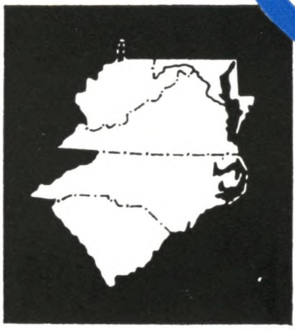
FEDERAL RESERVE BANK OF RICHMOND

MONTHLY REVIEW

Banking in the Consumer Protection Age

Social Security Financing

Federal Agency Issues



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Banking in the Consumer Protection Age: Part II

Last month, Part I reviewed the evolution of consumer protection legislation in the United States from the creation of the Federal Trade Commission in 1914 through enactment of the Truth in Lending Act in 1968 and the Fair Credit Reporting Act in 1970. In this month's article, three important topics involving the Truth in Lending Act are discussed: (1) enforcement practices, with particular emphasis on significant recent developments; (2) the special problem of dealer paper discounted by banks and their affiliates; and (3) the extensive regulation of consumer credit advertising methods and practices imposed by the Act.

Although Truth in Lending disclosures are frequently long, complex, and perhaps difficult for many consumers to understand, a high degree of compliance on the part of the vast majority of consumer creditors has been achieved since the Act went into effect two and one-half years ago. This widespread compliance is revealed in the results of two extensive surveys of consumer installment contracts reported by the Federal Trade Commission in April 1971. The nationwide surveys, which covered five major classes of consumer creditors, showed that 86 percent of the companies were in substantial compliance.[1]

The Board of Governors of the Federal Reserve System believes that compliance by supervised financial institutions is considerably better than that of the retail installment dealers surveyed by FTC.[2] Although the record of these financial institutions is comparatively good, it is clear that commercial banks and their affiliates must assign a high priority to effective internal compliance programs on a continuing basis, both to prevent intentional violations entirely and to minimize inadvertent violations. A very practical reason is the broad range of severe sanctions that may be imposed for failure to comply.[3]

Criminal and Civil Penalties For those individuals who are responsible for consumer credit activities in a bank or other organization, the criminal provisions of Truth in Lending are the mose serious. Section 112 of the Act states that whoever *willfully* and *knowingly* (1) gives false or inaccurate information or fails to provide information which he is required to disclose, *or* (2) uses any chart or table authorized by the Board of Governors as a means of determining annual percentage rates of interest in such a manner as to consistently understate such rates, *or* (3) otherwise fails to comply with any requirement imposed by the Act shall be fined not more than $5,000 or imprisoned for not more than one year, or both.[4]

Responsibility for enforcing these sanctions is lodged in the Department of Justice. During 1970, 12 cases were referred to appropriate United States' attorneys throughout the country for possible prosecution. In all of these, prosecution was declined because it was believed there was insufficient evidence of *willful* violation to justify return of an indictment.[5] In 1971, nine cases were referred, and prosecution was declined in five. Four cases were still under investigation at the end of the year.[6]

Another compelling reason for every bank or bank holding company to maintain a formal internal compliance program is the substantial civil liability for violations. Subject to certain important defenses discussed below, Section 130 of the Act provides that any creditor failing to disclose any information required to be disclosed shall be liable to the person entitled to the disclosure in an amount equal to the sum of (1) twice the amount of the finance charge in connection with the transaction, but in no case less than $100 nor more than $1,000; (2) the costs of the legal action to enforce liability; and (3) reasonable attorneys' fees as determined by the court.[7]

When violations occur, civil penalties may be assessed regardless of whether the defendant committed the wrong willfully or knowingly, or entirely innocently. This is a fundamental difference of the greatest importance between criminal and civil liability for failure to make necessary Truth in Lend-

[1] Federal Trade Commission, "Report on Surveys of Creditor Compliance with the Truth in Lending Act," April 1971.

[2] Letter by Governor J. L. Robertson, July 13, 1971, Commerce Clearing House, Chicago, Illinois, 4 *Consumer Credit Guide*, ¶30,723. This source is cited hereinafter as "4 CCH *Consumer Credit Guide*" for brevity.

[3] One respected authority reports an instance in which the only advice that could be given a client unintentionally violating Truth in Lending on a massive scale was to "pray." Ralph C. Clontz, Jr., *Truth-in-Lending Manual (1971 Supplement)*, Boston: Hanover Lamont Corporation, p. 37.

[4] 82 Stat. 151 (1968).

[5] 4 CCH *Consumer Credit Guide*, ¶99,593.

[6] Information regarding 1971 obtained by telephone from Consumer Affairs Section, Antitrust Division, Department of Justice, Washington, D. C.

[7] 82 Stat. 157 (1968).

ing disclosures. And civil liability may be very great, indeed.

Both points are illustrated by the pending case of *Ratner* v. *Chemical Bank New York Trust Company*, a case in which the defendant bank, after thorough review and on advice of counsel, left out information in the good faith belief that it was not required to be disclosed. The district court has already held that Chemical Bank violated the Act by failing to print the nominal annual percentage rate of interest on periodic open-end billing statements mailed to holders of Master Charge Cards, even though no finance charges were imposed for the periods covered by the statements and no actual annual percentage rates were charged.[8] It has also ruled that Ratner, an individual who received the inadequate disclosure statement, may recover at least $100 in damages, even though he paid no finance charge at all and was not deceived or misled by the omitted information.

In response to the bank's contention that its mistake was "reasonable" and that a "penalty" should not be imposed under the circumstances of the case, the court said:

> **The aim to protect consumers is the paramount aspect of the statute; the countenancing of "reasonable" violations would be grossly subversive of that. There are explicitly penal sanctions for the "unreasonable" violator who behaves "willfully and knowingly". . . . And for now, at any rate, we are concerned with only a single plaintiff, suing within a tight (one-year) statute of limitations, . . . and likely to recover a sum paltry by any pertinent standard.[9]**

The nightmare of *Ratner* for the consumer credit industry is the possibility that the amount awarded will not in fact be "paltry" but will instead be enormous. Yet to be decided is the question whether the action may properly be maintained by the plaintiff as a "class action" on behalf of all of the thousands of consumers who also received periodic billing statements omitting the required nominal annual percentage rate. If so, it is possible that the court will collect and distribute to each recipient of an erroneous billing statement at least $100, and perhaps more.

It may be that a class action will not be permitted in this particular case. But the mere threat of such actions in other situations—with possible damage awards running into the hundreds of thousands or millions of dollars—must stand as a grim reminder to every bank or bank affiliate that it is imperative to establish and maintain effective, continuing internal compliance procedures.[10] This need is further underscored by the existence of two key saving clauses in the civil liability provision of the Truth in Lending Act. Section 130(b) provides:

> **A creditor has no liability for civil penalties if within fifteen days after discovering an error, and prior to the institution of an action under this section or the receipt of written notice of the error, the creditor notifies the person concerned of the error and makes whatever adjustments in the appropriate account are necessary to insure that the person will not be required to pay a finance charge in excess of the amount or percentage rate actually disclosed.**

Even more important for large creditors who rely on computer techniques to prepare periodic statements for mailing to thousands of customers, where the risks of class actions for crippling damages are greatest, is this provision:

> **(c) A creditor may not be held liable in any action if the creditor shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures designed to avoid any such error.[11]**

The problem in *Ratner* was that the defendant bank knew what it was doing when it decided not to print the nominal annual percentage rate on monthly statements in which no finance charges were assessed.[12] Although the bank did not intend to violate the Act, it did intend to omit the nominal annual percentage rate from the billing statement. Thus, the omission was not the result of a "bona fide error." As the court pointed out:

> **It is undisputed that defendant carefully, deliberately — intentionally — omitted the disclosure in question. That defendant, in the Court's view, mistook the law does not make its action any less intentional. This is normally true in criminal cases. . . . It is surely the law here.[13]**

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[8] United States District Court for the Southern District of New York, No. 69 Civ. 4195, June 16, 1971, 4 CCH *Consumer Credit Guide*, ¶99,456.

[9] 4 CCH *Consumer Credit Guide*, ¶99,456, p. 89,415.

[10] More recently the Legal Action Council, a consumer organization, filed a class action against Bank of America charging violations of the Truth in Lending Act and asking damages that could, according to the plaintiff, total more than $1 billion. The complaint, according to a report of the action, alleges that the bank systemically failed to disclose annual percentage rates of interest on time payments until after the credit card holder had become obligated to pay the interest. *The American Banker*, December 8, 1971. A tentative settlement of another class action in the Midwest against Interbank Card Association, Banc Systems Association, Inc., and 35 Ohio banks was also announced in *The American Banker* on December 8, 1971. According to the report, the settlement calls for revisions of Master Charge monthly statements to incorporate a number of changes. Court costs, attorneys' fees, and the cost of mailing explanatory material to some 700,000 Master Charge cardholders must be paid by the defendants.

[11] 82 Stat. 157 (1968).

[12] *Ibid.* Representatives of the Office of the Comptroller of the Currency stated in the course of testimony before the National Commission on Consumer Finance in June 1971:

> Our initial assumption was that once a proper form was adopted, with spaces for each disclosure required by the Act, the main job would be completed. However, we have discovered that computerized billing, even on a properly drafted form, may sometimes result in misstatements of applicable rates and charges.

[13] 4 CCH *Consumer Credit Guide*, pp. 89,414-89,415. A different Federal District Court reached the same conclusion in the more recent case of *Buford* v. *American Finance Company, et al.*: 4 CCH *Consumer Credit Guide*, ¶99,302 (U. S. District Court for the Northern District of Georgia, Atlanta Division, Civil Action No. 14,638 (October 1, 1971). The opinion states that Section 130(c) ". . . is clearly meant to exempt clerical errors which result despite reasonable safety precautions and not 'good faith' error of law such as committed here by defendants."

