Remarks of
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And
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Compliance Issues before the FDIC

Good afternoon. I am very pleased to be here with you today to speak about an issue of great interest to all of us, compliance risk management and supervision. Most of you are deeply involved in bank compliance and consumer protection issues and I'm pleased to have this opportunity to share some thoughts with you. In my remarks today I am going to talk about the FDIC's approach to compliance and our supervisory expectations. I'll also provide you with an update on some of our key compliance and consumer protection priorities.

The FDIC's Compliance Supervisory Expectations

The FDIC's compliance supervisory program is designed to provide consumers with information to help them understand banking transactions, to ensure fair access to the financial system, and to ensure that banks comply with consumer protection laws and regulations. In ensuring that banks comply with consumer protection laws and regulations, the FDIC largely relies on the compliance examination process.

Our compliance examination process has several steps. All examinations begin with a pre-examination planning and evaluation phase that collects and draws on all available information regarding the bank's compliance function and its compliance record.

A detailed on-site evaluation of the bank's approach to compliance follows which involves an assessment of a bank's overall compliance management system. Every institution must have a system in place appropriate to the bank's size and product offerings, to ensure that it meets its consumer protection responsibilities on a continuous basis. Such a system encompasses acquiring up-to-date knowledge of laws and regulations, training employees, incorporating legal requirements into business processes, monitoring those processes to ensure that they work, and taking corrective action as necessary.

In their evaluation, examiners also conduct detailed reviews of bank operations and review transaction records to ensure that the compliance responsibilities are met on an ongoing basis. As part of this process, examiners identify the strengths and weaknesses of the bank's overall approach to compliance management, document violations of law and regulation, and identify actions to address compliance deficiencies and violations.

Examiners also analyze the involvement and responsiveness of the bank's Board of Directors, including whether the Board takes action as necessary, and whether the Board has given the compliance officers adequate powers and resources to be effective. Board involvement can set the overall tone of a bank's compliance and consumer protection orientation and thus plays an important role in our evaluation of a bank's compliance operations.

The outcome of this extensive process is the development of the bank's compliance rating. The compliance rating reflects the FDIC's overall evaluation of the bank's compliance system and how the bank's compliance activities measure up to the FDIC's overall compliance and consumer protection supervisory expectations.

Similar to evaluating a bank's compliance with consumer protection rules, the FDIC also examines for compliance with the Bank Secrecy Act ("BSA") during every safety and soundness (risk management) examination. I am aware of the considerable effort and resources that you dedicate to BSA compliance; and we all recognize that the BSA and its implementing anti-money laundering ("AML") rules have changed substantially over the years.

As you are aware, the blueprint for our BSA/AML examination process is the same as that used by other Federal Banking Agencies. Furthermore, our guidance and procedures are available to you through the Federal Financial Institutions Examination Council ("FFIEC") BSA/AML examination Manual, whose recent update was completed in July 2006. Many bankers present may be aware that through national trade groups, such as the ACB, your concerns and recommendations are factored into the editing process of the Manual.

To appropriately define the scope of the BSA/AML review, our examiners evaluate an institution's risk assessment to determine whether: (1) the bank has included all risk areas, including any new products, services, or targeted customers and geographic locations; and (2) the bank's process for periodically reviewing and updating its BSA/AML risk assessment is adequate. Examiners also review the adequacy of the bank's BSA/AML compliance program to determine whether the bank has developed, administered, and maintained an effective program for compliance with the BSA and its implementing regulations.

During the onsite BSA/AML process, examiners conduct transaction testing to evaluate the adequacy of the institution's regulatory compliance, determine the effectiveness of the bank's policies, procedures, and processes, and evaluate suspicious activity monitoring systems. The extent of transaction testing is based on various factors including the examiner's judgment of risks, controls, and the adequacy of internal systems. The scope of the transaction testing may be expanded to address issues or concerns identified during the examination. Relevant findings, from transaction testing identified violations of the BSA and implementing rules, and recommendations to strengthen the bank's BSA/AML compliance program, procedures, or processes will be reflected within the safety and soundness report of examination.

