Executive Summary

Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel

Report No. OIG-16-001
February 19, 2016

Why and How We Conducted This Inquiry

On December 17, 2014, Chairman Gruenberg requested that the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) conduct a "fact-finding review of the actions of FDIC staff" in the Department of Justice's Operation Choke Point. The Chairman's request was prompted by concerns raised by a letter from a member of Congress, dated December 10, 2014, asking that the role of five FDIC officials, and others as appropriate, be examined. Our office addressed the actions of the five FDIC officials in connection with Operation Choke Point in the OIG's September 2015 Report, *The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions that Conducted Business with Merchants Associated with High-Risk Activities* (AUD-15-008) (the Audit).

In that report, the OIG indicated that it would conduct further work on the role of FDIC staff with respect to the Corporation's supervisory approach to financial institutions that offered a credit product known as a refund anticipation loan (RAL). A RAL is a particular type of loan product, typically offered through a national or local tax preparation company in conjunction with the filing of a taxpayer's income tax return.[1] Although tax preparation firms were not specifically associated with Operation Choke Point, and RALs are financial products offered by banks and not a line of business related to Operation Choke Point, information we identified in the course of the Audit raised sufficient concern to cause us to also review the FDIC's supervisory approach to institutions offering RALs and the roles of FDIC personnel in that process.

This report describes our work and findings. It is based on interviews with knowledgeable individuals and an extensive review and analysis of FDIC internal emails, correspondence, supervisory materials, and other documents.

What We Learned

The FDIC had a lengthy supervisory relationship with institutions offering RALs, dating to the 1980s. In January 2008, the then-FDIC Chairman, Sheila Bair, asked why FDIC-regulated institutions would be allowed to offer RALs.[2] Shortly thereafter, the FDIC began to try to cause banks it supervised, which are the focus of this review, to exit the business line. In late December 2010, the Office of the Comptroller of the Currency (OCC) required an institution it supervised to exit RALs effective with the 2011 tax season. During this time period, the Internal Revenue Service also withdrew access to an underwriting

[1] The tax preparer, sometimes referred to as an electronic refund originator (ERO), works in cooperation with the financial institution to advance a portion of the tax refund claimed by individuals in the form of a loan. Typically the loan amount would include the tax return preparation cost, other fees and a finance charge.

[2] The Chairman's question was raised in the context of an incoming letter from a number of consumer advocacy groups. This letter, together with similar correspondence in 2009, expressed concern that RALs harmed consumers.

tool it formerly provided to tax preparers and banks that had been used to mitigate certain risks associated with RALs. Ultimately, the FDIC caused all three of its supervised institutions that then continued to facilitate RALs to exit the business in 2011 and 2012.

RALs were, and remain, legal activities, but ultimately were seen by the FDIC as risky to the banks and potentially harmful to consumers.[3] As discussed in our report, the FDIC's articulated rationale for requiring banks to exit RALs morphed over time. The decision to cause FDIC-supervised banks to exit RALs was implemented by certain Division Directors, the Chicago Regional Director, and their subordinates, and supported by each of the FDIC's Inside Directors. The basis for this decision was not fully transparent because the FDIC chose not to issue formal guidance on RALs, applying more generic guidance applicable to broader areas of supervisory concern. Yet the decision set in motion a series of interrelated events affecting three institutions that involved aggressive and unprecedented efforts to use the FDIC's supervisory and enforcement powers, circumvention of certain controls surrounding the exercise of enforcement power, damage to the morale of certain field examination staff, and high costs to the three impacted institutions.

The Washington Office pressured field staff to assign lower ratings in the 2010 Safety and Soundness examinations for two institutions that had RAL programs. The Washington Office also required changing related examination report narratives. In one instance a ratings downgrade appeared to be predetermined before the examination began. In another case, the downgrade further limited an institution from pursuing a strategy of acquiring failed institutions. The institution's desire to do so was then leveraged by the FDIC in its negotiations regarding the institution's exit from RALs. Although the examiners in the field did not agree with lowering the ratings of the two institutions, the FDIC did not document these disagreements in one instance, and only partially documented the disagreement in another, in contravention of its policy and a recommendation in a prior OIG report.

The absence of significant examination-based evidence of harm caused by RAL programs could have caused FDIC management to reconsider its initial assessment that these programs posed significant risk to the institutions offering them. However, lack of such evidence did not change the FDIC's supervisory approach. The FDIC's actions also ultimately resulted in large insurance assessment increases, reputational damage to the banks, as well as litigation and other costs for the banks that tried to remain in the RAL business.