Ratner is by no means the only private suit for civil damages alleging violation of the Truth in Lending Act currently pending in the courts. A number of additional ones are known to be on file. As decisions begin to be written in these cases, more reliable guidelines will be available to indicate the magnitude of possible monetary liability for violation, and the strength of the two protective clauses in Section 130.

Administration of Truth in Lending Apart from the responsibility of the Department of Justice for criminal prosecutions, nine separate Federal administrative agencies are authorized to enforce compliance with Truth in Lending. For insured banks, administrative responsibility is divided among the Comptroller of the Currency, who supervises National banks; the FDIC, which regulates State banks that do not belong to the Federal Reserve System; and the Board of Governors, which supervises State member banks.[14] For the various types of organizations subject to their respective jurisdictions, the Federal Home Loan Bank Board, the National Credit Union Administration, the Interstate Commerce Commission, the Civil Aeronautics Board, and the Department of Agriculture have compliance responsibilities. All other types of consumer creditors are subject to the jurisdiction of the Federal Trade Commission.[15]

Banks violating Truth in Lending are subject to cease-and-desist proceedings initiated by the appropriate bank supervisory authority, pursuant to Section 8 of the Federal Deposit Insurance Act. Willful violations or repeated failures to use good faith efforts to comply may conceivably lead to termination of insured status.[16]

The jurisdiction of the Federal Trade Commission in Truth in Lending proceedings is much more extensive than it is in unfair and deceptive practice cases under Section 5 of the FTC Act. The Commission's more extensive power results from Section 108(c) of the Truth in Lending Act, which includes the following provision:

> For the purpose of the exercise by the Federal Trade Commission of its functions and powers under the Federal Trade Commission Act, a violation of any requirement imposed under this title shall be deemed a violation of a requirement imposed under that Act. All of the functions and powers of the Federal Trade Commission under the Federal Trade Commission Act are available to the Commission to enforce compliance by any person with the requirements imposed under this title, *irrespective of whether that person is engaged in commerce or meets any other jurisdictional test in the Federal Trade Commission Act.*[17]

In proceedings involving Truth in Lending violations, therefore, the FTC has available the entire arsenal of procedural and substantive enforcement weapons in the Truth in Lending Act, as well as those in the FTC Act. At the same time, the FTC is *not* subject to the jurisdictional limitations imposed by the latter Act. One Federal court has already ruled that the FTC may require affirmative disclosures to be made *in addition to* those imposed by the Truth in Lending Act when such a remedy bears a reasonable relationship to the violation.[18] In another FTC Act case, not involving Truth in Lending but highly pertinent to it, the court upheld an FTC order requiring the respondent seller of home improvement products to disclose to credit customers that their contracts of indebtedness would be assigned to finance companies or other third parties.[19]

Especially relevant to consumer finance companies is the FTC's Consumer Credit Policy Statement No. 1. This statement not only defines terms such as "easy credit," "liberal terms," and "easy pay plan," but also specifies five characteristics consumer credit must possess if offered or advertised by vendors or creditors using these terms.[20] According to the Policy Statement, the definitions recognize the inherent conflict between "high-risk credit" and "low-cost credit."

It is reasonable to believe that FTC enforcement practices and policies in the consumer finance area will be of increasing significance to bank holding companies and their affiliates as they continue to expand the range of their nonbanking activities geographically and functionally.[21]

The Special Problem of Dealer Paper Banks face a particularly difficult compliance problem when discounting consumer installment contracts for such business customers as automobile dealers, furniture

[14] Enforcement of compliance by State member banks is in addition to the Board's general duty to prescribe regulations applicable to *all* types of consumer creditors and to interpret the law and Regulation Z.

[15] 82 Stat. 150 (1968). The few hundred noninsured State banks in the country are subject to FTC jurisdiction. Thus far, the Commission has obtained at least one consent order against such a bank, *In the Matter of Lone Oak State Bank*, 4 CCH *Consumer Credit Guide*, ¶99,671.

[16] 80 Stat. 1046 (1966).

[17] 82 Stat. 150 (1968). (Emphasis added.)

[18] *Leon A. Tashof* v. *F. T. C.*, 437 F. 2d 702 (D. C. Cir., 1970). In this case, even though the Truth in Lending Act does not itself require oral disclosures and does not require any disclosures at all where credit sales with specified minimum dollar finance charges are imposed, the FTC order required *both* disclosures of such minimum charges and, in addition, certain oral disclosures to be made.

[19] *All State Industries of North Carolina, Inc.* v. *F. T. C.* (4th Cir., 1970), 4 CCH *Consumer Credit Guide*, ¶99,765.

[20] 4 CCH *Consumer Credit Guide*, ¶30,251.

[21] The number of FTC enforcement actions in the Truth in Lending area increased sharply in 1971 as compared with 1970 (fiscal year basis). Formal complaints rose from 2 to 29. The number of all consumer protection complaints issued in 1971 was 208, as compared with 207 in 1970 and 192 in 1969. The FTC has announced that it anticipates even greater enforcement measures in 1972. 4 CCH *Consumer Credit Guide*, Report No. 75, September 21, 1971.

stores, appliance retailers, and the like. The problem arises from three provisions of the Truth In Lending Act. Section 130(d) clearly imposes liability on assignees of dealer paper under certain circumstances.[22] In addition to this, however, the definition of "creditor" in the Act implies even more extensive liability,[23] and this implication is reinforced by Section 131.[24]

Section 130(d) provides, in substance, that any consumer not receiving full and accurate disclosures from the retail merchant from whom he has made a credit purchase may, if two conditions are present, bring his action for money damages against the bank or other financial institution that takes an assignment of the installment contract from the original creditor. The first condition is that the transaction must involve creation of a security interest in real property of the consumer. For purposes of Truth in Lending, such an interest may arise not only by deliberate decision of the parties but also by operation of law. Examples are where mechanics' or materialmen's liens attach, or where a confession of judgment clause meeting certain requirements is included in the note signed by the customer.

The second condition is that the bank or its subsidiaries or affiliates (which of course includes bank holding companies and their subsidiaries) be engaged in a "continuing business relationship" with the original creditor, either at the time the credit was extended or at the time of the assignment.

Two defenses are written into Section 130(d) for the protection of assignees, but only one of these is likely to be of much practical value. The first, and less important, exists where the assignment is involuntary (for example, where the assignor takes bankruptcy). The second defense is of major significance, however, because it enables the assignee to avoid liability entirely, even where the original creditor was clearly at fault. Liability is avoided if the following is shown by a preponderance of the evidence: (1) that the assignee did not have reasonable grounds to believe that the original creditor was violating the law; and (2) that it (the assignee) maintained procedures reasonably calculated to discover such violation.

Banks and other financial institutions regularly purchasing installment contracts from retail dealers may have far more extensive liability for erroneous or inadequate disclosures by such dealers than that imposed by Section 130(d). Conceivably, courts may treat the assignee financial institutions as "creditors" themselves in these transactions, regardless of whether the two conditions imposed by Section 130(d) are present. This is because the Truth in Lending Act defines "creditor" to mean a natural person or an organization ". . . who regularly extend[s], or arrange[s] for the extension of, credit for which the payment of a finance charge is required. . . ."

In light of this broad, inclusive definition, the question may well arise whether an assignee financial institution is, in reality, the "creditor" in most of the larger installment purchases. Typically, these are situations where automobile dealers or appliance retailers, as a matter of regular practice, communicate with banks or other financial institutions to request credit information about the consumer *before* agreeing to sell to the consumer on credit, and where these retailers in the regular course of business assign such contracts to the financial institutions furnishing the requested information. Under these circumstances, it might well be argued that the retail dealer is an "arranger," and that *both* the dealer and the assignee financial institution are "creditors" in the transaction. Under this theory, the assignee financial institution would be equally liable with the retailer for money damages, court costs, and attorneys' fees. Support for such an argument may be found in Section 131 of the Act. It provides that *except in the case of actions brought under Section 130(d),* when an action is brought against an assignee the consumer's signed statement acknowledging receipt of Truth in Lending disclosures is conclusive proof of compliance by the assignee unless one of two conditions exists. These are that the violation is apparent on the face of the statement, or that the assignee had actual knowledge that the consumer did not in reality receive the disclosures.

Litigation or additional legislation will very likely

[22] "Any action which may be brought under this section against the original creditor in any credit transaction involving a security interest in real property may be maintained against any subsequent assignee of the original creditor where the assignee, its subsidiaries, or affiliates were in a continuing business relationship with the original creditor either at the time the credit was extended or at the time of the assignment, unless the assignment was involuntary, or the assignee shows by a preponderance of evidence that it did not have reasonable grounds to believe that the original creditor was engaged in violations of this chapter, and that it maintained procedures reasonably adapted to apprise it of the existence of any such violations." 82 Stat. 157 (1968).

[23] "The term 'creditor' refers only to creditors *who regularly extend, or arrange for the extension of,* credit for which the payment of a finance charge is required, whether in connection with loans, sales of property or services, or otherwise. The provisions of this title apply to *any* such creditor, irrespective of his or its status as a natural person or any type of organization." (Emphasis added.) 82 Stat. 147 (1968).

