Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

4-7-2010

Draft Financial Crisis Inquiry Commission Preliminary Staff Report - Role of Federal Reserve in Bank Supervision and Regulation

United States: Financial Crisis Inquiry Commission (FCIC)

https://elischolar.library.yale.edu/ypfs-documents/6011

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library.
For more information, please contact ypfs@yale.edu.

DRAFT: COMMENTS INVITED

Financial Crisis Inquiry Commission

Preliminary Staff Report

THE ROLE OF THE FEDERAL RESERVE IN BANKING SUPERVISION AND REGULATION

APRIL 7, 2010

This preliminary staff report is submitted to the Financial Crisis Inquiry Commission (FCIC) and the public for information, review, and comment. Comments can be submitted through the FCIC's website, www.fcic.gov.

This document has not been approved by the Commission.

The report provides background factual information to the Commission on subject matters that are the focus of the FCIC's public hearings on April 7, 8, and 9, 2010. In particular, this report provides information on the Federal Reserve and its regulation of the financial system, including its regulation of mortgage markets. Staff will provide investigative findings as well as additional information on these subject matters to the Commission over the course of the FCIC's tenure.

Deadline for Comment: May 15, 2010

CONTENTS

I. FEDERAL RESERVE STRUCTURE AND REGULATORY PURVIEW 3
- A. Prudential Supervision and Consumer Protection 5
- B. Guidance and rules 6
- C. Structure of the Federal Reserve 6

II. A BRIEF HISTORY OF BANKING REGULATION 7
- A. Evolution of the Glass-Steagall Act 7
- B. The 1999 Gramm-Leach-Bliley Act 9
- C. Federal Reserve's consolidated supervision under GLBA 10
- D. Choice of charter 11
- E. Nonbank subsidiaries during the financial crisis 13
- F. Prudential Supervision in the 2000s 13

III. APPROACH TO SYSTEMIC RISK 14

IV. FEDERAL RESERVE REGULATION OF MORTGAGE ACTIVITY 16
- A. Home Ownership and Equity Protection Act (HOEPA) 16
- B. Fair Lending Regulation 19
- C. Expanded disclosure under HMDA 19
- D. Supervisory Actions related to Mortgage Lending 20

APPENDIX 1 23

The Role of the Federal Reserve in Banking Supervision and Regulation

The purpose of this preliminary staff report is to provide a brief overview of the role of the Federal Reserve in banking supervision and regulation. The first section describes the structure of the Federal Reserve and the extent of the Federal Reserve's supervisory role as it stood at the beginning of the financial crisis. Section II describes the history of banking supervision and regulation in the United States, with a focus on the deregulatory environment that prevailed in the 1990s and early 2000s. Section III describes the Federal Reserve's approach to systemic risk in the recent period. Section IV discusses Federal Reserve supervision of mortgage lending activity.

I. FEDERAL RESERVE STRUCTURE AND REGULATORY PURVIEW

The Federal Reserve has played an important role in supervising financial institutions since its creation in 1913.[1] The Federal Reserve has supervisory authority over state-chartered member banks and bank holding companies. In its supervisory capacity, the Fed is responsible for ensuring the safety and soundness of the firms it regulates, as well as compliance with consumer protection laws and regulations.

Table 1: Federal Banking Supervisors as of 12/31/2009

	Institutions Supervised	*Total assets ($ trillion)*
Holding companies		
Federal Reserve*	5,030	15.1
OTS	452	5.5
Banks/thrifts**		
OCC	1,565	8.3
FDIC*	5,116	2.3
Federal Reserve*	862	1.9
OTS	780	1.1

* Figures for FDIC and Fed are year-end 2008.
** OTS supervises both thrifts and their holding companies. The Fed supervises commercial bank holding companies, including those that own banks supervised by the OCC, FDIC, and Fed.
Source: OCC and OTS 2009 annual reports; Federal Reserve and FDIC 2008 annual reports; www.fdic.gov

The Federal Reserve supervises 5,030 bank holding companies (BHCs), which are companies that own commercial banks (Table 1). That figure includes the 602 BHCs (557 domestic, 45 foreign-owned) that have qualified and elected to become "financial holding companies" and are thereby eligible to engage in a wider range of activities, such as securities underwriting and dealing or merchant banking, than other bank holding companies.

The Federal Reserve is the primary federal supervisor for 862 "state member banks," which are commercial banks that are both chartered at the state level and are members of their

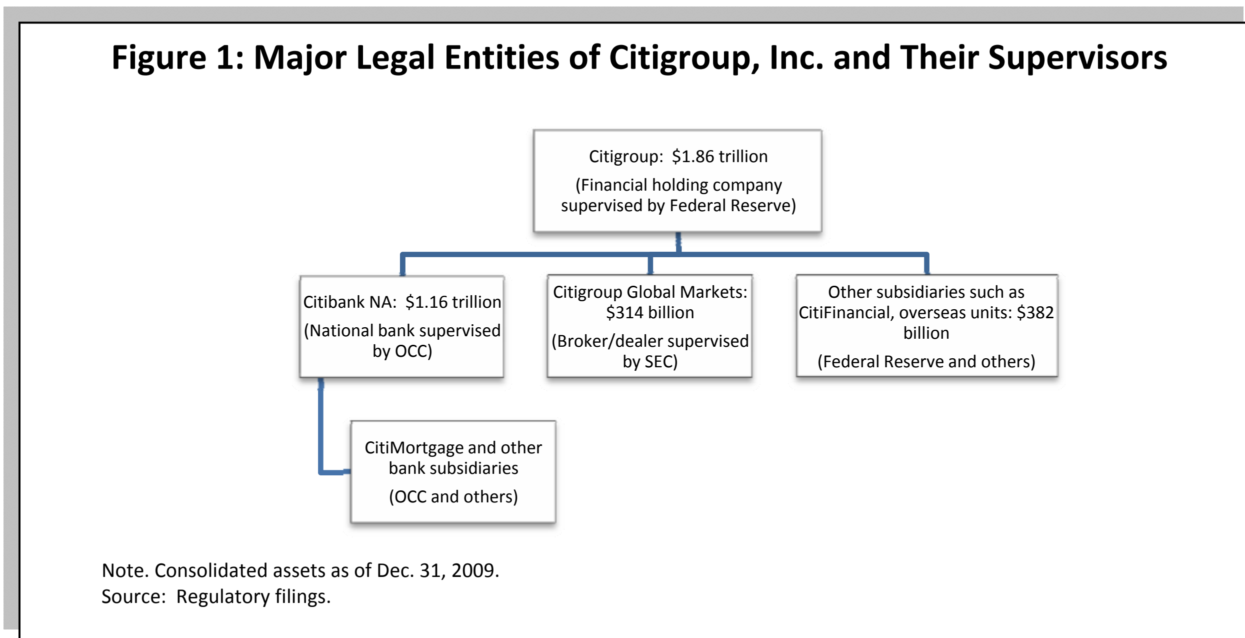
[1]The original act described its purpose as "to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." 12 USC Ch. 3.

regional Federal Reserve Bank. It also supervises the US operations of foreign banks with branches or other banking activities in the United States, as well as branches of foreign banks.[2]

Commercial banks in this country can pick their federal regulator. If they apply for a national bank charter, the Office of the Comptroller of the Currency (OCC) will supervise them. If they apply for a state banking charter, they will be supervised by their state banking supervisors and by either the Federal Reserve for banks choosing to be members of the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC) for non-members.

