



Neglect and Inaction: Bank Regulators Allowed Bad Lending: *Why Should They Remain in Charge of Consumer Protections?*

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Support the Consumer Financial Protection Agency (H.R. 3126 and pending Senate bill)

Three agencies are primarily responsible for regulating banks and policing consumer protections related to bank transactions: the Office of Thrift Supervision (OTS); the Office of the Comptroller of the Currency (OCC); and the Federal Reserve Board (FRB).

Yet under these agencies, harmful lending practices proliferated with disastrous results. Our current oversight system on consumer lending has been consistently neglectful and passive in the face of clear violations and serious issues, costing taxpayers hundreds of billions of dollars in lost wealth. With millions of Americans adversely affected by lack of effective oversight, the time for change has come. Consider these examples of neglect and inaction:

Banking regulators were well aware of lending abuses, but remained passive.

Victims of predatory lending, state regulators, and advocates repeatedly raised concerns about abuses in the expanding subprime mortgage market—the market whose implosion triggered the economic crisis. As early as 2005, an OCC survey of credit underwriting practices found “a clear trend toward easing of underwriting standards as banks stretch for volume and yield,” and the agency commented that conditions were ripe for encouraging “imprudent credit decisions.”

The agencies dragged their feet.

Even after the OCC survey, the agencies took two years to take action on subprime lending. By the time the agencies finally got around to saying that lenders must consider a borrower’s ability to pay, it was July 2007, and most of the subprime damage had already been done. As far back as 1994, Congress charged the FRB with prohibiting bad lending practices, but the FRB took no final action until July 2008, with the rules not taking effect until fall of 2009—again, too late to stop the epidemic of reckless lending.

The few “suggestions” issued to curb bad lending had no teeth.

When regulators did address new lending abuses, they did so through “guidance”—proposals and suggestions, not requirements. For example, according to law professor Patricia McCoy, a 2004 OCC rule prohibiting mortgages to borrowers who could not afford to repay “was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007.”

The OCC has actively obstructed efforts to stop bad banking practices.

While many state Attorneys General have pursued unfair and deceptive lending practices vigorously, the OCC went to court in 2001 to try to prevent states from taking action against such abuses by national banks. In 2002, the OCC stopped Washington State from inquiring into the mortgage practices of National City Mortgage. The following year, the parent company National City Bank and its subsidiary, First Franklin, were successful in persuading the OCC to rule that national banks could ignore state predatory lending laws. Six years later, First Franklin made the OCC’s own list of the “Worst Ten in the Worst Ten” among lenders with the most foreclosures.

Case Study: OCC Shrugs Off a Clear Case of Abusive Lending

Dorothy Smith, who was living on \$540 a month in government benefits, was taken in by a home repair contractor and a mortgage broker who landed her in a mortgage from First Union National Bank. The loan contract required her to pay two-thirds of her income for 15 years, followed by a balloon payment of more than \$30,000. After receiving Ms. Smith's complaint about First Union, the OCC brushed her off, claiming it couldn't intercede in a "private party situation."

- *The Wall Street Journal*, March 22, 2007. (Ip & Paletta, "Lending Oversight: Regulators Scrutinized in Mortgage Meltdown -- States, Federal Agencies Clashed on Subprimes As Market Ballooned.")

Enforcement actions were virtually non-existent. The OCC did not exercise its consumer protection authority to address unfair and deceptive practices under the FTC Act *for 25 years*. Most OCC actions regarding violations of consumer lending laws have targeted small national banks—even though "ten large banks accounted for four-fifths of all complaints" received by the OCC's customer assistance group in 2004. Despite the hundreds of thousands of complaints and inquiries it fielded between 2000 and 2008, the OCC took just a dozen public enforcement actions during this period for unfair and deceptive practices relating to home mortgages, credit cards and other consumer loans.

Loosely regulated banks engaged in harmful lending practices, ultimately paid for by taxpayers.

