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Division of Risk Management Supervision
Legal Division

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MEMORANDUM TO: Fred W. Gibson, Jr.
Acting Inspector General

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

Thank you for the opportunity to review and respond to the Draft Report of Inquiry (Draft Report) into *The FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel*, prepared by the FDIC's Office of Inspector General (OIG). We believe that the supervision and enforcement activities discussed in the Draft Report were supported by the supervisory record and handled in accordance with FDIC policy. These activities occurred more than five years ago with respect to the three banks that offered refund anticipation loans (RALs).

EXECUTIVE SUMMARY

In August 2015, the FDIC Office of Inspector General (OIG) determined to conduct a review of the role of FDIC staff with respect to the FDIC's supervisory approach to three institutions that offered refund anticipation loans, or RALs. The findings were presented to FDIC in a Draft Report on January 21, 2016 (Draft Report). The Draft Report presented the OIG's view of the FDIC's handling of its supervisory responsibilities with respect to these three financial institutions that offered RALs between five and eight years ago.

We believe that the supervision and enforcement activities identified by the OIG were supported by the supervisory record and handled in accordance with FDIC Policy.

Summary of FDIC Response

- RALs, as described in a GAO report[1], are short-term, high-interest bank loans that are advertised and brokered by both national chain and local tax preparation companies. RALs carry a heightened level of credit, fraud, third-party, and compliance risk because

[1] United States Government Accountability Office Report, GAO-08-800R Refund Anticipation Loans (June 5, 2008) (stating "the annual percentage rate on RALs can be over 500 percent").

they are not offered by bank loan officers, but by several hundred to several thousand storefront tax preparers (also referred to as electronic refund originators (EROs)).

- FDIC must provide strong oversight to ensure that the financial institutions it supervises are offering the product in a safe and sound manner and in compliance with applicable guidance and laws.
- FDIC issued relevant guidance for banks making RALs. In response to an OIG audit, FDIC issued a Supervisory Policy on Predatory Lending. Further, to describe its expectations for banks making loans through third-parties, FDIC issued Guidance on Managing Third-Party Risks.
- Supervisory issues were identified by field compliance examiners as early as 2004, including substantive violations of the Equal Credit Opportunity Act, weak ERO training, and a lack of RAL program audit coverage.
- One community bank grew its RAL program rapidly, nearly doubling the number of EROs through which it originated tax products between 2001 and 2004 to more than 5,600, and then nearly doubling that number again by 2011 to more than 11,000. By comparison, one of the three largest banks in the country at that time originated tax products through 13,000 EROs.
- Supervisory concerns increased through 2008 and 2009, as the management of two banks did not follow regulatory recommendations and directions, including provisions of enforcement actions.
- One of the three RAL banks moved its origination business to an affiliate without prior notice to the FDIC, effectively removing the RAL origination activity from FDIC supervision.
- The exit of large national banks and a thrift from the RAL business raised additional concerns, because similar prior exits had led to the business moving to the much smaller FDIC-supervised community banks.
- All three RAL banks conceded that the loss of the Internal Revenue Service (IRS) Debt Indicator would result in increased credit risk to the bank. The Debt Indicator was a key underwriting tool, supplied by the IRS, and used by the banks to predict the likelihood that a valid tax refund would be offset by other debt. Two of the three banks were unable to fully mitigate the risk created by the loss of the Debt Indicator, and neither substituted credit underwriting based on borrower ability to repay. The third bank may have had an acceptable underwriting substitute, but had such deficient controls and oversight that its RAL program was otherwise not safe and sound.
- The combination of risks outlined above caused the FDIC to ask the banks to exit the RAL business. All three banks declined.
- When poor practices of bank managements were not fully factored into examination ratings for two banks, Washington senior management provided direction to regional management, consistent with policy.
- Two banks were properly downgraded in the 2010 examination cycle based on well-defined weaknesses.
- The banks continued to decline to exit the poorly managed RAL programs.