[24] "Except as provided in section 125(c) and except in the case of actions brought under section 130(d), in any action or proceeding by or against any subsequent assignee of the original creditor without knowledge to the contrary by the assignee when he acquires the obligation, written acknowledgment of receipt by a person to whom a statement is required to be given pursuant to this title shall be conclusive proof of the delivery thereof and, unless the violation is apparent on the face of the statement, of compliance with this chapter. This section does not affect the rights of the obligor in any action against the original creditor." 82 Stat. 157 (1968).

be necessary before the nature and extent of liability on the part of assignee financial institutions is finally determined. In a prepared statement before the National Commission on Consumer Finance on June 23, 1971, the Chairman of the Federal Trade Commission asserted that ". . . if Section 130(d) were amended to expressly extend civil liability to all assignees, it would have an immediate corrective effect upon many millions of dollars of installment credit sales." Clearly, however, even now the statute places a great premium on the maintenance of effective programs by financial institutions to monitor compliance by retail dealers with whom they maintain a regular course of business relationships. Identical letters were sent to all insured banks by the three Federal bank supervisory agencies in the summer of 1971 advising as follows:

> Banks should take appropriate measures to see that they do not purchase or accept as collateral dealer paper concerning which the customer has not received a complete and accurate disclosure statement and rescission notice where applicable. The bank may be subject to whatever defenses or damage claims the customer may have under the Truth in Lending Act with regard to such paper.

Regulating Consumer Credit Advertising All types of consumer credit advertising are tightly regulated by the Truth in Lending Act and by Regulation Z of the Federal Reserve System. In fact, Congress would have been more accurate if it had designated the statute the "Truth in Lending and Advertising Act."

Requirements governing the format of consumer credit ads are conditioned by the general rules applicable to direct, person-to-person disclosure statements that must be given to individual consumers. Thus, the Annual Percentage Rate (APR) must be printed clearly and conspicuously, and other information contained in an ad must not be used in such a manner as to mislead or confuse the customer, nor to contradict or obscure disclosure of the APR.[25] Moreover, the terminology specified in Sections 226.7 and 226.8 of Regulation Z, dealing respectively, with open-end and closed-end disclosures in individual transactions, must be used in the advertising of consumer credit.[26]

Not all advertisements are regulated, however. In order to be subject to Truth in Lending, an ad must possess two characteristics. It must *both* promote an extension of consumer credit *and* include one or more specific credit terms. If it is not a "commercial message" involving an offer of consumer credit or soliciting the use of a credit plan, the advertising requirements do not apply.[27] If published materials are "educational in nature" and are not intended to be "commercial messages" soliciting the use of consumer credit, they are not required to conform to Regulation Z.[28]

Once an ad meets the above criteria, however, the coverage of Regulation Z is extremely broad. The term "advertisement" is defined to include any *commercial message* transmitted by means of any of the following media: by newspaper, magazine, leaflet, flyer, or catalog; by radio, television, or public address system; by direct mail literature or other printed material; by means of any interior or exterior sign or display; in any window display; or in any point-of-transaction literature or price tag which is delivered or made available to a customer or prospective customer in any manner whatsoever.[29]

A basic postulate underlying the regulation of consumer credit advertising is the belief that a substantial portion of all consumer purchases is induced by advertised credit terms. A second assumption is that if all relevant information is required to be included in advertising, consumers will be able to shop more effectively among alternative sources of credit. Another important objective is the prevention of "bait" ads.

Preventing "Bait" Advertising To eliminate entirely ads designed to lure customers to the premises of creditors or vendors who do not in fact make available advertised credit terms to the public on a general basis, two outright prohibitions are imposed on all consumer credit advertising. First, no ad may state that a specific periodic consumer credit amount or installment can be arranged unless the creditor usually and customarily arranges credit payments or installments for that period and in that amount. Second, no ad may state that a specified down payment is required in connection with any extension of consumer credit unless the creditor usually

[25] 4 CCH *Consumer Credit Guide*, ¶30,665.

[26] 4 CCH *Consumer Credit Guide*, ¶30,620; 30,174.

[27] 4 CCH *Consumer Credit Guide*, ¶30,254; 30,215.

[28] 4 CCH *Consumer Credit Guide*, ¶30,215; 30,336. However, a prospectus whereby a public utility proposed to offer stock to employees was ruled subject to Truth in Lending advertising provisions even though the employees themselves were not required to pay any finance charge. The utility permitted them to pay 10 percent down payment and pay the balance due over the next 18 months. Although the employees executed a note for the balance payable to a bank, the utility paid the entire finance charge. The Board's ruling that Truth in Lending applied was based on its four-installment rule. The present legal status of the four-installment rule is clouded because of differing rulings regarding its legality by different Federal courts, as discussed in Part I.

[29] 12 *C.F.R.* 226.2(b). (Emphasis added.) The FTC has ruled that oral responses to questions asked by individual consumers are *not* "advertisements" for Truth in Lending purposes. However, such oral misrepresentations are regarded by the FTC as "unfair and deceptive acts or practices subject to Section 5 of the FTC Act." Representative Leonor K. Sullivan (D.-Mo.) has alleged that some banks are quoting rates of 4½ percent over the telephone when, in reality, actual Annual Percentage Rates are double the alleged oral rate. *Washington Financial Reports*, June 28, 1971, p. A-2.

and customarily arranges down payments in that amount.[30]

Going beyond these general prohibitions, the rules governing consumer credit advertising become both complex and specific. They also differ greatly depending upon whether open-end or closed-end credit is being advertised. Moreover, required disclosures in advertising are not necessarily the same as the direct creditor-to-debtor disclosures that must be given pursuant to Regulation Z.

Advertising Open-end Credit Plans No advertisement for open-end plans may include *any* specific credit term unless the same ad clearly and conspicuously sets forth *all* of the following items:

(1) An explanation of the time period, if any, within which any credit extended may be repaid without a finance charge;
(2) The method of determining the balance upon which a finance charge will be imposed;
(3) The method of determining the amount of the finance charge, including any minimum or fixed amount which may be imposed as a finance charge;
(4) Where periodic rates (i.e., 1½ percent per month) are used to compute the finance charge, each such rate, the range of balances to which it is applicable, the corresponding annual percentage rate, and the periodic rates expressed as annual percentage rates;
(5) The conditions under which any other charges may be imposed, and the method by which they will be determined; and
(6) The minimum periodic payment required.[31]

Because it is usually impractical, if not impossible, to include all of this information in an ad, most advertisers try to mention credit possibilities in ways that do not trigger full disclosure requirements. An example is the word "Terms," which may be used in a credit ad without other disclosures, provided no specific credit provisions are included.[32] The phrase "Spread the Payments for as Long as 24 Months" may also be used without additional disclosures. However, it has been held that "A Small Monthly Service Charge on the Remaining Balance" is both a statement of the conditions under which a finance charge may be imposed *and* of the method of determining the balance upon which a finance charge may be imposed, either of which standing alone would call for full statement of all required open-end credit terms.[33]

A more troublesome problem in open-end advertising involves the use of such phrases as "No Payment Until Spring of '72," "No Payment 'til March," or "Charge it on your account—it will not be billed on your account until February" when, in reality, finance charges are assessed for the period between the purchase and the initial payment. The Federal Reserve Board staff's position is that neither Regulation Z nor the Act requires open-end advertising to state that finance charges accrue during this period even though the very same phrases used in advertising closed-end credit clearly *do* require full accompanying closed-end disclosures.[34] However, using the general regulatory authority granted by Section 5 of the Federal Trade Commission Act, the FTC has required at least one major retail seller to disclose that finance charges are imposed during the deferred period.[35] A consent order signed by the retailer was based upon an FTC complaint alleging that the advertised claims of "no monthly payment until" a future date has misled credit customers to believe that no finance charge would be imposed until the first installment date.

Advertising Closed-end Credit Plans To encourage advertising of the Annual Percentage Rate in closed-end transactions, such rate may be advertised *without* the inclusion of any other required information even though it may not be used in open-end ads without including all other required information. This is one, but only one, of the many important differences between the rules governing advertising of open-end and closed-end credit.

The basic principle in advertising closed-end credit is that if the ad states *either* (1) the amount of the down payment required or that no down payment is required, (2) the amount of any installment payment, (3) the dollar amount of the finance charge, (4) the number of installments, (5) the period of repayment, or (6) that there is no charge for credit, *then* all of the following information must be included using the terminology prescribed in Section 226.8 of Regulation Z:

(1) The cash price or the amount of the loan, as applicable;
(2) The amount of the down payment required, or that no down payment is required, as applicable;
(3) The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended;
(4) The amount of the finance charge expressed as an annual percentage rate; and
(5) Except in the case of the sale of a dwelling or a loan secured by a first lien on a dwelling to purchase that dwelling, the deferred payment price or the sum of the payments, as applicable.[36]

[30] 82 Stat. 158 (1968).

[31] *C.F.R.* 226.10(c).

[32] 4 CCH *Consumer Credit Guide,* ¶30,308.

[33] Two rulings by the Board's staff provide especially useful insights into the reasoning underlying open-end advertising regulations. They are printed in 4 CCH *Consumer Credit Guide,* ¶30,418, and 30,223. In brief, these rulings take the position that the purpose of the advertising regulations is to insure that the specific credit terms available to the customer are detailed in credit ads. In reality, as suggested above, the requirements imposed by the Truth in Lending Act have had just the opposite effect.

[34] 4 CCH *Consumer Credit Guide,* ¶30,344. The reasoning is that in open-end transactions the phrase "No Payment 'til March" is equivalent to saying "Charge It—Your Purchase Will Not Be Billed Until March."

[35] 4 CCH *Consumer Credit Guide,* ¶99,346 (September 28, 1971).

[36] 12 *C.F.R.* 226.10(d).

