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Remarks of J. L. Robertson

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Consumers in the 70's

I am pleased to be with you today and to have an opportunity to discuss developments in the consumer credit field from the vantage point of a member of the Federal Reserve Board. However, I was somewhat disconcerted by one thing in the letter of invitation that was sent to me. I was told that I had come to be regarded as the Federal Reserve's expert on consumer credit. I was thought of, I was told, as Mr. Consumer Credit. Well, if we can have attractive young ladies bearing such titles as Miss Retail Merchandising and Miss Environmental Protection, consumer credit certainly rates a sexy "Miss" instead of a sexagenarian "Mister".

However, I do not mind the title so much as long as I am not labeled an expert. I have been wary of that ever since one of the sages of my home town, Broken Bow, Nebraska, gave me a bit of advice as I set out many years ago to make my career in Washington. He told me that there were three ways to go to hell: the first was gambling; the second was women; the third was reliance on experts. He said gambling was the quickest; women were the pleasantest; but reliance on experts was the surest.

One thing that I do not want to do is to try to impress this knowledgeable group with my expertise. The best contribution that I can make is to give you my reaction to some of the problems that confront all of us now in the field of consumer credit regulation. I may indulge in a word of advice as to how some of these problems might be tackled.

It is said that we are entering into the age of the consumer, and since all of us are consumers, we can all take some satisfaction in having an age of our own. One fear that I have is that the age of the consumer may be superseded by the age of the regulator and the litigator. One should always remember that the main purpose of protective legislation and regulation is to help the consumer satisfy his material demands safely and at the lowest possible cost. One of the great dangers in any kind of regulation is the tendency of the regulation to become an end in itself, perpetuated by the vested interests of the regulators and by inertia.

I recall learning in my study of American history that one of the American colonists' complaints against Britain concerned laws and regulations that had been imposed in the distant past, partly, at least, in a well-meaning effort to protect consumers against squandering their limited means on ill-advised luxury expenditures. These laws outlived their usefulness and became a hindrance to industry and trade. To the extent that they hindered efficient production and distribution, they injured the consumer. One of the great contributions of Adam Smith, the father of the classical school of economics, was his demonstration that the consumers of Eighteenth Century England were being prevented from enjoying the fruits of the most efficient possible production. This was being accomplished both by governmental action and by private combinations in restraint of trade.

In this respect, I think it is a happy coincidence that the year 1776 saw the publication of both Adam Smith's Wealth of Nations - dedicated to the free marketplace - and our own Declaration of Independence which proclaimed political liberty. In this sense, the roots of the consumer age go back to 1776, for it is precisely the great technological developments, combined with relative freedom of enterprise and trade, which have enabled the ordinary consumer to enjoy material satisfactions that were beyond the reach of royalty in earlier epochs (*e.g.*, Louis XIV did not have a TV).

It is desirable to look at our present-day problems in this perspective. We are not on the threshold of any comparable advance in consumer welfare at the present time. Essentially, we are simply oiling the engine and polishing the brass to make the machinery not only look better, but work better and more smoothly, for the benefit of the consumers. It is desirable that we do this. At the same time, we must keep our eye firmly fixed on the objective of keeping the productive machinery operating efficiently. We must be sure it is oil, not sand, that we are putting in the bearings.

Since the passage of the Truth in Lending Act in 1968, which everyone must recognize as a landmark, a spate of new legislation has been passed or proposed that affects your relations with your customers. In 1970, Congress prohibited the unsolicited distribution of credit cards and severely restricted card holder liability for lost or stolen cards. These measures may have reduced somewhat the profitability of credit card operations, but they have gone far to eliminate consumer complaints about that convenient device. Credit cards are here to stay, and the measures taken in 1970 to protect users probably gave the cards a firmer base of public acceptance.

Last year the Fair Credit Reporting Act became effective. This gave consumers important new rights to receive notice from creditors when credit was denied, or its cost increased, because of an adverse credit report. It also gave consumers access to the information in their credit files so that they can correct any errors that may have crept in. In a sense, this was a logical extension of the principle underlying Truth in Lending. The borrower is not only entitled to correct and clear information about the terms of credit being offered, but he is also entitled to know the reasons for decisions that denied him credit or increased its cost to him.

