Attached is a copy of a speech written for Governor Seger by D. Smith and K. Brueger on the topic of "Banking and the Consumer: A View from the Fed." It was delivered before the New York State Bankers Association's Consumer Banking Division on September 26, 1986.

October 10, 1986

Introduction

Good morning. I appreciate the opportunity to speak to you today on banking and the consumer from my perspective on the Board of Governors.

The banking industry has obviously been subject to a lot of changes in the economic environment for a number of years now, and those changes directly or indirectly have also affected consumers -- benefitting certain sectors of the public, while creating new concerns for others. For example, the lifting of restrictions on interest rates several years ago made it possible at last for financial institutions to compete with the money market funds. The holders of savings accounts were the beneficiaries. At the same time, because of the increased cost of funds, banks began passing on some of their costs to checking account customers through the imposition of new or increased service charges -- leading to a variety of other consumer concerns.

In my remarks today I will be tallking about a wide range of consumer issues some of them are regulatory matters that have recently been before the Board, others are issues that have received attention in the Congress this session.

Uniform Disclosures for Adjustable Rate Mortgages

Some factors in the economic environment have affected consumers more directly than others -- as in the period of the high interest rates that we faced several years ago. Some institutions found themselves locked into fixed interest rates at low levels at a time when market rates kept rising and when they were losing customers to competitors who were paying higher returns.

Looking for ways to protect themselves for the future, many institutions turned to variable rate lending. This shifted interest rate risk to the consumer by way of adjustable rate mortgages (ARMS), raising concerns about whether consumers were sufficiently aware of the potential impact of future rate increases. There was also concern about the fact that three of the federal financial regulatory agencies were enforcing three different disclosure rules. All of these concerns led, as you may recall, to a Board proposal for the amendment of the Truth in Lending requirements applicable to ARMs disclosures. We have been working on this issue a long time -- seeking to develop a uniform requirement to facilitate compliance for lenders and to make it easier for consumers to comparison-shop.

I am pleased to report that we have achieved a breakthrough. Just last month the Federal Financial Institutions Examination Council announced its approval of uniform disclosures that it is recommending to its member agencies. As the Board's alternate representative to the FFIEC, I was involved in the discussions about this issue. I can tell you that we were really tackling a tough problem -- developing disclosures that would give the borrower enough information about loan programs while not over-burdening the creditor who has to produce the disclosures.

The uniform disclosure we developed requires distribution of the Consumer Handbook on Adjustable Rate Mortgages (a brochure developed by the Board and the Federal Home Loan Bank Board) and distribution of a pre-printed insert that gives all necessary facts about the loan program. The insert will describe the particular ARM loan program in which the borrower is interested and will give an example of how a change in the index or formula values used to compute interest rates could affect the borrower's mortgage interest rates and payments. A ten-year history of the index or formula will be used in the example to start, and expanded over time to 15 years.

Exclusion From Regulation Z Right of Rescission

The attention to ARMs resulted from the rise in interest rates we were experiencing a few years ago. More recently, we have had declining interest rates, so, naturally, new issues come into focus. As I'm sure you're well aware, there has been a substantial increase recently in consumer applications to refinance mortgages, primarily because consumers want to take advantage of these declining interest rates. And because of the increase in refinancings, we have received a number of inquiries and complaints about the effect of the Truth in Lending rescission provisions on refinancings.

To give you some background, the Truth in Lending Act gives consumers the right to rescind certain credit transactions if a security interest is taken in the consumer's principal dwelling. The right of rescission means that the consumer has an opportunity to reexamine the credit contract and cost disclosures before the contract becomes final. It allows reconsideration of the decision to place an important asset -- the home -- at risk. During the 3-day rescission period, in the case of refinancings, the creditor is prohibited from disbursing funds to pay off the existing loan.

Some consumers have complained of having to pay "double interest." This situation occurs when finance charges on the new loan accrue prior to disbursement of the funds, while finance charges continue to accrue on the old loan until it is paid.

In response to the inquiries and complaints received, the Board considered whether these particular refinancings are the type of transactions in which the consumer needs the right of rescission. The regulation currently exempts from the right of rescission certain refinancings by the same creditor, provided no new money is disbursed. (This directly parallels a provision in the Truth in Lending Act.) Last month, the Board published a proposal to expand the category of refinancing transactions that would be exempt. Under the proposal, refinancings by a new creditor also would be exempt, provided that, first, no new advances of money are made to the consumer, and second, that the annual percentage rate (the APR) for the new obligation is both (1) a fixed rate and (2) the same as -- or lower than -- the APR for the obligation being replaced. The Board's exemption would also not apply to new obligations in which there is a balloon payment feature.

The comment period for this proposal ended September 10. The staff is currently reviewing the 150 or so comments that the Board received, for final action sometime next month.

