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Statement of
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Member
Board of Governors of the Federal Reserve System
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Committee on Financial Services
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Chairman Frank, Ranking Member Bachus, and members of the Committee, I want to thank you for the opportunity to discuss the Federal Reserve Board's ongoing efforts to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise.

While the expansion of the subprime mortgage market over the past decade increased consumers' access to credit, too many homeowners and communities are suffering today because of lax underwriting standards and other unfair or deceptive practices that resulted in unsustainable loans. The Federal Reserve is committed to improving consumer protections and promoting responsible lending practices through each of the roles we play as supervisor for safety and soundness and consumer compliance, and as rulewriter.

I will discuss the Federal Reserve's ongoing efforts as a banking supervisor to ensure that the institutions we supervise are managing their mortgage lending activities in a safe and sound manner and in compliance with laws and regulations. I will also discuss the rules and guidance that have been issued over the past several years that address many of these issues. In addition to our own examination and enforcement activities, I will talk about our ongoing efforts to coordinate with other law enforcement agencies to hold those who are involved in criminal activities in our supervised institutions accountable.

The Federal Reserve's enforcement efforts begin with the examination of its supervised institutions. The Federal Reserve conducts regular examinations of state member banks for both safety and soundness and compliance with consumer protection laws. We also conduct regular inspections of bank holding companies. We examine the mortgage businesses of these institutions, including subprime residential portfolios, as applicable.

Institutions with weaknesses are expected to take corrective actions that include improving their risk management and underwriting practices in the future. In those rare instances where the bank is not willing to address the problem, we have and use a full range of powerful enforcement tools to compel corrective action. To ensure that banks with performance deficiencies give appropriate attention to supervisory concerns, we may require them to enter into nonpublic enforcement actions, such as memoranda of understanding. When necessary, we use formal, public enforcement actions, such as Written Agreements, Cease and Desist Orders, or civil money penalties.

Mortgage Fraud and Investigations

In recent years, there has been a significant increase in suspected criminal activity with respect to mortgage fraud and other mortgage-related criminal activity. Mortgage fraud occurs in various ways. In many cases mortgage fraud is perpetrated against the financial institution by brokers, appraisers, and other third parties. In other situations fraud is perpetrated by insiders of the institution. As I will discuss further, there are other abusive practices that occur in mortgage lending that harm borrowers and the safety and soundness of financial institutions.

The Suspicious Activity Reports (SARs) that banking organizations are required to file reveal significant suspected mortgage fraud activity. As recently reported by FinCEN, there is a continuing upward trend of SARs filed by depository institutions involving suspected mortgage loan fraud.¹ From July 1, 2007, through June 30, 2008, depository institutions filed a total of 62,084 SARs reporting suspected mortgage loan fraud. This represents an increase of 44 percent in SARs involving mortgage fraud compared with the prior year. During the reporting period, mortgage loan fraud was the third most reported activity in SARs. The top 25 filing institutions of mortgage loan fraud SARs submitted 82 percent of the total 62,084 SAR filings. SARs

¹ FinCEN, Filing Trends in Mortgage Loan Fraud, February 25, 2009

alleging mortgage fraud involve numerous varieties of conduct from large-scale multi-million-dollar “straw borrower” and property flipping schemes to single incidents of overstated income or assets by individual borrowers.

Federal Reserve staff regularly review SARs filed by the financial institutions the Fed supervises. When bank insiders may be involved, we initiate investigations, make referrals to law enforcement, coordinate with law enforcement and other regulatory agencies, and pursue enforcement actions against individuals, including seeking prohibition orders and, in appropriate cases, civil money penalties and restitution. We are pursuing numerous investigations involving insiders relating to possible mortgage-related fraud, both commercial and residential. The Federal Reserve has established a Federal Reserve System examiner group to share information on the detection of fraud and pending investigations. On the local level, Reserve Bank staff also interacts with representatives from law enforcement, the Federal Bureau of Investigation, the Internal Revenue Service, and other agencies in SAR “review teams” to review SARs and coordinate actions. These meetings provide an opportunity to share information about criminal activities, including mortgage fraud, occurring within the district.

