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MONTHLY REVIEW

Banking in the Consumer Protection Age
Capital Notes and Debentures
Cyclical Indicators of Economic Activity

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Banking in the Consumer Protection Age: Part I

Protection of the consumer is not a new idea in the United States. As long ago as 1914 the Federal Trade Commission was created with this objective in mind, and even today the FTC remains the principal guardian of the consumer against unfair and deceptive trade practices.

Fundamental changes are now occurring in the way Government seeks to protect the consumer, however. The new Consumer Age dawned for the banking industry in 1968 with passage of the Truth in Lending Act.[1] This was followed two years later by the Fair Credit Reporting Act.[2] A variety of similar bills are pending in Congress, including "Truth in Savings" and "Truth in Billing."[3] Twice within the past three years President Nixon has urged Congress to enact a comprehensive new legislative program aimed at establishing a "Buyer's Bill of Rights."[4] A new Office of Consumer Affairs has been created in the White House itself.

In the past, Government action to protect the consumer was chiefly directed toward suppression of overtly false and deceptive trade practices. The older approach, symbolized by the Federal Trade Commission Act, relied for its effectiveness upon administrative proceedings to correct false, deceptive or misleading practices after they had occurred.

In contrast, the key to the new approach is the requirement of affirmative disclosure of relevant factual information to the consumer, in writing, at a time when possession of the information will enable him to make more rational choices among competing vendors or creditors, or, in the case of Fair Credit Reporting, make it possible for him to eliminate erroneous and harmful adverse information from his credit file.

Both the old and the new methods of protecting consumers are of growing importance to commercial banks. Although banks are exempt from enforcement jurisdiction of the FTC, bank holding companies and their nonbank subsidiaries may not be in light of the particular wording of Section 5 of the FTC Act.[5] Thus, at the very time that banks find themselves subject to many of the new consumer protection laws, the older trade regulation rules enforced by the FTC may be applicable to bank holding companies and their nonbanking subsidiaries as they expand into new nonbanking business areas.

A formidable array of civil, criminal and administrative penalties may be imposed for failure to comply with the broadening spectrum of consumer protection laws. Banks and their affiliates face the added exposure of periodic examinations by Federal and State authorities who are increasingly conscious of their assignment to monitor compliance by the supervised institutions.

Background of Federal Consumer Protection Legislation The FTC was created in 1914 to aid in enforcing the antitrust laws by preventing "unfair methods of competition in commerce." However, until 1938 its effectiveness was impaired by court decisions restricting the power of the FTC to prohibit unfair and deceptive practices causing injury to the public. The leading case was the Supreme Court's 1931 opinion in *F.T.C.* v. *Raladam Co.*,[6] which held that the Commission could not prevent false and misleading advertising of an "obesity cure" even though it found that Raladam's advertising had deceived the public and that the preparation could not safely be used by the public without medical direction. The reason given by the Court for ignoring the harm to consumers was that ". . . there is neither finding nor evidence from which the conclusion legitimately can be drawn that these advertisements substantially injured, or tended thus to injure, the business of any competitor generally . . . ." False statements to the public in and of themselves, and without proof that the falsehoods diverted business from competitors, were thus deemed inadequate to invoke the FTC's jurisdiction.

Refusal of the Court to permit the FTC to protect consumers injured by dishonest business practices was particularly significant in view of the fact that common law remedies for deceit, misrepresentation

[1] Title I, Consumer Credit Protection Act, Public Law 90-321, May 29, 1968, 82 Stat. 145.

[2] Title VI, Consumer Credit Protection Act, Public Law 91-508, October 26, 1970, 84 Stat. 1128.

[3] S. 1848, S. 652 and H. R. 1125.

[4] Statement of the White House, October 30, 1969; Statement of the White House, February 24, 1971.

[5] Section 5(a) of the Federal Trade Commission Act provides, in relevant part:

> The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations, *except banks* . . . from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce. (Emphasis added)

38 Stat. 719 (1914), as amended 52 Stat. 111 (1938), 52 Stat. 1028 (1938).

[6] 283 *U. S.* 643 (1931).

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or breach of warranty are not effective in many consumer transactions. Sellers have usually been accorded wide latitude for "puffing" the claimed virtues of their products, and even when misrepresentation has been proved, the courts have tended to conclude that the consumer either should not have relied on the claims because they were obviously untrue or did not rely on them as an inducement to purchase. Apart from this, most consumer products are relatively inexpensive, and it is impractical for deceived consumers to hire lawyers to try to recover damages or rescind the transactions. Finally, attempts by the States to regulate business for the benefit of consumers have been spotty, at best.

In an effort to improve the consumer's position, Congress in 1938 adopted the Wheeler-Lea amendment to the Federal Trade Commission Act, adding the words in italics to Section 5 of the FTC Act:

> Unfair methods of competition in commerce, *and unfair or deceptive acts or practices in commerce,* are hereby declared unlawful.[7]

The House Report on the amendment emphasized its purpose of equalizing the consumer's status with that of the businessman in FTC proceedings:

> By the proposed amendment to Section 5, the Commission can prevent such acts or practices which injuriously affect the general public as well as those which are unfair to competitors. In other words, *this amendment makes the consumer, who may be injured by an unfair trade practice, of equal concern, before the law, with the merchant or manufacturer* injured by the unfair methods of a dishonest competitor.[8]

Yet even after Wheeler-Lea, the FTC's ability to protect the public against deceptive business practices has remained limited. One reason is that the Commission has very little power to prevent unfair and deceptive practices at the local level, where most consumer deception occurs, except in Truth in Lending cases. Under Section 5 of the FTC Act, unfair methods of competition and unfair and deceptive acts or practices must actually be "in commerce" —meaning interstate commerce—to be subject to FTC jurisdiction. Purely intrastate transactions, or ones which merely affect interstate commerce but are not "in" such commerce in the sense of crossing state lines in some respect, are beyond the Commission's reach.[9]

Until recently, another factor constricting the Commission's power in deceptive practices cases was the reluctance of courts to permit the Commission to require affirmative disclosures of information. This is illustrated by the Commission's "tired blood" cases. In *Alberty* v. *F.T.C.*[10] the defendant sold Vitamin A Shark Liver Oil, Oxorin tablets and other nostrums, advertising their alleged beneficial effects along the following lines:

> Pep up your blood! Iron * * * A principal factor in Red Blood Cells. * * * The disease Fighting Units of the Blood.
>
> When you are weary, tired, run-down, just dragging yourself around with no ambition left, when every effort you make seems to leave you weak and spent then try Oxorin Tablets, a tonic for the blood.