While these measures may add to the costs and headaches of the lenders to some degree - and I am not at all sure that they will - I view them as useful oiling of the credit machinery. The advantage gained in terms of diminishing the chance that a serious injustice may be done to a customer or a shattering loss may be visited upon a credit card holder is quite substantial. At a time when our economic system is under attack on the grounds that it is mindless, impersonal, and dehumanizing, it is, I submit, merely enlightened self-interest to minimize the chance of injustice and introduce as much rationality, due process, and concern as is reasonably possible in the areas which impinge on the daily lives of so many Americans. Moreover, and to return to the question of cost, I think these safety devices, if I may call them that, are virtually indispensable accessories to the miraculous data-processing hardware which itself has afforded such expanded horizons to the whole credit industry and whose overall costs as accessories is an infinitesimal portion of the resulting productivity gains.

Congress now has under consideration a proposal that is called the "Fair Credit Billing Act" - S. 652. This bill recently passed the Senate, after having been substantially altered from the form in which it was introduced by Senator Proxmire. Some of the provisions taken out by the Senate may be restored by the House. No one knows precisely the form this bill may finally take.

As the bill came out of the Senate, it required some significant changes in the handling of billing statements, changes that may overcome some of the dehumanization that has been introduced by computerized billing. The legislation would require creditors to acknowledge promptly customer queries about billing errors and to investigate the validity of complaints. It would forbid a creditor to threaten a customer with an adverse credit report during the investigation period. Where a billing dispute continues even after the investigation has been made, the creditor may not report the account delinquent unless he also reports that there is a dispute. He must also tell the customer the name and address of the party to whom he is reporting the credit information.

This legislative proposal also provides that in accounts involving a "free ride", a finance charge may not be imposed unless the billing statement is mailed at least fourteen days before the date by which payment must be made to avoid the charge. It would also bar the practice of some merchants in limiting the use of credit for returned merchandise to the purchase of other merchandise in the store.

Such provisions are a little more oil for the machinery. But there are some larger issues that have been associated with this piece of legislation. The original Senate bill provided for a radical reduction in the scope of the time-honored "holder-in-due-course doctrine".

Under that rule, as you know, a bank or other person that has bought a promissory note from a retailer, for example, can enforce the obligation against the maker even if the note was given for a refrigerator that did not refrigerate or a car that did not run, provided the bank is a "holder in due course". If the bank did not know that the merchandise was faulty when it bought the note, it has a valid claim on the maker, even though the maker has a valid defense at law against the dealer who sold the note to the bank.

While English and American courts have generally enforced the rule, they have done so in a manner which has often followed St. Paul's injunction that the letter killeth and the spirit giveth life. Indeed, judicial sympathies with the victimized consumer have been obvious in the hard line that courts have so often taken in requiring financing institutions to come squarely within the legal definition of due-course-holding, and the frequency with which they have denied such standing by reason of the workday incidents of the bank-dealer relationships. So, as a lawyer, I count it all to the good when courts and judges will be permitted to enforce the equities of the situation in response to the plain letter of the law and not through a process of strained rationalization, however just the results may be.

The holder-in-due-course rule was developed in order to promote commercial fluidity. It was the consequence of a negotiable instrument as a "courier without luggage" which moved as a money-substitute among relatively small but highly and equally sophisticated parties in interest. It was thought that if bankers and other investors had to worry about the health of a horse, for example, that had been sold to the maker of the note, they would hesitate to purchase such paper, and commerce would languish for lack of working capital. When sued on such a note by an innocent transferee, the maker was not permitted to defend on the ground that the horse, warranted to be three years old, actually was thirty. His remedy, he was told, was against the dishonest horse trader. By this time, unfortunately, the trader had changed his name and disappeared, or had gone into bankruptcy.

In my judgment, the holder-in-due-course doctrine <u>should</u> be changed with respect to consumer transactions whether installment contracts or credit card purchases. In this I am far from alone. Indeed, I note that a survey of the President's Office of Consumer Affairs found the doctrine under heavy attack in 1971, with thirteen states now substantially restricting or even outlawing it in consumer transactions. Moreover, in retrospect, I am not so sure that the doctrine should have ever been permitted to creep into consumer transactions in the first place. Be that as it may, the world is a very different place than when the doctrine first arose, and while I am emphatically not suggesting that it be enforced with any less vigor in commercial dealing between commercial parties, it is surely worth noting that even the Federal Reserve has abolished negotiability as a precondition of eligibility of commercial paper at the discount window.

