Statement of
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Federal Deposit Insurance Corporation
on
Federal and State Enforcement of Consumer
And
Investor Protection Laws
before the
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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding federal and state enforcement of consumer and investor protection laws.

Earlier this month, in a speech before the National Association of Attorneys General, FDIC Chairman Bair stated that many of the current problems in the economy were caused by a widespread failure to protect consumers. It is essential that those whose actions contributed to the current crisis and who are engaging in practices harmful to consumers be held accountable. In addition, it is important to take steps to prohibit these practices from reoccurring in the future.

The FDIC has a strong commitment to the vigorous and effective enforcement of consumer protection laws and other statutes under our jurisdiction in order to ensure fair treatment of individuals, protect the safety and soundness of insured financial institutions, and carry out our core mission of maintaining public confidence in the banking system. The FDIC brings a unique perspective to this issue because of the variety of functions it performs including deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed insured depository institutions.

My testimony today will discuss how the FDIC conducts enforcement both with regard to failed institutions in our role as receiver, and with regard to open banks in our role as supervisor. In addition, I will touch on the efforts of the FDIC's Office of Inspector General (OIG). I also will suggest a measure that would address a limitation on our existing authority.

Enforcement -- Failed Institutions

In addition to overseeing the national deposit insurance system and acting as primary federal supervisor for approximately 5,000 state chartered banks that are not members of the Federal Reserve System, the FDIC is responsible for resolving all failures of insured financial institutions in the United States. When a bank fails, and thus is unable to meet its financial or capital requirements (or both), the chartering authority closes the institution and appoints the FDIC as receiver. As receiver, the FDIC either pays depositors directly for their insured deposits, or arranges for a purchase of the failed institution by another insured financial institution.

Immediately following the closing of every failed institution -- regardless of size, circumstances or primary federal regulator -- our investigations staff and our attorneys who specialize in professional liability issues together begin an investigation. The purpose of the investigation is to determine, among other things, whether the failed institution's directors, officers, and professionals, such as accountants, appraisers and brokers, were responsible for its losses, and, if so, to hold them accountable.

At the closing, our investigators and attorneys will: determine the reason for the bank's failure; look for evidence of potential fraud that may have contributed to the institution's failure; identify any cause of action against directors, officers or other professionals who contributed to the failure; preserve Bankers Bond and Director and Officer insurance coverage for any potential or existing claim; maintain and protect the integrity of the bank's records; and establish the chain of custody for such records.

Among the "assets" the FDIC as receiver acquires from failed institutions are the institution's pending or potential "professional liability claims," that is, legal claims against its officers, directors, bond carriers, independent accountants, attorneys, appraisers and others who provided professional advice to the institution. These are civil claims filed primarily in federal court. For each existing potential claim, our attorneys determine whether to seek authority to sue or terminate the investigation, weighing the merits of the claim, the cost of pursuing it, and the amount likely to be recovered. If a meritorious claim exists but is not likely to be cost-effective, we refer the claim to the appropriate primary financial regulator for administrative enforcement action.

For each insured bank or thrift that fails, our attorneys open 11 different types of professional liability investigations. The more important of these (in terms of required staff resources and potential recoveries) are investigations of directors, officers, attorneys, accountants, fidelity bond carriers, appraisers, perpetrators of mortgage fraud, securities brokers, and commodities brokers. Since 1986, the FDIC through its professional liability program has recovered a total of $6.1 billion and incurred expenses of $1.4 billion. To put this in context, recoveries in recent years are at a relatively low level because of the small number of financial institution failures from 2004 until the fall of 2007. In 2008, for example, the FDIC recovered only $31.2 million from professional liability claims, a historical low. Professional liability activity – and recoveries – are expected to increase substantially now that institutions are failing and giving rise to significantly increased professional liability claims and investigations.

Recent failures of insured financial institutions – 3 failures in 2007, 25 failures in 2008, and 17 failures just since the start of 2009 – have resulted in a substantial increase in our investigations and professional liability workload. Since the beginning of 2007 through today, investigations of mortgage fraud claims have increased from 0 to 4375, investigations of professional liability claims other than mortgage fraud have increased from 34 to 427, and mortgage fraud lawsuits have increased from 0 to 113.