In fact, the products would not help people who were tired and run-down except where their symptoms were due to simple iron deficiency anemia, and most people with the advertised symptoms did not have iron deficiency anemia. The Commission's remedial order therefore required Alberty to disclose that ". . . the condition of lassitude is caused less frequently by simple iron deficiency anemia than by other causes and . . . in such cases this preparation will not be effective in relieving or correcting it." Alberty objected to this order and the reviewing court refused to require it. The court said:

> In short, the Commission requires that the advertiser tell the public that his product is more frequently valueless than it is valuable.
>
> * * *
>
> The Commission must find either of two things before it can require the affirmative clause complained of: (1) that failure to make such statement is misleading because of the consequences from the use of the product, or (2) that failure to make such statement is misleading because of the things claimed in the advertisement. There is no such finding here.[11]

On occasion the Commission has been able to prove one or both of the two prerequisite items specified above. A recent example is in connection with "Geritol," another heavily advertised remedy for so-called "iron-poor" blood.[12] Yet even here, after ten years of litigation with the maker and its advertising agency in which the Federal court approved an affirmative disclosure order along the lines of the one rejected in *Alberty* years earlier, the Commission was eventually forced to refer the matter to the Department of Justice.[13]

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[7] 52 Stat. 111 (1938).

[8] House Report No. 1613, 75th Cong., 1st Sess. (1937), p. 3 (Emphasis added).

[9] *F. T. C.* v. *Bunte Bros., Inc.*, 312 *U. S.* 349 (1914). Legislative proposals are now pending in Congress to broaden the Commission's jurisdiction to cover transactions that merely "affect" interstate commerce. If one of these proposals becomes law, it is reasonable to assume that few transactions thereafter will be beyond the Commission's jurisdiction.

[10] 182 F.2d 26, *cert. den.*, 340 *U. S.* 818 (1950).

[11] 182 F.2d, pp. 38-39.

[12] *J. B. Williams Co.* v. *F. T. C.*, 381 F.2d 884 (6th Cir., 1967).

[13] In April of 1970 the Department of Justice filed suit in the United States District Court for the Southern District of New York charging the Williams Company and its advertising agency with violations of the Commission's order, originally entered in 1962 and affirmed by the Court of Appeals in 1967. The complaint charged the defendants with continuing to advertise the product in a manner prohibited by the order, and sought civil penalties of $500,000 from each defendant. 458 *Antitrust & Trade Regulation Report*, p. A-22, April 21, 1970.

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Ironically, the very success of the FTC in combating overtly false representations has had certain adverse consequences for the consumer. It has, for example, tended to inhibit all representations of fact in advertising. The advertising art has become increasingly successful in getting its message across by the shrewd use of innuendo, ambiguity and suggestion without misstating anything factual at all. As a matter of law, except where affirmative disclosure is specifically required by statute, the vendor or creditor does not have to furnish the consumer with any factual information. The general rule was stated in the House Report on the Wheeler-Lea amendment to the FTC Act as follows:

> It will be observed that it is not mandatory on the advertiser to state anything. The only requirement is in case he does advertise, he shall not make statements that are misleading in a material respect.
>
> It is incumbent on the advertiser to reveal facts material in the light of representations made in the advertisement.[14]

New Approaches to Consumer Protection A portent of change to come in the rationale of consumer protection legislation was the Automobile Information Disclosure Act of 1958, requiring manufacturers of new automobiles to post a label on the window or windshield of each new vehicle stating its make, model, name and retail price, and itemizing each optional item with its price.[15] The law was enacted because Congress felt that automobile merchandising techniques had reached the stage where most consumers could not determine comparative costs of competing vehicles in a way that would enable them to make informed choices, no matter how diligent their efforts.

Then, in the 1960's, after a heavy barrage of consumer messages and proposed bills from Presidents Kennedy and Johnson, Congress began to make further important inroads into the privilege of sellers, lenders and advertisers to say nothing factual, or at least as little as possible, about their products and services. In 1966 Congress took note that in modern consumer markets, packages themselves are a major promotional device. Because of this, Congress concluded that the package's role as its own best advertisement increasingly conflicted with the function of informing consumers of contents, quantity and price.[16] It was believed that large numbers of consumers were frustrated in trying to determine the contents or comparative cost of the 8,000 or more prepackaged items on the shelves of supermarkets, drug stores and other self-service establishments. The Fair Packaging and Labeling Act of 1966 was the result. Among its requirements, every "consumer commodity" (as the term is defined in the Act) must carry a label identifying the product by name, giving the name and place of business of the manufacturer, packer or distributor, and showing the net quantity of contents.[17]

Different problems confronted consumers in markets for larger, more expensive durables such as automobiles, furniture and appliances, and for home improvements. Credit is needed to finance most of these purchases, yet many consumers felt that it was literally impossible to shop for credit in any effective way. This was because a host of different credit disclosure practices had grown up, in large part to avoid violations of state usury ceilings, and most of the different disclosure methods were not comparable. In determining finance charges, some creditors used an "add on" rate which understated the simple annual interest rate by about 50 percent, while others used monthly rates. Yet a different group added various fees or charges to the stated rates. Many disclosed no interest rates at all, giving instead the cost of credit in dollars and cents. Many more quoted only a weekly or monthly installment charge. A further element of confusion was that no single method of computing interest charges on a simple annual basis was in use, even among creditors who disclosed percentage charges. At least seven different methods may be used to compute simple interest on a per annum basis, each resulting in a somewhat different finance charge, and all were in wide use before 1969. Testimony before Congressional committees indicated that no one segment of the consumer credit industry felt that it could reform itself without risking violations of usury laws and incurring significant competitive disadvantages.[18]

A more fundamental problem, however, was that many consumers buying on credit were utterly unaware that they were in reality shopping in two distinct markets: one for the particular product or service desired, another for funds to finance the purchase. A survey conducted by a private research

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[14] House Report No. 1613 on S. 1077, 75th Cong., 1st Sess. (1937), p. 3. Among the important exceptions are the Federal Food, Drug and Cosmetic Act, 52 Stat. 1040 (1938); the Wool Labeling Act of 1939, 54 Stat. 1128 (1940); The Fur Products Labeling Act, 65 Stat. 175 (1951); The Flammable Fabrics Act, 67 Stat. 111 (1953); and the Textile Fiber Products Identification Act, 72 Stat. 1717 (1958). Although the consumer benefited from these laws, in a number of cases they were designed primarily for the benefit of producers such as those who make products from wool or fur, to protect them from less reputable concerns passing off their merchandise as "100 percent wool" or "genuine chinchilla," for example.

[15] Automobile Information Disclosure Act, Public Law 85-506, July 7, 1958, 72 Stat. 325.

[16] Senate Report No. 1186, May 25, 1966, *U. S. Code Cong. and Adm. News* (1966), Vol. 3, p. 4070.

[17] Public Law 89-755, November 3, 1966, 80 Stat. 1296.

[18] *U. S. Code Cong. and Adm. News* (1968), Vol. 2, p. 1970.