The Federal Reserve regularly coordinates with law enforcement in a number of ways. Staff participates in monthly interagency meetings led by the U.S. Department of Justice (DOJ) Fraud Section and attended by other law enforcement and regulatory agencies. This interagency group, the “Bank Fraud Working Group,” discusses and shares information on recent cases, trends, and other issues, including mortgage fraud.

Supervision Examinations and Enforcement

In the Federal Reserve’s regular safety and soundness examinations of state member banks and bank holding companies, we evaluate risk-management systems, financial condition,

and compliance with laws and regulations. In assessing a bank's risk management systems for its mortgage lending activity, examiners evaluate the adequacy of the bank's practices to identify, manage, and control credit risk. This includes the appropriateness of the bank's underwriting standards, credit administration, quality control processes over its own originations and third-party originations, and appraisal and collateral valuation practices.

To assist institutions in understanding our supervisory expectations, the Federal Reserve has supplemented its long-standing guidelines on safe and sound real estate lending practices by joining the other federal bank regulatory agencies in issuing additional guidance on mortgage lending practices.

Specifically, starting in 2005, the Federal Reserve and the other federal agencies observed that lenders were increasingly originating nontraditional mortgage loans that lacked principal amortization and had the potential for negative amortization. We were also concerned about the growing use of adjustable rate mortgage products with "teaser" rates that adjust to a variable rate plus a margin for the remaining term of the loan, in addition to other risky characteristics. These products could result in payment shock to borrowers, and present heightened risks to lenders and borrowers. Moreover, the easing of underwriting standards and the marketing of these products to lower credit quality borrowers, including those purchasing investment properties, held the potential to create significant risks for institutions and for borrowers.

To address those concerns and prevent supervised institutions from making unaffordable mortgage loans, the Federal Reserve and the other federal banking agencies issued the *Interagency Guidance on Nontraditional Mortgage Products Risks* in 2006 and the *Interagency Statement on Subprime Mortgage Lending* in 2007. The nontraditional mortgage guidance

highlights sound underwriting procedures, portfolio risk management, and consumer protection practices that institutions should follow to prudently originate and manage mortgage loans with payment option and interest-only features. A key aspect of both statements is the recommendation that a lender's analysis of repayment capacity should include an evaluation of the borrower's ability to repay debt. The subprime guidance emphasizes the risks of stated income or reduced documentation loans in the subprime sector. Further, the subprime guidance outlines certain practices that are considered predatory in nature and stipulates that institutions should not engage in these practices regardless of loan features.

Also, in 2005 the Federal Reserve and the other banking agencies issued the *Interagency Guidance on Independent Appraisal and Evaluation Functions*. This statement reinforces the importance of appraiser independence from the loan origination and credit decision process to ensure that valuations are fairly and appropriately determined. Independence has been a core principle in the Board's appraisal regulation and guidance, which have been in place since the early 1990s. When we examine a bank's real estate lending activities, examiners consider the adequacy of the appraisal function to ensure that it complies with the appraisal regulation and has appropriate risk management practices. A strong appraisal function is essential to combating the potential for mortgage fraud by protecting the collateral valuations from influence by individuals whose intent is to deceive the lender about the condition and value of the collateral. The agencies took steps to further strengthen their guidance in this area by proposing interagency appraisal and evaluation guidelines last November.

More recently, the collapse of the global credit market, triggered by the end of housing booms in the United States and other countries and the associated problems in mortgage markets, has led to a deterioration of asset values and credit conditions. As a result, financial institutions

have incurred losses that in and of themselves have caused financial institutions to tighten credit underwriting standards to ensure that borrowers have the capacity to repay. Furthermore, sweeping new rules issued by the Board under its authority in the Home Ownership and Equity Protection Act (HOEPA) will further ensure that mortgage lenders that offer high-cost mortgages have appropriate practices to ensure consumers can repay their loans.

Consumer Compliance Examination and Enforcement

The Federal Reserve conducts regular examinations of state member banks to evaluate compliance with consumer protection laws, the fair lending laws, and the Community Reinvestment Act. These examinations are conducted by a specially trained cadre of examiners for the approximately 875 banks we supervise. The Board has a long-standing commitment to ensuring that every bank it supervises complies fully with federal financial consumer protection laws, including the fair lending laws. The scope of these examinations includes a review of the bank's compliance with the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act (ECOA), the Community Reinvestment Act, and other federal consumer protection laws.

