Board of Governors of the Federal Reserve System

Speech

Governor Randall S. Kroszner
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Protecting Consumers in the Credit Marketplace

I am delighted to be here today to help open this important conference. I thank my hosts, President Pianalto and her staff at the Federal Reserve Bank of Cleveland, for the invitation. This year's conference explores a confluence of consumer-related finance issues in the context of the current difficulties in the mortgage markets. In my remarks today, I would like to discuss the key role of consumer credit in our economy and describe how information disclosure and protecting consumers can work to facilitate and promote the efficient functioning of markets for such credit.[1]

Good information is essential to achieving well-functioning markets. Consumers, equipped with the right information at the right time, can make the choices most appropriate to their individual circumstances and desires. For consumers to make the most meaningful use of the relevant information, such information should be accessible and understandable. In turn, businesses rely on consumers through their choices to signal their desires and preferences in order to produce the products that consumers want. If consumers are not well informed, it is difficult for them to be effective in conveying to businesses what they most want and in rewarding those businesses that do produce such products. Good information in a marketplace thus not only empowers consumers to make better choices but also helps competition work more effectively to provide the products consumers most desire.

There are challenges in ensuring that the appropriate information is provided to help markets function efficiently. Product suppliers may not always provide needed information or present it in a format that enables meaningful comparison across competing products. Consumers must also have the financial skills to evaluate the information effectively. However, even in the presence of good information, practices can emerge that offer little benefit to consumers and, in some cases, may cause harm. In such cases, improved disclosure alone may be insufficient to address these issues.

Rules can establish standards that promote increased certainty and restrain abusive practices. At the same time, such rules need to be implemented in a careful and informed manner so that the potential benefits of such rules are not offset by unintended consequences or the imposition of unnecessary costs. The challenge to policymakers is to strike the right balance--that is, to find ways to empower and protect consumers without diminishing access to credit and hindering future innovation. With these principles in mind, I will briefly describe some of the key steps that the Federal Reserve is undertaking to strike this balance in the area of consumer regulation to protect consumers and provide them with the information they need, and when they need it, to make sound decisions.

Credit and the Economy

Credit is the lifeblood of the American economy. Whether it is to finance an education, purchase an automobile or home, or simply bridge short-term differences in the timing between our income and expenses, virtually all of us rely on credit at various points in our lives. Accordingly, choosing the right type of credit with the most appropriate terms and conditions is important to each of us. The Federal Reserve has an important role to play in this regard, as it has been given a mandate by the Congress to help ensure that the costs and terms of credit use are both transparent and understandable and to protect consumers from unfair and deceptive lending acts and practices. In our role as a supervisor of banking institutions, the Federal Reserve also seeks to ensure that lending is undertaken in a safe and sound manner.

Credit is not only important to each of us as individuals; it also plays a central role in the working of our economy. Today's economy relies on consumer spending as an engine of growth--it accounts for about 70 percent of the gross domestic product. Credit is an important underpinning to such spending. Overall, evidence from the Federal Reserve's Survey of Consumer Finances shows that about three-quarters of all households carry some debt.[2] About three-quarters of automobile purchases are currently either financed or leased, and about 95 percent of home purchases involve a mortgage. The use of revolving credit is similarly widespread; about 75 percent of consumers hold credit cards. The annual transaction volume on general-purpose credit card accounts reached nearly $1.8 trillion in 2006, and our latest information suggests that consumers owed nearly $1 trillion on revolving credit accounts of all types. Because consumer credit plays a central role in the economy, the Federal Reserve has a macroeconomic interest in facilitating the efficient functioning of consumer credit markets.

The Role of Credit

The prudent use of credit by households provides a number of important economic benefits. First, for many families, credit allows for easier and timelier purchase of assets and goods, such as homes, educations, and automobiles and other consumer durables that can generate savings in cost and time and improve employment and income-generating opportunities.[3] By facilitating such investment-oriented spending, credit enables consumers to save and consume at times that meet their needs. For example, the purchase of an automobile, which many are only able to do using credit, can expand employment opportunities, which, in turn, can lead to higher incomes. Access to consumer credit also enables many entrepreneurs to finance the start-up or expansion of small businesses, a large source of employment in the United States.