- Senior FDIC management recommended enforcement actions based on the supervisory records of the institutions.
- Senior FDIC management appropriately briefed the FDIC Chairman and other Board members on the supervisory actions being taken.
- While some members of the Legal Division raised concerns about litigation risk, the supervisory records supported approval of the enforcement cases, and supervision and legal officials ultimately approved them.
- The recommendations for enforcement action were reviewed by the FDIC's Case Review Committee (CRC), consistent with the FDIC Bylaws and the CRC governing documents.
- One of the final enforcement actions described violations of law by one of the RAL banks because of its efforts to impede examination activities.
- Settlement of the approved enforcement actions addressed the supervisory issues and was handled consistently with FDIC policy. It is not unusual for institutions that cannot engage in expansionary activities because of their condition to take steps to remedy regulatory concerns in order to regain the ability to expand.

We look forward to reviewing the details of the final report and will provide actions to be taken in response within the 60-day timeframe specified by the OIG.

Introduction

We reviewed the materials relied upon by the OIG, which included select email communications between FDIC employees, one former employee's personal notes, draft reports of examination, and information from interviews that OIG staff conducted with select past and current FDIC personnel. Having reviewed relevant materials, we believe that the supervision and enforcement activities that occurred with respect to the three banks discussed in the Draft Report were supported by the supervisory record and handled in accordance with FDIC policy. Nonetheless, the Draft Report did identify areas where better communication, both internally and externally, could have improved understanding of the agency's supervisory expectations and bases for action. Additionally, the Draft Report describes at least one instance in which a former employee – new to the FDIC at the time[2] – communicated with external parties in an overly aggressive manner. The FDIC does not condone such conduct, that type of conduct is not consistent with FDIC policy, and steps were taken to address the conduct at the time.

Risks of Refund Anticipation Loans

RALs are short-term, high-interest bank loans that are advertised and brokered by both national chain and local tax preparation companies. By their very nature, RALs carry a heightened level of credit, fraud, third-party, and compliance risk. Financial institutions must execute strong oversight of the storefront tax preparers (also referred to as electronic refund originators (EROs)) that originate RALs because banks are responsible for the actions of their third-party agents. Similarly, supervisory authorities must provide strong oversight to ensure

[2] The employee left the agency later that same year.

that financial institutions are offering the product in a safe and sound manner and in compliance with applicable guidance and laws. Fewer than 10 financial institutions have ever offered RALs.

FDIC Took an Incremental Approach to Supervising Banks that Offered RALs

The Draft Report suggests that actions taken by the FDIC represented a sharp and rapid escalation in oversight of the institutions with RAL programs. The supervisory record, however, indicates that concerns were raised about risk management oversight of the RAL programs at the institutions for a number of years.

The FDIC first developed supervisory concerns with the risk management practices and oversight provided by the board and senior management of two institutions in 2004. FDIC had concerns with another RAL lender at the time that was not reviewed by the OIG. That lender exited the business in 2006 when its tax preparation partner wanted to offer a product the bank deemed too risky.

Between 2004 and 2009, the two institutions were subject to annual risk management examinations and two compliance examinations. The examinations identified repeated weaknesses in risk management practices. Both banks' RAL programs experienced heavier than normal losses in 2007. Examinations in 2008 showed continuing weaknesses in risk management practices and board and senior management oversight, and both institutions' compliance ratings were downgraded to less-than-satisfactory levels. Examinations in 2009 showed continued weaknesses in risk management practices and oversight, and both institutions were downgraded to an unsatisfactory level for compliance and "Needs to Improve" for CRA.

By December 2009, FDIC continued to have a variety of concerns with the RAL programs of both institutions. One of the institutions had moved the RAL business to an affiliate for the 2009 tax season and was not in compliance with a February 2009 Cease and Desist Order requiring enhancement of its program oversight. Later, that institution entered into contracts to expand its ERO lender base without the required prior notice to the FDIC.

Another institution was operating under a Memorandum of Understanding (MOU) requiring it to improve its oversight, audit, and internal controls over its RAL business. The bank's management was not in compliance with those provisions of the MOU.

Given identified risk management weaknesses and concerns about one institution's continued expansion, in December 2009, FDIC directed the institution to deliver a plan to exit the RAL business. Based on similar concerns with another bank's risk-management weaknesses, and reports that the Internal Revenue Service was contemplating discontinuance of its Debt Indicator, a key underwriting tool for RAL lending, FDIC sent similar letters to two other banks in February 2010, requesting that they develop and submit plans to exit the RAL business.