The 4375 mortgage fraud claims under investigation are expected to result in over 900 additional civil mortgage fraud lawsuits over the next three years. Defendants in civil mortgage fraud cases primarily are mortgage brokers, appraisers, closing attorneys and other closing agents, title companies, title insurance companies, and other third parties that participated in mortgage fraud against FDIC-insured banks and thrifts.

A case from our investigation of the failure of IndyMac bank is indicative of the kinds of mortgage fraud activities our investigators are discovering and pursuing. The case involves a fraudulent appraisal, fraudulent mechanics liens, a "straw" borrower who received $10,000 cash in a briefcase, and a $500,000 loss on two loans totaling $885,000. The appraiser valued the property at more than double its actual market value by using inappropriate comparables, inflating the square footage, and omitting the fact that the house had been listed for sale at substantially less than the contract price. The closing agent recorded two false mechanics liens on the eve of closing as a means to skim off $200,000 cash. The borrower signed two loan applications falsely representing her employment, income and residence, in return for round trip first class airfare from Brooklyn to Houston and car service in Houston to attend the loan closings, in addition to the briefcase of cash. She never resided in the house or made a payment on the loans. In this case, fraud was committed against the FDIC-insured lender by the appraiser, the closing agent, and the borrower. The FDIC is seeking recovery of the full $500,000 loss.

Another consequence of an institution being placed in receivership is that the FDIC has the authority to terminate contracts upon an insured depository institution's failure. The FDIC routinely terminates compensation and other contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts typically can be accomplished at little or no cost to the FDIC. Indeed, some compensation agreements are self-terminating in a receivership context. In addition, placing a failed institution in receivership usually results in its stock having little or no value. To the extent that the previous management was compensated in stock, they generally receive no value unless all depositors and general creditors have been made whole, which is rare.

The FDIC, through its Professional Liability Group, also has the ability to pursue claims in federal court for excessive compensation received prior to the receivership. This includes cases in which the individual left the institution before it failed, as long as his or her departure date was within the period of the applicable state statute of limitations. These claims, at least when pursued directly as "excess compensation" cases, have been challenging to pursue as civil claims in federal court because of the difficulty of defining relevant peer groups and the inherent judgment involved in establishing what is excessive. Our attorneys are actively investigating potential excess compensation claims as part of each investigation of a failed FDIC-insured institution.

FDIC's professional liability attorneys also have pursued related claims that address excess compensation issues. For example, the FDIC filed director and officer liability claims out of Hamilton Bank, N.A., which failed in 2002, based on several theories. One of these theories was that the Chairman and Chief Executive Officer (CEO) of the Bank and other executive officers engaged in a series of secret asset swaps to prop up the price of the stock of Hamilton Bancorp, Hamilton's parent company, in order to increase their compensation among other things. The FDIC settled its claims in this case for $9.4 million. The FDIC now is pursuing a $15.5 million fidelity bond claim out of Hamilton, which is pending in federal court at this time, asserting, among other things, that between November 1998 and August 1999, during which time Bancorp's share price was artificially inflated due to the swaps fraud, the Chairman and CEO caused his personal Trusts to sell Bancorp stock for a gain of $2.3 million.

In addition to the development and support of civil claims brought by the FDIC with regard to failed institutions, our investigators also identify signs of possible criminal activity in a closed financial institution. When appropriate, investigators will file a Suspicious Activity Report (SAR) regarding possible criminal activity. In criminal cases where fraud has been committed against the FDIC itself, this is done in coordination with our OIG. The investigation findings provide supporting documentation that subsequently can be used by the Department of Justice (DOJ) to pursue and prosecute the wrongdoers. Our investigators work with DOJ in the calculation of damages, serve as expert witnesses, and review and analyze financial information, as well as either direct or help with prosecutors' review of bank operations. Acting in our capacity as receiver for failed institutions, the FDIC also coordinates with other federal, state, international, and private sector agencies and groups to detect and deter bank fraud by supporting fraud prosecutions and collecting restitution and forfeiture orders from defendants convicted of fraud against FDIC-insured institutions.