For commercial banks, the Federal Reserve is the supervisor of their holding company.[3] As a result, the Federal Reserve shares supervisory and regulatory responsibilities with the OCC and with state banking supervisors. Because the largest commercial banks owned by bank holding companies are national banks, the Federal Reserve and the OCC must work closely together to supervise these organizations.[4] For illustration, Figure 1 charts Citigroup's major legal entities and their supervisors; this chart is simplified, as Citigroup also has entities supervised by the Office of Thrift Supervision (OTS), state insurance regulators, and overseas banking, insurance, and securities authorities.

Figure 1: Major Legal Entities of Citigroup, Inc. and Their Supervisors



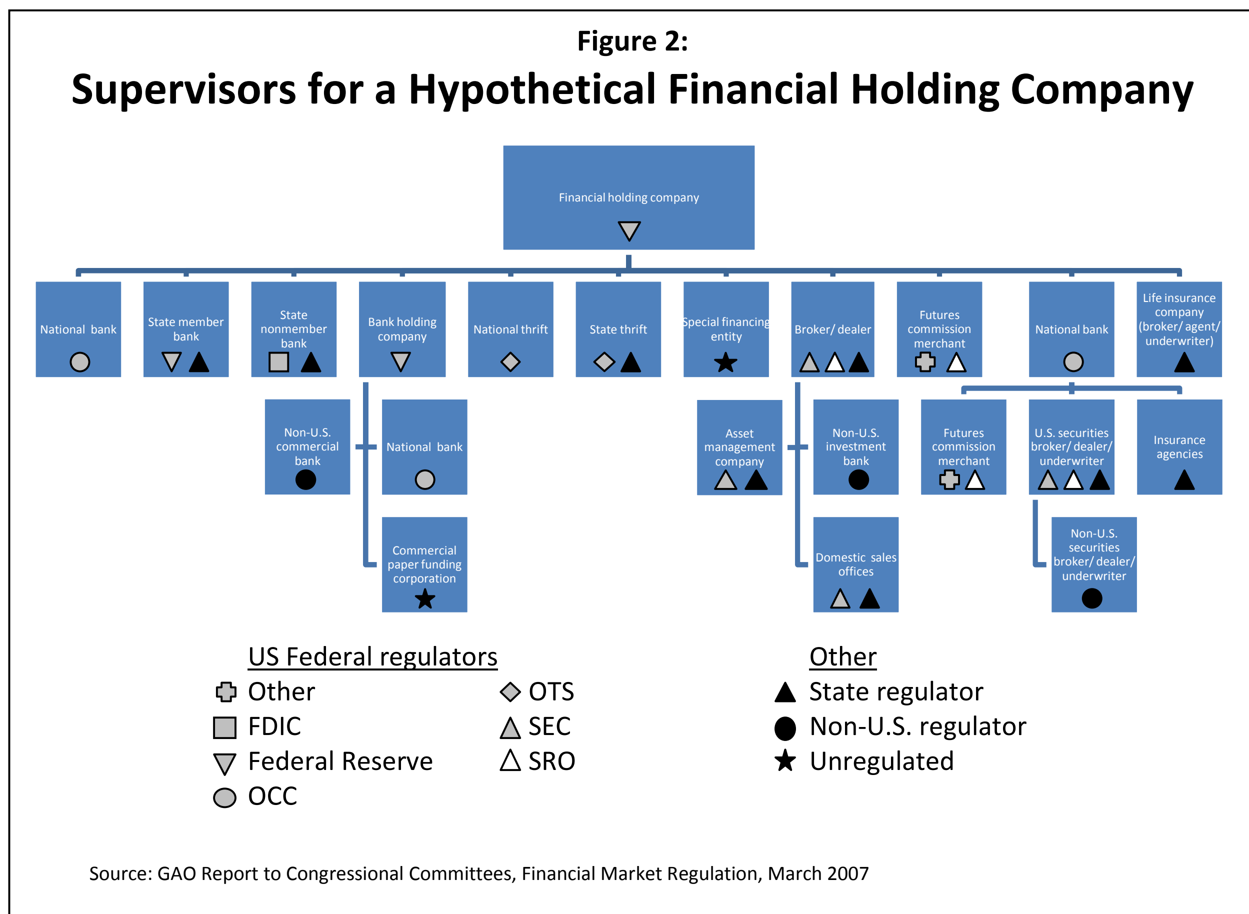
Note. Consolidated assets as of Dec. 31, 2009.
Source: Regulatory filings.

[2] In addition, the Federal Reserve is responsible for supervising overseas branches and investments of state member banks, Edge Act and agreement corporations, and bank holding companies. Edge Act and agreement corporations are chartered specifically to provide domestic corporations with a means to finance international business, especially exports.
[3] Industrial loan company holding companies, described in Section IID, are an exception.
[4] National banks are automatically Federal Reserve members.

The complexity of the supervisory system in the United States has been criticized because: (1) the diversity of chartering authorities creates opportunities for banks to shop for the most lenient regulator, and (2) the presence of more than one supervisor at an organization creates the potential for both gaps in coverage and unnecessary overlap. Others have argued that this complexity can be helpful: (1) two sets of eyes, particularly on the largest, most complex institutions, may make the surfacing of important issues more likely, and (2) the choice of charters allows supervisors to specialize in certain types of institutions. Figure 2 diagrams the various supervisory entities and relationships involved in regulating a hypothetical financial holding company.

Figure 2:

Supervisors for a Hypothetical Financial Holding Company



Source: GAO Report to Congressional Committees, Financial Market Regulation, March 2007

A. PRUDENTIAL SUPERVISION AND CONSUMER PROTECTION

The Federal Reserve, similar to other state and federal bank regulators, has a dual mandate in the supervision of financial institutions: it seeks to promote their safe and sound operation through so-called "prudential" supervision, and it seeks to ensure that they are in compliance with all relevant laws and regulations. These goals are broadly consistent.

Noncompliance with laws and regulation can threaten a firm's safety and soundness and can be an indicator of broader management weaknesses.

With respect to consumer protection laws, the two supervisory mandates tend to be closely aligned. Predatory lending – the practice of targeting under-served communities with products that they can't afford – is a supervisory concern from both a consumer protection and a prudential point of view. Supervisors also expect banks to have proper procedures and policies to detect fraud. More information on fraud in US mortgage markets is contained in Appendix 1. The Federal Reserve has also been tasked by Congress with the responsibility to write certain consumer protection regulations.