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firm under contract with the Board of Governors just before Truth in Lending went into effect in July 1969 revealed that large numbers of the respondents, ranging from 26.7 percent on first mortgage loans to 57.7 percent on purchases of furniture and appliances, had no idea what rate of interest they were paying for consumer debt. Equally significant, the evidence indicated that those who *thought* they knew what interest rate they were paying in reality had seriously underestimated the cost of their credit.[19]

Growth of the Consumer Credit Industry Since 1945 the consumer credit industry has been one of the most rapidly expanding segments of the United States economy. Excluding real estate mortgage loans, the amount of consumer credit expanded from about $6 billion at the end of 1945 to almost $100 billion by late 1967, the year before the Truth in Lending law was enacted. Moreover, of the latter amount almost $75 billion consisted of installment credit, the type of credit in which finance charges tend to be highest and least understood by consumers. Automobile paper accounted for over $31 billion of the total, or about 30 percent, while revolving or "open end" credit was almost $6 billion. Although "open end" credit had traditionally consisted primarily of charge accounts of department stores and mail order houses, by 1968 commercial banks were increasingly entering this area. The House Report on the Truth in Lending bill stated that "Currently, American families are paying approximately $13 billion a year in interest and service charges for consumer credit. This is about as great as the Federal Government itself pays for interest on the national debt."[20]

There was no doubt that serious abuses existed in some segments of the consumer credit industry, although no evidence was ever produced showing any such abuses by commercial banks. One study from the files of the Cook County, Illinois (Chicago) Bankruptcy Court revealed that finance charges ran as high as 283.9 percent for used cars, 235 percent for TV and hi-fi sets, 199.6 percent for clothing and 105.2 percent for furniture.[21]

By 1968, Truth in Lending was an idea whose time had come.

Fundamentals of Truth in Lending The basic objective of the Truth in Lending Act is stated in its opening declaration:

> It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able *to compare more readily the various credit terms* available to him and avoid the uninformed use of credit.[22]

To achieve its purpose, the Act's coverage is exceedingly broad, and penalties for failure to comply are both severe and varied. Every individual person, partnership, corporation "or any type of organization" must comply with its requirements, provided but one criterion is met: that such person or organization is regularly engaged in extending credit or arranging for its extension to natural persons who use the credit primarily for personal, family, household or agricultural purposes. Even today no one has any very reliable data on the number of creditors subject to the Act, but the number is clearly very large. In 1970 the Board of Governors estimated that between 250,000 and 1,000,000 individuals and organizations were covered.

Two particularly difficult initial problems in achieving compliance with Truth in Lending resulted from the extremely broad definition of consumer creditor. First, many people and organizations were covered who had never previously regarded themselves as engaged in extending consumer credit. Second, the many differing classes of consumer creditors—ranging from banks and department stores to plumbers and dentists—were required to conform their various methods of making disclosures (if, in fact, they were making any prior to Truth in Lending) to the method specified in Regulation Z, using standard terminology to disclose the required information on a comparable basis. These formidable obstacles to compliance were overcome, in the months after the Act was passed, by a massive education program organized and administered by the Federal Reserve System and other Federal agencies with responsibilities for enforcement.[23]

Congress delegated the duty of drafting and publishing a regulation defining the precise requirements of Truth in Lending to the Board of Governors, over its protest that the task should, more

[19] Survey of Consumer Awareness, Appendix to Annual Report, Board of Governors of the Federal Reserve System, 1969. As early as December 1966, the four Federal agencies supervising banks and savings and loan associations (the Board of Governors, the FDIC, the Comptroller of the Currency and the Federal Home Loan Bank Board) began to require their supervised institutions to state interest rates in terms of the simple annual rate of interest.

[20] House Report No. 1040, December 13, 1967, *U. S. Code Cong. and Adm.* News (1968), Vol. 2, p. 1967.

[21] *Congressional Record,* June 14, 1967.

[22] 82 Stat. 146 (1968).

[23] More than 1,300,000 copies of an informational pamphlet prepared by the Board, entitled "What You Ought to Know About Truth in Lending," were distributed to creditors and the public. Visual aids, including a professionally produced filmstrip with accompanying recorded discussion and projection slides, were made available through the Federal Reserve Banks and the Federal enforcement agencies to anyone who expressed interest. Speakers were provided by the Board, other Federal enforcement agencies, and the Reserve Banks. Literally thousands of written and telephone questions regarding the requirements of Regulation Z were answered.

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appropriately, be performed by a consumer-oriented agency such as the Federal Trade Commission. The exceedingly broad mandate from Congress authorizes the Board to make "such classifications, differentiations, or other provisions, and . . . provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this title to prevent circumvention or evasion thereof, or to facilitate compliance therewith."[24]

All types of consumer credit are divided into two basic classes—"open end" and "credit other than open end" (referred to hereinafter as "closed end"). "Open end" credit is defined as credit that meets three basic requirements: (1) it is extended under a plan pursuant to which the creditor (such as a large department store or credit card issuer) may permit the customer to make purchases or obtain loans from time to time, directly from the creditor or indirectly by use of a credit card, check, or other device; (2) the customer has the privilege of paying the balance in full or in installments; and (3) a finance charge *may be* computed by the creditor from time to time on an outstanding unpaid balance.[25] All other consumer credit falls into the "closed end" category.[26]

A major question has arisen with regard to whether a finance charge must be assessed in order for disclosures to be required. The controversy originates with the very definition of "consumer credit." The term is defined to include credit ". . . for which either a finance charge is or may be imposed or which, *pursuant to an agreement, is or may be payable in more than 4 instalments.*"[27]

The Board of Governors believes that the four-installment rule is necessary to prevent creditors from evading compliance with Regulation Z by simply not imposing a finance charge as such, but instead increasing prices when purchases are to be paid for over a period of time. This reasoning and the four-installment rule itself were approved by the Federal District Court in Chicago in the case of *Strompolos* v. *Premium Readers Service.*[28] The court noted that a seller in any industry selling primarily on long-term credit could easily set a theoretical unitary cash and credit price, knowing no one would pay in less than four installments. By this means it would be possible for such a seller to effectively exempt himself from coverage under the Act if there were no four-installment rule, or one similar to it.

In a more recent decision, however, a United States Court of Appeals has declared the four-installment rule invalid as an improper exercise of delegated authority by the Board, and also on the grounds that it amounts to an unconstitutional "conclusive presumption" violative of the Fifth Amendment.[29] The question whether a direct finance charge must be imposed in order for Truth in Lending disclosures to be required is clouded at this point. In all likelihood, further litigation or legislation will be required before the issue is resolved.

Another unusual feature of Truth in Lending, and one that has been exceedingly troublesome, is the inclusion of discounts for prompt payment in the statutory definition of "credit." This is a traditional practice in some consumer industries, and where such discounts are given, full disclosures required by Regulation Z must be made. This has caused some vendors to simply abolish the discounts.