To handle the substantially increased workload, the FDIC began to increase its legal staff in the Professional Liability Group, from 6 at the beginning of 2008 to 16 currently, and to 21 by mid-year 2009. We also have retained 16 outside law firms to perform professional liability investigations and litigation in connection with recently-failed institutions and will be retaining additional firms for this purpose, as well as firms to handle residential mortgage fraud cases specifically. FDIC also has added to both its civil and criminal investigations staff for a total of 67, including contractors.

Enforcement -- Open Banks

Under the Federal Deposit Insurance Act, the FDIC pursues enforcement actions against insured depository institutions, their directors and officers, employees and other institution affiliated parties, where warranted, including third parties and independent contractors such as accountants, attorneys and appraisers. The FDIC employs specialized examiners in fraud, risk management, consumer compliance and Bank

Secrecy Act who regularly examine insured depository institutions to ensure compliance with state and federal laws and regulations, including all consumer protection laws, and the safe and sound operation of FDIC supervised institutions. When FDIC examiners find either violations of law, breaches of fiduciary duty, unsafe and unsound practices or mismanagement in banks' consumer protection responsibilities, the FDIC requires immediate corrective action.

During 2007 and 2008, the FDIC issued 142 Cease and Desist Orders and 102 Removal and/or Prohibition Orders, which ban individuals from banking. These enforcement actions were based on all types of harm or risks caused to an insured depository institution and include most frequently theft and embezzlement by an employee of the bank, poor lending policies or procedures, and fraudulent actions on the part of a lending officer.

The FDIC polices misconduct at open banks through enforcement actions targeting mortgage fraud and other abuses in all types of lending, such as improper underwriting, record alteration, discriminatory practices, and nominee borrower schemes. A recent example involves a former financial center manager and loan officer, where the loan officer created or helped create false loan applications and accepted fraudulent property appraisals that he knew contained false information. The actions of the loan officer caused significant loss to the institution. When discovered, the FDIC successfully sought a prohibition action against this individual to assure that he would never be provided the opportunity to conduct these frauds against another institution. In addition, we worked with the Assistant United States Attorney's office to provide any necessary information in order for criminal actions to be pursued.

Removing from office and prohibiting from banking those who commit financial crimes is a primary goal of FDIC enforcement actions. The majority of the prohibition or removal actions taken by the FDIC were the result of theft, embezzlement or misappropriation on the part of Bank employees. Since 2007, 90 enforcement cases have arisen from these fraudulent concerns. The employees are removed from these positions of trust, and are often required to make restitution and pay a financial penalty to remedy their transgressions.

A recent enforcement case involving fraudulent activities began when examiners doing a routine bank examination discovered that bank management was illegally transferring past-due subprime loans from a related mortgage company to the bank. The FDIC instituted an enforcement action to ban further transfers, freeze the assets of the bank principals involved, and require restitution to the bank for its losses in the illegal transaction. After these orders were issued, the bank recovered more than $10 million.

Open bank enforcement actions protect both the banking industry and consumers. The FDIC currently is working on several enforcement actions related to unfair and deceptive practices. The FDIC recently issued an enforcement order against a bank for providing deceptive marketing material related to its student loan products. The materials were confusing in that they appeared to be products offered from the educational institution's financial aid office and did not clearly state that they were being offered through a private company. The co-branded documents produced by the bank in coordination with the various colleges and universities were deceptive. The FDIC obtained a cease and desist order from the bank requiring that it would increase controls and oversight regarding these products to protect consumers in the future.

The FDIC also is working to assess substantial penalties and require consumer reimbursement where unfair and deceptive acts and practices were identified relating to credit cards, overdraft protection programs, ATM usage of debit cards, rewards accounts, and other lending practices. In late December 2008, the FDIC and the Federal Trade Commission won a major settlement against a credit card company for misleading subprime credit card users. As a result, the company will correct its practices and provide $114 million in cash and credits to consumers who were improperly assessed fees as a result of inadequate and misleading disclosures. We also have pursued enforcement actions against three banks that used this same firm's services. Two of the banks have settled with the FDIC, are correcting their practices and substantially improving their compliance management systems and their oversight of third-party affiliates. In addition, the FDIC assessed civil money penalties in excess of $5 million. Our enforcement action against the third bank is currently pending, and we expect a similar resolution of that action.