Before moving on to my next topic, I would like to reinforce the FDIC's commitment to compliance. The dynamic nature of the banking industry and the rapid proliferation of complex financial products have increased the challenges in this area. However, we are committed to devoting sufficient resources to meet this challenge and to carry out our responsibilities in a fair and effective manner.

Key FDIC Compliance Priorities

Some of our key compliance and consumer protection priorities are focused in the areas of fair lending, financial access, and the non-traditional mortgage market.

HMDA Data and Fair Lending

One of the most important fair lending issues which has proven particularly challenging to assess in the compliance examination process has been the impact of race on the credit terms received by borrowers. As I mentioned earlier, the FDIC is committed to ensuring that the institutions under our supervision provide credit to all people in a fair and unbiased manner.

A major factor that has inhibited our ability to effectively examine this issue has been a lack of loan-level data that reports the credit terms received by consumers in different racial and ethnic groups. However, due to revisions in Home Mortgage Disclosure Act ("HMDA") reporting requirements, beginning with loans originated in 2004, HMDA data now includes pricing information on loans that are designated as "higher priced loans," defined as first lien loans with an APR-Treasury yield spread of greater than 3 percentage points or subordinate lien loans with an APR-Treasury yield spread greater than 5 percentage points.

Analyses of the first year of the HMDA pricing data revealed significant disparities in the incidence of higher priced loans across racial groups. Last September, the Federal Reserve published a study, concurrent with the release of the 2004 HMDA data, which clearly indicated that certain minority groups are more likely to receive higher-priced mortgage loans than non-minority groups.[1] The study attempted to explain these disparities by taking differences in income, loan amounts, and other borrower-specific HMDA information into consideration-- but the study was not able to fully explain the differentials between racial groups. Most other studies conducted since then have also been unable to fully account for the pricing disparities using data on borrower creditworthiness and other factors.[2] Indeed, the disparities identified using the 2004 HMDA data were significant and raised important public policy concerns.

Data on 2005 HMDA originations was just released to the public a little over a week ago along with another Federal Reserve study.[3] Relative to the 2004 data, the 2005 HMDA data reveal a significant increase in the incidence of high priced loans, which to some extent reflect broadening risks and an increase in subprime and near-prime lending activity in the mortgage market. However, analysts caution that the 2004 HMDA pricing data may have understated the breadth of the higher-risk market due to extremely low shorter-term interest rates which depress reportable APRs on mortgage products such as adjustable rate mortgages.

The 2005 pricing data and Federal Reserve study indicate not only a greater incidence of higher-priced lending in the mortgage market, but significantly larger disparities in the proportion of minorities receiving higher-priced loans compared to non-Hispanic whites. The 2005 study reported that the incidence of higher priced conventional home purchase loans was 54.7 percent for blacks and 46.1 percent for Hispanic whites compared to 17.2 percent for non-Hispanic whites. In 2004 the HMDA data revealed that the incidence of higher priced loans was 32.4 percent for blacks and 20.3 percent for Hispanic whites versus 8.7 percent for non-Hispanic whites. Data for both years reveal that Hispanic whites and African Americans are significantly more likely to receive higher priced loans than non-Hispanic whites. The evidence of such wide disparities in the incidence of HMDA reportable higher priced loans across racial groups in the HMDA data heightens concerns about the cost of credit to racial minorities.

The 2005 Federal Reserve analysis attempted to explain the disparity in the incidence of higher priced lending among minorities, but significant racial and ethnic differences in the incidence of higher priced lending remained unexplained even after accounting for other information reported in the HMDA data. The study found that borrower-related factors accounted for roughly one-fifth of the disparity in the incidence of higher-priced home purchase loans among Blacks and non-Hispanic whites.

Evidence from the 2005 Federal Reserve study regarding the incidence of higher-priced lending across geographies, lender, and lending channels suggests that higher-priced lenders may disproportionately work with and market to borrowers from minority neighborhoods. For example, the study found that metropolitan areas with larger minority populations and higher unemployment rates are more likely to have higher incidence of higher price lending. Previous studies have also suggested that subprime lenders are more active in lower income, urban areas and that minority access to credit is dominated by higher cost lenders. This is an area that deserves careful attention and analysis since it raises questions about the availability of low-priced credit in minority neighborhoods.