B. GUIDANCE AND RULES

Banking supervisors, including the Federal Reserve, have broad powers to set binding rules limiting financial activities of the institutions they regulate and to issue guidance describing the standards they will consider in supervising and evaluating those firms. Rules, for example, set standards on the amount of capital that institutions must hold to engage in certain activities. Examples of guidance issued prior to the financial crisis include statements describing how examiners would evaluate firms' exposures to commercial real estate lending and nontraditional mortgage products.

The federal banking supervisors seek to work together and with state supervisors to introduce consistent rules or guidance where possible, either through informal channels or through the Federal Financial Institutions Examination Council, which was established for that purpose. However, where they cannot reach agreement, supervisors can and have introduced guidance independently to their respective institutions.

The Federal Reserve also works with foreign supervisors to develop consistent standards. For example, the Federal Reserve played a key role in the international development of the first Basel capital standards in 1988 (Basel I) and in the revised Basel Capital Accord in 2004 (Basel II).

C. STRUCTURE OF THE FEDERAL RESERVE

The Federal Reserve System consists of the Federal Reserve Board of Governors and 12 regional Federal Reserve Banks. The Board of Governors is a federal agency located in Washington and consists of seven members, appointed by the President of the United States and confirmed by the United States Senate. The Federal Reserve sets monetary policy

through the Federal Open Market Committee, which consists of the seven Federal Reserve Governors and five Presidents of Federal Reserve Banks.[5]

While the Board is ultimately responsible for developing supervisory policy, it has delegated the function of implementing that policy to the 12 Reserve Banks. The Board's Division of Banking Supervision and Regulation, whose Director reports to the Board of Governors through a subcommittee, oversees the supervisory function at the Reserve Banks, develops guidance and rules that are issued by the Board, makes recommendations to the Board of Governors regarding specific actions that require decisions by the Board, and promotes resource-sharing and a sector-wide perspective in the conduct of supervision. There are approximately 250 staff in the Division of Banking Supervision and Regulation.

The Reserve Banks are not part of a government agency but are separately chartered corporations. They operate as the eyes and ears of the Federal Reserve System when it comes to supervising financial institutions. The examiners who actually inspect the records of bank holding companies and other Federal Reserve-supervised institutions are employed by the Reserve Banks. In 2005, there were roughly 2,500 people employed in the supervision departments at the 12 Reserve Banks.

II. A BRIEF HISTORY OF BANKING REGULATION

A. EVOLUTION OF THE GLASS-STEAGALL ACT

The relationship between commercial banking and investment banking has been uneasy throughout US banking history. The Glass-Steagall Act (part of the Banking Act of 1933) mandated the separation of commercial banking from investment banking in order to address stock market speculation, self-dealing (using clients' funds for personal gain), and other abuses. The original act, as amended in 1935, did not disturb the power of banks to underwrite US government securities and trade these securities for clients; it did, however, provide that a bank could not itself underwrite or deal in most other securities, for example,

[5] From www.federalreserve.gov: Each Federal Reserve Bank has a nine-member board of directors. The member banks elect the three Class A and three Class B directors, and the Board of Governors appoints the three directors in Class C. Class A directors of each Reserve Bank represent the member banks of the Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; Unlike Class A directors, Class B and Class C directors may not be officers, directors, or employees of any bank. The president of each Reserve Bank is selected and can be removed by its Board of Directors. Directors of Reserve Banks do not make decisions involving the supervision and examination of financial institutions. Reserve Bank presidents do make supervisory decisions, typically relying on their officers in charge of supervision.

commercial paper, equity securities, or municipal revenue bonds, or be affiliated with a company "principally engaged" in such activities.

Banks faced increasing competitive pressures in the 1980s from bank-like activities offered by money market mutual funds, the commercial paper market, finance companies, and credit unions, for example. At the same time, the securities market, led by investment banks, took over an increasing portion of the country's financial intermediation activities through the expansion of corporate debt and equity markets and through burgeoning new markets such as non-agency mortgage securitizations.[6]

Bank regulators, supported by court decisions, responded by gradually expanding the scope of activities available to banks and their affiliates. In 1982, the FDIC determined that Glass-Steagall did not apply to affiliates of FDIC-supervised banks.[7] Beginning in 1987, the Federal Reserve found that the Glass-Steagall Act allowed bank holding companies to establish securities subsidiaries to underwrite and deal in mortgage-backed securities, commercial paper, and municipal revenue bonds. At first, the Federal Reserve set a 5 percent limit on the portion of the subsidiary's total revenue that could come from such activities; it increased that limit to 10 percent in 1989 and 25 percent in 1997. The Federal Reserve attached limitations on transactions between the bank and other BHC affiliates in order to protect the bank (whose depositors were federally insured) from risks posed by these new activities and to prevent conflicts of interest from arising by virtue of the two different activities. The courts found these interpretations to be consistent with the Glass-Steagall Act.

During the same period, the OCC similarly expanded the eligible activities of national banks. In 1990, the US Court of Appeals for the Second Circuit held that mortgage securitization activities are within the "business of banking," a decision that paved the way for national banks to underwrite non-agency mortgage-backed securities. In 1995, the US Supreme Court upheld the OCC's determination that the definition of the "business of banking" necessarily includes some securities activities, and left it to the OCC to determine which activities are within that definition.[8] In response, the OCC took the position that operating subsidiaries of banks were not necessarily limited to activities permissible for a national bank; on that basis, it approved, on a case-by-case basis, operating subsidiaries of banks to

---

[6] Non-agency mortgage securitizations are, in contrast to agency mortgage securitizations, not guaranteed by Fannie Mae, Freddie Mac, or the Federal Housing Administration.

[7] FDIC, *Statement of Policy on the Applicability of the Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Nonmember Banks*, August 23, 1982: "It is the opinion of the Board of Directors of the FDIC that the Banking Act of 1933, popularly known as the Glass-Steagall Act and codified in various sections of title 12 of the United States Code, does not, by its terms, prohibit an insured nonmember bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities."

[8] *Securities Industry Association v. Clarke*, 885 F.2d 1034 (2d. Cir.), cert. denied, 493 U.S. 1070 (1990) and *Nationsbank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 2051 (1995).

engage in new activities such as underwriting corporate bonds and municipal revenue bonds.[9]

As a result of these changes, the distinction between the activities that could be conducted in the subsidiary of a bank and those that could be conducted in the subsidiary of a holding company was blurred before the Gramm-Leach-Bliley Act, which is discussed below. Critics have noted that the ability to engage in a particular activity through different types of entities creates the potential for a form of regulatory arbitrage, meaning that firms that are holding companies and have banks with subsidiaries can choose where to put certain activities or assets based on the expected regulatory and supervisory treatment.