In the rare situation where the dealer has cheated all of his customers and is now insolvent, it is more equitable, I believe, for a financial institution to bear the loss, rather than helpless consumers. Both are innocent of wrongdoing; both were taken in by the same dishonest merchant. And in such cases, there is an old rule of the common law which may be of some help. It is that where one of two innocent parties must suffer, let it be the one most responsible for the loss. While I am far from suggesting it as a rule of universal causation, I think it is worthy of consideration that in so many of these cases the defaulting merchant would not even have been in business had he not had the benefit of an ongoing association with and the assistance of a financial institution. And quite apart from this consideration of knowing the originator of paper and choosing him with care - which will bring a parity of competition between the careful, concerned, and ethical financing institutions and those who may be less so - is it also not better to spare the individual and leave it to the institution to recoup or to spread the loss, almost imperceptibly, throughout the community?

You may ask: Why did this rule develop and stand for hundreds of years if it is unjust and deserves repeal or modification? The answer is simple: Times change. The rule was developed when poor people did not sign notes. In the eighteenth century, the names on commercial paper were those of merchants, aristocrats, ship owners, and such. Today, in consumer credit, the maker of a note and the payee do not trade as equals. The danger of overreaching is considerable, and most consumers do not have the knowledge, time, or means to protect themselves. In this field, the holder-in-due-course doctrine has outlived its usefulness, and it should be trimmed back.

There are those who argue that this step would amount to putting sand in the bearings - that consumers will try to avoid their obligations by false claims of merchandise or service defects. I believe that such fears are exaggerated. One thing that our long experience with consumer credit has taught us is that the overwhelming majority of borrowers are honest. The deadbeat problem has been minimal. The problems in this area are more likely to arise from the activities of a few unscrupulous businessmen, and lending institutions are in a better position than are consumers to right those wrongs.

Another area of controversy associated with this legislation relates to the means of redress available to those who are victimized by violations of the Truth in Lending Act. The legal situation as it now stands is not satisfactory.

On the one hand, the consumer with a small claim against a creditor who has violated Truth in Lending is not likely to go to the trouble and expense of litigation. True, he may recover his expenses at the conclusion of the law suit, provided he is successful. But often the damages would not make it worth his trouble. On the other hand, we have the excessive exposure for technical Truth in Lending violations under class actions, when you multiply the $100 minimum recovery per customer by the vast numbers of consumers in a given class - for example, credit card holders. It may be that our existing court system is simply not the appropriate mechanism for handling such consumer claims, either of a small nature or of an unduly large class. Alternatives to either of these possibilities need to be explored. Perhaps some system of flexible and informal proceedings such as the use of hearing examiners may be the answer. Or possibly there may be some useful analogies suggested in the recent Brookings Commission report on the bankruptcy courts where the not dissimilar problems of cost, time, and formalism were considered.

With reference to class actions under Truth in Lending, a good deal has been said about the danger of judgments running into millions of dollars on behalf of a "class", for an unintentional minor violation of Regulation Z by a credit card issuer. In my view, creditors should not be subject to liability where they have in good faith followed Regulation Z and the Federal Reserve Board's interpretations of that regulation. At present, it is conceivable that a court might declare the Board's rules or interpretations invalid and subject a creditor to liability for failure to follow the Act, where the court construes the Act differently than the Board has. To remedy this inequitable jeopardy, the Board suggested to Congress that a "good faith reliance" provision be added to the civil liability provisions of the Truth in Lending Act, and such a provision would be added to the Act by S. 652. It provides that a creditor is not liable for any act done or omitted in good faith and in conformity with any regulation or interpretation of the Board, even if the regulation or interpretation is later determined by a court to be invalid.

While this "good faith" provision is a necessary addition to the Act in order to avoid the unfair imposition of liability, S. 652 would also modify the civil liability provisions of the Truth in Lending Act in ways that, in my own view, unnecessarily restrict the ability of consumers to proceed against creditors who willfully or negligently violate the Act.