ADVERTISING GLOSSARY

Requiring No Other Disclosures

OPEN-END CREDIT

1. "Charge accounts available"
2. "Open a revolving budget account"
3. "Just say charge it"
4. "Shopping dollars go further when you use branch X charge-all charge cards"
5. "Open your all-purpose charge account and just say charge it"
6. "All major credit cards honored"
7. "X charge card honored"
8. "Use our convenient charge plan"
9. "Put all your purchases on a 30-day no carrying charge account"
10. "Your first installment [do not use 'payment' unless you state '**monthly** payment'] begins in June"

CLOSED-END CREDIT

1. "18% Annual Percentage Rate"
2. "Low, low financing"; "liberal budget terms"
3. "Bank financing available"
4. "Financing by XYZ Bank"
5. "Terms arranged"
6. "Store financing"
7. "On the spot financing"
8. "Easy monthly payments"
9. "Convenient credit can be arranged"
10. "Financing available"
11. "Terms to fit your budget"
12. "Arrange low terms for instant credit"
13. "Low Downpayment accepted"
14. "90 days (3 payments) same as cash"
15. "No finance charges if paid in 4 installments"

Requiring Full Disclosure

OPEN-END CREDIT

1. "No downpayment"
2. "You don't need cash"; "Leave your pocketbook at home"
3. "$50 down"
4. "Pay $9 a month"; "Up to $50 monthly"
5. "18% financing"
6. "Less than 2% per month"
7. "Minimum payment $10"

CLOSED-END CREDIT

1. "$50 Down"
2. "No money down"
3. "No downpayment"
4. "$9 a month"
5. "$5 per week"
6. "20 installments of $10 each"
7. "Finance for under $100"
8. "$5 financing"
9. "Less than $100 interest"
10. "30 equal payments"
11. "36 months to pay"
12. "No charge for credit"
13. "No cash needed"
14. "100% financing available"
15. "Nothing to pay until June"
16. "No payment until August"

Two closed-end advertising issues have already generated a substantial body of quasi-metaphysical, semantic lore. These revolve around the questions whether and when a representation has in fact been made that no down payment is required, and when a statement has been made of the "period of repayment."

Down Payment or No Down Payment: That is the Question One of the simpler decisions in this area is the FTC staff's conclusion that use of the phrase "Leave Your Pocketbook at Home" is synonymous with a "no down payment" claim, and that therefore the required closed-end information must be included in the ad.

A distinction has been drawn, however, between "You May Defer Your First Instalment Until February" and "You May Defer Your First Payment Until February." It has been held that the former may be used in closed-end ads without triggering full disclosure because the reference is to installment payments in general. The latter expression is regarded as the equivalent of a statement that no down payment is required, hence calling for full disclosure.[37]

This leads into the "90% financing" and "100% financing" series of rulings. The latter is always tantamount to a representation of "No Down Payment" and therefore requires disclosure of other credit terms.[38] Whether "90% financing" does or does not require disclosure depends on what else is in the ad. The rationale underlying this distinction has been stated as follows:

> Where a cash price of an item is given in an ad as well as a statement such as "90% financing," by implication a statement has been made of the dollar amount of the downpayment and full disclosure of credit terms would be required. On the other hand, a lender advertising "90% financing" where no cash price is given would not be required to

[37] 4 CCH *Consumer Credit Guide*, ¶30,223.

[38] 4 CCH *Consumer Credit Guide*, ¶30,601.

state the additional disclosure since no dollar amount of downpayment is determinable from the ad.[39]

The "Period of Repayment" Do phrases such as "Pay Weekly," "Pay Monthly," or "Up to Two Years to Pay" state a period of repayment and require full disclosure? It has been held that the first two phrases do not, in and of themselves, require additional disclosures regardless of whether closed-end or open-end plans are invloved. Insofar as closed-end plans are concerned, the requirement of disclosure depends upon whether the total period of repayment of the credit extension is stated (for example, "3 Years to Pay") and not the interval of each installment.[40] With regard to open-end plans, the "period of repayment" requirement refers to the normal "free-ride" period during which any credit extended may be paid without incurring a finance charge.

The rule is different for "Up to Two Years to Pay," however. This phrase *does* require all additional disclosures if used in connection with closed-end credit, but does *not* require other disclosures if used to promote open-end plans.[41] However, advertising the phrase "No carrying charge if you pay off your account within 30 days" does require the advertiser to make full open-end disclosures in the ad.[42]

An Advertising Glossary To aid those who must comply with the baffling maze of advertising regulations, the FTC has compiled a list of terms requiring, or not requiring, as the case may be, additional disclosures in advertising open-end and closed-end credit. This list is shown in the table of advertising terms appearing on the opposite page.

Liability Among the many important differences between Truth in Lending provisions governing individual disclosure requirements, on the one hand, and those relating to advertising, on the other, are the liability features. It is clear that every advertiser is subject to Truth in Lending, whether or not he himself is engaged in extending or arranging for credit. The test is whether the *advertisement* promotes consumer credit, not whether the advertiser is a consumer creditor or arranger. Advertising agencies, trade associations, manufacturers, and even Government agencies such as FHA must comply with Truth in Lending advertising requirements.[43] Some protection against liability is afforded advertising media by Section 145 of the Act, however. It provides that:

> There is no liability under this chapter on the part of any owner or personnel, as such, of any medium in which an advertisement appears or through which it is disseminated.[44]

Moreover, in *Jordan* v. *Montgomery Ward & Co., Inc.* it was held that private actions for money damages may not be brought based on violation of the advertising provisions above.[45] It thus appears that enforcement of the advertising provisions is by administrative action of the various Federal agencies designated in the Act and by the Department of Justice where intentional violations occur.

Possible Changes in Advertising Regulations In its *Annual Report* on Truth in Lending for the year 1970, the Board of Governors advised Congress that creditors continue to complain that the advertising provisions of the Truth in Lending Act have the effect of discouraging the advertising of credit terms, thereby limiting the consumer's ability to shop for credit. Without advertising, consumers must physically go from creditor to creditor to obtain information to compare credit costs—certainly an undesirable state of affairs.

It seems clear that the present complex network of rules, regulations, and interpretations, with differing effects depending upon whether open-end or closed-end credit is advertised, should be revised and simplified if at all possible. It is understood that this important problem is now receiving the close attention of the Truth in Lending staff of the Board of Governors.

William F. Upshaw

[39] 4 CCH *Consumer Credit Guide*, ¶30,407.

[40] 4 CCH *Consumer Credit Guide*, ¶30,046; 30,185.

[41] 4 CCH *Consumer Credit Guide*, ¶30,185.

[42] 4 CCH *Consumer Credit Guide*, ¶30,723.

[43] 4 CCH *Consumer Credit Guide*, ¶30,254; *see also* the FTC's consent order against Chrysler Corp. and its advertising agency, Young & Rubicam, 4 CCH *Consumer Credit Guide*, ¶99,750.

[44] 82 Stat. 159 (1968).

[45] 317 F. Supp. 948 (September 9, 1970), *affirmed* by United States Court of Appeals for the Eighth Circuit, 4 CCH *Consumer Credit Guide*, ¶99,502 (May 3, 1971); petition for *certiorari denied* October 12, 1971, 4 CCH *Consumer Credit Guide*, ¶99,322 (October 26, 1971). However, in the case of *Garza* v. *Chicago Health Clubs, Inc.*, 4 CCH *Consumer Credit Guide*, ¶99,384 (July 29, 1971), the district court assumed, without deciding, that a consumer may bring a civil action for an injunction to prevent fraudulent credit advertising in violation of Regulation Z.

Part III, the final article in this series, will appear next month and will cover the following subjects: (1) elements of an internal Truth in Lending compliance program for banks; (2) principal features of the Fair Credit Reporting Act; (3) important recent and pending legislation involving bank credit cards; and (4) the work of the National Commission on Consumer Finance.

SOCIAL SECURITY FINANCING:
A New Package Or Just New Packaging?

INTRODUCTION

The social welfare activities of Government have grown significantly since the passage of the Social Security Act in 1935. Congress has progressively expanded the original social security program to include disability insurance, hospital insurance, and supplementary medical insurance, as well as old-age and survivors insurance.

The expansion in programs has been accompanied by expansion in coverage of workers. The proportion of persons in paid employment covered by social security increased from 58 percent in 1940 to 90 percent in 1971. By 1950, the Social Security Act had been amended to cover railroad workers, certain World War II veterans, regularly employed farm and domestic workers, nonfarm self-employed persons, and Federal civilian employees not under the Federal retirement system. Legislation in the 1950's and 1960's brought professional, self-employed individuals, members of the Armed Forces, and ministers into the programs.

Social security tax receipts also have grown over the past 35 years because of growth in covered population, higher tax rates, and higher maximum wage bases—the maximum annual wages to which social security tax rates are applied (Table I). Social security taxes paid in fiscal 1971 totaled $52.7 billion, compared to the $593 million paid in 1940. In 1937, covered employees and their employers each were taxed at a rate of 1 percent of the employee's annual wages up to $3,000. By 1971, the tax rate on individual employee wages paid by both the employee and employer had increased to 5.2 percent, and the wage base had risen to $7,800. The 1972 tax rate is 5.2 percent, with a maximum wage base of $9,000. Under present law (PL 92-5), the base is not scheduled to increase after 1972, but the tax rate will rise to 6.05 percent by 1987.

Whether these future tax schedules will become effective is problematical. In accordance with the provisions of the Social Security Act, in 1969, the Secretary of Health, Education, and Welfare appointed an Advisory Council, composed of 13 members representing different public interests, to review the status of the social security trust funds in terms of long-term commitments, adequacy and scope of benefit coverage, and impact on public assistance.[1] The Council's recommendations, submitted in March 1971, call for provisions to increase benefits and the maximum tax base automatically and to formalize the present pay-as-you-go financing system. Limitation of trust fund balances at a level approximately equal to one year's benefit payments and revision of current conservative estimates of future tax receipts could result in larger benefit payments without comparable tax increases in the near future. Other recommendations, however, include larger benefit payments not currently scheduled.

If Congress were to adopt the financing and benefit payment reform recommended by the Advisory Council, increases in tax rates after 1972 might be postponed until after the year 2000. Under this proposal, the tax rate paid by both employees and employers would increase to 6 percent in 1972, and the maximum wage base would rise to $12,000 in 1974. Further increases would automatically follow gains in employee earnings (Table II). Even so, under this proposal, total social security taxes paid would increase. The Council's recommendations are discussed in a later section of this article.