Destructive lending practices by banks that are "too big to fail" pose high risks, not only for the direct victims of bad loans, but—given costly government bailouts—also for all taxpayers and the entire economy. A few examples of reckless or harmful lending practices by banks:

Wells Fargo: In 2006, over 23% of the bank's refinance home loans were subprime. The bank also created investments out of substantial numbers of loans that had been approved with little or no documentation, and failed to check loans that came from mortgage brokers. In addition, Wells was among the national banks that routinely made a disproportionate number of subprime loans to minority borrowers. Two former Wells Fargo employees have signed declarations that the bank's sales staff steered minorities into high-cost subprime loans.

Bank of America was active in approving loans without documentation, as was **JPMorgan Chase Bank**. When there were public protests about the high volume of no-documentation loans made by JPMorgan Chase, the OCC took no action, claiming that the bank had adequate "checks and balances" in place.

WHAT EXPLAINS REGULATORS' INACTION?

- Conflicts of interest. OTS and OCC funding depends on fees from the bankers they charter and regulate. These agencies have come to view banks as customers rather than entities to be regulated.
- Competing priorities. All three of the regulating agencies also oversee bank safety and soundness. This is a serious and consuming task, and it's not surprising that consumers have taken a back seat. But taxpayers and the national economy would benefit enormously from focused oversight.

Market failures have hurt honest competition as well as consumers. Hallmarks of a fair and competitive market are transparency and appropriately-aligned incentives. In fact, lenders have had strong market incentives to hide fees and other terms in long, incomprehensible "disclosures," resulting in overcharges and hidden traps in home loans, credit cards, overdrafts and all types of consumer lending. As a result, financial institutions that do act fairly are at a competitive disadvantage. Better oversight would benefit responsible lenders as well as consumers.

The safety and soundness of banks has received intense attention; now we need an entity focused on the safety and soundness of ordinary people. The proposed Consumer Financial Protection Agency would bring the accountability we need to prevent another economic crisis in the future.

A more detailed version of this report is available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/regulators-failure-to-enforce-consumer-protections.html>.

Sources

Concerns raised during subprime boom: See, e.g., “Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*,” New York Times (Dec. 18, 2007), available at www.nytimes.com/2007/12/18/business/18subprime.html.

OCC survey: Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005*; see also Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

Comments by Prof. Patricia McCoy: *Consumer Protections in Financial Services: Past Problems, Future Solutions: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (statement of Patricia A. McCoy, Professor of Law, Univ. of Conn.), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=40666635-bc76-4d59-9c25-76daf0784239.

Washington state investigation stopped: See Eric Nalder, *Mortgage System Crumbled While Regulators Jousted*, Seattle Post-Intelligencer, Oct. 11, 2008, at A1.

OCC ruling exempts national banks from state laws: See 68 Fed. Reg. 46,264 (Aug. 5, 2003).

OCC-regulated First Franklin “worst of worse”: Letter from John Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel (Feb. 12, 2009) (listing First Franklin and two other significant subprime lenders under OCC’s supervision on the list).

OCC’s lack of enforcement for 25 years: See Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246 & n.25, 1253 (2003) (conceding that “[a]n obvious question is why it took the federal banking agencies more than twenty-five years to reach consensus on their authority to enforce the FTC Act”).

Large banks account for large share of complaints in 2004: Arthur E. Wilmarth, Jr., *The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 Ann. Rev. Banking & Fin. L. 225, 237-52 (2004).

OCC lack of enforcement between 2000 and 2008: See OCC, Consumer Protection News: Unfair and Deceptive Practices, <http://www.occ.gov/Consumer/Unfair.htm>.

Wells Fargo deliberately targeted minority borrowers for high-cost loans: Affidavits by Elizabeth M. Jacobson and Tony Paschal in *Mayor and City Council of Baltimore v. Wells Fargo Bank*, No. 1:08-cv -00062-BEL (D. Md.), Documents 74-16 and 74-17.

Complaints produced no action: *Consumer Protections in Financial Services: Past Problems, Future Solutions: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, Patricia McCoy, see full cite above.

About the Center for Responsible Lending

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

For additional information, please visit our website at www.responsiblelending.org.