B. THE 1999 GRAMM-LEACH-BLILEY ACT

Years of discussion and gradual expansion of banking activities culminated in the passage of the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act, or GLBA.[10] The act repealed the limitations on affiliations contained in the Glass-Steagall Act. It also confirmed the Federal Reserve as the consolidated supervisor of bank holding companies (BHCs) and introduced the concept of financial holding companies (FHCs). Bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in a wider range of financial activities than they could otherwise, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales.

The Act also introduced limitations often referred to as "Fed-Lite." These provisions limit the Federal Reserve's authority to examine, impose capital requirements on, or obtain reports from the subsidiaries of FHCs that are regulated by the Securities and Exchange Commission or the state insurance regulators, collectively known as the "functional regulators." The act also requires the Federal Reserve to rely "to the fullest extent possible" on the examinations and reports of other bank regulators for the depository institution subsidiaries of a BHC or FHC. To fulfill its responsibilities as consolidated supervisor subject to that constraint, the Federal Reserve has worked out information-sharing agreements with the other regulators; furthermore, in the supervision of large institutions, examiners from the Federal Reserve and other federal and state bank regulators often work together when examinations cross legal-entity lines.

The justification for Fed-Lite was to reduce regulatory burden on holding companies and their newly broadened group of affiliates and to focus the Federal Reserve's bank holding company supervision on protecting the safety and soundness of the depository institution subsidiaries; thus, under GLBA, the Federal Reserve was expected to focus on whether the

[9] OCC Conditional Approval #331, November 1999.
[10] Public Law 106-102.

activities of nonbank subsidiaries threatened the safety and soundness of depository subsidiaries.[11]

Following GLBA, the largest bank holding companies, including Citigroup, Bank of America, and JP Morgan Chase, became financial holding companies as defined by GLBA.[12] Each of these firms developed large and active securities underwriting affiliates that competed with established investment banks. However, contrary to the expectations of many observers, GLBA did not result in a significant change in the business models of the large investment banks. Four years later, Federal Reserve Vice Chairman Roger Ferguson noted "the slow pace of change since 1999… I suggest that the financial conglomerate, or the financial supermarket, or whatever you want to call it, is in fact much more difficult to implement than many may have thought. True, there were about 600 domestic FHCs of the end of 2002. But less than one-third reported actually engaging in any new activities authorized by Gramm-Leach-Bliley."[13]

C. FEDERAL RESERVE'S CONSOLIDATED SUPERVISION UNDER GLBA

While GLBA reinforced the leading role of the Federal Reserve as the consolidated supervisor of bank holding companies, the Federal Reserve was still expected to rely to the fullest extent possible on the work of subsidiaries' supervisors to facilitate its understanding of banking and other regulated subsidiaries. GLBA does provide that the Federal Reserve may request information or examine such subsidiaries without going through their supervisors, under certain circumstances.[14] The GLBA imposed limits on the authority of the Federal Reserve to examine nonbank subsidiaries of bank holding companies for compliance with laws, authorizing the Federal Reserve to examine for compliance only with laws the Federal Reserve has specific jurisdiction to enforce against the company being examined.

[11] In implementing Fed-Lite, GLBA was meant to clarify how supervision should work in increasingly complex institutions. Federal Reserve Governor Laurence Meyer said at the time: "[T]he new regulatory and supervisory regime is hardly a revolution. It's more of an evolution, following naturally from the changes expected in the financial services industry. The Congress, in effect, decided to maintain the current supervisory structure for consolidated financial institutions that include a bank. But the Congress also made clear that it wanted the Federal Reserve to respect the authority of functional regulators and not impose a separate supervisory framework that involved excessive duplication or burden." Meyer, *The Implications of Financial Modernization Legislation for Bank Supervision*, December 15, 1999.

[12] These firms continued to be supervised on a consolidated basis by the Federal Reserve. Under GLBA, the Federal Reserve continues to supervise BHCs and determines whether firms are eligible for FHC status.

[13] Ferguson, *The Future of Financial Services—Revisited*, October 8, 2003.

[14] Those circumstances are: "[O]nly if the Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution; the Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of the [subsidiary's risk management] systems," or the Board "has reasonable cause to believe that a subsidiary is not in compliance with… any Federal law that the Board has specific jurisdiction to enforce." Public Law 106-102.

During the 2000s, the Federal Reserve approach to "Fed-Lite" supervision of nonbank subsidiaries evolved. For example, in 2004, the Federal Reserve issued a Cease and Desist Order and levied a $70 million civil money penalty against Citigroup Inc. in conjunction with the subprime lending program of CitiFinancial Credit Company, a nonbank affiliate. The order alleged violations of various consumer protection regulations and unsafe and unsound underwriting and lending practices in connection with subprime loans. The Federal Reserve conducted this review as part of its process of reviewing the proposal by Citigroup to acquire Associates Financial (the predecessor of CitiFinancial).

On October 16, 2008, in the midst of the crisis, the Federal Reserve issued guidance describing an "enhanced" approach to the consolidated supervision of bank holding companies. The approach emphasized the importance of financial firms having strong corporate governance, capital adequacy, and funding/liquidity management. It also noted that the Federal Reserve would take a more aggressive approach to the supervision of material nonbank subsidiaries of bank holding companies.[15]

Since the crisis, the Federal Reserve has emphasized weaknesses in the GLBA framework. Chairman Ben Bernanke recently observed that, "under the Gramm-Leach-Bliley Act of 1999, the Federal Reserve's consolidated supervision of bank holding companies was both narrowly focused on the safety and soundness of their bank subsidiaries and heavily reliant on functional supervisors of the bank and regulated nonbank subsidiaries of these companies."[16]

D. CHOICE OF CHARTER

GLBA did not stop charter-shopping by financial institutions. Financial institutions could choose the industrial loan company (ILC) or thrift charter, allowing them to take deposits and benefit from federal deposit insurance while avoiding supervision at the holding company level by the Federal Reserve.

Table 2: Largest ILCs as of 12/31/2007

	Assets ($bn)	*Rank**
Merrill Lynch Bank USA	78.1	2
Morgan Stanley Bank	35.1	4
Discover Bank	30.7	5
GMAC Bank	28.4	6
American Express Centurion Bank	26.0	7
UBS Bank USA	25.0	8
Goldman Sachs Bank USA	19.1	9

* Rank by assets among commercial banks supervised by the FDIC.
Source: FDIC

First, several states allow depository institutions to organize as "industrial loan companies" or ILCs. While ILCs are supervised by their state bank

[15] Federal Reserve Board, *SR 08-9/CA 08-12: Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*, October 16, 2008.
[16] Bernanke, *The Federal Reserve's role in bank supervision, Before the Committee on Financial Services, U.S. House of Representatives,* March 17, 2010, footnote 5.

regulator and by the FDIC, ILCs can be owned by financial or nonfinancial firms that are not supervised or regulated on a consolidated basis by the Federal Reserve.[17] Prior to the crisis, large institutions with ILCs included financial firms such as Merrill Lynch, Morgan Stanley, and Discover Financial Services, and nonfinancial firms such as General Motors and Target (see Table 2). These companies used their ILCs for access to the payments system or to provide limited deposit services to their customers. Since the financial crisis, most of the largest ILCs have converted to regular bank charters (including those owned by Morgan Stanley, Discover, GMAC, American Express, and Goldman Sachs) and are now being supervised by the Federal Reserve on a consolidated basis.