Second, a robust consumer credit market facilitates the growth of consumer durables industries (e.g., computers, autos, and appliances) in which new technologies, mass production, and economies of scale have historically created employment growth and new wealth. It is simply hard to imagine the pace of development in the automobile and appliance industries in the twentieth century without the availability of credit to purchase their output. Indeed, the lack of well-developed credit markets has been found to be an impediment to economic growth and prosperity.[4] Even in a well-developed economy such as ours, innovation in credit markets over the past two decades or so has expanded credit availability to lower-income households and increased options for middle-income consumers as well.[5]

Third, from an economy-wide perspective, credit provides an important outlet for the savings of consumers through the financial intermediation process. Ultimately, the source of funds for consumers who borrow is other consumers who have savings they hold in deposit accounts, life insurance and pension reserves, or portfolios of securities that include bonds, stocks, and mutual fund shares. Efficient markets for household credit are part of a well-functioning system of financial intermediation that allocates savings to the most productive uses.

The developments in credit markets have generally benefited consumers. However, some of these developments have increased the complexity of our choices and made mistakes potentially more costly.[6] A key challenge is to find ways to improve consumers' ability to identify products that are suitable to their needs without diminishing the benefits market innovations can provide and without reducing future access to credit. One important way this challenge can be met is by improving the information available to consumers.

The Central Role of Information

Information is critical to the efficient functioning of markets.[7] A central tenant of economics is that markets are more competitive, and therefore more efficient, when accurate and complete information is available to both consumers and product suppliers. Accurate and complete information about credit terms and prices is essential for households to make sound judgments about the use of credit. Information disclosure improves consumers' ability to compare products and to choose those products that will help them meet their personal goals.

To be effective, disclosures must give consumers information about credit pricing and important terms at a time when it is relevant, and in language consumers can easily understand. The information must also be presented in a format that allows consumers to pick out and use the information that is most important to them. Effective disclosures give consumers information they notice, understand, and can use. Better credit-term disclosures permit better-informed credit decisions and lead to more-intense competition among creditors. In a nutshell, effective disclosure empowers consumers to choose wisely and enhances competition.

In some circumstances, the disclosure rules can facilitate efficient market outcomes by establishing guidelines to improve information flows and establishing uniform standards for how information is provided. For example, since enactment of the Truth in Lending Act of 1968, which requires uniform disclosure of the cost of credit and other key lending terms, consumer awareness of and sensitivity to interest rates in credit decisions has increased.[8] Evidence also suggests that these disclosures have improved competition and helped consumers.[9] The prohibition of the provision of misleading or erroneous information can also help to improve competitive outcomes.

To evaluate the effectiveness of disclosures, we must know what consumers understand, what information they use, and how they use the information in making decisions. In designing rules, we need to take consumers' actual behavior and understanding into consideration. As a result, the Federal Reserve has been using consumer testing to address the considerable challenge of making disclosures effective. As mentioned, consumers increasingly face more-diverse and more-complex financial products, including nontraditional mortgages and credit cards with multiple and complex features. Given this complexity, we are mindful of the challenges of information overload and seek to design disclosures that are not only accurate, but also clear and concise, so that they are meaningful and useful to consumers.

Numerous pages of fine print may provide the comprehensive descriptions that lawyers may prefer, but they can also be confusing, or provide limited value, to consumers. We increasingly rely on feedback from surveys and testing from actual consumers to determine the information they need to make informed choices. In this regard, we recently completed several rounds of consumer testing for credit card disclosures. That testing has been essential to our effort to redesign and improve them. We have also begun using consumer testing of mortgage disclosures to help develop more-effective disclosures around product features and other terms that consumers need to know.