The two critical disclosure elements in most consumer credit transactions are the annual percentage rate (APR) and the finance charge. Both terms are defined in Regulation Z. The finance charge is the cost of credit in dollars and cents as determined in accordance with detailed procedures set forth in Section 226.4 of the Regulation. The APR is the finance charge converted to a percentage in accordance with specified procedures listed in Section 226.5 of the Regulation. Different methods are prescribed for computing the APR, depending upon whether open end or closed end credit is involved.

The distinction between open end and closed end credit is, in fact, of crucial importance for any creditor seeking to comply with Regulation Z. To be sure, a number of important disclosure requirements apply to both types of consumer credit. There are many differences, however, not only in disclosure requirements but also in connection with the advertising of credit terms, depending upon whether open end or closed end credit is involved. As pointed out in an opinion letter by the staff of the Board of Governors:

> Whether a particular advertisement falls within §226.10(c) *Advertising of open end credit* or §226.10(d) *Advertising of credit other than open end*, . . . depends upon the character of the particular plan being advertised. If that plan meets the definition of open end credit in §226.2(r) the advertisement would be governed by §226.10(c) [of Regulation Z]. If it does not meet that definition it would be subject to §226.10(d). Study of the credit plan itself should reveal whether it meets

[24] 82 Stat. 147 (1968).

[25] Regulation Z, Section 226.2(r), 12 C.F.R. 226.2(r).

[26] Regulation Z, Section 226.8, 12 C.F.R. 226.8.

[27] Regulation Z, Section 226.2(k), 12 C.F.R. 226.2(k).

[28] 4 *Consumer Credit Guide*, ¶99,471 (D. Ill., May 18, 1971).

[29] *Mourning* v. *Family Publications Service, Inc., Antitrust & Trade Regulation Report*, No. 531, September 28, 1971, pp. A-7 and A-8.

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the tests of §226.2(r). The fact that a particular customer chooses only to finance a single transaction under the plan would not necessarily affect its characterization. We will be happy to consult with you as to the proper category under Regulation Z applicable to a particular plan.[30]

The Right to Rescind Cutting across the entire fabric of Truth in Lending is the right of rescission, a new consumer right created by the Truth in Lending Act. Its purpose is to give the consumer a "cooling off" period to reflect on the possible loss of his family's residence as a consequence of his impulse purchase on credit.

Two *separate* and equally significant consequences flow from the right to rescind. First, where the right exists, additional disclosure requirements are imposed on the creditor in order that the consumer may be notified of this right and informed how to exercise it. Second, failure to make all the required disclosures, including how and when one may rescind, leaves the consumer with a continuing power to rescind the transaction until the disclosures are actually made, regardless of how far in the future this event may occur.

The right to rescind a consumer credit contract arises when a creditor retains a security interest in real property used or intended to be used by the consumer as his principal residence. This absolute right continues until midnight of the third business day following consummation of the transaction in which the security interest was acquired or retained by the creditor, *or until delivery of the required disclosures to the consumer,* whichever is later. As indicated above, if the creditor fails to make the required disclosures either through oversight, error or by design, the right continues indefinitely.[31]

When a consumer rescinds, he is not liable for any finance or other charge, and any security interest he has given becomes void. Within ten days after receipt of the notice of rescission, the creditor must return to the consumer any down payment or earnest money and ". . . take any action necessary or appropriate to reflect the termination of any security interest created under the transaction." In addition, the consumer is permitted to retain any property delivered to him until the creditor performs his duties. Thereafter, the consumer must tender such property to the creditor, but may do it at his residence or at the location of the property, whichever the consumer chooses. If the creditor fails to take possession of the property within ten days, title vests in the consumer.

The varied consequences of rescission for creditors have caused many to seek to prevent the right from arising by waiving all security interests in residential real property of consumers. Two particular problems are encountered in attempting to waive the right. One is that some security interests arise by operation of law—for example, mechanics and materialmen's liens—regardless of what the creditor wants to do. To illustrate the point, installation of wall-to-wall carpet may under some State laws create a security interest in the real estate for the benefit of the workmen, even if the seller of the carpet acquires no interest for his own benefit.[32]

The second problem concerns confession of judgment clauses in promissory notes signed by consumers. Such clauses frequently authorize creditors to create a lien on a consumer's residence in the event of default. In order to prevent circumvention or evasion of the consumer's right of rescission, the Board of Governors has ruled that all liens which may be entered against the consumer without notice and an opportunity for hearing, whether or not recorded, are included in the term "security interest."[33] However, such clauses are *excluded* from the definition of security interest in those states where the obligor is entitled to notice of the pending action and is afforded an opportunity to enter defenses *before* a lien may be recorded on his residence.[34]

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[30] 4 *Consumer Credit Guide,* ¶30,185 (October 16, 1969).

[31] There is one significant exception to the right to rescind: it does not apply "to the creation or retention of a first lien against a dwelling to finance the acquisition of that dwelling." Perplexing questions arise in determining when this exception applies. The confusion stems from the fact that the term "residence" is used in creating the right, while "dwelling" is used in defining the exception; and the definitions of these terms are not the same. "Residence" means real property in which the customer "resides or expects to reside," and includes ". . . a parcel of land on which the customer resides or expects to reside. . ." regardless of whether there is a dwelling. The term "dwelling" is defined as ". . . a residential-type structure which is real property and contains one or more family housing units, or a residential condominium unit wherever situated." Accordingly, the right to rescind arises where a first mortgage is given on an unimproved lot which may be the customer's "residence" in the future, but not where the first lien is given in connection with the acquisition of a "dwelling" in which the consumer resides or expects to reside.

[32] See, e.g., 4 *Consumer Credit Guide,* ¶30,061; 12 *C.F.R.* 226.901.

[33] 4 *Consumer Credit Guide,* ¶30,064.

[34] 4 *Consumer Credit Guide,* ¶30,001; 30,064; 30,193; 30,422; 30,450; 30,462; 30,473; 30,527.

Part II, to appear next month, discusses the current status of criminal and civil enforcement of Truth in Lending and comments on the special compliance problem involved in discounting dealer paper by banks and other financial institutions. It also reviews the regulation of consumer credit advertising under Truth in Lending.

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The Forgotten Liabilities . . .

CAPITAL NOTES AND DEBENTURES

Introduction Prior to the 1960's, capital debenture or long-term debt financing by commercial banks carried the stigma of distress financing, an image that grew out of its use during depression days. In the period from 1940 to 1960, banks that had been forced to issue capital debentures in the 1930's made every effort to retire them as soon as possible. Moreover, supervisory authorities, as well as bankers, were opposed to the issuance of capital debentures or preferred stock. In the early 1960's, however, attitudes slowly began to change. Memory of the depression period had faded, and as banks began to feel the profit squeeze, an increasing number of bankers turned to capital notes and debentures as a source of funds.