A final example is a recent investigation of vendors and payment processors using banks to capture Social Security benefits for loan repayments or check cashing fees via direct deposit accounts. The FDIC is completing an investigation of three banks that were allowing their systems to be used by third parties to solicit customers for direct deposit of their Social Security benefits. The investigations discovered that some of the banks were not actively managing these third party relationships and were unaware of how customers were being treated when they attempted to get their money from the third parties. The FDIC discovered instances where check cashers, payday lenders, and small retail merchants were using a host of bad practices to keep consumers as customers, and worse yet, to keep them in perpetual debt.

As the FDIC completes this investigation, we will be seeking enforcement actions against these banks to require them to review their compliance programs and procedures and make the necessary changes to avoid these problems in the future. In addition, where we found the most egregious compliance violations that were beyond repair, we directed the bank to unwind these accounts, and help consumers find better ways of getting their benefits. The FDIC has worked with the Social Security Administration to understand the benefit payment systems. In addition, the Social Security Administration has been instrumental as the banks seek to close these programs and transfer the consumers' benefit payments, without harming any consumers. Once our investigation revealed that there were other banks involved in these programs, we alerted the Federal Reserve to our concerns and shared our accumulated understanding of these programs so that they could begin their own investigations as to banks they supervise.

The Social Security benefit investigation is only one example of institutions failing to provide the appropriate oversight of third party relationships. The risks of third party relationships have been known in the industry for some time, and the FDIC updated our guidance on third parties in June 2008. We have taken open bank enforcement actions in cases where the bank used third parties to implement refund anticipation loan programs, credit card programs, reward programs, overdraft protection programs, and subprime and/or predatory loan programs.

The FDIC also has focused on utilizing the data provided under the Home Mortgage Disclosure Act or HMDA. It has been a significant effort to establish a program to allow us to analyze this statistical data provided by the banks to identify differences in pricing of mortgages along racial, gender or ethnicity lines. The FDIC is dedicated to investigating any instances of discrimination that the HMDA data or our examinations suggest. We have been working closely with DOJ in referring apparent instances of discrimination and in pursuing FDIC actions against institutions for discrimination. The HMDA pricing data became available for the first time following collection of 2004 data, and we now have several cases that are in development.

As the current economic crisis continues, more and more institutions are suffering financial difficulties, which can lead them to look for higher returns and fee income wherever possible, including offering products that may not be advantageous for most consumers, or necessarily for the bank. Introduction of new products requires the FDIC's increased focus during examinations to assure that the institutions are not taking too much risk. When the FDIC discovers poorly devised products with the propensity to hurt consumers or provide opportunities for fraud, we pursue enforcement actions to revise the product or eliminate it completely.

The FDIC is very concerned about the excessive compensation and executive bonuses that have dominated the news in recent weeks with regard to financial institutions. As I noted in discussing this issue in the context of enforcement in failed banks, historically we have found bringing excessive compensation claims to be difficult but we do have enforcement tools available to us in cases where such schemes affect the safety and soundness of institutions or they involve a breach of fiduciary duty. These claims are highly fact intensive. Generally the FDIC's claim will be stronger in cases involving troubled or significantly undercapitalized institutions, and will also depend upon the extent to which the compensation at issue was manifestly unreasonable, and disproportionate to any legitimate business purpose. We continue to review these issues and expect to pursue claims on this basis.