The letters sent to all three of the banks expressed concern about the utility of the product to the consumer given high fees. This concern was consistent with the FDIC's Supervisory

Policy on Predatory Lending, which stated that signs of predatory lending included, among others, the lack of a fair exchange of value. All three institutions declined the request that they develop a plan to exit the business.

FDIC had Operative Guidance for Banks Engaged in RALs

The Draft Report suggests that the FDIC did not have guidance that was applicable to RALs. In fact, the FDIC has well-established guidance for the supervision of banks that offer RALs, stemming from longstanding guidance governing predatory lending as well as guidance for banks engaged in third-party lending arrangements.

In June 2006, the OIG's Audits and Evaluations staff issued OIG Report 06-011, *Challenges and FDIC Efforts Related to Predatory Lending*. The Report recommended that FDIC issue a policy on predatory lending, and FDIC complied. The Policy, which was issued in January 2007, states, "[s]igns of predatory lending include the lack of a fair exchange of value or loan pricing that reaches beyond the risk that a borrower represents or other customary standards."[3] Further, FDIC issued FIL-44-2008, *Guidance for Managing Third-Party Risk*, in June 2008. Both pieces of guidance were relevant to the banks engaged in the RAL business.

Headquarters Management Properly Oversaw Regional Offices

The Draft Report suggested that decisions by FDIC officials to change draft ratings assigned by examiners were improper and unfounded. However, such oversight is appropriate and the review of the examination documents suggests the changes had a strong supervisory basis.

In 2010, FDIC headquarters instructed the Chicago Regional Office to consider bank practices, not just their current financial conditions, in assigning ratings to two banks with identified weaknesses in their RAL programs. This instruction was consistent with interagency rating guidelines. The instruction was also consistent with the concept of forward-looking supervision that the FDIC had emphasized in response to OIG recommendations following Material Loss Reviews of failed banks.

Forward-looking supervision encourages examiners to consider the fact that even financially strong institutions can experience stress in cases in which risks are not properly monitored, measured, and managed. Further, examiners are encouraged to take proactive and progressive action to encourage banks to adopt preemptive measures to address risks before their profitability and viability is impacted.

[3] See https://www.fdic.gov/news/news/financial/2007/fil07006.html, FDIC Financial Institution Letter 6-2007, FDIC's Supervisory Policy on Predatory Lending, January 22, 2007.

The ratings for the two banks were fully supported by the weaknesses identified in both banks' risk management practices and board and senior management oversight of their RAL businesses.

Supervisory Practices were Appropriate and Risk-Focused, Consistent with Longstanding Policy

During 2010, FDIC's concerns about the safety and soundness of RAL programs grew. OCC and OTS had each directed a large institution to exit the RAL business, and an additional large financial institution exited the RAL lending business on its own. The FDIC was concerned that the activities would migrate to the three FDIC supervised community banks, two of which had documented weaknesses in the oversight of their existing RAL programs. Further, the IRS announced in August it would discontinue the Debt Indicator (DI) before the 2011 tax season; the DI had proven to be a key tool for reducing credit risk in RALs. In November 2010, the institutions were asked to outline their plans for mitigating the resulting increase in credit risk following the loss of the tool. All three institutions conceded that the loss of the DI would result in increased risk to their banks. Despite these concerns, all three institutions continued to decline to exit the business. Finally, in December 2010, OCC directed the final national bank making RALs to exit the business before the 2011 tax season.

In response to these concerns, as well as the ongoing compliance issues that were being identified by 2010 risk-management examinations, the FDIC planned to conduct unannounced horizontal reviews of EROs during the 2011 tax season. These types of reviews were not a novel supervisory tool for the FDIC; in fact third-party agents of one of the institutions had previously been the subject of a horizontal review in 2004 that covered two additional FDIC-supervised institutions.

The 2011 horizontal review ultimately only covered EROs of one of the banks. The review confirmed that the institution had violated law by interfering with the FDIC's review of the EROs during the 2009 compliance examination and during the 2011 horizontal review by coaching ERO staff and providing scripted answers. The review identified a number of additional violations of consumer laws and unsafe and unsound practices, violations of a Consent Order, and violations of Treasury regulations for allowing third-party vendors to transfer up to 4,300 bank accounts for Social Security recipients without the customers' knowledge or consent.

