms and structures, such as balloon payments or negative amortization terms, that may conceal the true nature of the loan obligation from an unsophisticated borrower, and
- ◆ adding unearned broker fees or single premium insurance to the financed amount, thereby further reducing the borrower's equity.

While some of these lending practices are not necessarily unlawful and are not always harmful, the totality of the circumstances surrounding a loan structured with one or more of these features can result in concerns that it is predatory in certain circumstances. This can particularly be the case when the loan is made to unsophisticated, possibly illiterate, or elderly borrowers or borrowers who are under undue pressure or duress.

It is hypothesized that a diverse array of creditors, often those involved in the subprime mortgage market, may engage in predatory lending practices. These institutions could include mortgage companies, mortgage brokers, finance companies, and secondary

¹ The same predatory lending examination procedures would be used during examinations of state member banks.

market participants. But the breadth of predatory lending and even the extent of practices that constitute predatory lending are not fully known.

Actions being taken by the Board to Address Predatory Lending

The Board has legal authority under the Bank Holding Company Act to examine, and can undertake certain enforcement measures with respect to, nonbank subsidiaries. Currently, we have no information about the level of compliance with consumer protection laws in general and those relating to predatory lending in particular at nonbank subsidiaries of bank holding companies because the Board has opted not to take on responsibility for examining these entities routinely for consumer compliance. (See Appendix A "History of the Board's Policies with Respect to the Enforcement of Consumer Protection Laws at Nonbank Subsidiaries" for more discussion.)

The Board is taking action on a number of fronts to target predatory lending practices. Board staff participates in interagency working groups seeking to address the difficult issues involved in defining, determining the scope of, and curbing predatory lending. The outcomes of these interagency deliberations may aid in refinement of the inspections we are proposing. Regulatory responses are also being considered in possible revisions to the Home Owners Equity Protection Act (HOEPA), as evidenced in the recent HOEPA hearings, and Home Mortgage Disclosure Act (HMDA) data collection. Additionally, Community Affairs staff is developing consumer education initiatives to better equip the public to avoid the pitfalls of predatory loans. The adoption of this inspection program would provide another avenue through which the Board can address predatory lending practices.

Inspections

To implement this pilot program of inspections of nonbank subsidiaries for predatory lending practices, examination procedures will be needed to guide examiners through the process of analyzing potential violations of various regulations that may arise from predatory lending and to define predatory lending that does not involve violations of law. Division staff will develop these examination procedures in concert with selected Reserve Bank staff. The inspections undertaken in conjunction with this pilot project will begin under the

guidance of the initial draft procedures, but these procedures will be further enhanced and developed as they are used in the field for the initial reviews.

A team of System examiners would conduct predatory lending inspections² at six to eight nonbank subsidiaries of different bank holding companies over an eighteen-month period. The inspection team would be assembled from Reserve Banks throughout the System and would work with guidance from and participation by Board staff. To ensure that data will be adequate for a meaningful follow up analysis, the nonbank subsidiary inspection candidates would be selected randomly from the pool of seventy-two nonbank subsidiaries that are HMDA reporters.³ (We would first remove institutions with little or no subprime lending activity from consideration.) We would choose six to eight inspection candidates, but only one nonbank subsidiary per bank holding company would be included in the pilot program. Per our consultation with Board economists, we understand that the structure of the random sample will allow us to use the inspection results to draw preliminary conclusions about the existence and extent of predatory lending involving home mortgage lending in all nonbank subsidiaries. It would also give an indication of the resource implications of taking on this job more routinely.

Reserve Bank examiners would complete a predatory lending inspection of each nonbank subsidiary selected, using draft examination procedures.⁴ It is anticipated that senior examiners will lead these inspections, which will require a complex analysis of facts obtained from the entity's lending patterns, behaviors and actions taken toward individual applicants, and relationships with third parties involved in the lending transactions.

While the review will be limited to provisions of regulations that can be indicative of predatory lending, examiners may find violations of other consumer laws not connected to predatory lending. There may be problems, for instance, with respect to the accuracy of data reporting under HMDA. In addition, examiners might find other violations of such laws as the Truth in Lending Act or the Equal Credit Opportunity Act that are not

² This would consist of a review of compliance with the relevant provisions of the TILA/HOEPA/Regulation Z, ECOA/Regulation B, the Fair Housing Act, the Real Estate Settlement Procedures Act/Regulation X, and the Home Mortgage Disclosure Act/Regulation C, as well as nonviolative practices deemed to constitute predatory lending.

