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Fed Held Back as Evidence Mounted on Subprime Loan Abuses

By Binyamin Appelbaum
Washington Post Staff Writer
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The visits had a ritual quality. Three times a year, a coalition of Chicago community groups met with the Federal Reserve and other banking regulators to warn about the growing prevalence of abusive mortgage lending.

They began to present research in 1999 showing that large banking companies including Wells Fargo and Citigroup had created subprime businesses wholly focused on making loans at high interest rates, largely in the black and Hispanic neighborhoods to the south and west of downtown Chicago.

The groups pleaded for regulators to act.

The evidence eventually led Illinois to file suit against Wells Fargo in July for discrimination and other abuses.

But during the years of the housing boom, the pleas failed to move the Fed, the sole federal regulator with authority over the businesses. Under a policy quietly formalized in 1998, the Fed refused to police lenders' compliance with federal laws protecting borrowers, despite repeated urging by consumer advocates across the country and even by other government agencies.

The hands-off policy, which the Fed reversed earlier this month, created a double standard. Banks and their subprime affiliates made loans under the same laws, but only the banks faced regular federal scrutiny. Under the policy, the Fed did not even investigate consumer complaints against the affiliates.

"In the prime market, where we need supervision less, we have lots of it. In the subprime market, where we badly need supervision, a majority of loans are made with very little supervision," former Fed Governor Edward M. Gramlich, a critic of the hands-off policy, wrote in 2007. "It is like a city with a murder law, but no cops on the beat."

Between 2004 and 2007, bank affiliates made more than 1.1 million subprime loans, around 13 percent of the national total, federal data show. Thousands ended in foreclosure, helping to spark the crisis and leaving borrowers and investors to deal with the consequences.

Congress now is weighing whether the Fed should be fired. The Obama administration has proposed shifting consumer protection duties away from the Fed and other banking regulators and into a new watchdog agency. That proposal, a central plank in the administration's plan to overhaul financial regulation, is opposed by the industry and faces a battle on Capitol Hill.

The Federal Reserve is best known as an economic shepherd, responsible for adjusting interest rates to keep prices steady and unemployment low. But since its creation, the Fed has held a second job as a banking regulator, one of four federal agencies responsible for keeping banks healthy and protecting their customers. Congress also authorized the Fed to write consumer protection rules enforced by all the agencies.

During the boom, however, the Fed left those powers largely unused. It imposed few new constraints on mortgage lending and pulled back from enforcing rules that did exist.

The Fed's performance was undercut by several factors, according to documents and more than two dozen interviews with current and former Fed governors and employees, government officials, industry executives and consumer advocates. It was crippled by the doubts of senior officials about the value of regulation, by a tendency to discount anecdotal evidence of problems and by its affinity for the financial industry.

Fed Chairman Ben S. Bernanke testified before Congress this summer that the Fed has protected consumers with renewed vigor in recent years, writing new rules and responding to problems more quickly. The Fed has avoided a public position on the new agency, but Bernanke has testified that Congress instead could choose to strengthen the Fed's responsibilities.

An Industry Rises

Subprime mortgage lending sneaked up on the Federal Reserve.

Most subprime affiliates began life as independent consumer finance companies, beyond the watch of banking regulators. These firms made loans to people whose credit was not good enough to borrow from banks, generally at high interest rates, often just a few thousand dollars for new furniture or medical bills. But by the 1990s, thanks to big changes in laws, markets and lending technology, the companies increasingly were focused on the much more lucrative business of mortgage lending.

As profits soared, hundreds of banking companies took notice, buying or creating finance businesses for themselves. Consumer advocates demanded that regulators take notice, too.

The advocates amassed evidence of abusive practices by lenders, such as Fleet Finance, an affiliate of a New England bank that eventually paid the state of Georgia $115 million to settle allegations that it charged thousands of lower-income black families usurious interest rates and punitive fees on home-equity loans. The National Community Reinvestment Coalition pressed the Fed to investigate allegations against other affiliates.

On Jan. 12, 1998, the Fed demurred. Acting on a recommendation from four Fed staffers including representatives of the Philadelphia, St. Louis and Kansas City regional reserve banks, the Fed's Board of Governors unanimously decided to formalize a long-standing practice, "to not conduct consumer compliance examinations of, nor to investigate consumer complaints regarding, nonbank subsidiaries of bank holding companies."

The Fed could balk because Congress had allowed the laws governing the financial industry to become outdated.

Banks and the companies that own them, known as holding companies, have long operated under federal oversight. But a growing share of loans were made by companies that competed with banks, such as consumer finance firms. The money they gave to borrowers came from Wall Street rather than depositors. As a result, those firms operated beyond the authority of banking regulators, and Congress did not task anyone else with oversight.