Indeed, a recent Brookings Institution study compared the prices paid by lower income families for a wide variety of consumer goods and found that lower income families tend to pay higher than average prices for all sorts of basic household necessities, including financial services such as home and car loans, check cashing, short term loans, and remittance services.4 The study revealed that the added costs incurred by lower income consumers are the result of higher real and perceived costs of doing business with lower income consumers, unscrupulous business practices, and lack of access to good market information. The study further suggests that dense concentrations of high-priced providers in lower income neighborhoods tend to limit the choices of lower income consumers. These are important findings with significant public policy implications for the financial services industry.

Careful analysis needs to be undertaken to examine whether institutional or geographical lending patterns that have emerged in prime and subprime markets may be limiting the access of qualified minority borrowers to lower-priced prime credit, contributing to fair lending as well as community reinvestment concerns. If such structural marketplace factors are in fact part of the problem, we need to develop strategies to address them so that all individuals can gain access to credit reflective of their actual credit histories.

Clearly, more work remains to be done. In the meantime, the FDIC remains committed to enforcing federal fair lending laws. Although the HMDA data do not include all of the information necessary to fully evaluate the extent to which discrimination exists, bank supervisors have access to the information in actual loan files through the bank compliance examination process. Consequently, the FDIC has worked to integrate the new HMDA pricing data into its fair lending compliance examination program on an institution-by-institution basis. The FDIC is doing this in two ways.

First, the FDIC is employing the new HMDA pricing data in its fair lending compliance examinations. The FDIC now requires compliance examiners to evaluate racial and gender-related patterns in the HMDA pricing data when conducting periodic compliance examinations of all institutions subject to HMDA reporting requirements. These fair lending reviews are a critical component of the FDIC's compliance supervisory process, and the new HMDA data provides another tool to enhance this process. In their fair lending exams, the examiners consider the new HMDA data along with all other relevant loan level information lenders use to make lending decisions.

Second, to more effectively target examination resources, the FDIC is using the new HMDA pricing data to identify "outlier" institutions that warrant special scrutiny because of larger pricing disparities for minorities or females in one or more loan product areas than are evident for other FDIC-supervised institutions. Institutions identified as outliers are asked to provide the FDIC with information that explains the channels through which people obtain mortgage loans and the factors the bank considers in making its pricing decisions for the loan product under review. As necessary, comparative analysis is conducted to determine whether those factors were fairly and neutrally applied.

Examinations at a handful of the outlier institutions suggest the possibility of discriminatory pricing on the basis of race. Such observed instances have typically involved situations where loan officers enjoyed broad, unmonitored pricing discretion. The work of the FDIC in this area is ongoing and we intend to take all appropriate enforcement action, including referral to the Department of Justice, if necessary.

Financial Access -- Banking the Unbanked

Relevant to the findings of the HMDA data, the FDIC continues to pursue initiatives aimed at promoting the ability of all consumers to gain access to competitively priced banking services and expanding opportunities for the underserved banking population in the United States to enter the financial mainstream. Recent studies indicate that a significant portion of the United States population lacks access to the banking system and spends significantly more on financial transactions as a result. One recent study estimated that there are 28 million unbanked people in the U.S., and 45 million underserved people who lack full access to credit5 Another recent study indicates that the population underserved by banks is significantly concentrated among minorities. According to this study, 46 percent of African Americans and 34 percent of Hispanic Americans are unbanked.6

The FDIC has focused on this issue of the unbanked since its launch of the New Alliance Task Force (NATF) in its Chicago region in 2003. NATF has successfully brought Latino immigrants into the financial mainstream by promoting financial education and outreach programs and innovative banking products that serve unbanked immigrants. To date, largely as a result of NATF efforts, more than 50,000 new bank accounts have been opened, with more $100 million in deposits.