Enforcement by the FDIC's OIG

The FDIC's OIG brings another level of enforcement that contributes to the FDIC's mission of maintaining confidence in the banking system. The OIG conducts investigations of fraud and other criminal activity in or affecting FDIC-regulated open financial institutions, all closed institutions and receiverships, and other FDIC-related programs and operations. Currently the OIG has about 170 active investigations, involving open and closed institutions. The work focuses on various types of fraud, including mortgage, securities, wire and mail, or bank crimes, such as embezzlement or money laundering. As an example, the OIG, together with the United States Attorney's Office for the Central District of California and the Federal Bureau of Investigation, is conducting an investigation to identify and prosecute any criminal activity that may have contributed to the failure of IndyMac Bank

The OIG investigates crimes against the FDIC as well as crimes against FDIC-insured institutions and receiverships. A staff of 41 federal law enforcement officers conducts these investigations throughout the country and operates a headquarters-based electronic crimes unit and computer forensic lab. The OIG's resources extend beyond its staff as it continues to work closely and partner with the other divisions of the FDIC, DOJ, Federal Bureau of Investigation (FBI), and other law enforcement organizations.

Investigations of financial institution fraud currently constitute about 88 percent of the OIG's investigative caseload. Over the last 2 years, the OIG has closed about 100 investigations, with the crimes occurring almost exclusively in open institutions. These investigations have resulted in over 230 indictments, 170 convictions, and over $530 million in fines, restitution, and monetary recoveries.

The OIG also is involved in stopping fraud schemes that rob depositors and FDIC-insured financial institutions of millions of dollars. The OIG has an ongoing effort to identify, target, disrupt, and dismantle criminal organizations engaged in such schemes that target financial institutions and prey on the banking public. These schemes range from identity theft to Internet scams, such as "phishing" and "pharming." By way of example, with the help of sophisticated technology, the OIG has recently been engaged in shutting down fraudulent emails, purportedly from the FDIC, which attempt to entice consumers to divulge personal information and/or respond to a request for money. In many of these cases, the OIG has been able to trace the schemes to locations outside of the United States, and then work with law enforcement of the relevant foreign country to shut down the scheme.

The OIG also works with other divisions of FDIC to identify individuals who have already committed financial institution crimes and are attempting to avoid their resultant financial obligations by concealing their assets.

In addition, section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the Inspector General of a failed financial institution's primary regulator conduct a review if the Deposit Insurance Fund incurs a material loss as a result of a bank failure. A material loss exists when the estimated loss from the failure exceeds the greater of $25 million or 2 percent of the bank's total assets at the time the FDIC is appointed receiver. Once the FDIC calculates the estimated loss associated with an FDIC-supervised institution, the OIG begins its review. The review provides an independent analysis of why the institution failed and resulted in a material loss and evaluates the relevant regulators' supervision of the institution, and may provide additional information valuable for civil and/or criminal investigations into the failure. The OIG has six months to conduct and publicly report on the results of its review.

During the material loss review, the OIG team of auditors and/or evaluators reviewing bank and supervision records will coordinate with OIG investigators. If the team suspects or uncovers evidence of fraud, the investigators are immediately contacted. In these cases, fraud could have easily contributed to the bank's failure.

Authorities -- Current Restriction

Under the Federal Trade Commission (FTC) Act, only the Federal Reserve Board (FRB) has authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, and the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they supervise. The FTC has authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan institutions, and federal credit unions. As FDIC Chairman Bair and other senior officials have noted before this Committee previously, the FTC Act does not give the FDIC authority to write rules that apply to the approximately 5,000 entities it supervises -- the bulk of state banks -- nor to the OCC for their 1,700 national banks. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or non-banks, including mortgage lenders and credit card issuers. While the "deceptive" and "unfair" standards are independent of one another, the prohibition against these practices applies to all types of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections and the termination of the customer relationship.

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC has recommended that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. The FDIC's perspective -- as deposit insurer and as supervisor for the largest number of banks, many of whom are small community banks -- would provide valuable input and expertise to the rulemaking process. The same is true for the OCC, as supervisor of some of the nation's largest banks. As a practical matter, these rulemakings would be done on an interagency basis and would benefit from the input of all interested parties.

Conclusion

Thank you for the opportunity to address this important issue. The FDIC looks forward to working with the Committee to ensure fair and effective enforcement of consumer protection laws in financial services.

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