Second, large financial institutions may acquire thrifts, formerly known as savings and loans, whose main purpose originally was to extend residential mortgages. The OTS supervises thrifts and their holding companies on a consolidated basis. Major financial institutions that owned subsidiaries with thrift charters prior to the crisis included AIG, GE Capital, Merrill Lynch, Lehman Brothers, and Morgan Stanley.

In 2004, the European Union required that foreign financial institutions operating in Europe either be subject to consolidated supervision in their home country or establish a Europe-based holding company. The SEC responded by creating the Consolidated Supervised Entity (CSE) program, which introduced a new option under which investment banks could be supervised on a consolidated basis. The five major investment banks could then pick from among the Federal Reserve (by setting up a national bank or state member bank and becoming a BHC), the OTS (by setting up a thrift), or the SEC. All five chose to be supervised by the SEC under the new program, although some also continued to be supervised by the OTS because they owned a thrift. The CSE program was discontinued in 2008 after all five of the large investment banks that were not controlled by a BHC had closed, merged into other entities, or converted to FHCs to be supervised by the Federal Reserve.

The Federal Reserve has argued that the availability of the thrift and ILC charters for depository institutions allowed substantial financial activities to go unregulated or under-regulated during the 2000s. Chairman Bernanke recently said that the "lack of strong

[17] There is regulatory precedent for the FDIC's Board of Directors entering into and employing Parent Company Agreements and Capital and Liquidity Maintenance Agreements to require a parent company of an industrial loan company to, among other provisions, (1) consent to supervision, (2) disclose the nature of activities and operations, (3) serve as a source of strength for the insured institution, and (4) maintain the insured entity's capital at such levels as the FDIC deems appropriate, and/or take such other actions as the FDIC deems appropriate to provide the insured entity with a resource for additional capital and liquidity. In examining any insured depository institution, the FDIC has the authority (under Section 10(b) of the FDI Act) to examine any affiliate of the institution, including the parent company, for purposes of determining (i) the relationship between the ILC and its parent and (ii) the effect of such a relationship on the ILC. See 12 U.S.C. Sec. 1820(b).

consolidated supervision of systemically critical firms not organized as bank holding companies proved to be the most serious regulatory gap" prior to the crisis.[18]

E. NONBANK SUBSIDIARIES DURING THE FINANCIAL CRISIS

During the financial crisis, several of the largest financial institutions posted significant losses or brought onto their balance sheet substantial assets arising out of their nontraditional banking activities. Some of these activities had been focused within the legal structure of the depository institution, which in most cases was supervised by the OCC, while others had been focused outside the depository institution, which was supervised by the SEC (for broker-dealer affiliates) or the Federal Reserve (for most other holding company subsidiaries).

Depository institutions and their holding companies provided extraordinary support to nonbank subsidiaries and off-balance sheet vehicles during the financial crisis. In 2007, Citigroup and Wachovia purchased assets from their Structured Investment Vehicles, which they had no contractual obligation to do. In early 2008, Wachovia and others purchased assets from their Auction Rate Securities (ARS) programs, following investor lawsuits. Later in 2008, Bank of America, US Bancorp, Bank of New York, SunTrust, Northern Trust, and Wachovia provided support to affiliated money market mutual funds by purchasing underlying assets to assist the funds in meeting redemption requests. To the extent that the support to ARS programs and mutual funds was provided by the bank subsidiaries of the relevant firm, it required Federal Reserve approval under Section 23A of the Federal Reserve Act, which governs transactions between depository subsidiaries and other holding company affiliates regardless of which agency regulates the institutions.

F. PRUDENTIAL SUPERVISION IN THE 2000s

Due to the growing complexity of large financial institutions in the 1990s, supervisors reconsidered the traditional examination process, which had been based on periodic examinations to evaluate the safety and soundness of financial institutions at a point in time. In the 1990s, the Federal Reserve, OCC, and other federal banking agencies introduced the "risk-focused" approach which "focuses more effectively on an organization's principal risks and on its internal systems and processes for managing and controlling these risks."[19] This approach relies extensively on banks' internal risk-management systems. Chairman Greenspan said in 1999: "As internal systems improve, the basic thrust of the examination process should shift from largely duplicating many activities already conducted within the

[18] Bernanke, ibid.
[19] Federal Reserve Board, *SR 97-24: Risk-Focused Framework for Supervision of Large Complex Institutions*, October 27, 1997.

bank to providing constructive feedback that the bank can use to enhance further the quality of its risk-management systems."[20]

In 2005, the Federal Reserve reformed the rating system that examiners use for rating bank holding companies based on the risk-focused approach. Bank holding companies are rated by supervisors on a 5-point scale based on the quality of risk management, their financial condition, and the potential impact that nonbank subsidiaries could have on the depository subsidiary.

During the 2000s, the Federal Reserve also took an increasingly comparative approach to the supervision of large financial institutions. Supervisors conducted more cross-company or "horizontal" reviews of specific business lines and risk management processes, to become familiar with industry practices and to identify best practices. For example, horizontal reviews were conducted on financial institutions' prime brokerage operations; use of derivatives in portfolio management; and stress-testing of capital adequacy.

III. APPROACH TO SYSTEMIC RISK

Promoting financial stability is central to the Federal Reserve's mission. During the 1990s and 2000s, the focus of financial stability concerns shifted in response to major events.

Following the 2001 terrorist attacks, banking supervisors intensified efforts to ensure that banks had sufficient business continuity plans in place, measured, for example, by the establishment of remote data backup facilities. In 2003, the Federal Reserve, SEC, and OCC issued an interagency paper providing guidance on business continuity planning and disaster recovery which focused on companies, particularly those involved in clearing and settlement activities, that could pose risks to the financial system during a crisis.[21]

Following the Enron and other accounting scandals in 2002, supervisory focus increased on compliance risk management. In 2003, the SEC disciplined Citigroup and JP Morgan Chase for their roles in facilitating Enron's manipulations of its financial statements, and the two companies entered into formal enforcement actions with the Federal Reserve under which they committed to overhaul their approach to risk management in the structured products business.[22] In 2007, the federal banking agencies and the SEC issued a final statement

---

[20] Greenspan, *The evolution of bank supervision*, October 11, 1999.
[21] Federal agencies, *Sound Practices to Strengthen the Resilience of the U.S. Financial System*, April 8, 2003.
[22] SEC, *SEC Settles Enforcement Proceedings against J.P. Morgan Chase and Citigroup,* July 28, 2003; Federal Reserve Board, *Written agreement with Citigroup, Inc.*, July 28, 2003, and *Written agreement with J.P. Morgan Chase & Co.*, July 28, 2003.

describing risk-management expectations for firms engaged in complex structured finance activities.[23]

In the early 2000s, Chairman Greenspan expressed increasing concerns about the systemic risks posed by government-sponsored enterprises (GSEs). "As always, concerns about systemic risk are appropriately focused on large, highly leveraged financial institutions such as the GSEs that play substantial roles in the functioning of financial markets." Greenspan advocated stronger regulatory authority for the GSEs' regulator, then the Office of Federal Housing Enterprise Oversight, and limits on the size of the GSE's balance sheets.