³ Initially, mortgage lenders will comprise the members of our sample due to the greater amounts of data available regarding their practices. Should the Board establish a longer-term program, other types of nonbank subsidiary lenders, such as finance companies, could be included.

associated with predatory lending.⁵ These violations will have to be dealt with, as we do not believe it would be proper simply to ignore them because they do not involve predatory lending. The more technical of them may, however, be only pointed out to the institution with instructions to correct the matter.

A rating would not be issued as a result of these inspections; however, findings, when appropriate, could be considered as part of the bank holding company's risk assessment. A supervisory letter would be sent to the bank holding company and the nonbank subsidiary's board of directors communicating the inspection findings. If discriminatory or predatory lending practices or other violations of law are found in the course of an inspection, including violations of law not related to predatory lending, these practices, and any corrective actions necessary, would be discussed in the supervisory letter. Inspection findings would also be shared with the FTC, HUD, state banking authorities, and the Department of Justice, as appropriate.

Analysis of the Inspections

During the course of the inspections, examiners would gather information considered germane to or predictive of an institution's potential for predatory lending. Some commonly discussed characteristics of predatory lenders are contractual relationships with loan brokers, the targeting of minority or low-income geographies, and the offering of subprime loan products. Though these factors are often identified as associated with predatory lenders, as pointed out in a recent Senate Banking Committee report, we do not have "systematic or organized data on predatory lending" from which we can confidently define these factors as predictive of an entity's potential for predatory behavior. The data gathered during the inspections should help in that regard.

After the completion of the pilot program of inspections, the second phase of this project would commence. During this post-inspection phase, we would analyze the information obtained on potentially predictive lender characteristics to determine whether that information

⁴ Draft predatory lending examination procedures would be validated through their use during these inspections as well as during bank examinations.

⁵ These data might be helpful in evaluating whether or not our current policy of not routinely examining nonbank subsidiaries for overall compliance should be revisited.

can, in fact, be used to predict a likelihood of predatory behavior. We would also review data to determine whether and how predatory loans made by nonbank subsidiaries are being considered in the course of CRA examinations of affiliated banks. Predatory lending examination methodologies, including the draft examination procedures and predatory-lending risk factors, could be refined based on the results of the inspections.

The post-inspection phase of this project would also include a review of other information collected during the inspections, including violations cited; an assessment of the degree and extent of predatory lending at these nonbank subsidiaries; and an evaluation of the resources expended on these inspections. This analysis, which should require two to three months of work, would be used to develop a recommendation with respect to the System's long-term policies for supervising nonbank subsidiaries of bank holding companies regarding predatory lending.

Considerations with Respect to this Approach

Even though these inspections would be limited in scope, they would be resource intensive due to the complex nature of the analysis and the fact that less than a handful of nonbank subsidiaries have undergone such a review to date. In the case of our current population of member banks, System examiners have developed a broad knowledge of bank compliance capacity based on many years of examination experience, which facilitates a risk-focused approach to those examinations. Examiners do not have a similar knowledge base for nonbank subsidiaries. Consequently, it is expected that examiners will need to conduct a substantial amount of transaction testing and/or statistical sampling in order to (1) verify that the nonbank subsidiary's actual practices match its policies and procedures, and (2) determine whether the nonbank subsidiary is engaging in predatory lending.

Another approach to nonbank subsidiary supervision is being discussed in San Francisco. This approach introduces compliance oversight of nonbank subsidiaries through the bank holding company supervision process. The approach evaluates the risk of a lending subsidiary's noncompliance with consumer protection laws, including predatory lending practices, utilizing risk profiles developed off-site. Institutions deemed to have higher risk ratings would be addressed through a variety of supervisory activities, with on-site

examinations limited to rare situations involving only the highest rates of risk. Our proposal, on the other hand, applies examiner resources directly to on-site predatory lending inspections to more immediately uncover the extent of predatory lending activities that may be occurring in these entities. We believe that, absent these inspections, so little is known about the actual practices of nonbank subsidiaries that precise risk profiling would be difficult, at best. In fact, one goal of our inspections will be to gather information to evaluate what considerations should be taken into account when developing a risk profile. Upon the completion of our proposed pilot inspections, we hope to have gained the experience to accurately assess the risk of predatory lending associated with these institutions and the nature of any predatory lending activity within them. At that point, we will be in a better position to decide if the San Francisco approach is an appropriate manner of addressing predatory lending in these entities.