THE CURRENT PROGRAM

Financing Employers withhold social security taxes from their employees and remit the proceeds, along with their own matching contributions and withheld income taxes, to the Treasury. Social security taxes are then transferred from the Treasury's general revenue fund to the social security trust funds according to the tax rates on wages of covered employees shown in Table I. Those who are eligible and elect to participate in the supplementary medical insurance program pay monthly premiums that are matched by Government contributions from the general revenue fund. Additional trust fund receipts from the general revenue fund finance certain benefit payments and cover interest on U. S. Treasury securities held by each trust fund.

Trust Funds Reflecting the concept that social security benefits are related to contributions, the tax receipts are placed in designated trust funds that are separate from the general revenue fund. The current

[1] U. S. Cong., H.R., *Reports of the 1971 Advisory Council on Social Security*, Communication from Secretary of Health, Education, and Welfare, 92d Cong. 1st Sess., April 5, 1971 (Washington: Government Printing Office, 1971).

method of financing and the present size of trust fund balances, however, reflect a current-cost financing system or a pay-as-you-go approach. Current balances in the OASI and DI trust funds would support benefit payments at their present level for only 13 months. This current-cost system certainly would not meet the actuarial standards of private insurance companies. To be considered actuarially sound, a private insurance fund should be sufficient to pay all accrued liabilities if operations were terminated. Social security actuaries and most policymakers, however, have an alternate conception of soundness for social security insurance. That is, expected future receipts should be sufficient to cover anticipated benefit payments and administrative costs over a specific valuation period. Under this theory, the benefits to be paid to current contributors depend upon the taxes to be paid by future contributors.

Cycle of Financing and Benefit Payments Congress has followed no official schedule or guidelines in increasing social security taxes and benefits over the years. In recent years, however, pressure to raise benefits has arisen because of sharp increases in prices and loss of purchasing power of benefits. In addition, a noticeable pattern has resulted, in part, from the method of forecasting future taxes and benefit payments used by the Social Security Administration.[2] Even though more accurate short-and intermediate-range estimates of future tax receipts are prepared, conservative, long-range forecasts have dominated Congressional decisions regarding increases in benefit payments. Benefit and tax schedules are determined so that the social security programs are actuarially sound according to social security insurance standards—long-run benefit payments equal long-run receipts. The long-range forecasts, though, have historically underestimated future tax receipts because they have underestimated future earnings. As a result, cash surpluses have been higher than estimated, and trust fund balances have increased to such an extent that the program has appeared to be overfinanced according to social security actuarial standards.

As a result, strong pressure to increase benefits has developed every year or so, and on several occasions Congress has amended the Social Security Act to liberalize benefits. When this has been done, however, Congress has usually set new tax schedules

[2] For more complete discussion see Joseph A. Pechman, Henry J. Aaron, and Michael K. Taussig, *Social Security: Perspectives for Reform* (Washington: The Brookings Institution, 1968), pp. 149-164.

Table I

MAXIMUM TAXABLE EARNINGS, TAX RATES, PREMIUMS, AND AVERAGE MONTHLY BENEFITS UNDER SOCIAL SECURITY, 1937—1971

		Tax Rate (Percent)[1]				Monthly Premium	Average Monthly Benefits		
Year	Annual Maximum Wage Base	Total	OASI[2]	DI[3]	HI[4]	SMI[5]	Retired Worker and Wife[6]	Survivor—Widow and 2 Children[7]	Disabled Worker — 2 or More Children[7]
1937-49	$3,000	1.0	1.0	....	....	....	$ 38.40[8]	$ 47.90[8]	....
1950	3,000	1.5	1.5	....	....	....	71.70	93.90	....
1951-53	3,600	1.5	1.5	....	....	....	78.90	103.90	....
1954	3,600	2.0	2.0	....	....	....	99.10	130.50	....
1955-56	4,200	2.0	2.0	....	....	....	104.70	138.20	....
1957-58	4,200	2.25	2.0	.25	....	....	109.80	149.00	$165.50
1959	4,800	2.5	2.25	.25	....	....	121.60	170.70	188.30
1960-61	4,800	3.0	2.75	.25	....	....	125.20	188.70	193.00
1962	4,800	3.125	2.875	.25	....	....	127.90	190.70	194.70
1963-65	4,800	3.625	3.375	.25	....	....	133.90	201.90	203.50
1966	6,600	4.2	3.5	.35	.35	$3	142.50	221.90	217.80
1967	6,600	4.4	3.55	.35	.5	3	144.20	224.40	217.30
1968	7,800	4.4	3.325	.475	.6	4	166.30	257.10	242.00
1969	7,800	4.8	3.725	.475	.6	4	168.90	255.80	241.30
1970	7,800	4.8	3.65	.55	.6	5.30	197.00	295.00	272.00
1971	7,800	5.2	4.05	.55	.6	5.60	N.A.	N.A.	N.A.

[1] Tax rate paid by each employer and employee. Self-employed pay 75 percent of combined rate paid by employer and employee for OASDI and the same rate as the employee rate for HI.
[2] Old age and survivors insurance.
[3] Disability insurance.
[4] Hospital insurance.
[5] Supplementary medical insurance. Monthly premium paid by participant and matched by Federal government and determined annually by the Secretary of HEW.
[6] Wife's entitlement not dependent on having entitled children in her care.
[7] Wife's entitlement dependent on having entitled children in her care.
[8] Benefit payments began in 1940.
Source: **Social Security Bulletin, Supplement,** 1969, pp. 39 and 43; **1971 Annual Report of the Board of Trustees of FOASDI Trust Funds,** p. 14.

Table II

SOCIAL SECURITY TAX RATES
(EMPLOYEE AND EMPLOYER, EACH)
1972—2045

(Percent)

	Present Law[1]			Advisory Council Recommendation[1 2]		
Year	OASDI	HI[3]	Total	OASDI	HI and SMI[3]	Total
1972	4.6	.6	5.2	4.70	1.30	6.00
1973	5.0	.65	5.65	4.65	1.35	6.00
1974	5.0	.65	5.65	4.45	1.55	6.00
1975	5.0	.65	5.65	4.45	1.55	6.00
1976	5.15	.7	5.85	4.40	1.60	6.00
1977	5.15	.7	5.85	4.40	1.60	6.00
1978	5.15	.7	5.85	4.35	1.65	6.00
1979	5.15	.7	5.85	4.35	1.65	6.00
1980-1981	5.15	.8	5.95	4.35	1.65	6.00
1982-1986	5.15	.8	5.95	4.20	(4)	(4)
1987-2020	5.15	.9	6.05	4.20	(4)	(4)
2021-2045	5.15	.9	6.05	5.50	(4)	(4)

[1] Maximum wage base under present law would be $9,000. Under Council's recommendation, maximum wage base would be $9,000 for 1972 and 1973 and $12,000 for 1974. Thereafter, Council recommends that the maximum wage base increase automatically to reflect increases in the cost of living.
[2] Tax rates would be increased if benefits are increased to reflect adjustments for standard of living.
[3] Under present law, SMI is financed by contributions from participants. Revision of Medicare financing under Council's recommendation would increase payroll tax to finance SMI.
[4] Not available since Council recommends estimates for HI and SMI to be made for only 10 years forward.
Source: Reports of the 1971 Advisory Council on Social Security, p. 73.

to provide for relatively small increases in the funds.

Underlying Assumptions Projections of future social security tax receipts and benefit payments are largely dependent upon future taxable earnings and population growth and composition. Estimates for the various time periods shown in Table III are based on alternate assumptions. Short-range estimates for old-age survivors insurance and disability insurance are based on the assumption that tax and benefit schedules will not change from those under existing law. Intermediate-range estimates for both programs assume periodic increases in the maximum taxable earnings base. Because growth in both earnings and benefits is assumed in the short- and intermediate-range forecasts, these projections are more realistic than long-range estimates.

Hospital insurance (HI) estimates are based on assumptions that include growth in taxable earnings and rising costs of benefits because of a larger number of beneficiaries and higher hospitalization costs. The maximum wage base is expected to increase at the same rate as wages covered by social security.

Evaluation of the actuarial soundness of the supplementary medical insurance (SMI) program is made by comparing short-range estimates of benefit payments to estimates of tax receipts based upon the current contribution premium. If the contributions are projected to fall short of benefit payments, the Secretary of Health, Education, and Welfare may increase the monthly premium each December.

To insure ample trust fund balances, conservative, long-range projections, which underestimate future tax receipts, assume that average earnings and prices will remain unchanged from those prevailing at the time of the forecast. Policy decisions by Congress are usually based on intermediate-cost estimates of long-range forecasts that are simply averages of high-cost and low-cost estimates. Different projections of population growth result in a range of cost estimates rather than a single projection. Comparison of intermediate-range projections with long-range projections of trust fund balances for 1980, 1985, and 1990 shows that forecasts that assume no change in wages and prices consistently underestimate future trust fund balances. Therefore, if long-range forecasts were based on more realistic assumptions, Congress could increase the amount of current benefits and, at the same time, continue to provide for an actuarially sound program.

ADVISORY COUNCIL RECOMMENDATIONS

Selected changes in social security financing recommended in March 1971 by the Advisory Council on Social Security are summarized below:

1. Cost estimates for cash benefits should be based—as the estimates for the hospital insurance program now are—on the assumptions that earnings levels will rise, that the contribution and benefit base will be increased as earnings levels rise, and that benefits will be increased as prices rise.

2. Tax rates should be based on single, best estimates derived from a single set of assumptions that reflect likely future trends in factors that affect income and outgo of the program.

3. Current-cost financing should be adopted to include maintenance of trust fund levels equal to one year's expenditures.