The 1990s and 2000s were also a period of rapid change in the financial sector. The Federal Reserve generally took a benign view of that change, arguing that the growing use of derivatives and the securitization process would better distribute risks across financial institutions. On derivatives, Chairman Alan Greenspan said in a 1999 speech, "These instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it."[24]

The Federal Reserve also drew attention to the novel risks posed by these developments, both publicly and in its communication with supervised institutions. Greenspan noted potential systemic risks posed by derivatives: (1) they may facilitate the growth in leveraged trading strategies, and (2) they may heighten exposures to counterparty credit risk. Nonetheless, his conclusion in that same 1999 speech was that OTC markets "function quite effectively" without regulation.[25]

Similarly, the Federal Reserve took a neutral stance over the years as the capital markets increasingly took over banks' traditional role in credit intermediation. In a 2004 speech, Vice Chairman Roger Ferguson noted that commercial banks were recording record profits, partly due to their leading role in capital markets: "Indeed, banks' development of sophisticated risk-management techniques helped to fuel the growth of new financial instruments. More generally, by providing lines of credit and assuming other off-balance-sheet exposures, banks support the advancement and ongoing operation of financial markets and lower the costs of market-based finance for many market participants."[26]

Securitization in particular was seen by the Federal Reserve as beneficial because it allowed investors direct access to assets, such as home loan mortgages, which had not been available

---

[23] Federal agencies, *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities,* January 5, 2007.
[24] Greenspan, *Financial Derivatives*, March 19, 1999.
[25] Greenspan said a year later: "What I suspect gives particular comfort to those of us most involved with the heightened complexity of modern finance is the impressive role private market discipline plays in these markets." *Banking evolution*, May 4, 2000.
[26] Ferguson, *The Role of Central Banks in Fostering Efficiency and Stability in the Global Financial System*, May 17, 2004.

for investment before, and because it had the potential to reduce costs to borrowers. In 2004, Chairman Greenspan said:

> Credit supply is far more stable today than it was because it is now founded on a much broader base of potential sources of funds. The aspiring homeowner no longer depends on the willingness of the local commercial bank or savings and loan association to hold his or her mortgage. Similarly, the sources of credit available to purchasers of cars and users of credit cards have expanded widely beyond local credit institutions. Unbeknownst to such borrowers, their loans may ultimately be held by a pension fund, an insurance company, a university endowment, or another investor far removed from the local area.[27]

The Federal Reserve did highlight the potential systemic risks of an emerging financial system that was increasingly dominated by financial markets rather than commercial banks. In a 2004 speech, Federal Reserve Bank of New York President Timothy Geithner noted that these changes had the potential to create "a more competitive and more innovative financial system, one that is more flexible and resilient," but also that there were serious systemic concerns and that "we do not know a lot about the underlying dynamics of financial crises in the context of the evolving financial system."[28]

IV. FEDERAL RESERVE REGULATION OF MORTGAGE ACTIVITY

A. HOME OWNERSHIP AND EQUITY PROTECTION ACT (HOEPA)

Congress passed the Truth In Lending Act (TILA) of 1968 to protect consumers in connection with mortgage and other lending products. The Federal Reserve wrote Regulation Z in 1969 to implement TILA. Regulation Z applies to all lenders but is enforced by the Federal Reserve only for state member banks and their subsidiaries. Other regulators implement Regulation Z for institutions within their regulatory purview.[29]

In 1994, Congress enacted the Home Ownership and Equity Protection Act (HOEPA), which amended the Truth In Lending Act. HOEPA was passed in response to evidence of abusive lending practices in mortgage refinancing. In particular, Congress was concerned that certain communities were "being victimized … by second mortgage lenders, home

[27] Greenspan, *Government-sponsored enterprises*, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 24, 2004.
[28] Geithner, *Changes in the Structure of the U.S. Financial System and Implications for Systemic Risk,* October 1, 2004.
[29] Appendix I of Regulation Z describes which federal agency supervises particular classes of businesses.

improvement contractors, and finance companies who peddle high-rate, high-fee home equity loans to cash-poor homeowners."[30]

HOEPA originally defined a category of loans with high interest rates or high up-front fees. Specifically, "HOEPA loans" were non-purchase, non-construction, closed-end loans with an interest rate exceeding the rate on comparable maturity Treasury securities by more than 10 percentage points or loans with incurred points and fees in excess of the greater of $400 or 8 percent of the total loan amount. For these loans, the statute mandated special disclosures three days before consummation of the transaction; prohibited terms such as excessive balloon payments, negative amortization, prepayment penalties, and the extension of credit without consideration of the borrowers' ability to repay; and provided for civil liability for failure to comply with these requirements.[31]

According to the Senate Committee report accompanying the legislation, the Committee was concerned that "the prohibitions are an imprecise tool of policy," and that some of the provisions might affect products that on net are beneficial to borrowers.[32] For this reason, the statute also states that the Federal Reserve Board "may" exempt certain products from the statute's prohibitions. It also states that Board "shall prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair, deceptive or designed to evade the provisions of the [act]." Quoting from the report,

> "[T]he Committee also realizes that new products and practices may emerge that facilitate reverse redlining.[33] For this reason, the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section. It is the Committee's intention that the Federal Reserve will examine complaints and utilize this legislation to provide adequate protections for consumers under Truth in Lending."[34]

2001 REVISIONS TO REGULATION Z UNDER HOEPA

Following a series of hearings in 2000, the Federal Reserve Board expanded the protections under Federal Reserve Regulation Z, which implemented the Home Ownership and Equity Protection Act (HOEPA). Specifically, it lowered the interest rate trigger for first-lien loans from 10 percentage points above the comparable maturity treasury rate to 8 percentage points; included the costs of optional credit insurance products when computing the fee

[30] S. REP. NO. 103-69, at 22-23 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1993.
[31] Home Ownership Act of 1994, codified in 15 USC 1639.
[32] S. REP. NO. 103-69, at 22-23 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1993.
[33] "Redlining" refers to the illegal discriminatory practice of refusing to extend credit to certain borrowers, for example based on race or ethnicity. "Reverse redlining" is another term for "predatory lending."
[34] S. REP. NO. 103-69, at 22-23 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1993

trigger; and, prohibited certain acts such as repeated refinancing for HOEPA loans and structuring a mortgage as open ended credit simply to evade HOEPA.[35]

At the time, Federal Reserve economists collected data that suggested the revised regulation would substantially expand the scope of Regulation Z by increasing the percent of subprime first-lien loans covered by HOEPA from 9 percent to 26 percent. The inclusion of the credit insurance product in the fee trigger would expand the percentage of subprime first-lien loans covered by HOEPA subprime loans to 38 percent.[36]

In discussing the new prohibitions, the Board stated that:

> "[HOEPA] provides that the Board shall prohibit practices: (1) In connection with *all mortgage loans* if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and (2) in connection with *refinancings of mortgage loans* if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower."[italics in original]

It further explained its reasoning, stating that:

> "The final rule is intended to curb unfair or abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions."