One objective of our consumer compliance examination program is to identify compliance risks at banks before they harm consumers and ensure that state member banks have appropriate controls in place to manage those risks. In conducting a consumer compliance examination at a state member bank, examiners review the commitment and ability of bank management to comply with consumer protection laws as well as the bank's actual compliance with such laws. Examinations follow a risk-focused approach tailored to fit the risk profile of the bank. This approach directs supervisory attention and resources to the products, services, and areas of the bank's operations that pose the greatest risk to consumers. Our examiners

prepare a stand-alone consumer compliance examination report bearing a distinct consumer compliance rating for each state member bank we supervise. These confidential reports include an evaluation of the bank's compliance management program, a summary of the fair lending review, and a discussion of violations of consumer laws and regulations.

When examiners identify banks with weak and ineffective compliance programs, they document the weaknesses in the examination report and take appropriate supervisory action. Banks with a poor record of compliance are examined more frequently than those with favorable records. When necessary to obtain compliance with consumer protection laws, we can, and do, use our enforcement tools, ranging from nonpublic actions to public Cease and Desist Orders. However, most banks voluntarily address any violations and weaknesses in consumer compliance management programs that our examiners identify so we find public formal actions are not typically necessary.

Important tools for examiners and financial institutions are guidance and examination procedures for enforcing the Federal Trade Commission Act's prohibition of unfair or deceptive acts or practices. The *Unfair or Deceptive Acts or Practices by State-Chartered Banks* issued by the Board and the FDIC in 2004 outlines strategies for banks to use to avoid engaging in unfair or deceptive acts or practices, to minimize their own risks and to protect consumers. Among other things, the guidance focuses on loan servicing and managing and monitoring creditors' employees and third-party service providers.

The Federal Reserve's consumer compliance supervision authority extends to bank holding companies as well as to state member banks. In recent years, banking organizations have greatly expanded the scope, complexity, and innovation of their business activities. At the same time, compliance requirements associated with these activities have become more complex.

To assist financial institutions in addressing these challenges, the Federal Reserve recently issued guidance in 2008 clarifying its expectations regarding firm-wide compliance risk management and oversight for both prudential and consumer protection supervision in *Complex Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles*. Further, Federal Reserve consumer compliance examiners routinely participate in the review and assessment of the adequacy of large bank holding company compliance risk management programs.

In addition to its own supervisory efforts related to bank holding companies, the Federal Reserve, along with the Office of Thrift Supervision, the Federal Trade Commission, and a number of state authorities, recently completed a pilot consumer protection compliance review as part of an interagency project to enhance the supervision of subprime mortgage lenders. Under the pilot project, the agencies coordinated to conduct consumer-protection compliance reviews at selected entities with significant subprime mortgage operations. The reviews included independent state-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. These reviews included targeted evaluations of mortgage underwriting standards, risk management strategies, and compliance with certain consumer protection laws. We are currently assessing the results of the pilot project. The results will guide the Board's decisionmaking as to how it may supervise these entities in the future.

Focus on Fair Lending Enforcement

Although the Federal Reserve's fair lending enforcement program is not intended to detect mortgage fraud, it is a vital component of the Federal Reserve's efforts to ensure fair access to responsible credit. The Federal Reserve is committed to ensuring that every bank it

supervises complies fully with the federal fair lending laws, the ECOA and the Fair Housing Act. Every consumer compliance examination includes an evaluation of the bank's fair lending compliance program, as well as an assessment of the bank's fair lending risk across all types of lending, including mortgage lending. Examiners also test the institution's actual lending record for specific types of discrimination, such as pricing discrimination in mortgage lending. A specialized Fair Lending Enforcement Section on the Board's staff works closely with staff at the 12 Reserve Banks across the country to provide guidance on fair lending matters and to ensure that the fair lending laws are enforced rigorously.

When examiners find fair lending violations, the Board takes appropriate supervisory action. If we have reason to believe that an institution has engaged in a pattern or practice of discrimination under the ECOA, the Board, like other federal banking agencies, has a statutory responsibility under the Act to refer the matter to the DOJ, which reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. The DOJ may instead return the matter to the Federal Reserve for administrative enforcement. When this occurs, we ensure that the institution takes all appropriate corrective action. If a fair lending violation does not constitute a pattern or practice, we similarly ensure that the bank takes all appropriate corrective action.