Change in method of reserve adjustment Not only was there a change in attitude toward capital debt in the 1960's, but commercial banks also altered their method of adjusting reserve positions. Banks previously had concentrated their reserve management efforts in increasing or decreasing their secondary reserves, primarily short-term Government securities. For example, a shortfall in needed reserves would be met by a sale of Treasury bills, or unneeded reserves would be used to purchase these money market instruments. Yet, because banks had become more aggressive in their loan policies, Treasury securities not pledged to Government deposits were reduced to a minimum. As a result, banks searched for an alternative method of obtaining reserves during periods of tight monetary policy.

With the innovation of negotiable certificates of deposit (CD's) in 1961, banks designed liability management as a complement to and, in part, a substitute for asset management. Liability management has focused primarily on short-term liabilities such as CD's, bank related commercial paper, Eurodollar liabilities, Federal funds, and promissory notes. In this case, instead of adjusting its reserve position by selling or purchasing secondary reserves, a commercial bank increases or decreases its managed liabilities.

However, long-term liabilities in the form of capital notes and debentures were not utilized to any great extent, especially in the latter half of the decade. The outstanding volume of such notes and debentures actually leveled off after a brief period of sharp increase from 1963 to 1966. This article examines the advantages and disadvantages of debt capital as an alternative to equity capital and short-term debt in the financial structure of commercial banks. It also looks into the question of why banks have made only limited use of debt capital financing in recent years.

Capital Notes and Debentures Defined Bank capital, in contrast to capital of a nonfinancial corporation, usually is defined to include not only equity but also long-term debt in the form of capital notes or debentures. These long-term liabilities are subordinate to depositor claims against the assets of the issuing bank in the event of bank liquidation. Before June 1970, the Federal Reserve Board allowed capital debt to include instruments with original maturity as short as two years and in denominations as small as $100. Banks had been issuing these shorter-term capital instruments as an alternative to CD's and promissory notes[1] that were subject to Regulation Q ceiling interest rate constraints and reserve requirements. To clarify the distinction between savings-type debt instruments and capital debt, the Board of Governors of the Federal Reserve System ruled in June 1970 that capital debt must have an original maturity of at least seven years and be in denominations of at least $500.

Generally, these debt issues have original maturities ranging from ten to thirty years with heavy concentration in the twenty- to twenty-five-year category. Capital debt is usually issued by large banks with deposits over $200 million. It may be convertible into common stock and can be placed either publicly or privately. The size of issues has varied widely from as low as $50,000 to as high as $250 million.

An Alternative to Equity Capital The primary function of bank capital, both equity and long-term debt, is to protect depositors against loss and to support bank growth. However, there are distinct advantages to issuing debt capital as an alternative to equity capital. At times, debt capital may be a cheaper source of funds. Another advantage is that the return to stockholders may be increased via the leverage effect[2] by avoiding dilution of stockholder

[1] Promissory notes issued after June 26, 1966 were subject to Regulations Q and D, effective September 1, 1966.

[2] Profits may be increased by increasing revenues more than the fixed costs of debt financing.

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interest. Also, interest payments on debt issues are tax deductible, whereas dividends to stockholders are not. On the other hand, one of the disadvantages of using debt instead of equity financing is that fixed payments of interest and repayment of principal are required. During business downturns, the required payments might become burdensome, if not damaging, to the financial position of the bank, particularly if the average rate of return earned on loans and investments falls below the rate paid on debt issues, thus reversing the leverage effect on earnings. By comparison, equity capital requires no repayment and dividends may be reduced or postponed.

Supervisory regulations When choosing a source of funds, banks must consider applicable supervisory rulings and regulations. The Comptroller of the Currency allows national banks to include capital notes as part of unimpaired surplus[3] for purposes of calculating lending limits on unsecured loans to any one borrower. The Board of Governors, however, has ruled that state member banks may not include capital notes and debentures as a part of capital, capital stock, or surplus for purposes of calculating limits on various lending, borrowing, and investment programs. A ruling by the Comptroller of the Currency also limits certain liabilities, including capital debt, of a national bank to 100% of the capital stock plus 50% of the unimpaired surplus.

Approval by the Federal Deposit Insurance Corporation must be obtained before an insured bank may repay its note or debenture issue. Finally, the authority to issue capital notes and bonds varies widely among state jurisdictions. Most states permit the issuance of capital debt, but less than half of them allow capital debt to be included as part of capital for purposes of determining lending limitations.

[3] Unimpaired capital includes all capital accounts that are derived from either paid-in capital or retained earnings and are not subject to known charges, such as reserves for declared dividends or reserves for taxes and interest.

Table I

COMPARISON OF AVERAGE RATES AND AVERAGE COSTS

Year	Avg. Rate of Return on Loans	Avg. Rate of Return on Investments	Avg. Rate on 6-mo. CD's-Secondary Mkt.[1]	Avg. Cost of Debenture Issues
1963	5.87	3.16	3.69	4.58[2]
1964	5.88	3.32	4.25	4.60
1965	5.85	3.40	4.66	4.48
1966	6.24	3.66	5.97	5.39
1967	6.39	3.99	5.53	5.59
1968	6.81	4.23	6.30	5.13
1969	7.43	5.30	8.30	6.07[3]
1970	7.91	5.68	8.22	N.A.

[1] All CD figures adjusted for reserve requirements.

[2] Last 6 months.

[3] First 6 months.

Sources: **Federal Reserve Bulletin; Salomon Brothers; Bank Stock Quarterly.**

Short-term vs. Long-term Financing The liquidity of a bank may be enhanced by the extension of the maturity of its liabilities or by an increase in equity outstanding. However, it is important to note that capital debt financing is not suitably used as a means of short-term reserve adjustment. Specifically, adjustment of reserves has been conducted through short-term asset and short-term liability management. Even so, long-term financing is not without advantages and disadvantages when compared to short-term financing.

An advantage of obtaining needed funds through short-term liabilities is that these borrowed funds can be invested or loaned at current or near current rates; whereas, if these funds were obtained through the issuance of capital notes, the rate of return during the lifetime of the debt would be less certain. In periods of high interest rates, banks are understandably reluctant to issue capital debt, thereby committing themselves to high fixed charges over a long period. Also, financing by short-term liabilities makes it much easier to cut back borrowing if loan demand diminishes in the future.

Alternatively, there are definite advantages to issuing capital debt rather than short-term debt. If funds obtained through the issuance of short-term liabilities are invested in longer-term assets, the bank cannot know what the cost of these funds will be over the life of the assets acquired. Hence, if banks can take advantage of low debt costs in a period when it is likely that interest rates will increase, they can improve both profits and liquidity. Furthermore, when short-term liabilities mature, the funds may be difficult to roll over. Therefore, banks risk a future shortage of funds or risk having to obtain these funds only at high interest rates when using short-term financing.