4. Explicit procedures to determine benefit and tax schedules should be established. Increases in benefits should be automatic and based on increases in prices. The maximum wage base should increase to $9,000 in 1972 and to $12,000 in 1974. Thereafter, the maximum wage base should increase automatically at the same rate earnings increase. Tax rate increases would be established by Congress on an *ad hoc* basis at the time real improvement in benefit payments is granted.

5. General revenue financing of the combined Medicare program should eventually equal one-third of total program costs.[3]

EVALUATION OF RECOMMENDATIONS

The first three recommendations reflect the Council's desire for Congress formally to adopt and improve the present method of pay-as-you-go financing. More realistic estimates of future cash flows and trust fund balances would eliminate the conservative bias that usually results in overfinancing. Coordination of the new estimates with the plan to limit trust fund balances would mean that social security taxes, in this century, could be less than presently scheduled.

The Council's fourth recommendation is designed to eliminate the present financing cycle by establishing an explicit schedule to increase social security taxes and benefits. To supplement the automatic increases designed to maintain purchasing power of beneficiaries, Congress could finance *ad hoc* changes in real benefits—benefit increases greater than changes in price levels—by increasing social security tax rates.

Revision of Medicare financing, recommendation five, is necessary because the health insurance trust fund will be exhausted in 1973. Also, the Council believes that the current method of financing supplementary medical insurance from monthly premiums paid by current beneficiaries results in an excessive burden on contributors. Because supplementary medical insurance benefit payments are not based on prior earnings or contributions, increased financing from the general revenue fund is advocated. Benefits would be financed by equal contributions from employee, employer, and general revenue.

Comparative Costs The Advisory Council's proposal to stabilize social security tax rates at 6 percent would seem very appealing when compared to the alternative of rising tax rates scheduled under current law (Table II). The Council's recommendations, however, call for greater contributions by increasing the maximum wage base at the same rate as the earnings of workers covered by social security. Furthermore, the Council's recommendations include greater benefits than currently legislated. Yet, even though these larger benefits are not scheduled under current law, if the current financing system were maintained, benefits would be increased over time as overfinancing again resulted in surpluses.

Overemphasis of the declining tax rate for old-age, survivors, and disability insurance until after the year 2000 could lead to misunderstanding of the true cost of the recommended program. These declining tax rates would be offset by an increase in tax rates for Medicare, i.e., hospital and supplementary medical insurance.

The Office of the Actuary of the Social Security Administration has estimated that the cost of benefits recommended by the Council would average 15.82 percent of taxable payroll over the valuation period ending in the year 2045.[4] By comparison, the cost of benefits provided by present law would average 13.41 percent of taxable payroll. In addition, increased general revenue financing under the proposed program is estimated to total 1.3 percent of taxable payroll in 1975.

Stabilization of tax rates under the Council's program is predicated on the benefit schedule of the proposed system. After 1975, benefit payments under the Council's plan would rise more slowly

Table III

ESTIMATES OF SOCIAL SECURITY BENEFIT PAYMENTS AND TRUST FUND BALANCES FOR SELECTED YEARS, 1971 — 2025

(millions of dollars)

Calendar	OASDI[1]		HI[2]	
Year	Benefits	Balance	Benefits	Balance
Short-Range[3]				
1971	37,022	41,426	6,419	1,948
1972	38,999	48,606	7,593	819
1973	40,662	61,603	8,902	(6)
1974	42,347	76,503	10,149	
1975	44,087	93,115	11,499	
Intermediate-Range[4]				
1980	75,466	149,771	17,696	
1985	109,543	204,427	24,221	
1990	155,858	221,305	32,752	
Long-Range[5]				
1980	49,060	112,626		
1985	56,219	147,720		
1990	63,241	171,691		
1995	69,079	189,918		
2000	73,186	213,814		
2025	117,506	272,675		

[1] OASI and DI combined.
[2] Estimates reflect increasing earnings and benefits.
[3] Estimates for OASI and DI reflect increasing earnings and tax and benefit schedules of PL 92-.5
[4] Estimates for OASI and DI reflect increasing earnings and benefits.
[5] Estimates reflect level earnings and constant prices.
[6] Fund exhausted in 1973.

Source: **1971 Annual Report of the Board of Trustees of the Federal Old-Age and Suvivors Insurance and Disability Insurance Trust Funds, pp. 25, 26, 36, 37, and 41. 1971 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund, p. 14.**

[3] For discussion of the recommendations listed above, see *Reports of the 1971 Advisory Council on Social Security*, pp. 57-74.

[4] *Ibid.*, p. 87.

than they have in the past because automatic increases in benefits would be tied to price increases. However, Congress could still decide to increase real benefits and finance the increase by hikes in the tax rate. Therefore, the Advisory Council's 6 percent tax rate figure might well be considered only a minimum. Furthermore, the Council estimated wages —the source of taxes—to grow at twice the rate of increase of prices. A slower productivity growth would reduce this relationship and increase pressure to raise tax rates to finance scheduled benefits. Also, in the past, a large part of the increased financing resulted from expanded coverage of workers. Expansion of coverage in the future, however, will be limited because 90 percent of workers in paid employment are already covered by social security. Thus it seems likely that in the future most unanticipated financing needs will have to be met by increasing tax rates or the maximum wage base.

Expected changes in the composition of the population after the year 2000 will affect both the proposed and current program. The ratio of beneficiaries, mainly those who are 65 years of age or older, to taxed wage earners, those who are 20 to 64 years of age, is expected to increase significantly. If the current-cost financing proposed by the Council is adopted, tax rates would have to increase sharply near the year 2011. Alternatively, if trust fund balances were allowed to increase as currently forecasted, these funds could be drawn down to supplement tax receipts in the next century.

PENDING LEGISLATION

In June 1971, less than three months after the Advisory Council presented its report to Congress, the House passed bill HR 1, which included certain reforms recommended by the Council.[5] At the time of this writing, the Senate has not yet acted on this legislation. Under this bill, liberalization of certain benefits would become effective in January 1972, in addition to an increase in benefits of 5 percent beginning in June 1972. The maximum wage base would increase to $10,200 in 1972 and to $10,800 in 1974; tax rates would increase to 5.4 percent in 1972, 6.2 percent in 1974, and 7.4 percent in 1977.

To maintain the purchasing power of the benefits, the bill provides for automatic increases if prices rose by a least 3 percent during the preceding year and if no increase in benefits had been granted during the preceding year on an *ad hoc* basis. The increase in benefits, to compensate for a rising cost of living, would be financed by an increase in the maximum wage base in proportion to the increase in the level of average covered wages.

The long-range estimates of taxes and benefits used to determine the actuarial soundness of the provisions in bill HR 1 were based on the assumption of constant prices and constant average earnings. As in the past, the long-range estimates to determine benefit and tax schedules were based on intermediate-cost assumptions. No single, best estimate, as recommended by the Council, was used. The House voted not to increase contributions from the general fund to finance social security programs, except to cover benefits extended to certain disabled beneficiaries.

In part, the automatic adjustments in benefit payments and maximum wage bases would incorporate the current-cost or pay-as-you-go financing system into the social security program. Short-range estimates of future balances of old-age, survivors, and disability insurance trust funds under bill HR 1 are closer approximations of yearly expenditures. Even so, under bill HR 1, long-range estimates of future trust fund balances are significantly higher than those estimated under current law. Under bill HR 1, it is estimated that the old-age and survivors trust fund would total $410.7 billion by the year 2025, compared to $272.7 billion under current law. Therefore, the pay-as-you-go financing system has not been completely adopted.

CONCLUSION

The adoption of a predetermined system to establish tax and benefit schedules has definite advantages. In the past, social security beneficiaries have had to rely on *ad hoc* decisions by Congress to receive increased benefits. Adoption of the recommendations by the Advisory Council would result in automatic adjustments of benefit payments following increases in prices.

Revising the method of forecasting benefit payments and taxes to reflect more accurately anticipated economic conditions and maintaining trust fund balances equal to one year's benefits would allow payment of benefits to increase without comparable tax increases in the near future. This change, however, would not reduce the overall cost of payments.

The new financing system might reduce the volume of social security tax receipts temporarily, but it would also necessitate a larger volume of tax receipts in the next century. An increase in benefits would have to be financed, sooner or later, from an increase in taxes.

James R. McCabe

[5] U. S. Cong., H.R., *Social Security Amendments of 1971*, Report of Committee on Ways and Means on HR 1, 92d Cong., 1st Sess., May 26, 1971 (Washington: Government Printing Office, 1971).

FEDERAL AGENCY ISSUES

INTRODUCTION

On September 16, 1971, the Federal Open Market Committee (FOMC) of the Federal Reserve System announced that System open market operations would include output transactions in Federal agency securities. This decision was not a sudden one, for the advantages and disadvantages of operations in agency securities had been carefully weighed since 1966 when Congress broadened the System's authority to purchase agency issues. Of the factors that influenced the FOMC's decision, the rapid growth of the agency market during the past five years has been one of the most important. This article examines the characteristics of the agency market and the operating guidelines established by the FOMC to overcome potential problems that might arise as a result of System transactions in agency issues.

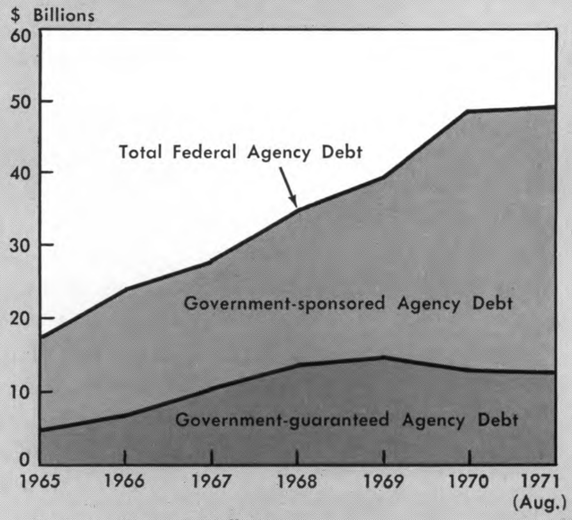
BASIC CHARACTERISTICS OF THE AGENCY MARKET

The Agencies Five privately owned, Government-sponsored corporations are responsible for most of the growth in the agency market. They are the Federal National Mortgage Association (FNMA), Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, and Federal Home Loan Banks (FHLB). Since 1965, the securities of the "big five" have comprised approximately 75 percent of total Federal agency debt outstanding. The primary function of the FHLB and the FNMA is to provide funds to the mortgage and home-building markets. The other three corporations provide farm credit.