FDIC's Enforcement Actions Were Legally Supported

Contrary to what the Draft Report suggests, the presence of litigation risk does not mean an enforcement action has no legal basis. While some in the Legal Division – in particular the Deputy General Counsel, Supervision Branch (DGC) – believed that enforcement action against one institution presented litigation risk, the General Counsel and the DGC both approved the enforcement actions taken by the FDIC. Their own actions demonstrated their belief that the enforcement action was legally supportable.

The decision to pursue an enforcement action against the bank despite the presence of litigation risk is consistent with guidance offered by the OIG. In a 2014 report on enforcement actions, the OIG noted that legal officials need to ensure that their risk appetite aligns with that of the agency head and should clearly communicate the legal risks of pursuing a particular enforcement action, but the agency head or senior official with delegated authority should set the level of litigation risk that the agency is willing to assume.

Moreover it is important to note that experienced enforcement counsel and subject matter experts in the Legal Division reviewed and responded to the concerns raised by the Chicago Regional Counsel in a series of memoranda.

Communications Between FDIC Board Members and Staff Were Appropriate

The Draft Report suggests that discussions between staff and FDIC Board members on the RAL programs were unusual and inappropriate. However, as discussed below, such discussions are expected and appropriate. No member of the FDIC Board directed FDIC staff to order any banks to discontinue offering RAL products or to take any action that was not supported by supervisory findings.

The FDIC bylaws set forth the organizational structure of the FDIC and the foundation for communications and exercise of authority of both the FDIC Board and its Officers. The FDIC Board has overall responsibility for managing the FDIC, while day-to-day responsibility for managing the FDIC and supervising its Officers is delegated to the FDIC Chairman. FDIC Officers have a duty to keep the Chairman informed of their actions as well as other Board members as appropriate, and they meet this duty through regular briefings of the Chairman and updates to other Board members about the ongoing activities in their organizations.

Case Review Committee Acted Consistently With Existing Guidelines

Contrary to the suggestion in the Draft Report, the Case Review Committee (CRC) acted consistently with existing guidelines in connection with the issuance of the Notice of Charges against an institution in February 2011. The CRC is a standing committee of the FDIC Board of Directors that is responsible for overseeing enforcement matters. Its voting members consist of one internal FDIC Board member who serves as the CRC Chairman and one special assistant or deputy to each of the other four FDIC Board members.

First, the Notice of Charges sought a Cease & Desist Order (C&D) which does not require CRC approval under governing documents. Authority to issue C&D Orders was delegated to staff and therefore the CRC was not required to vote on the C&D Order.

Second, CRC governing documents provide for staff to consult with the CRC Chairman if a proposed enforcement action may affect FDIC policy, attract unusual attention or publicity, or involve an issue of first impression. Under such circumstances, the CRC Chairman may, in his or her discretion, determine whether review and approval by the CRC would be desirable, in

which case the matter would be heard by the CRC. Thus, the Notice of Charges did not require a CRC vote.

Finally, CRC governing documents provide that the CRC Chairman is expected to take an active role in the enforcement process and to meet regularly with senior supervision and legal enforcement personnel to review enforcement activities and matters. As such, it was wholly permissible and appropriate for the CRC Chairman to engage with staff in active debate over a matter affecting the FDIC.

Settlement Discussions Were Handled Properly

The FDIC acted consistently with outstanding agency policy when conducting settlement discussions. In the case referenced by the OIG, the bank was prevented from participating in failed bank acquisitions by two issues: an outstanding enforcement action and compliance and risk-management problems stemming from its RAL program. Once the bank settled its enforcement action and agreed to exit the RALs business, there was no reason to prevent the bank from qualifying for the "failed bank bid list." To do otherwise could have been arbitrary and unduly punitive.

Conclusion

The FDIC had longstanding supervisory histories with respect to RALs. To differing degrees, the institutions engaged in the RAL business had a record of supervisory deficiencies identified by examination staff in both risk management and compliance stemming from their RAL programs. These issues formed the basis for the examination and enforcement actions described in the report. Nonetheless, the Draft Report did identify areas where better communication, both internally and externally, could have improved understanding of the agency's supervisory expectations and bases for action. Additionally, the Draft Report describes at least one instance in which a former employee – new to the FDIC at the time[4] – communicated with external parties in an overly aggressive manner. The FDIC does not condone such conduct, that type of conduct is not consistent with FDIC policy, and steps were taken to address the conduct at the time.

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