To some degree, the choice of method of financing may be determined by supervisory regulations. Reserve requirements are applied to all of the managed, short-term liabilities mentioned previously, except Federal funds. Regulation Q limits the maximum interest that can be paid on CD's and promissory notes, and CD's are subject to FDIC assessment. Capital debt is not subject to the above regulations, however, the level of such borrowing by a national bank is limited by the amount of the bank's equity.

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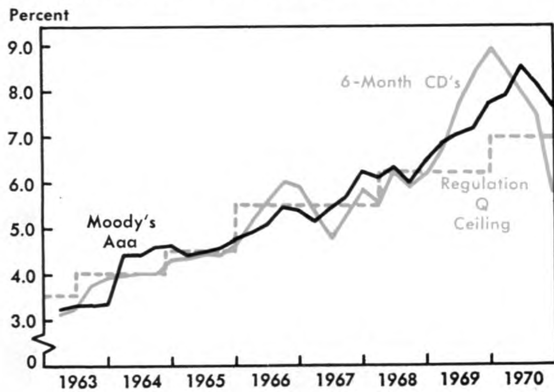

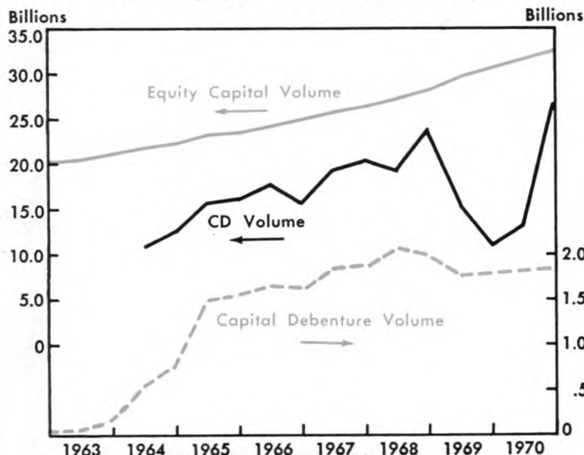

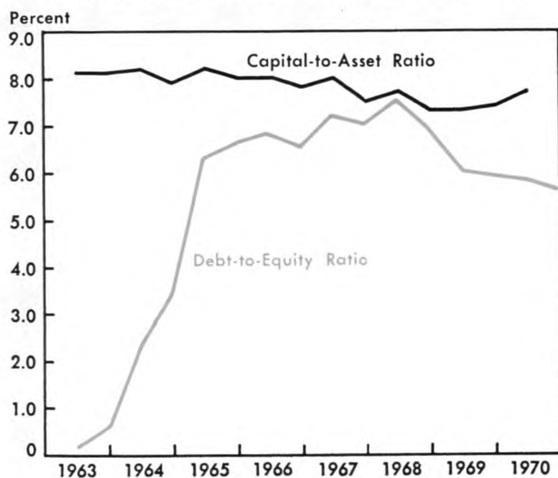

Developments in the 1960's In December 1962, the Comptroller of the Currency ruled that national banks could issue subordinate capital notes and debentures. By the middle of 1963, banks began to do so, and $1.5 billion in capital notes and debentures were issued by 135 national banks and 87 state banks between 1963 and 1966. The popularity of capital debentures temporarily increased, but then the rate of increase in the use of long-term financing tapered off after 1965.

This swing in bankers' sentiment regarding the use of capital debentures is related to movements in interest rates. As interest rates began to rise sharply toward the end of 1965, the growth rate of capital debt slowed significantly. Thereafter, the volume of notes and debentures issued continued to move inversely with interest rates (Chart 1), and the higher level of interest rates during the last half of the decade apparently stifled the issuance of long-term debt. During this period, banks obtained the majority of additional capital through increasing their equity capital.

Capital debt not substituted for short-term debt Prior to 1966 when Regulation Q ceilings were not restrictive and rates on capital notes and debentures were attractive, both capital debt and CD's were used extensively to obtain funds. However, when the average cost of capital debt was less than that of CD's, banks did not substitute, to a significant extent, capital debt for CD's. During 1966 and 1969 when CD runoffs were especially large, commercial banks moved to other short-term liabilities and not to capital debt as sources of funds. In the last half of 1966, increasing Federal funds purchases and the Eurodollar market provided needed funds. During 1969 Federal funds, Eurodollar liabilities, and bank related commercial paper were tapped to substitute for the declining CD's.

Conclusion The ruling by the Comptroller of the Currency in 1962, in combination with relatively favorable interest rates, led to a sharp growth in capital notes and debentures from 1963 to 1966. Thereafter, as interest rates moved to historically high levels, banks preferred to borrow in the short-term market rather than issue long-term debt. Regulations affecting borrowing and lending limits do not appear to have been a major factor affecting this decision. The steady growth of equity capital, throughout the 1960's, however, suggests a continuing preference for equity financing as a source of long-term funds.

B. Gayle Burgess and James McCabe

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Cyclical Indicators of Economic Activity: Part II

Part I of this article, which appeared in August 1971, concentrated on the leading indicators of economic activity. The purpose of Part II is to define, explain, and evaluate the performance of other important measures of business activity. The initial section deals with the "roughly coincident" indicators. These economic time series are defined as measures of economic activity that in the past have usually experienced cyclical peaks or troughs at about the same time as general economic activity. The second section is devoted to a discussion of the "lagging" indicators, which usually reach cyclical peaks and troughs after changes in general business conditions. The remainder of the article is devoted to other important indicators such as diffusion indexes and "anticipations and intentions" data.

ROUGHLY COINCIDENT INDICATORS

Coincident indexes are primarily useful in providing an analytical base for determining specific dates of business cycle peaks and troughs. Economic series included in this classification are aggregate measures of production, employment, income, and sales. Since these data measure the general level of business activity, their cycle should roughly conform to the general business cycle. In addition to their use as confirming indicators, the coinciders, like the leaders, are also useful in explaining links between different measures of economic activity.

NBER Short List and Composite Index The National Bureau of Economic Research (NBER) and the United States Department of Commerce report twenty-five economic series classified as roughly coincident indicators in Business Conditions Digest (*BCD*). These twenty-five series are cross-classified into six economic processes as illustrated in Table 1 in the first part of this article.

A short list of eight coincident indicators is published in *BCD* each month. This list is provided as a summary of various unduplicated coincident economic indicators. Five of the eight series in the short list are combined to form the composite index of five coincident indicators. The five series include: (1) the industrial production index, (2) personal income, (3) manufacturing and trade sales, (4) employees on nonagricultural payrolls, and (5) the unemployment rate. Although GNP is not included in the composite index, this measure of economic activity is an important measure of current business conditions and is therefore included in the short list of eight coincident indicators in both current and constant dollars. Retail sales completes the series in the short list. Both categories of GNP are calculated quarterly; the five series in the composite index and retail sales are compiled monthly. Each series and the composite are updated following revisions by the individual source agencies.