The Board issued the new rules prohibiting repeated refinancing and the restructuring of loans to avoid HOEPA under the first of the clauses above, which covers all mortgage loans. The revision in the regulation had a much smaller effect than the Federal Reserve's projections. In the end, only about 1 percent of subprime loans were covered by HOEPA; the difference was likely due in part to lenders' changing of mortgage terms in response to the revision in the regulation.[37]

2008 REVISIONS TO REGULATION Z UNDER HOEPA

The Fed did not promulgate any other regulations to prohibit mortgage lending practices it deemed to be unfair or deceptive (including with respect to subprime home purchase mortgages) until July 2008.[38] The rule promulgated in July 2008 created a new definition of "higher-priced mortgage loans," intended to include virtually all subprime mortgage loans.

---

[35] "Truth in Lending," Board of Governors of the Federal Reserve, 66 Federal Register 245 (20 Dec 2001), pp. 65604.
[36] "Truth in Lending," Board of Governors of the Federal Reserve, 66 Federal Register 245 (20 Dec 2001), pp. 65608.
[37] Gramlich, 2007.
[38] "Truth in Lending," Board of Governors of the Federal Reserve, 73 Federal Register 147 (30 Jul 2007), pp. 44522-44614.

For these loans, both purchase loans and refinance loans, the regulation adds four key protections: it prohibits a lender from making a loan without regard to a borrower's ability to repay; it requires creditors to verify the income and assets they rely upon to determine a borrower's ability to repay; it bans any prepayment penalty if the payment can change in the initial four years; and it requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.[39]

B. FAIR LENDING REGULATION

The Equal Credit Opportunity Act (ECOA) prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or because an applicant receives income from a public assistance program or exercises rights protected under the Consumer Credit Protection Act.[40] Regulation B, issued by the Federal Reserve Board, provides the framework for fair lending enforcement under ECOA. Depending on the type of lending institution, various federal agencies are charged with monitoring compliance with ECOA. These agencies include bank regulators such as the Federal Reserve Banks, the OCC and the OTS as well as agencies that do not have regular bank surveillance duties such as the FTC. Should a pattern or practice of discrimination which violates ECOA be found, ECOA requires these agencies to refer matters to the Justice Department.

As the subprime market grew during the 2000s, many industry observers grew concerned about potential abuses and expressed concerns about fair lending violations. For example, industry observers noted evidence suggesting that minority populations were much more likely to obtain subprime mortgages than non-minorities.

C. EXPANDED DISCLOSURE UNDER HMDA

Under the Home Mortgage Disclosure Act (HMDA), and the regulations issued by the Federal Reserve, most mortgage lenders in metropolitan areas are required to collect data about

---

[39] For higher-priced loans and most other mortgage loans, the new rules prohibit lenders from paying mortgage brokers “yield spread premiums” that exceed the amount the consumer had agreed to in advance; the rules prohibit certain servicing practices, such as failing to credit a payment to a consumer’s account when the servicer receives it, failing to provide a payoff statement within a reasonable period of time, and “pyramiding” late fees; the rules prohibit a creditor or broker from coercing or encouraging an appraiser to misrepresent the value of a home; and the rules prohibit seven misleading or deceptive advertising practices for closed-end loans, e.g. using the term “fixed” to describe a rate that is not truly fixed. It also requires that all applicable rates or payments be disclosed in advertisements as prominently as introductory or “teaser” rates.

[40] 15 U.S.C. 1691 et seq. A second act also governs fair lending. The Fair Housing Act, 42 USC 3601 et seq., prohibits discrimination in home mortgage loans, home improvement loans, and other residential credit transactions, on the basis of race, color, religion, national origin, sex, familial status or disability. The Department of Housing and Urban Development has issued regulations under the Fair Housing Act, including regulations addressing fair lending issues. 24 C.F.R. Part 100, Subpart C.

their housing-related lending activity, report the data annually, and make the data publicly available. In 2002, the Board made three changes to the HMDA rules motivated by the increases in subprime lending.[41] The Board added a requirement to report loan price information for certain higher priced loans, extended reporting responsibilities for independent state-regulated mortgage companies, and required that all HOEPA loans be flagged in HMDA reports.

D. SUPERVISORY ACTIONS RELATED TO MORTGAGE LENDING

Several supervisory actions taken by the Federal Reserve that are related to mortgage lending, both for safety and soundness and consumer protection reasons, are described below. A number of these actions are issuing guidance, which describes the standards that will be considered in supervision and evaluation of supervised firms. Issuing guidance is less restrictive than issuing rules, which set binding limits on financial activities of the supervised and other regulated institutions.

- In January 1998, formalizing a policy not to conduct routine consumer compliance examinations of nonbank subsidiaries of bank holding companies. Describing the change, the Board stated, "On January 12, 1998, the Board adopted a policy that the Federal Reserve will (1) not routinely conduct consumer compliance examinations of nonbank subsidiaries of bank holding companies, and (2) not investigate consumer complaints relating to these subsidiaries. This action formalizes a policy regarding examinations that has been System practice all along."[42]

- In March 1999, issuing Interagency Guidance on Subprime Lending with the other federal bank regulators. Noting that many banks had "experienced losses attributable to ill-advised or poorly structured subprime lending programs," the guidance emphasized that institutions should hold greater capital against subprime loans and described "essential components" of a sound risk-management program for subprime lending. The guidance also noted the liquidity risks in securitizing mortgage loans, as "investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile."[43]

- In January 2001, issuing Expanded Guidance for Subprime Lending Programs with the other federal bank regulators. This guidance provided for intensified supervisory scrutiny of companies whose subprime lending programs exceeded 25 percent of tier 1 capital. In particular, the guidance introduced the expectation that institutions

[41] Testimony by Sandra Braunstein, Director Division of Consumer and Community Affairs, March 27, 2007.
[42] Board of Governors of the Federal Reserve System, Division of Consumer and Community Affairs, Letter CA 98-1, dated January 20, 1998.
[43] Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, Interagency Guidance on Subprime Lending, March 1, 1999.