In carrying out our supervisory responsibilities related to fair lending, Federal Reserve examiners perform many reviews to detect pricing discrimination, redlining, and steering in mortgage lending. These illegal practices can limit fair access to responsible credit, and make it more likely that minorities will fall prey to potentially abusive lending practices. Several of these reviews have resulted in referrals to the DOJ. In the past three years, we have referred

fifteen matters to the DOJ and four of these matters have involved illegal discrimination in mortgage lending based on race or ethnicity.

The Board referred two nationwide mortgage lenders to the DOJ because we determined that Hispanic and African-American borrowers paid more for their loans than comparable non-Hispanic white borrowers. These reviews resulted from a process of targeted reviews for mortgage pricing discrimination that the Federal Reserve initiated when the mortgage pricing data became available under the Home Mortgage Disclosure Act. We also referred a lender for imposing a restriction on rowhouse lending that resulted in discrimination against African Americans. Finally, we referred a lender for redlining. The lender's marketing strategy was based on negative racial stereotypes and, as a result, excluded a cluster of minority neighborhoods from its lending activity.

Rules Banning Unfair and Deceptive Practices

In addition to our supervisory activities, the Federal Reserve Board in 2008 finalized sweeping new rules for home mortgage loans to better protect consumers and facilitate responsible residential mortgage lending. The rules, which amend Regulation Z (Truth in Lending), were adopted under HOEPA, and prohibit unfair, abusive or deceptive home mortgage lending practices and restrict certain other mortgage practices. Importantly, the rules apply to all mortgage lenders, not just depository institutions supervised by the federal banking and thrift regulators. These rules resulted from a series of field hearings conducted by the Board in 2006 and 2007 and a review of approximately 4,500 comment letters representing a broad spectrum of views that were received in response to the Board's proposed rule issued in December 2007.

The final rule adds four key protections for a newly defined category of "higher-priced mortgage loans" secured by a consumer's principal dwelling. The higher-priced thresholds

adopted by the Board would cover all, or virtually all, of the subprime market and a portion of the Alt-A market. For loans in this category, these protections will prohibit a lender from making a loan without regard to a borrower's ability to repay the loan from income and assets other than the home's value. Second, lenders are prohibited from making "stated income" loans and are required in each case to verify the income and assets they rely upon to determine borrowers' repayment ability. Third, the rules restrict the use of prepayment penalties in cases where the borrower could encounter payment shock. Finally, creditors are required to establish an escrow account for property taxes and homeowner's insurance for all first-lien mortgage loans.

In addition to rules for higher-cost loans, the Board adopted other protections that apply to all mortgage loans secured by a consumer's principal dwelling, regardless of the cost. The rules prohibit lenders or brokers from coercing, influencing or otherwise encouraging an appraiser to misstate or misrepresent the value of the property. The rules also prohibit, among other things, servicers from engaging in certain unfair practices.

I note that the Board is working on another important rulemaking action with other federal agencies and state organizations to implement the registration requirements for residential mortgage loan originators employed by federally supervised institutions, as required by the S.A.F.E. Mortgaging Licensing Act of 2008 (SAFE Act). The SAFE Act, when implemented, will provide for increased accountability and tracking of loan originators in a publicly accessible database. Under the SAFE Act, an individual is prohibited from engaging in loan origination without obtaining and maintaining annually a unique identifier and either a license and registration as a state-licensed loan originator or a registration as a federal loan originator.

Prevention and Future Challenges

The Federal Reserve will continue to take actions against institutions that violate consumer protection or fair lending laws, engage in unfair or deceptive practices, or otherwise engage in unsafe or unsound lending practices. We will continue to focus on strong supervision to prevent the occurrence of these practices and violations. In addition to our own examination and enforcement activities, we will continue our efforts to coordinate with other law enforcement agencies to hold those who are involved in our supervised institutions accountable for criminal activities related to mortgage lending.

Again, I want to thank you for the opportunity to discuss what the Federal Reserve does to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise.