Through its disclosure regulations, the Federal Reserve strives to improve transparency in consumer finance markets

BY CHARLES GERENA

When Jack Weiss joined the Federal Reserve Bank of Richmond as a bank examiner in the mid-1970s, it had been only a few years since the Federal Reserve System ventured into the realm of consumer protection. In addition to auditing a bank’s safety and soundness, he had to verify compliance with a series of federal laws that were passed in the late 1960s and early 1970s because of wide disparities in how the consumer finance industry operated and how it was regulated by states.

Congress charged the Federal Reserve and a varied group of federal agencies — from the Office of Thrift Supervision to the Department of Housing and Urban Development — with enforcing these laws. It also gave the Fed unique authority to write the regulations for the various disclosure and anti-discrimination provisions. Lawmakers recognized the Fed’s credibility as an apolitical organization and its expertise in banking regulation.

At first, banks only had to answer a question on the exam form to prove they were following the Fed’s disclosure requirements. “It didn’t say whether the disclosures were correct or not, it just said whether they were provided,” recalls Weiss. But as consumer credit regulations grew in detail and scope, the Richmond Fed and other Reserve Banks created specialized teams of examiners to conduct separate compliance audits.

Today, Weiss and other consumer compliance examiners help the Federal Reserve enforce a book of regulations several inches thick. Many of the regulations focus on mandatory disclosures outlined by Congress and crafted by the Fed. By making creditors describe the price and terms of their product in a consistent manner, buyers can comparison shop. By making firms account for how they approve or deny credit, the Fed and other regulators can look for patterns of discrimination.

Here is a taste of how the Fed’s disclosure requirements pull back the curtain on the consumer finance industry and the value of what it reveals.

Knowledge is Power, But at What Price?

Consumer protection groups want borrowers to know what they’re getting into; ignorance breeds fraud in their eyes. But why should the Federal Reserve care if John Doe knows the over-the-limit fee on his credit card?

Besides the fact that the Consumer Credit Protection Act of 1968 and subsequent legislation make it the Fed’s business, market transparency has economic benefits. “If consumers are better informed about practically anything, they will make better decisions and the markets will function better,” notes Thomas Durkin, an economist at the Federal Reserve Board of Governors and an expert on consumer credit regulation.

Generally, consumers gain from a transparent market because they should be better matched to their needs and prices should be more competitive. Lewis Mandell, professor of finance and managerial economics at the State University of New York at Buffalo, says that consumer finance companies benefit as well. Informed borrowers are expected to make fewer missteps, creating surplus capacity in credit markets because there is less unrecoverable debt to write off.

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standardize how they describe the cost of
and requires disclosure of
prices and credit terms, both before and
after customers sign on the dotted line.
For example, a credit card solicita-
tion must include key information such
as the minimum finance charge that cus-
tomers have to pay and the grace period
for repaying consumer credit without incurring
finance charges. The most important
disclosure is the annual percentage rate
(APR), which is supposed to express the
total cost to customers of credit pur-
bures, cash advances, and balance
transfers on an annualized basis.

Regulation M imposes similar dis-
closure requirements on companies
that offer consumer leases. These com-
pnies must provide information on
the cost and terms of leases so con-
sumers can compare one lease with
another or weigh leasing against pur-
chasing a product outright.

Not surprisingly, banks and other
consumer finance companies grouse
about the dozens of detailed disclosures
they make in the name of creating an
informed public. Richard Insley, a
banking consultant who used to be a
compliance officer at Signet Banking
Corp. and an examiner at the Richmond
Fed, says it hasn’t been easy or cheap
for banks to keep up with disclosure
requirements. “The early nickname
given to the Truth in Lending law was
the ‘Lawyers and Printers Relief Act.’
Truth in Lending has been an enormous
regulation that covers just about every
imaginable credit product that con-
sumers use,” says Insley, president of
Richmond, Va.-based APR Systems Inc.
Economists have found that the
monetary burden of consumer credit
regulations is proportionately larger for
small firms, according to Richmond
Fed economist John Walter. For
example, a bank needs a compliance
officer to make sure that it follows all
of the regulations, whether it has
branches nationwide or a single office
in a rural town.

Computer technology has dramati-
cally reduced compliance costs and
improved the reliability of disclosures
for everyone, notes Insley, but the
chances of violating Regulation Z are
significant. According to the Federal
Reserve’s 2002 Annual Report to
Congress, 77 percent of banks examined
by the Fed and other federal agencies
were
fully compliant with the regulation.
However, that is the lowest compliance
rate among the consumer protection
regulations tracked by the Fed.

“In a bank of any size with any kind
of sophisticated product line, if you look
long enough you’ll find something
wrong,” Insley adds.

The Fed’s Thomas Durkin believes
that the price of keeping up with reg-
ulation changes is the real issue. “Banks
can comply with anything. They just
don’t want the regulations changing all
of the time.”

Of course, the consumer finance
industry is always evolving and the
Federal Reserve has to keep pace. There
are new services like refund anticipation
loans and overdraft protection that
aren’t subject to the same disclosure
requirements as standard consumer
loans. Debit cards function like credit
cards, yet they aren’t subject to the same
requirements either. In addition, Con-
gress amends Truth in Lending and
other consumer credit laws in response
to industry changes, and that usually
requires the Fed to tweak its regulations.