should hold capital against subprime loans portfolios "in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type." The guidance also warned, "When a primary supervisor determines that an institution's risk management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime lending programs."[44]

- In March 2004, issuing Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks with the FDIC. This guidance described steps that state-chartered banks should take to avoid engaging in unfair or deceptive acts or practices. [45] The guidance mirrored guidance that the OCC had articulated two years earlier in its supervision of nationally-chartered banks.[46]

- In September 2006, issuing Interagency Guidance on Nontraditional Mortgage Product Risks with the other federal bank regulators. The guidance focused on nontraditional mortgages such as "interest-only" and "payment option" adjustable-rate mortgages, which allow borrowers to defer payment of principal and, sometimes, interest. The guidance described acceptable risk-management practices for financial institutions issuing such mortgages, as well as certain consumer protection issues.[47]

- In June 2007, issuing an Interagency Statement on Subprime Mortgage Lending with the other federal bank regulators. The statement built on the September 2006 guidance to focus specifically on subprime borrowers and on so-called "payment shock" loans, which start with low fixed interest rates and then, usually after two years, adjust to a higher variable rate for the remaining life of the loan. The statement emphasized that lenders should verify a borrower's ability to repay the loan at the higher interest rate.[48]

---

[44] Expanded Guidance for Subprime Lending Programs, dated January 31, 2001, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.
[45] Unfair or Deceptive Acts or Practices by State-Chartered Banks, dated March 11, 2004, issued by the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.
[46] Office of the Comptroller, *Advisory Letter 2002-3, Guidance on Unfair or Deceptive Acts or Practices*, March 2002.
[47] Interagency Guidance on Nontraditional Mortgage Product Risks, dated September 29, 2006, issued by Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve system, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration
[48] Statement on Subprime Mortgage Lending, dated June 28, 2007, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve system, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

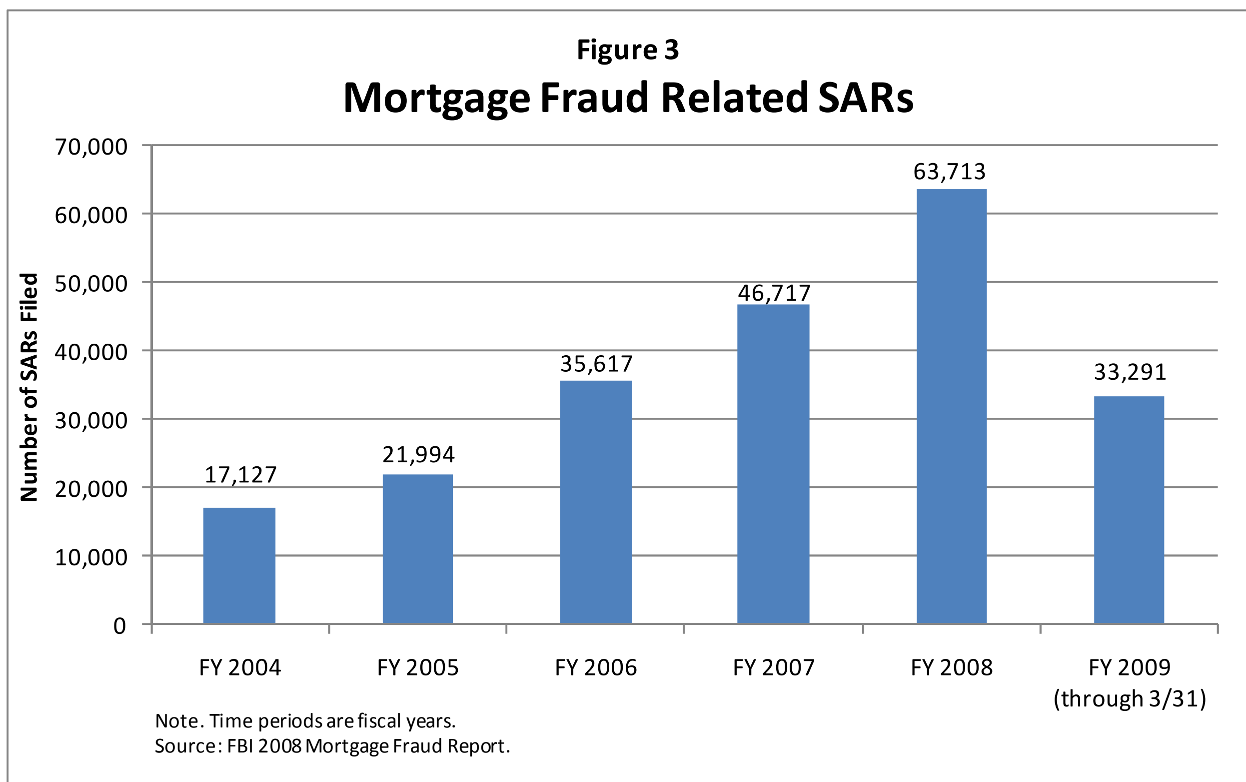
- In September 2009, following a two-year pilot project, the Federal Reserve announced that it would extend its regulatory oversight of bank holding companies for consumer compliance to include the supervision of nonbank subsidiaries such as subprime mortgage lenders. The pilot project involved the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators.[49]

[49] Board of Governors of the Federal Reserve System, Division of Consumer and Community Affairs, Letter CA 09-8, dated September 15, 2009. Also, see "Federal and State Agencies Announce Pilot Project to Improve Supervision of Subprime Mortgage Lenders," dated July 17, 2007, press release issued by the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Trade Commission, the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators.

APPENDIX 1

Mortgage fraud can roughly be defined as a material misrepresentation in the mortgage loan document(s) or orally in order to induce a lender to make a loan he or she might not otherwise make. *Fraud for housing* is perpetrated in an effort to live in the residence. In contrast, *fraud for profit* is just that, a scheme aimed to extract money in the transaction. Mortgage fraud is distinct from predatory lending: while mortgage fraud primarily harms lenders, or purchasers of the loans, predatory lending generally refers to practices that primarily harm borrowers.

As the subprime mortgage market grew, reports of mortgage fraud also increased. However, robust statistics on the number of fraud cases and the associated losses are not readily available. In its 2008 Mortgage Fraud Report, the FBI documents a steady increase in the number of Suspicious Activity Reports (SARs) reporting mortgage fraud. SARs are filed when a financial institution knows or suspects that a transaction facilitates illegal activity. As shown in figure 3, fiscal year 2008 shows a nearly-fourfold increase in reported mortgage-related SARs over fiscal year 2004.[50]



[50] FBI, 2009.

REFERENCES

Federal Bureau of Investigation, 2009, *2008 Mortgage Fraud Report.*

Gramlich, Edward M., 2007, *Subprime Mortgages: America's Latest Bust and Boom*.