Performance Record The NBER classifies an indicator as roughly coincident if it exhibits a significant number of turning points within ± 3 months of the turn in general business activity. As a result, most coincident indicators have median lead or lag times of one month or less though the median could be longer if the indicator did not meet the criteria established for a leader or lagger. For example, an indicator with a lead-lag pattern at peaks of —3, —2, +1, —2, +2 qualifies in timing as a roughly coincident indicator even though the median lead is two months. On the other hand, an indicator with a pattern of —2, —3, —2, —2, —1 qualifies as a leading indicator with a median lead of two months. In the former case, the indicator is not reliable as a leader; in the latter case, the indicator has a significant number of leads, albeit short, and has proven to be reliable as a leader over past cyclical peaks.

Using peak and trough dates established by the NBER in the five postwar recessions, the composite index of five coincident indicators showed a cyclical pattern quite similar to the cycle in general economic activity. Since the NBER uses some of the individual coincident indicators to determine cyclical turning points, the composite coincident index should be expected to display a pattern similar to the general business cycle. At specific trough dates, the lead or lag time of the composite index was zero for each of the recessions since World War II. At peak

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dates, the composite index led the 1960 peak by three months and the 1948 peak by one month; it lagged the 1969 and 1957 peaks by one month; and it was coincident with the 1953 peak.

Specific series in the composite index have shown much more variability than the composite index in postwar recessions. For example, manufacturing and trade sales showed a lag of nine months at the 1969 peak date and a five-month lead at the 1957 peak date. This example clearly shows the risk of relying on one specific indicator in determining cyclical turning points as opposed to several indicators or a composite of several indicators.

Variability of lead-lag times of individual components of the composite index appears to be somewhat greater at peak dates than at trough dates. The median lead-lag time was zero for three series at trough dates. Only one series exhibited a median time coincident with the general business cycle at peak dates. The median lead-lag time of the composite index was zero at both peak and trough dates in the postwar period.

LAGGING INDICATORS

Lagging indicators, like coincident indicators, are important in confirming past periods of economic expansion and contraction. They can also be helpful in analyzing important links between various economic processes.

In the past, the most reliable groups of indicators to meet the standards of performance required of lagging indicators have been interest rates and bond yields and labor costs per unit of output. Both book value of manufacturers' inventories and consumer instalment debt series have also displayed lagging characteristics. It is worthwhile to note that while inventories and consumer instalment debt are generally lagging series, changes in these groups are classified as leading indicators. In the early stages of general economic recovery, consumer instalment debt usually increases at a slow pace; toward the middle of the recovery stage, the rate of change reaches a maximum; and near the end of the recovery phase, the change in debt is positive but declining. As a result, the *change* in consumer instalment debt reaches a maximum and begins to decline before the peak in general economic activity, while the absolute *level* of the debt figure continues to rise slowly throughout the recovery phase.

A small number of economic series have been classified in the past as both leading and lagging series. Many times when a series consistently lags behind general business conditions at both peaks and troughs, such a series can also be said to lead oncoming troughs that follow peaks and oncoming peaks that follow previous troughs. This form of "inverting" a series from a lagger to a leader often has a clear and meaningful economic interpretation. For example, a downturn in a lagging series, such as yields on new mortgages, usually precedes an upturn in housing starts, which in turn is one of the leading indicators. Yields on new mortgages could, therefore, be considered a "long-lead" indicator rather than a lagging one.

NBER Short List and Composite Index The NBER reports a total of eleven lagging indicators each month in *BCD*. Of the eleven, six have been chosen to summarize the movements of the lagging indicators. This short list of six indicators contains two quarterly series and four monthly series. Business expenditures on new plant and equipment and bank rates on short-term business loans are reported quarterly; the long-term unemployment rate, book value of manufacturing and trade inventories, labor cost per unit of output, and commercial and industrial loans outstanding are reported monthly by their respective source agencies. The NBER cross-classifies the lagging indicators by timing and economic process, as shown in Table 1 of Part I of this article.

The six series comprising the short list are standardized and are combined to form the composite index of six lagging indicators. Since two series are reported quarterly, the composite index is revised quarterly to reflect deviations from extrapolated monthly figures and final quarterly figures of these two series. Additional revisions are made when reporting source agencies revise their earlier data.

Performance Record The performance of individual lagging indicators and the composite index have shown more consistency at trough dates than at peak dates in postwar cycles. The composite index reached its cyclical low point two to six months following the trough of each general downturn in the postwar period. At the peak dates of general business activity, however, the composite index reached its peak coincident with the general cycle in 1948 and 1960. The longest lag in the composite index was nine months following the November 1969 peak in general business.

In the 1969-1970 reference cycle, four of the six lagging indicators in the short list did not reveal a definite turning point at either the peak or the trough date, according to Appendix F in the November 1971 *BCD*. As indicated in a footnote to Appendix F, however, the choice of specific turning points is a subjective matter that could differ among individual

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analysts. One might, for example, conclude after analyzing the data that one or more of the four series did exhibit a turning point using different standards in selecting significant peaks and troughs.

ANTICIPATION AND INTENTION SURVEYS

One relatively new technique for predicting future business conditions in the U. S. is direct surveys of attitudes and buying plans of consumers and business firms. The most widely publicized surveys to date have been the Office of Business Economics—Securities Exchange Commission (OBE-SEC) surveys of business plans and anticipations, the reports on consumer attitudes and buying plans of the Survey Research Center of the University of Michigan, the Census Bureau reports on consumer buying plans, the Conference Board (formerly National Industrial Conference Board) reports on new and unspent capital appropriations, and the McGraw-Hill investment intentions surveys.

The OBE-SEC survey is designed primarily to enable more accurate prediction of nonfarm business fixed investment, a major component of GNP. Quarterly questionnaires are sent to all registered corporations by the SEC, and a sample survey of unregistered corporations is conducted by the OBE. Participating firms are asked to state both their investment in the previous time period and their investment intentions for each of the next two quarters and the calendar year. Results of the surveys are

