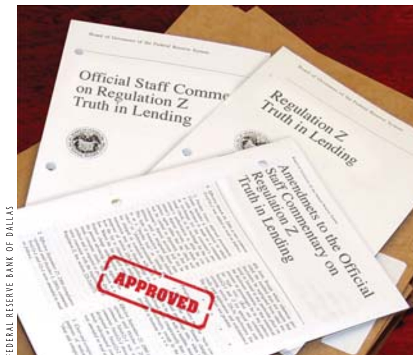
Information, Please?

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

BY CHARLES GERENA



FEDERAL RESERVE BANK OF DALLAS

The Fed's Regulation Z keeps evolving and expanding to keep pace with changes in the financial services industry.

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.

If transparency benefits both sides of the market, why doesn't it occur on

its own without government regulation? "Sometimes, if you have a monopoly position [as a result of] consumer ignorance, you may not want to give up some of those profits," surmises Mandell, but the answer is not that simple and is still under debate among economists.

Regulation Z is the Federal Reserve's primary means of encouraging transparency in consumer finance. Implementing provisions in the "Truth in Lending" portion of the Consumer Credit Protection Act, it mandates that creditors standardize how they describe the cost of their services and requires disclosure of prices and credit terms, both before and after customers sign on the dotted line.

For example, a credit card solicitation must include key information such as the minimum finance charge that customers have to pay and the grace period for repaying 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 purchases, cash advances, and balance transfers on an annualized basis.

Regulation M imposes similar disclosure requirements on companies that offer consumer leases. These companies must provide information on the cost and terms of leases so consumers can compare one lease with another or weigh leasing against purchasing 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 consumers 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 dramatically 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 regulation 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, Congress 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 potential 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 disclosure requirements "so that you have the intended impact without creating unnecessary burdens or risks," says Michaels, assistant director for financial 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 consumers 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 decisions. 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 consumer may take out a loan at a high rate of interest," explain 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 multitude 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-disclosed' 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 disclosures 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." **RF**

Readings

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