[3] The FDIC's current and historical policy is that it will not criticize, discourage, or prohibit banks that have appropriate controls in place from doing business with customers who are operating consistent with federal and state law. The FDIC applies this policy to services offered to bank customers, i.e., depositors or borrowers. Because RALs are offered through EROs and are third-party relationships, the FDIC does not believe this policy applies.

The Washington Office also used a cursory analysis of underwriting plans that two banks submitted to show their mitigation of perceived risk to reject those plans. In fact, when the initial review suggested these underwriting plans could effectively mitigate certain risks, the Washington Office narrowed and repeated its request to solicit a different outcome. It appears that the decision to reject the plans had been made before the review was complete. The alleged insufficiency of the underwriting plans also formed the basis for an enforcement action against one of the banks.

While the FDIC's Legal Division believed the pursuit of an enforcement remedy against the banks presented "high litigation risk," the FDIC chose to pursue such remedies. Members of the Board, including the then-Chairman of the Case Review Committee, were involved in drafting the language of a proposed enforcement order and in advising management on the development of supervisory support for the enforcement case. The FDIC also attempted to strengthen its case by pursuing a compliance-based rationale. To that end, in early 2011 the FDIC employed extraordinary examination resources in an attempt to identify compliance violations that would require the bank to exit RALs. This examination effort, in the form of a "horizontal review," involved deploying an unprecedented 400 examiners to examine 250 tax preparers throughout the country and the remaining bank offering RALs. The horizontal review was used as leverage in negotiations to get the final bank to exit RALs. Ultimately, the results of the horizontal review were used for little else.

The FDIC also employed what it termed "strong moral suasion" to persuade each of the banks to stop offering RALs. What began as persuasion degenerated into meetings and telephone calls where banks were abusively threatened by an FDIC attorney. In one instance, non-public supervisory information was disclosed about one bank to another as a ploy to undercut the latter's negotiating position to continue its RAL program.

When one institution questioned the FDIC's tactics and behavior of its personnel in a letter to then-Chairman Bair and the other FDIC Board members, the then-Chairman asked FDIC management to look into the complaint. FDIC management looked into the complaint but did not accurately and fully describe the abusive behavior. Nevertheless, the behavior was widely known internally and, in effect, condoned. Other complaints from the banks languished and ultimately were not addressed or investigated independently. Ratings appeals that included these complaints were not considered because they were voided by the FDIC's filing of formal enforcement actions. These complaints were eventually subsumed by settlement processes that, in the case of one bank, appeared to trade improved ratings and the right to purchase failing institutions for an agreement to exit RALs permanently.

Conclusion and Matters for Consideration

The facts developed by this review strongly reinforce the concerns and issues raised in the OIG's earlier Audit. In our view, the FDIC must candidly consider its leadership practices, its process and procedures,

and the conduct of multiple individuals who made and implemented the decision to require banks to exit RALs. While we acknowledge that the events described in our report surrounding RALs involved only three of the FDIC's many supervised institutions, the severity of the events warrants such consideration. The FDIC needs to ask how the actions described in our report could unfold as they did, in light of the FDIC's stated core values of integrity, accountability, and fairness. Further, the Corporation must address how it can avoid similar occurrences in the future.

In December 2015, in response to concerns raised in the Audit, the FDIC removed the term "moral suasion" from its guidance. We appreciate the central importance of informal discussions and persuasion to the supervisory process; however, we believe more needs to be done to subject the use of moral suasion, and its equivalents, to meaningful scrutiny and oversight, and to create equitable remedies for institutions should they be subject to abusive treatment.

Because our work is in the nature of a review, and not an audit conducted in accordance with government auditing standards, we are not making formal recommendations. However, we request that the FDIC report to us, 60 days from the date of our final report, on the steps it will take to address the matters raised for its consideration.

The Corporation's Response

The OIG transmitted a draft copy of this report to the FDIC on January 21, 2016. We asked the Corporation to review the draft and identify any factual inaccuracies they believed existed in the report. We met with staff from the FDIC, on February 10, 2016, to consider whether any factual clarifications were appropriate, reviewed the documentation they provided, and subsequently made some clarifications to the report. The Corporation also requested that we include its response to our report herewith. We have provided the FDIC's full response at Appendix 9. The FDIC's response has not changed our overall view of the facts.