COMPOSITE INDEXES OF ECONOMIC INDICATORS

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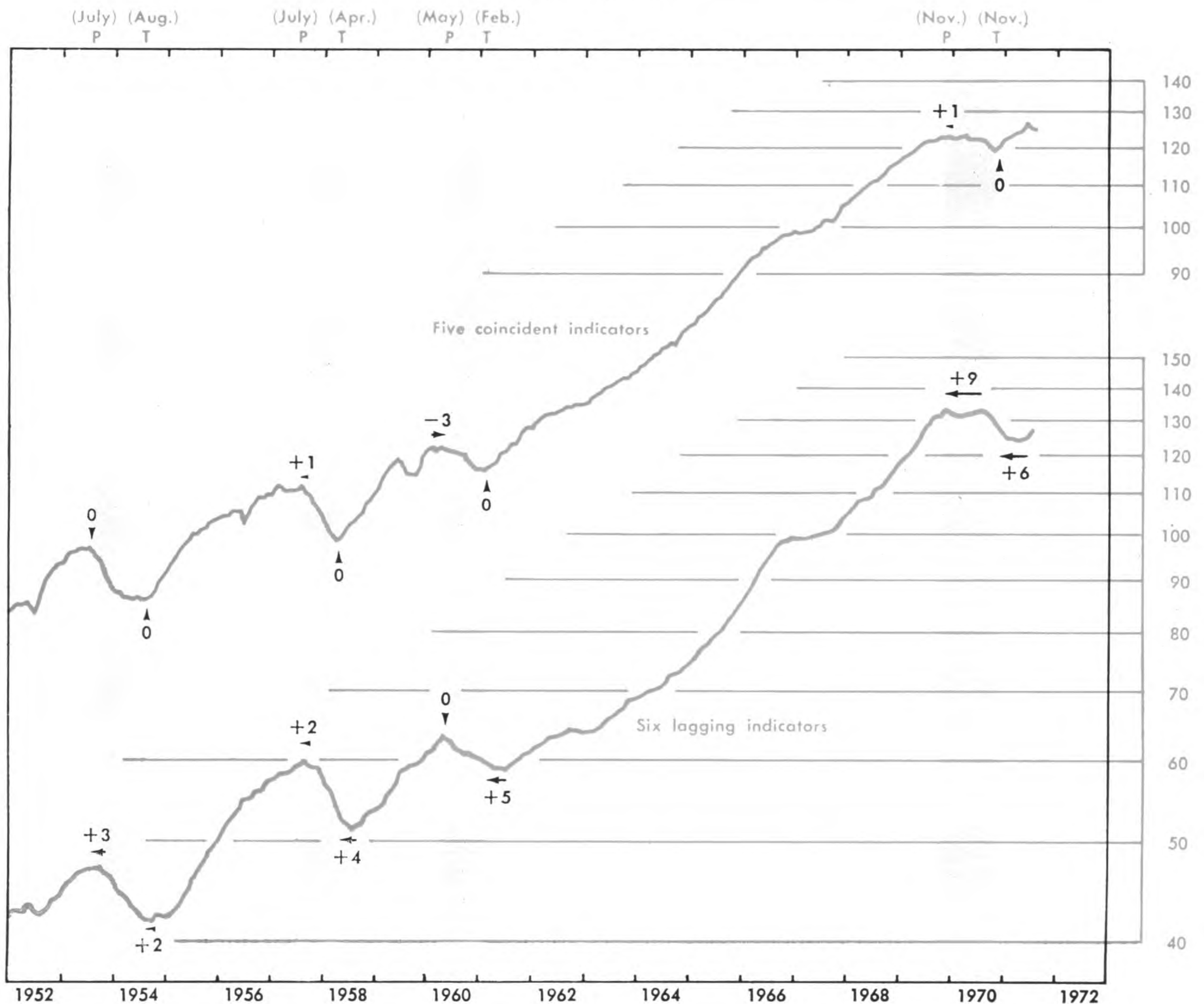

Source: U. S. Department of Commerce, **Business Conditions Digest**, September 1971.

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released on a quarterly basis and on a yearly basis in March.

Predictive accuracy of the OBE-SEC survey has been impressive in the postwar period. An analysis of the accuracy of this survey, which uses a naive model,[1] shows that the OBE-SEC survey has been quite useful in determining future investment expenditures. Primarily because of construction and delivery delays and the inability of firms to predict precisely the turning points of business conditions, yearly surveys have been more accurate than quarterly surveys.

The McGraw-Hill investment anticipations for the coming year are released in the first November issue of *Business Week*. Because the figures are the first to be released, their performance record has been somewhat inferior to that of the OBE-SEC. In fact, evidence suggests that a naive model, which states that the increase in investment next year will be equal to the yearly average over the postwar period, has been more accurate than the results derived from the McGraw-Hill survey.[2]

The Conference Board survey reflects formal decisions made by large manufacturing firms to acquire capital over future periods of time. The underlying assumption of this method is that current planning decisions to spend precise amounts, as shown in capital budgets, will be reflected in future expenditure patterns of indivdiual firms. Results from the Conference Board surveys have varied considerably from year-to-year, primarily because revisions of present capital spending plans by participating firms have been frequent in some years.

Surveys designed to determine consumer attitudes and intentions had their beginning in World War II. One of the most widely followed surveys in recent years has been the survey designed by the Survey Research Center (SRC) of the University of Michigan. Two basic types of information are gathered from the survey: (1) the consumer's general attitude about business conditions and (2) the consumer's buying plans in the months immediately ahead. The performance record of the SRC survey suggests that the index of consumer attitudes is more reliable than the index of buying plans. Further, the results indicate that consumers change buying plans rapidly and frequently make "spur of the moment" purchases. Recent analyses of the SRC survey show that the results are not reliable in forecasting future consumption patterns but are very useful for gathering other important consumer information such as liquid asset holdings, income levels, family debt, and other data useful in analyzing consumer spending patterns.

Another closely watched consumer survey is one conducted quarterly by the Bureau of the Census. This survey is designed to measures actual and anticipated household spending on houses, cars, and other major durable consumer goods. In the survey, households are requested to report their expected purchases during the next six, twelve, and twenty-four months.

DIFFUSION INDEXES

A diffusion index is designed to reflect the overall behavior of a group of economic time series. The index measures the percentage of series rising within a specified group; thus, the range of each diffusion index extends from 0 percent (all series falling) to 100 percent (all series rising).

Diffusion indexes are used to determine how widely spread particular economic movements are within a particular industry or from one industry to another. For example, *BCD* reports a diffusion index on industrial materials prices that includes thirteen specific industrial materials. It also reports industry-to-industry diffusion indexes, such as the average workweek of production workers in manufacturing that shows in how many of twenty-one different industries the workweek is increasing.

Most diffusion indexes change direction before their corresponding aggregate measures, for reasons similar to those that explain why the change in a series reaches a peak prior to the absolute value of a particular series. The industrial production index, for example, is a roughly coincident indicator; however, the diffusion index of the industrial production index for twenty-four industries has been a reliable leading indicator in the postwar period.

CONCLUSION

The purpose of this article has been to familiarize the reader with some of the major indicators of economic activity. Most of the indicators discussed are readily available on a monthly basis through *BCD*. Several other useful series, such as foreign trade and payments, Federal Government activities, and price movements are also reported in *BCD*. These indicators, used with soundly based economic models, can be extremely helpful to the forecaster and policy-maker in analyzing prospective economic conditions.

Clyde H. Farnsworth, Jr.

[1] Naive models are frequently used to determine the usefulness of anticipations data and forecasts. They generally assume either (1) no change from the previous period or (2) the change during this period will be equal to last period's change.

[2] Michael K. Evans, *Macroeconomic Activity: Theory, Forecasting, and Control* (New York: Harper & Row, Publishers, Inc., 1969), pp. 455-60.

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