Federally operated agencies, in contrast to Government-sponsored corporations, include the Export-Import Bank, the Federal Housing Administration (FHA), Farmers Home Administration, Government National Mortgage Association (GNMA), and the Tennessee Valley Authority (TVA). GNMA was established in 1968 to assume special assistance, management, and liquidating functions previously conducted by FNMA. The Export-Import Bank supports U. S. exports through loan guarantees and insurance. The FHA provides a system of mutual mortgage insurance for builders, buyers, and mortgage-lending institutions. As a part of the Department of Agriculture, the Farmers Home Administration extends loans in rural areas for farms, homes, and community facilities. The TVA was established by an Act of Congress to assist the development of the Tennessee River and the surrounding area.

Chart 1

VOLUME OF AGENCY DEBT OUTSTANDING



Source: Treasury Bulletin.

The Issues Securities of Government-sponsored and Federally operated agencies consist of short-term notes, debentures, and participation certificates. Neither principal nor interest on Government-sponsored agency issues is guaranteed by the Federal Government, although both are fully guaranteed by the issuing agencies. In contrast, the issues of Federally operated agencies are fully guaranteed by the Government. Average original maturities of outstanding Government-sponsored issues range from five months to five and one-half years (Table I). Guaranteed securities generally have a longer average original maturity, ranging from four months for TVA's notes to 15 years for TVA's debentures. Almost half of all agency securities outstanding mature within two years. The average size of Government-sponsored issues is $314 million or roughly $100 million greater than the average size of guaranteed securities. Although most agency issues, both sponsored and guaranteed, are available in denominations ranging from $1,000 to $500,000, both types of obligations are occasionally offered in smaller- or larger-than-average denominations.

There are three ways in which a new issue may be placed on the market. First, a Fiscal Agent, or middleman, may handle the security and organize his own selling group for distribution. Second, the agency may by-pass the Fiscal Agent and place the issue directly with one or more syndicates. Third, the agency may sell the issue directly to the public. In each of these three cases the rate may be fixed, auctioned, or negotiated.

Comparison of yields on alternative agency securities shows that issues of Federally operated agencies generally have a higher yield than do Government-sponsored securities. However, average yields on all agency obligations are somewhat higher than yields on comparable Treasury securities. For example, yields on short-term agency issues average 30 to 60 basis points above yields on Treasury bills or Treasury issues of like maturity. To some degree, this yield difference may reflect the "no guarantee" aspect of agency debt. However, it is unlikely that the U. S. Government would permit default of agency debt. Of greater importance is the thinness of the agency market when compared to the market for Treasury securities. Since the average size of agency issues is considerably less than Treasury issues and the number of market participants is fewer, there is greater risk of adverse price movement when investors sell their holdings. Even so, since 1965, yields on agency issues have fluctuated only slightly more than yields on Treasury issues of comparable maturity.

The yield disparity between short-term Treasury debt and short-term agency debt has fluctuated during the past five years and has been greatest during periods of tight money when the general level

Table I

COMPARISON OF AGENCY ISSUES

	Guaranteed	Avg. Original Maturity (Months)	Avg. Yield 1971	Avg. Size (Mil.)	Denomination Size (Thous.)	Frequency of Issue	Method of Issuance[2]	Taxed By[3]
A. Government-sponsored corporations								
1. FNMA								
a. Notes	No	5	n.a.	n.a.	$ 5 - $ 1,000	Monthly	A, B	F, S, L
b. Debentures	No	65	5.54	286	$10 - $ 500	Monthly	A, B	F, S, L
2. Banks for Cooperatives								
a. Debentures	No	6	4.69	286	$ 5 - $ 100	Monthly	A	F
3. Federal Home Loan Bank								
a. Notes and Bonds	No	46	5.45	293	$10 - $ 1,000	Monthly	A, B	F, S
4. Federal Intermediate Credit Bank								
a. Debentures	No	9	4.99	438	$ 5 - $ 500	Monthly	A	F
5. Federal Land Banks								
a. Bonds	No	64	5.55	265	$ 1 - $ 100	Bi-Monthly	A	F
B. Government-guaranteed agencies								
1. Export-Import Bank								
a. PC's	Yes	72	5.48	200	$ 5 - $ 1,000	Last Issue	B	F
b. Debentures	Yes	54	5.41	400	$ 5 - $ 1,000	Apr. 1, 1970	B	F
2. Federal Housing Administration								
a. Debentures	Yes	n.a.	n.a.	6	$50 - $10,000[1]	n.a.	n.a.	F
3. Farmers Home Administration								
a. Notes	Yes	119	6.96	219	Each Issue Varies	Quarterly	A, B, C	F
4. GNMA								
a. PC's	Yes	145	6.00	124	$ 5 - $ 1,000	No Longer Issued		F, S, L
5. Tennessee Valley Authority								
a. Notes	Yes	4	5.13	183	Multiples of	Monthly	A	F
b. Bonds	Yes	180	7.10	69	$1,000	Quarterly	B	F

1. Dollars
2. A. Use Fiscal Agent; B. Issue Direct to Syndicate; C. Issue Direct to Public.
3. F—Federal, S—State, L—Local

Source: **Securities of the United States Government and Federal Agencies**, First Boston Corporation, 1970; Bond Buyer; Salomon Brothers' quote sheet; Morgan Guaranty Trust Company's quote sheet; telephone contact with each agency.

Table II

PERCENTAGE DISTRIBUTION OF OWNERSHIP

Agency	Commercial Banks	Mutual Savings Banks	Insurance Companies	Savings & Loans	Corporations	State & Local Govts.	U. S. Govt.	All Other*
1965								
Banks for Cooperatives	28.4	5.5	2.6	1.3	8.2	9.3	0.6	44.2
Federal Home Loan Banks	24.7	6.3	3.8	4.7	9.6	5.7	....	45.2
Federal Intermediate Credit Banks	25.8	5.7	2.6	1.0	7.1	7.4	0.7	49.8
Federal Land Banks	18.7	6.6	4.7	0.7	2.4	7.9	0.1	59.0
FNMA	6.3	5.5	4.3	4.3	2.2	26.9	....	50.5
Total** Outstanding	20.8	6.0	3.8	2.7	6.0	10.0	0.2	50.3
1971								
Banks for Cooperatives	25.5	1.5	0.8	4.5	2.9	9.9	....	54.9
Federal Home Loan Banks	20.9	5.0	1.1	10.2	1.0	3.8	....	58.1
Federal Intermediate Credit Banks	24.6	2.6	0.7	5.4	2.7	6.7	....	57.2
Federal Land Banks	20.7	4.3	2.0	3.0	2.3	6.9	....	60.9
FNMA	21.0	5.8	1.3	7.8	1.6	8.5	....	54.0
Total** Outstanding	19.7	4.8	1.9	6.1	1.5	8.5	4.2	53.3

* Includes all owners of agency issues who do not report in Treasury Survey of Ownership.
** Includes issues not itemized.
Source: **Treasury Bulletin.**

of interest rates was high. In contrast, the spread between yields on long-term agency and Treasury debt has been constantly rising since 1965. This continued increase in the disparity between the yields is the result of not only tight monetary policy but also the relatively sharp growth in long-term agency issues.

Ownership of Agency Issues The Treasury Survey of Ownership reveals that commercial banks consistently have been the most active buyers of agency securities, holding about 20 percent of the total outstanding agency debt (Table II). From 1965 to 1971, the ownership distribution has not changed appreciably except in one area. In 1965, state and local governments owned 27 percent of FNMA's outstanding issues, while commercial banks held only 6 percent. By 1971 this pattern reversed itself because state and local governments, faced with tight liquidity positions, began selling-off their holdings of FNMA securities to help meet their financial needs. During the same period, commercial bank investment portfolios increased in dollar volume and included larger holdings of agency securities.

FOMC OPERATIONS IN AGENCY ISSUES

The Guidelines In 1966, Congress authorized the Federal Reserve to conduct open market transactions in agency issues, but until September 1971, the System limited activity in agency securities to repurchase agreements. The FOMC postponed the decision to operate in agency issues for a number of reasons. First, it was feared that transactions in agency obligations might be subject to political pressures and, thus, might conflict with the broad objectives of general monetary policy. Second, it was felt that System activity in agency issues might, because of the thinness of the market, result in an undesirable dominance of the market by the Federal Reserve. Third, outright transactions in agency debt would encounter technical problems, since agency obligations cannot be rolled-over at maturity like Treasury debt. Finally, since the agency market is highly fragmented, compared to the Treasury security market, the FOMC felt that this fragmentation would hinder operations.