Balancing the potential benefits of
market transparency against the poten-
tial costs to industry is the job of James
Michaels and his colleagues at the
Federal Reserve Board’s Division of
Consumer and Community Affairs.
The division’s goal is to tailor disclo-
sure requirements “so that you have the
intended impact without creating
unnecessary burdens or risks,” says
Michaels, assistant director for finan-
cial services regulations. But there are
always tradeoffs, so the division reports
both sides to the members of the
Board of Governors and they decide
which way to go.

Michaels believes that public
comment periods and hearings are useful
for determining the benefits and
costs of the Fed’s regulations. However,
it is a major challenge to do a benefit-
cost analysis of market transparency.

There is a consensus that credit
markets are more competitive and con-
sumers have greater awareness of the
terms of their credit since the 1960s.
But how much of these benefits came
from mandated disclosures or what its
impact has been in dollars and cents is
hard to pin down, says Durkin.

Also, disclosures only give consumers
the means to make wiser credit deci-
sions. People still take on more debt
than they can afford. “If he has to pay
a doctor bill … and doesn’t have any
money or made a Super Bowl bet and
the bookie is coming after him with a
ball-peen hammer, the rational con-
sumer may take out a loan at a high
rate of interest,” explains SUNY’s Lewis
Mandell. “We can also assume that there
are a lot of folks who cannot calculate
interest or totally ignore it because they
don’t understand the concept.”

Mandell insists that the current mul-
titude of disclosures “may be more
harmful than beneficial.” Based on 35
years of research, he has concluded that
consumers aren’t capable of focusing
on more than one piece of information
when evaluating credit. “I would like
to see a lot of stuff disclosed, but …
there has to be one point that is ‘super-
colored’ in order to reach as many
people as possible.”

A Watchful Eye
While disclosures under Regulations Z
and M provide a means for people to
help themselves, other mandated dis-
closures help the Fed ensure equal
access to credit.

Regulation B implements the Equal
Credit Opportunity Act of 1974, which prohibits creditors from treating borrowers differently on the basis of their race, ethnicity, religion, gender, marital status, or age. Among its many rules, Regulation B prohibits firms from doing anything to selectively attract or discourage certain borrowers from applying for credit. It also establishes boundaries on what creditors can ask borrowers during the pre-screening and evaluation of applications, and requires firms to provide a detailed notification when they deny an application or make a decision that adversely affects an existing customer.

On top of disclosing the reasons behind their actions, creditors are required by Regulation B to retain any records concerning those actions for 25 months. In addition, they must collect information on the race, gender, marital status, and age of people who borrow money to buy a house.

Regulation C, which fulfills the provisions of the Home Mortgage Disclosure Act of 1975, also requires financial institutions to collect data. They must provide information on the geographic distribution of their mortgage and home improvement loans, organized by gender, race, and other applicant characteristics.

Using computer models, consumer compliance examiners use the information obtained under Regulations B and C to detect potential problems in a bank’s lending practices. Jack Weiss describes the steps taken by the examiners that he manages at the Richmond Fed. “A regression analysis takes loans of a similar category like purchase money mortgages,” then compares approved and denied applications “to see whether the bank’s loan policy is being applied uniformly to ensure discrimination does not take place.”

The regression analysis doesn’t always raise a red flag if a bank’s lending is biased. “It is only an indicator,” says Weiss, and not every bank makes enough loans to produce sufficient data for this analysis. As a result, examiners also conduct interviews to see if discrimination is taking place and pull samples from the bank’s files to perform various types of analysis.

For example, an examiner might do a pricing analysis to see if every customer with a Hispanic last name paid more interest than the average customer was charged. At that point, a more thorough examination would be conducted.

Even with all the information at the examiner's fingertips, Weiss says that verifying compliance with Truth in Lending disclosures is more straightforward than checking for violations of fair lending regulations. In fact, examiners will often reach conclusions that are very different from what consumer groups come to when they look at the loan information provided to the public.

Henry Franzyshen, a supervisory examiner at the Richmond Fed, says that his colleagues must rule out all appropriate factors before they charge discrimination. “While the Regulation C data may show minorities are being denied at a higher rate, the data only includes a limited number of borrower and loan characteristics such as income, race, sex, location, and loan rate spreads. But information from credit bureaus and other sources might point to valid reasons for any lending disparities, based on sound financial practice.”

**On the Front Burner**

While disclosure requirements will always need adjustment, Weiss doesn’t see the amount of requirements decreasing in the future. “Congress and consumer advocates think this information needs to be put forth. They just won’t touch it.”

Actually, the Federal Reserve’s regulatory responsibilities keep on growing. In 1999, the Financial Modernization Act gave the Fed and other regulators the task of implementing restrictions on how banks use their customers’ personal information. Two years later, Regulation P required financial institutions under the Federal Reserve’s supervision to disclose their privacy policy. They also must ask customers if they want their information shared with nonaffiliated third parties.

More recently, the passage of the Fair and Accurate Credit Transactions Act last December will require the Federal Reserve, the Federal Trade Commission, and other federal banking agencies to jointly write at least 10 new rules concerning consumer privacy, according to staffers at the Board of Governors. The rules will include model forms for creditors to use for obtaining information on applicants and regulation of creditors’ use of medical information.

In addition to privacy issues, the Federal Reserve will soon have to deal with the growing amount of consumer credit sold through the Internet. “The information flow to people is coming faster and through more types of devices,” adds consultant Richard Insley. As a result, a person waiting at an airport can shop for a loan using his web-enabled telephone.

As more people use the Internet to shop for credit, Insley thinks more needs to be done to ensure compliance with disclosure requirements. “I suspect there are a lot of people out there who are shopping [for credit] and missing information they are supposed to have.”

**Readings**


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