Basic Banking Services

Another of the issues receiving much attention these days is the byproduct of an economic environment marked by increased competition from outside the traditional financial institutions, increased cost of funds, and interest rate volatility. In this environment, some institutions have turned more to explicit pricing of many services that were previously offered without charge. As service charges and minimum balance requirements have increased, some observers have asserted that less affluent consumers may be "priced out" of the traditional banking marketplace. In response, several bills have been introduced in the Congress dealing with "basic banking" accounts, that is, minimal essential banking services that would be provided free or at a nominal cost. Last year, the OCC issued a banking circular urging national banks to voluntarily provide basic banking services, and both the American Bankers Association and the Consumer Bankers Association have encouraged their members to offer such services.

The Board's Consumer Advisory Council studied this issue at length last year. Ultimately, the Council recommended that the Federal Reserve Board issue a policy statement encouraging state-member banks to voluntarily offer basic financial services that would be accessible to low- and moderate-income consumers. The Council also recommended that the Board encourage the other federal financial regulatory agencies to do the same. On September 10, the Board approved in principle a policy statement that encourages efforts by both individual institutions and by industry associations. This policy statement has been sent to the FFIEC for consideration at its October 2 meeting, with the hope that the agencies will join together in issuing it.

Personally, I prefer voluntary action by the private sector to regulatory measures. However, I can understand the support for a policy statement by the Board. It gives greater weight to the initiatives already undertaken by industry groups. And of course there is always the concern that, absent some action by the Board, a heavier burden in the form of legislation might present itself.

Community Reinvestment Act

Another current consumer issue that should be of interest to you as bankers, in part because of the current atmosphere of increased acquisition activity, involves the Community Reinvestment Act (CRA).

The CRA, as you know, requires the federal financial regulators both to encourage institutions to meet the credit needs of their communities, including low- and moderate-income neighborhoods, and to assess institutions' CRA performance during examinations. An institution's record of performance is also taken into account, along with other factors, when the Federal Reserve

Board decides whether or not to approve certain applications from the institution, such as to form a holding company or to acquire a bank.

Because of the increase in acquisitions, CRA has lately been the focus of increased community and state legislative interest and concern. One of the concerns expressed regards the potential for banks to be less responsive to local concerns if decisions about local bank policies are made by institutions in other states. Some states are now imposing community reinvestment standards before approving applications from institutions located in other states.

At the Board, we received a record number of CRA protests last year against holding company applications from community and other groups, with the trend continuing in 1986. In most cases, the Community Affairs Officer and staff at the appropriate Reserve Bank have worked with the applicant financial institution and the protestant, and an amicable settlement has been achieved and the protest withdrawn. The point to keep in mind as bankers is, I think, that you have an obligation under the law to respond to your local community's credit needs. In addition, keep in mind that a protest filed when you are in the process of attempting to arrange an acquisition, for example, can be both time-consuming and expensive to deal with, and could even result in the denial of your application.

Truth in Savings

Another topic under the grouping of consumer issues that have emerged in reaction to changes in the industry, is that of "truth in savings."

A truth in savings bill was passed by a House Banking subcommittee this summer, and is expected to receive the full Banking Committee's attention --

today, as a matter of fact. The bill would require the Board to establish uniform methods of interest rates and yields on deposits for all depository institutions. It would also mandate the disclosure of fees and terms applicable to deposits and services offered, and would impose certain requirements regarding advertising.

The Board has had comprehensive regulations on advertising in Regulation Q since 1969, as you know. In January of this year, we proposed for public comment a series of amendments to update the current advertising rules. That proposal already addresses many of the advertising issues covered by the truth in savings bill, such as requiring the disclosure of an annual percentage yield ("APY") and requiring advertisements to include a statement regarding service charges. Given the Board's current proposal to revise Regulation Q, we stated before Congress earlier this year that we would not seek passage of the federal legislation.

Credit Card Interest Rates and Disclosures

There are two other topics that have received a lot of attention by the 99th Congress the issue of credit card interest rates and disclosures, and the practice of delaying the customer's access to funds represented by check deposits.

With regard to credit cards, several proposals that would establish nationwide ceilings on credit card interest rates have been introduced out of concern on the part of some members of Congress at the failure of credit card interest rates to decline along with market rates. The Board has testified against the imposition of a federal ceiling on credit card rates. A vote on a federal ceiling on credit card interest rates was taken September 12 in a

House subcommittee. The measure was defeated, and, I would guess, is unlikely to re-emerge this year.

On the subject of credit card disclosures, again, several bills were introduced in the Congress this session. They would require disclosure to the consumer of certain cost information on any application or solicitation for a credit card. (Under the present law, only when certain "triggering" terms are stated must additional credit information be given.) The Board's testimony, presented at a Senate hearing in May, supported full disclosure of credit terms and indicated that the burden on financial institutions for disclosure requirements as to solicitations by mail would not be substantial. We did note, however, that the need for increased disclosures is by no means certain, and further, that requiring the inclusion of disclosures on all applications -- not just mail solicitations -- could be both burdensome and costly to a degree that would exceed consumer benefits. The Board's staff is working on a study to determine the benefits of providing consumers with comparative cost information in the installment lending area, and the Board suggested that congressional action on reporting requirements should, therefore, be postponed.