Limitations of Disclosure Protections

When consumers are fully aware of and understand product terms and features, they are better positioned to make the right choices and achieve the outcomes most appropriate to their given circumstances, as well as give the signals and rewards to businesses that produce the products and services consumers most value. However, some product features and contract terms may be so complex that they are not readily understood. In some instances, even small misunderstandings, misjudgments, or the challenge of focusing on the most essential features of a product can lead to serious problems down the road. This is one reason why financial education and literacy efforts are essential to enabling consumers to navigate our complex consumer financial marketplace.

Problems can arise if competition does not ensure that relevant information on some terms or product features is provided in a timely and comprehensible way.[10] Moreover, product terms or features can sometimes emerge that offer little or no benefit to the vast majority of consumers. Double-cycle billing, for example, is a practice in the credit card industry that is so complex that few consumers can fully understand the implications of this practice, even in the presence of full disclosure. Generally speaking, institutions using this practice assess interest not only on the balance for the current billing cycle, but also on the balance for the preceding billing cycle. The Board has conducted extensive consumer testing of various ways to describe this balance computation method and found that disclosures are not successful in helping consumers understand it. In such cases, improving information disclosure alone may not adequately address the issue. Consequently, the goal of consumer protection may be most effectively realized, weighing the potential costs and benefits, if certain product features are modified by rule or prohibited outright rather than disclosed.

Current Challenges and the Federal Reserve's Regulatory Proposals

In today's vast and complex consumer finance marketplace, we face the challenge of ensuring that disclosures for consumer credit remain effective in light of the growing complexity of consumer credit products and terms. We also face the challenge of identifying when restrictions and prohibitions are appropriate to ensure meaningful consumer protection and do not involve unintended consequences that could ultimately reduce consumer welfare.

With the increased complexity of mortgage loans and credit cards in recent years, for example, there has been great concern about the need for more-effective disclosure and increased consumer protection in these transactions. The Federal Reserve has undertaken extensive efforts to gain insight into industry practices and consumer experiences to understand how to improve disclosures when possible and to enhance consumer protections where needed.

With respect to mortgage lending, we have been working to finalize the rules under the Home Ownership and Equity Protection Act that we proposed in December. In developing this proposal, we gained valuable insight through public hearings, discussions with industry and consumer groups, input from our Consumer Advisory Council, and other sources. The amendments we have proposed would better protect consumers from a range of unfair or deceptive mortgage lending and advertising practices that have been the source of considerable concern and criticism. Our proposal includes key protections for higher-priced mortgage loans secured by a consumer's principal dwelling. Specifically, the proposal addresses concerns about underwriting and lenders' consideration of the borrower's ability to make the scheduled payments, including verifying the income and assets that lenders rely upon in making the loan. The proposal also addresses concerns about prepayment penalties and the impact on consumers when lenders fail to establish escrow accounts for taxes and insurance. We are working toward issuing final regulations in July.

For credit cards, the Federal Reserve has employed a two-step strategy toward improving consumer protection. Our first step was the Board's proposal to substantially revise and improve credit card disclosures under the Truth in Lending Act. We have done extensive consumer testing to determine the type of information and its format that consumers find most useful in shopping for and choosing a credit card. We issued this proposal last year, and we are still carefully considering the public comment letters received on that proposal, many of which contain suggestions for how we might further improve the disclosures. We believe that this proposal will result in credit card disclosures that are significantly more effective for today's complex products. Testing disclosure forms and formats with credit card users is crucial to ensuring that the disclosures are understandable and useful to consumers. Effective disclosures can help to empower consumers and enhance the competition because consumers find it easier to comparison shop. We are continuing to use consumer testing as we work toward issuing final rules by year-end.

This extensive consumer testing--and the thousands of public comments generated by our 2007 credit card proposal--suggested that disclosures might not provide sufficient consumer protection with regard to certain practices. Therefore, in May we took the next step in our ongoing effort to enhance protections for consumers who use credit cards by proposing rules under the Federal Trade Commission Act to prevent financial harm to consumers from specific practices. We proposed rules that go beyond disclosure and could require financial institutions to make changes to their business models and to alter some practices.