There may be some potential drawbacks to undertaking this pilot program. The initiation of these inspections may raise expectations that the Board should implement a permanent policy to conduct inspections of nonbank subsidiaries for consumer compliance matters generally on a routine basis. Consequently, if the System undertakes the pilot program and then the results do not support continuation, the Board could receive more intense public and political criticism if it decides not to go forward than if the inspections were never undertaken at all. Moreover, even the addition of the inspections taken on during this project will result in the reallocation of resources from other aspects of the System's compliance examination program. For example, some resources will necessarily be diverted from conducting examinations of state member banks to conduct these inspections.

We believe there are a couple of ways we can address these concerns to minimize the potential risks associated with this pilot program. First, if we clearly disclose the purpose, scope, and nature of the project to Congress and the public, through, perhaps, meetings and a press release, or other public announcement, we can seek to manage the expectations generated by the project. Second, we will structure the work to utilize System resources in a manner that fosters the greatest efficiency and minimizes disruptions to Reserve Bank operations to the greatest extent possible. Reserve Bank managers have expressed interest in structuring the review team in a manner similar to the structure successfully employed during last year's horizontal reviews, where the same team conducted all of the reviews, thereby

maintaining continuity and maximizing learning and information building. This approach may help minimize disruption of other aspects of the compliance examination program while allowing the team to gain expertise.

cc: Governor Laurence Meyer
Shawn McNulty
Maureen English
Adrienne Hurt
Suzanne Killian
Jim Michaels
Scott Alvarez

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APPENDIX A

History of the Board's Policies with Respect to the Enforcement of Consumer Protection Laws at Nonbank Subsidiaries

The issue of whether the Federal Reserve System should enforce compliance with consumer protection laws and regulations in nonbank subsidiaries has been reviewed periodically by the Board over the years the Board's compliance program has been in place, most recently in January 1998. Currently, the Federal Reserve does not routinely conduct consumer compliance examinations of nonbank subsidiaries of bank holding companies; and does not investigate consumer complaints related to these subsidiaries, but forwards them to the Federal Trade Commission (FTC). Nonetheless, we do perform reviews of nonbank subsidiaries when serious fair lending and other compliance concerns problems arise or are brought to our attention, particularly, but not exclusively, in connection with applications¹.

In deciding on its present policy, the Board took into account the fact that the FTC is the primary enforcement agency with respect to nonbank subsidiaries, as designated by fair lending and consumer protection statutes such as the Equal Credit Opportunity Act (ECOA) and the Truth In Lending Act (TILA). The FTC does not, however, examine the entities for which it has enforcement authority. Rather, it enforces through administrative action and judicial litigation prompted by, for example, its receipt of a number of complaints about a particular practice or a particular entity or industry.

Consequently, the question continues to be raised whether the Board should use its derivative authority under the Bank Holding Company Act to examine for compliance with these laws, particularly as they relate to "predatory" lending. Additional considerations which contributed to the present policy related to the expense of taking on these responsibilities as a routine matter and the issue of regulatory evenhandedness, since similar entities that are not a part of a bank holding company would not be subject to comparable examination oversight. On the other hand, the Board considered possible Congressional expectations that the Federal

¹ Comments regarding the activities of a nonbank subsidiary that constitute a protest of an application are routinely reviewed during the application process.

Reserve indeed monitors these entities for consumer compliance because of its holding company responsibilities, the risk of embarrassment to the Board from a “hands off” policy in the face of a high-profile protest or lawsuit about illegal or ill-conceived practices at a nonbank subsidiary, and the ability of a state member bank to receive positive consideration in its CRA examination for activities of a nonbank affiliate. In weighing these considerations, the Board decided not to take this job on routinely.

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