The Senate Committee which reported the bill recommended that liability in a class action be limited to the <u>lesser</u> of $50,000 or 2 per cent of the net worth of the creditor. I believe that this remedy is not strong enough to insure compliance among all creditors and that class action liability should not be so limited as to remove the deterrent effect and encouragement to compliance which is the product of stiff, but fair, class action provisions. The stakes must be high for those who cavalierly violate the Act, in fairness to those of you who have borne the significant cost of conscientious efforts to comply. Consequently, I recommended, during consideration of S. 652, that the provision should be changed to allow for such damages as the court may allow, but not more than the greater of $50,000 or 1 per cent of the creditor's net worth. With discretion to impose liability within these limits, the courts would be free to impose a lesser liability where a $50,000 judgment might threaten the solvency of the defendant, or where the violation was inconsequential or unintentional. Serious violators could be subjected to stiffer penalties.

However, as it passed the Senate, S. 652 set an upper limit of $100,000 on class action liability, without any reference to net worth - a figure that could be catastrophic for a small lender, but insignificant for a big one. In my view, this limitation is too low. The possibility of a heavy penalty, imposed with judicial discretion, is needed to provide the deterrent effect so necessary if Truth in Lending is to be effective against lenders with resources running up into the billions.

The problem, then, is to find a formula that will provide a meaningful deterrent to large companies but which will not be so large as to threaten bankruptcy for any defendants. This was the intent - and would be the effect - of linking the size of the penalty to the net worth of the offender. There should be a reasonable upper limit that recognizes differences in the resources of creditors (and the often corresponding sizes of classes of affected consumers).

These are only a few of the legislative issues that are currently of concern to consumer credit people. Unquestionably, your field is going to continue to receive the attention of the consumer activists and of the national and state legislatures. This is both natural and desirable because of the important role that consumer credit has come to play in our economic life. However, if you sometimes feel that you are being sniped at because of relatively minor imperfections, let me assure you that I, for one, am an admirer of the achievements of consumer credit in this country. We have led the world in developing consumer credit and in pioneering such conveniences as credit cards. I believe that these accomplishments have added greatly to consumer satisfaction and to our ability to distribute the goods that our great industrial machine is capable of producing.

Sometimes, of course, industry has not been willing or able to apply its own lubricant to the squeaking parts. It is then that Congress has stepped in. Intervention of this type represents the greatest challenge to industry - to assure that necessary adjustments will be made as expertly as possible. Let me offer you, briefly, my thoughts on how you can assure that the legislative tune-ups will be truly beneficial.

The first requisite is knowledge of which components of the machinery really need attention. That comes from realistic appraisal of the areas of legitimate consumer concern and industry shortcomings. Congressional interest in consumer matters should not be underestimated, or misjudged as political posturing. A false assessment of public and Congressional concern may cause the industry to miss its opportunity to participate constructively in the development of inevitable legislation. As a regulator, I know firsthand of troublesome problems in the enforcement of statutes that could have been solved at the drafting stage. However, the industry's mechanics - those who knew the machinery best - simply were not there when the adjustment should have been made.

Industry's essential participation does not end with the enactment of legislation. There is a continuing need for its comments and criticisms during the regulation drafting stage. We at the Federal Reserve Board listened attentively to industry's comments during and after the issuance of Regulation Z. I urge you to make continued constructive use of the opportunity to present your views on how to make regulatory proposals less burdensome, more understandable to all, and of greater benefit to the public. For example, one of the most pressing tasks at hand is to find a means of simplifying Regulation Z. We have not had much success. Perhaps some of you can point the way.

There are going to be changes required of the consumer credit industry that will present new challenges as well as new opportunities. Those who fail to anticipate the trends and to respond creatively may find the adjustment process painful. Those who fail to recognize and accept the adjustments, who insist on doing "business as usual", without the extra effort required to satisfy today's consumers, may fall by the competitive wayside. However, those who understand and work to shape new consumer-credit regulation, those who respond to the new relationships between creditors and customers, will not only survive new regulation but will emerge as leaders of the industry. Responsive credit grantors, attuned to the times, have an unprecedented opportunity to woo and win today's more enlightened, more discriminating, more demanding customers.

The consumers of the 70's have more bargaining power, are more knowledgeable about credit, and are more demanding in what they want for their money. At the same time, they are more affluent, more comfortable with credit purchasing, and more sensitive to the importance of maintaining good credit ratings. They make ideal customers. By meeting the challenges presented by these new-style customers, by tuning up this great credit machine of ours, by systematically and intelligently applying oil to the machinery to keep it operating smoothly, the consumer credit industry can continue to point with pride to the vital role it plays in our economy, and at the same time provide the most effective defense against those who would pour sand in the bearings.