A credit card disclosure measure is part of the truth in savings bill expected to be considered by the full House Banking Committee today.

Delayed Funds Availability

The practice by some financial institutions of delaying a depositor's ability to withdraw funds deposited by check -- "delayed availability of funds" -- too has been the subject of much congressional attention this session. I realize that the concept of delayed funds is hardly one I need to explain here today since New York has had a delayed funds law since 1983, I believe.

In January of this year, the Expedited Funds Availability Act was passed by the House of Representatives. That bill would require institutions to disclose their availability policies, and to compute interest on funds deposited by check no later than the date that provisional credit is received. The bill also directs the Board to develop within three years a system that would enable institutions to provide availability within one day for checks from institutions located in the same Federal Reserve check processing region, and within three days otherwise. An interim availability schedule would be imposed until that time. A bill with similar provisions -- but without the mandatory availability schedules -- was introduced in the Senate last November.

(The Board generally supports legislation to require disclosure of availability policies to consumers and to mandate improvements in return check processing. We continue, however, to oppose mandatory availability schedules.)

There apparently remains considerable interest in this legislation, at least in the House. A delayed funds bill passed earlier this year has been included in a new package of banking measures. That package was just approved by the full House Banking committee on Tuesday of this week, and is likely to receive prompt Senate attention.

New York Exemption

There are two final items that I want to mention today. The first has to do with a request that the Board received from the State of New York, asking for an exemption from the Credit Practices Rule, under Regulation AA. This is the rule that makes it an unfair practice, for example, for a bank to include certain terms in its consumer contracts -- such as confession of judgment clauses. (There are also limitations on the pyramiding of late payment charges, and certain provisions applicable to cosigners.) This rule was adopted in response to similar action by the Federal Trade Commission -- something that we were required to do under the FTC Improvements Act.

The Board will have to determine whether New York's requirements afford consumers a level of protection that is substantially equivalent to -- or greater than -- the protection provided by the federal law. If the exemption is granted, banks will be subject solely the New York law, and will not also have to comply with the federal. Our staff is in the process of analysis, and I expect the matter will be coming to the Board sometime in October. We will, of course, publish our proposed determination for comment before final action is taken.

Business Credit

Finally, let me talk to you about business credit. In the two years since I joined the Federal Reserve Board, I have been meeting with a lot of groups throughout the United States. Many of them have been banking groups such as this one. But others have been women's groups and organizations of small business owners, where one recurring theme has been access to credit for small businesses. In today's business climate, the availability of credit is critical -- particularly to the increasing numbers of women who now have their own businesses.

I will be the very first to acknowledge that the granting of business credit is a selective process. Banks are not investors in a business -- they are lenders, and they have an obligation to their stockholders and depositors to be sure that the loans they make will be repaid. I am also aware that many small businesses fail each year.

However, it is clear from my dealings with these various women's and small business groups -- and from stories that I read in the newspapers and in magazines -- that many women applicants sometimes believe that they may be receiving less favorable treatment than other applicants, not for credit related reasons, but because of their sex or marital status. And in some cases, I would have to say, their concern may be valid.

Now you all know that we have a federal law that bars discrimination in credit transactions -- on the basis of sex, marital status, race, and a number of other factors. That law, the Equal Credit Opportunity Act, is implemented by the Federal Reserve Board's Regulation B. The ECOA and Regulation B make it every bit as unlawful for a lender to discriminate on a "prohibited basis" in a business transaction as in consumer credit transactions. There are some modifications that the Board made with respect to business credit transactions -- having to do with the written notice of denial and with record retention -- but they are very modest.

I am a firm believer in dealing with problems in a nonregulatory way to the extent possible. Consequently, I would much prefer to see banks acting to police themselves in this area rather than having the Board mandate, for example, that banks send written notices automatically on credit denials, or that they keep records for 25 months, as in the case of consumer credit.

What I would like to suggest to you today is that you need to ensure that loan officers in your banks are fully aware of what is required by the law. Have them review our regulations. Make sure that they are complying not only with the technical requirements but also with the spirit of the law.

Because we saw a special need for education in this area, the Board earlier this year published a brochure -- A Guide to Business Credit and the Equal Credit Opportunity Act. Its purpose is two-fold: to give business applicants useful, practical information about how to go about preparing an effective loan presentation, and to let them know about their rights under the ECOA. The Guide was developed with the assistance of the American Bankers Association, the National Association of Bank Women, and other banking groups. We also had help from the Small Business Administration and the National Association of Women Business Owners.

I have been particularly pleased with the reception that it is receiving. We enlisted the assistance of the various groups who worked on its development, and of the other financial regulators -- the OCC and the FDIC -- in distributing the pamphlet. I also sent letters to some three dozen magazines with national circulation, and I am told by our publications office that the brochure is a very popular item. In fact, I would have brought copies today, except that because of demand, our initial printing has been exhausted. But I would welcome your help in distributing and using our brochure, and will be glad to see to it that you receive copies as soon as they are available.

Thank you.