The Board has worked jointly with the Office of Thrift Supervision and the National Credit Union Administration in drafting and issuing a proposal intended to prevent financial harm to consumers from specific practices that the agencies find to be potentially abusive. Among other things, the proposed rules would address the following:

- Creditors would be required to provide consumers a reasonable amount of time to make payments before they are considered late.
- As a general rule, for accounts having multiple interest rates for different balances, creditors would be prohibited from maximizing interest charges by applying payments exceeding the minimum to the lowest rate balance first.
- Creditors would no longer be permitted to increase the interest rate on existing account balances at any time for any reason. Instead, card issuers could only apply a higher rate to the existing balance under limited circumstances, such as when a consumer has been delinquent for 30 days. Of course, creditors could still increase the rate on new transactions and could offer variable-rate cards that have the rate on existing balances adjust based on changes to an index.
- Creditors could no longer accrue finance charges using the two-cycle balance computation method.

The rules also prohibit a practice associated with the issuance of some subprime credit cards, in which most of the credit limit is used for security deposits and high fees imposed at account opening before the consumer actually receives the card.

In addition to rules for credit cards, our proposal also addresses potentially abusive practices in connection with banks' payment of overdrafts to ensure that consumers have a choice of obtaining overdraft protection and receive information related to its service and costs.

Conclusion
A robust, innovative, and competitive consumer finance market is crucial to a healthy economy and, as I described earlier, can provide significant benefits to consumers. Such a market works most effectively and brings the greatest benefits when consumers are well-informed and are not subject to abusive practices. The Federal Reserve is working diligently to best use its authorities to provide both creditors and consumers with rules that strike the right balance between ensuring that consumers receive useful information at an appropriate time and restricting certain practices, while at the same time minimizing the risk of unintended consequences and the imposition of unnecessary costs that could reduce the benefits of a vital consumer finance marketplace.

Footnotes

1. Defined here, consumer credit includes both mortgage loans and other types of loans extended to consumers. Return to text

2. Brian K. Bucks, Arthur B. Kennickell, and Kevin B Moore (2005), "Recent Changes in Family Finances: Evidence from the 2001 and 2004 Survey of Consumers Finances (444 KB PDF)," *Federal Reserve Bulletin*, vol. 91, pp. A1-A38. Return to text

3. Refer to, for example, F. Thomas Juster and Robert P. Shay (1964), "Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation," Occasional Paper 88 (New York: National Bureau of Economic Research). Return to text

4. Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine (2004), "Finance, Inequality, and Poverty: Cross-Country Evidence," Working Paper Series 10979 (Cambridge, Mass.: National Bureau of Economic Research, December). Return to text

5. Joseph Nocera (1994), *A Piece of the Action* (New York: Simon and Schuster). Return to text

6. For example, Woodward finds that complicated loan arrangements raise the costs to homebuyers engaging in mortgage transactions; Susan E. Woodward (2008), *A Study of Closing Costs for FHA Mortgages* (Washington: U.S. Department of Housing and Urban Development). Return to text

7. Refer to, for example, George J. Stigler (1961), "The Economics of Information," *Journal of Political Economy*, vol. 69 (June), pp. 213-25. Return to text

8. Thomas A. Durkin (2006), "Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior (104 KB PDF)," *Federal Reserve Bulletin*, vol. 92, pp. A109-A121; Thomas A. Durkin and Gregory Elliehausen (forthcoming), *Financial Economics of Information Disclosure: Applications to Truth-in-Lending* (New York: Oxford University Press). Return to text

9. Durkin and Elliehausen (forthcoming), *Financial Economics of Information Disclosure.* Return to text

10. Xavier Gabaix and David Laibson (2006), "Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets," *The Quarterly Journal of Economics,* vol. 121 (May), pp. 505-40. Return to text

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