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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**

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
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.

<u>Safety and Soundness Examination Guidance</u>

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.

<u>Compliance Examination Guidance</u>

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.

<u>Federal Reserve Board Guidance</u>

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.

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

<u>Validity and Reliability of Data from Computer-based Systems</u>

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.

<u>Performance Measures</u>

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.

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.

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

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[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.

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.

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.*

<u>OCC</u>

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

FDIC

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
Acting Director

CONCUR: 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.

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. <u>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.</u>

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 <u>any or all</u> 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 <u>See</u> "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 <u>Id</u>. at p.21.

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.

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.