At its August 24, 1971, meeting, the Federal Open Market Committee voted to conduct outright trans-

Table III

DISTRIBUTION OF OUTSTANDING MARKETABLE AGENCY ISSUES BY AGENCY, SIZE OF ISSUE AND CURRENT MATURITY
October 8, 1971

(amounts in millions)

	Maturing:					
	Under 2 Years		2 to 5 Years		Over 5 Years	
	#	Amount	#	Amount	#	Amount
Federal Intermediate Credit Banks						
0 - $199 million						
200 - 299 million	2	$ 403	2	$ 436		
300 and over	9*	4,839*				
Federal Home Loan Banks						
0 - $199 million						
200 - 299 million	4	900	7	1,716	2*	400*
300 and over	6*	2,610*	4*	1,250*	1	350*
Banks for Cooperatives						
0 - $199 million	1	100				
200 - 299 million	3	863				
300 and over	2*	765*				
FNMA—bonds, notes and debentures						
0 - $199 million	3	346			2	348
200 - 299 million	6	1,350	4	950	6*	1,400*
300 and over	10*	3,950*	11*	4,750*	3*	900*
GNMA—PC's						
0 - $199 million	8	220	11	300	17	655
200 - 299 million	2	525			2*	475*
300 and over	2*	780*			6*	3,015*
Federal Land Banks—bonds						
0 - $199 million	3	379	3	428	2	298
200 - 299 million	2	430	2	420	2*	509*
300 and over	8*	3,166*	5*	1,580*	1*	300*
Ex.-Im. Bank-PC's and debentures						
0 - $199 million			1	150		
200 - 299 million					1*	250*
300 and over	2*	800*				
TVA—notes and bonds						
0 - $199 million			3	250	8	525
200 - 299 million						
300 and over						

SUMMARY OF OUTSTANDING MARKETABLE AGENCY ISSUES BY SIZE OF ISSUE AND CURRENT MATURITY

(amounts in millions)

	Total Issues					
	Under 2 Years		2 to 5 Years		Over 5 Years	
	#	Amount	#	Amount	#	Amount
0 - $199 million	15	$ 1,845	18	$ 1,128	29	$1,826
200 - 299 million	19	4,471	15	3,523	13	3,034*
300 and over	37	16,910*	20	7,580*	11	4,565*
Totals	71	23,226	53	12,231	53	9,425

* Indicates issues that would be eligible for outright System operations under the proposed guidelines.

Note: The above tabulation does not include discount notes of FNMA and TVA, Farmer's Home Administration insured notes and, tax-exempt housing notes and bonds backed by the full faith and credit of the U. S.

actions in Federal agency securities for the purposes of widening the base of System operations and adding breadth to the agency market. Accompanying this authorization was a set of stringent guidelines designed to guard against the pitfalls the System feared. The guidelines[1] are:

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

3. As an initial objective, the System would aim at building up a modest portfolio of agency issues, with the amount and timing dependent on the ability to make net acquisitions without undue market effects.

4. System holdings of maturing agency issues will be allowed to run off at maturity, at least initially.

5. Purchases will be limited to fully taxable issues for which there is an active secondary market. Purchases will also be limited to issues outstanding in amounts of $300 million or over in cases where the obligations have a maturity of five years or less at the time of purchase, and to issues outstanding in amounts of $200 million or over in cases where the securities have a maturity of more than five years at the time of purchase.

6. System holdings of any one issue at any one time will not exceed 10 percent of the amount of the issue outstanding. There will be no specific limit on aggregate holdings of the issues of any one agency.

7. No new issue will be purchased in the secondary market until at least two weeks after the issue date.

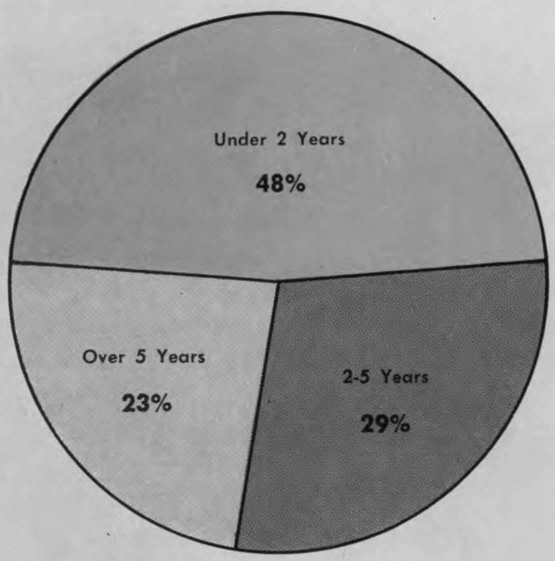
8. All outright purchases, sales and holdings of agency issues will be for the System Open Market Account.

Guidelines 1 and 2 emphasize that System operations in agency obligations will be conducted only as another means of implementing general monetary

[1] Federal Reserve Board press release, September 19, 1971.

Chart 2

MATURITY DISTRIBUTION OF FEDERAL AGENCY ISSUES



Source: Bond Buyer.

policy. These guidelines are designed to counter possible future pressures on the Committee to bolster particular sectors of the economy. As a tool of monetary policy, agency transactions could be helpful when it is desirable to supply reserves without exerting downward pressure on Treasury bill rates. These operations would focus chiefly on the short-term market, thus having minimal effect on long-term rates.

The problem of System dominance in the agency market has been reduced by the establishment of guidelines 3, 5, 6, and 7. Under these guidelines, 81 issues totaling $32 billion would have been eligible for trading as of October 1971 (Table III). The average size of each eligible issue in 1971 was approximately $395 million compared to $100 million in 1967. Comparison of the agency market with the Treasury security market shows that the ratio of agency debt to Treasury debt has increased from 5½ percent in 1960 to 28 percent in 1971. By limiting System holdings to 10 percent of a single agency issue at any one time, the FOMC has further reduced the risk of System dominance. By comparison, the System currently holds about 26 percent of the one- to five-year Treasury securities. Furthermore, as seen in Table IV, dealer activity in agency issues compares favorably to activity in Treasury coupon issues maturing within one year. In view of these guidelines and developments, System dominance in the agency market is not expected.

One of the System's main concerns about transactions in agency issues was the obvious technical problems that would arise. Guidelines 4 and 7 are designed to counter such problems. Since agency obligations are not issued in a manner similar to Treasury securities, it is not always possible to rollover or replace the issues at maturity. Furthermore, refunding operations are generally irregular. New securities may or may not be issued immediately when outstanding issues mature.

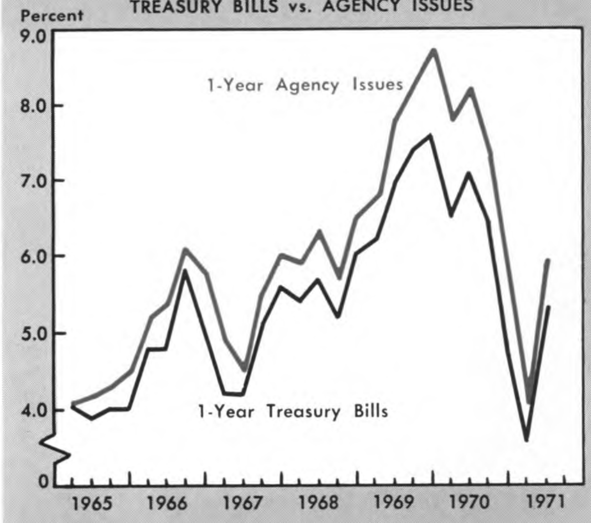
Guideline 8 merely answers a procedural question. All purchases of agency securities are to be held in the System Open Market Account, not merely in the Account of the Federal Reserve Bank of New York.

The Question of Fragmentation Because agency issues have widely varying characteristics, the market for agency issues is highly fragmented. This fragmentation has been a principal deterrent to System operations in the agency market. Although the market has grown significantly during the 1960's, it has not consolidated. Moreover, during the past several years, new agencies such as the United States Postal Service, Farmers Home Administration, and Federal Home Loan Mortgage Corporation have appeared. Many others, such as the environmental finance agency and the rural development bank, have been proposed. Of all existing agencies, only the

Chart 3

YIELD DISPARITY

TREASURY BILLS vs. AGENCY ISSUES



Sources: Board of Governors, Federal Reserve System and Salomon Brothers.

Farm Credit Administration has made any effort toward consolidation of its debt.

A Federal Financing Bank has been proposed by the Treasury Department to help reduce the fragmentation of agency debt. The Bank would be created to purchase debt of Federally operated agencies and in turn issue its own, more homogeneous, debt to the public. However, this Bank would not purchase issues of Government-sponsored agencies now in existence; thus the effective reduction of fragmentation is uncertain. It has been estimated that the consolidation of the debt

Table IV

AVERAGE DEALER POSITION AND TRANSACTIONS IN AGENCY SECURITIES AND TREASURY COUPON ISSUES BY MATURITY

(in millions)

	Agency Issues		Treasury Coupon Issues	
	Within 1 year	After 1 year	Within 1 year	After 1 year
Dealer Position				
1969	332	251	250	299
1970	469	305	351	642
1971*	479	467	268	887
Transactions				
1969	224	137	140	357
1970	270	227	162	481
1971**	231	459	184	728

*Through August.

**Through September.

Source: Board of Governors, Federal Reserve System.

Table V

ESTIMATE OF ADDITIONAL ELIGIBLE DEBT WITH CONSOLIATION

(in billions)

Direct agency debt—marketable and nonmarketable	$11.2
Less marketable debt of GNMA and Ex.-Im. already considered eligible	5.3
Net additional eligible debt	$ 5.9

Source: **Treasury Bulletin** and Board of Governors, Federal Reserve System.

of Federally operated agencies would create an additional $6 billion of eligible debt, still leaving $10.5 billion of sponsored agency debt ineligible for open market purchases (Table IV). Even so, because System open market operations are confined to larger issues, the Government-sponsored agencies might be encouraged to consolidate their own debt.

CONCLUSION

The rapid growth of the Federal agency market led to the FOMC's decision to include agency issues in open market operations. Anticipated problems, such as System domination of the market, led to carefully drawn guidelines to control transactions in agency securities. The System has set an exacting course for its activities, but exactly what effect FOMC operations in the agency market will have on issue size and maturity, or the agencies themselves, remains problematical.

B. Gayle Burgess

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