The Fed Board decided that even when a nonbank was purchased by a bank holding company, the Fed still lacked authority to police its operations.

Fed staff recommended that it continue to investigate complaints from Congress, which oversees the central bank's performance as an industry regulator. Everything else was passed to the Federal Trade Commission, which has law-enforcement powers but neither the authority nor the resources to oversee the fast-growing industry.

The Fed's hands-off policy was quickly criticized by other parts of the federal government.

A 1999 report by the General Accounting Office warned that the Fed's decision created "a lack of regulatory oversight," because the Fed alone was in a position to supervise the affiliates.

"If the Fed really wants to take action against predatory lending, here is a clear opportunity," John Taylor, president of the National Community Reinvestment Coalition, told Congress after the report was issued.

A 2000 joint report on predatory lending by the Treasury Department and the Department of Housing and Urban Development made a similar recommendation. The report said the Fed clearly had the authority to investigate evidence of abusive lending practices, and urged a policy of targeted examinations.

Even inside the Fed, there was dissent. Gramlich was starting to express concern about predatory lending in his public speeches. He had voted for the hands-off policy in 1998, but by 2000 concluded that the Fed could demonstrate leadership by subjecting the lending affiliates to examinations. "A good defense against predatory lending, perhaps the best defense society has devised, is a careful compliance examination for banks," Gramlich later told a 2004 meeting of bankers in Chicago.

Alan Greenspan, then chairman of the Fed, recalled that Gramlich broached the subject at a private meeting in 2000. Greenspan said that he disagreed with Gramlich, telling him that such inspections would require a vast effort with no certainty of results, and that the Fed's involvement might give borrowers a false sense of security.

Gramlich did not press the issue. Years later, in 2007, after an account of the meeting appeared in newspapers, he sent Greenspan a note that read in part, "What happened was a small incident, and as I think you know, if I had felt that strongly at the time, I would have made a bigger stink."

Unchecked Growth

After the Fed's decision, several of the largest bank holding companies added finance arms, expanding into the regulatory vacuum.

In March 1998, First Union bought the Money Store, a California lender with a ziggurat for a headquarters, ads featuring baseball Hall of Famers Jim Palmer and Phil Rizutto, and a catchy phone number: 1-800-LOAN-YES.

"Thank goodness you can buy all of the things you need with a fixed-rate second mortgage loan," Rizutto told audiences.

In April 1998, Citibank announced a merger with Travelers and its finance arm, which was renamed CitiFinancial. Two years later, Citigroup added the nation's largest consumer finance company, paying $31 billion for Associates First Capital. Both the Justice Department and the FTC were investigating Associates for abusive lending practices, but Citi executives promised reforms. In 2002, the company agreed to pay the FTC a record fine of $215 million to settle allegations that Associates had "engaged in systematic and widespread deceptive and abusive lending practices."

The last of the large finance companies was also snapped up in 2002, as HSBC agreed to pay $14 billion for Household International. The Chicago firm described itself as the nation's oldest finance company and boasted in its corporate history that it pioneered direct-mail loan solicitations in 1896. More recently, it had become the subject of a massive investigation by state attorneys general who charged that it routinely misled borrowers about the true cost of refinance loans. Immediately before announcing its deal with HSBC, Household agreed to pay $484 million to settle those charges.

By 2004, the consumer finance industry had largely been folded into the banking industry, and the finance arms of bank holding companies were making at least 12 percent of all mortgage loans with high interest rates, according to data reported by lenders under the Home Mortgage Disclosure Act.

The rapid growth of subprime lending by affiliates renewed the interest of the GAO, which repeated its call for the Fed to examine affiliates in a 2004 report on shortcomings in federal efforts to combat predatory lending. The report noted the FTC investigations of Fleet Finance and Associates as reasons for concern.

"The significant amount of subprime lending among holding company subsidiaries, combined with recent large settlements in cases involving allegations against such subsidiaries, suggests a need for additional scrutiny and monitoring of these entities," the GAO said.

This time, the GAO suggested that Congress clarify the question of legal authority to address the Fed's concerns.

A response letter signed by Gramlich, who died in 2007, said the Fed had all the authority it needed if it wanted to act. "The existing structure has not been a barrier to Federal Reserve oversight," he wrote.

Five months later, the Fed took its first public enforcement action against an affiliate, fining Citigroup $70 million. In settling the FTC's earlier charges, Citigroup had agreed to a number of reforms. The Fed found that some practices had continued in violation of that commitment, and that employees had misled regulators.

Fed officials cite the fine as evidence that the agency was able to protect consumers without conducting regular examinations. Consumer advocates took the opposite lesson: Despite finding that a major affiliate was violating consumer protection laws, the Fed still was refusing to create a reliable system for identifying other abuses.