The FDIC is now focused on expanding the NATF program to unbanked people across the country through the organization of broad-based coalitions in each of the FDIC's six regions composed of banks, community organizations, foundations, educators, and local, state, and federal agencies. Building on the success of its NATF initiatives, the FDIC will seek to build partnerships among public, private, and non-profit organizations to bring the unbanked and underserved into the financial mainstream.

Expanding financial access to the underserved represents an enormous opportunity for the U.S. banking system. It's a win-win situation for those who lack access to the financial system as well as for financial institutions seeking new market opportunities.

Non-Traditional Mortgages

Recent trends in non-traditional mortgage lending have also raised concerns about how such loan products are marketed to consumers. Non-traditional mortgages include loan products such as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "pay option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization. Such mortgage products have been offered by some insured institutions for many years, and can provide beneficial financial flexibility for creditworthy borrowers. Over the past two to three years, however, non-traditional mortgages have experienced rapid growth and are now being offered to a broader range of borrowers.

Non-traditional mortgages raise the potential for negative amortization and payment shock, that is, significantly higher payment requirements when a loan begins to fully amortize. From a consumer protection standpoint, our concern is that these products are being increasingly offered to borrowers who may not fully understand the associated risks and who don't have the financial cushion to bear them. At the point in time when these customers make critical decisions about how to finance transactions and what amount to pay each month, they simply may not have enough information to understand the full cost of their choices. Moreover, the risks associated with these mortgages are even greater in a slowing housing market such as the one we appear to be experiencing currently in many areas of the country.

Last December the FDIC joined the other federal financial institution regulatory agencies in proposing guidance on non-traditional mortgages that sets forth our expectations for institutions to effectively assess and manage the risks they raise. The agencies are now nearing completion of the final version of this guidance after receiving comments from industry earlier this year. We want to make sure that these new and relatively untested types of mortgages are being appropriately underwritten and to encourage institutions to communicate clearly with consumers, particularly unsophisticated borrowers, about the risks inherent in these mortgages.

The proposed guidance focuses on qualification standards for borrowers, payment shock, and portfolio management and emphasizes that borrowers should be qualified at the fully indexed rate, assuming a fully amortizing payment, including potential negative amortization amounts. We expect that the guidance will recommend that promotional materials and other product descriptions provide consumers with full and balanced information about the costs, terms, features, and risks of non-traditional mortgage products. Without such information, consumers cannot make rational product selections. We are particularly concerned about potential payment shock and negative amortization, product features such as prepayment penalties and the additional costs of reduced documentation loans.

While the guidance does not recommend pre-purchase counseling, it reiterates the need to fully disclose costs. Regardless of the form the final guidance takes, it is important that lenders offer pre-purchase counseling to consumers, particularly unsophisticated borrowers, where possible to fully inform them about the consequences of their mortgage loan decisions.

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Thank you again for the opportunity to talk to you about the FDIC's approach to compliance and consumer protection. This is an area of particular importance to me, and one that I look forward to working on together with many of you.

1. 1 Robert B. Avery, Glenn B. Canner and Robert E. Cook, "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin, Summer 2005.

2. See, for example, Robert B. Avery, Ken P. Brevoort, and Glenn B. Canner, "Patterns of Higher-Priced Lending by Race and Ethnicity," unpublished manuscript, presented at the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 2006; "The 2005 Fair Lending Disparities: Stubborn and Persistent II," National Community Reinvestment Coalition, May 2006; and Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages," Center for Responsible Lending, May 31, 2006.

3 Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA data," Federal Reserve Bulletin, September 2006.

4 "From Poverty, Opportunity, Putting the Market to Work for Lower Income Families," The Brookings Institution Metropolitan Policy Program, 2006.

5 "Private-Label Card Program From GE Offers 'Road to Credit' To Tap Greater Portion of Market," citing statistics from Bearing Point, The Wall Street Journal, July 7, 2006.

6 Sherrie L. W. Rhine, "A Closer Look at the Unbanked," May 22, 2006, and Sherrie L. Rhine and William H. Greene, "The Determinants of Being Unbanked for U.S. Immigrants," Journal of Consumer Affairs, summer 2006, Vol. 40 Issue 1, p. 21-40. Statistics cited refer to U.S. born African Americans and Hispanic Americans.

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