The Citigroup case remains the Fed's only public enforcement action against a lending affiliate.

Retreat From Oversight

The Fed's reluctance was part of a broad governmental retreat from oversight of the financial industry. Greenspan and many politicians in both parties saw regulation as a blunt instrument that often deprived more people than it protected.

"There was a long period when things were going very well and regulation was viewed as something that got in the way," said Alice Rivlin, the Fed's vice chairman from 1996 to 1999 and now a fellow at the Brookings Institution.

The Fed also minimized repeated warnings about mortgage lending abuses in part because it was an institution dominated by big-picture economists focused on the health of the broader economy rather than the problems faced by individual borrowers.

Greenspan said in an interview that he did not think the Fed was suited to policing lending abuses because of its focus on broader issues, but he added, "I'm not sure anyone could have done it better." He said the administration's plan to create a consumer protection agency was "probably the right decision."

Throughout the lending boom, consumer advocates trooped regularly to the Fed's monumental marble headquarters on Constitution Avenue to offer specific accounts of abuses in financial transactions. But what seemed powerful to advocates often was dismissed as anecdotal by regulators.

"The response we were getting from most of the governors and the staff was, 'All you're able to do is point to the stories of individual consumers, you're not able to show the macroeconomic effect,' " said Patricia McCoy, a law professor at the University of Connecticut who served on the Fed's consumer advisory council from 2002 to 2004. "That is a classic Fed mindset. If you cannot prove that it is a broad-based problem that threatens systemic consequences, then you will be dismissed."

As the anecdotes piled up, so did the frustration of advocates. By refusing to conduct examinations of lending affiliates -- by refusing to look systematically -- the Fed was basically preventing itself from finding systemic problems.

"I stood up at a Fed meeting in 2005 and said, 'How may anecdotes makes it real?' " said Margot Saunders of the National Consumer Law Center's Washington office. "How many tens or thousands of anecdotes will it take to convince you that this is a trend?' "

The Boom, the Burden

As the great housing boom soared toward its cataclysm, lending abuses became increasingly hard to ignore.

The Fed's Board of Governors had voted in 2002 to require more detailed annual reports from mortgage lenders. When the first data were released in the fall of 2005, they confirmed that the largest banking companies had developed split personalities. The banks, subject to regular scrutiny, mostly made loans at market rates and concentrated their lending in white, suburban neighborhoods. The unwatched subprime affiliates mostly made loans at high rates and concentrated their lending in minority neighborhoods.

Wells Fargo Bank, for example, charged high interest rates on only 9 percent of its loans between 2004 and 2007. Wells Fargo Financial, which used the same stagecoach logo and the same red-and-yellow color scheme, charged high rates on 80 percent of its loans during the same period. The disparities were similar at Citigroup and HSBC.

Nationwide, the data showed that black borrowers making more than $100,000 were charged high rates more often than white borrowers making less than $40,000.

The three companies have all said they complied with lending laws and that race was not a factor in their decisions.

Wells Fargo said that it complied with all relevant laws, and it is contesting the Illinois lawsuit. The company merged its subprime affiliate into its bank last year.

"We served customers across the United States regardless of their race. Our pricing and underwriting simply doesn't factor race into the equation at all," David Kvamme, president of Wells Fargo Financial, said in an interview. "We were regulated on a consistent basis by the states, and the states looked deeply into our compliance with all laws including consumer protection laws."

Consumer advocates used the data to press their case for increased regulation.

At the end of the March 2007 meeting of the Fed's consumer advisory council, during a slot reserved for presentations, two longtime advocates confronted the Fed's governors and staff with a study showing lending disparities in six cities including New York and Chicago.

"We thought it was pretty convincing evidence of discrimination," recalled one of the presenters, Sarah Ludwig of the Neighborhood Economic Development Advocacy Project, based in New York. "And afterward I remember nobody asking a question. I remember nobody making eye contact. Nobody called me from the Fed afterward saying, 'Let's talk about it.'"

"We thought it was incredibly important and we weren't seeing much of a response," she said.

Finally, as the housing market, then the financial system, then economy came crashing down, the reluctance to regulate started to fade away.

Bernanke asked the Fed's lawyers to revisit their concerns and, in July 2007, the Fed announced a pilot program to examine a few subprime affiliates.

This summer, pronouncing itself satisfied with the results, the Fed announced it would launch regular consumer compliance examinations.

"In looking at our responsibility to enforce these consumer laws we believe a somewhat more proactive stance is justified," Bernanke told Congress.

The Fed also said it will begin to investigate consumer complaints.

This is the first in an occasional series of articles about the record of the Federal Reserve.