Letter to focus on consumer regulations

The Fed Letter is published by the Federal Reserve Bank of St. Louis for Eighth Federal Reserve District bankers.

As the contents of this, the first issue, indicate, our intention is to devote the Letter largely to consumer credit protection regulations. We hope our comments on the subject will help district bankers with the difficult job of keeping informed about the extensive, complicated and frequently amended body of legislation and regulation that has developed in that area in the past eight years.

Future Fed Letters may deal, also, with other subjects we feel might be of interest to you. But, we will try our best to avoid publishing useless information just for the sake of filling a certain amount of space. No doubt, your desk is already stacked with magazines, newsletters, bulletins, reports and publications of every other imaginable description—probably with more than you can possibly read.

So, we will strive to keep our contributions to the pile worthwhile and small.

And, always, your suggestions for improving the Fed Letter will be greatly appreciated.

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Consumer compliance program

In 1969, when the Truth in Lending Act and Regulation Z went into effect, the Federal Reserve Bank of St. Louis began checking for compliance with the regulation as part of its regular examinations of state member banks.

And, as each new consumer regulation has come along in the eight years since enactment of Truth in Lending, that regulation has been added to the items investigated by St. Louis Reserve Bank examiners.

Two years ago, reserve banks added consumer affairs sections to their bank supervision and regulation departments.

The latest major development in this area came in March when the Federal Reserve Board of Governors announced a standard system-wide consumer compliance program.

The new two-part program consists of a special examination program and an advisory service.

The advisory service, an entirely new departure in the Federal Reserve System's efforts to aid member banks in complying with consumer regulations, is available to all member banks (including national banks).

To any member bank that requests the service, the St. Louis Reserve Bank will send a trained specialist to assist in the development of appropriate policies, procedures and forms. The specialist also will answer questions on consumer credit protection laws and regulations.

A few Eighth District member banks have already requested the advisory service.

The special examination program involves only state member banks. However, the Comptroller of the Currency, last November, instituted a similar consumer compliance examination program for national banks.

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The Fed and at least one national bank district that encompasses part of the Eighth Federal Reserve District conduct consumer compliance examinations concurrent with regular commercial examinations. However, in most national bank districts, consumer compliance examinations are conducted separate from commercial examinations.

Prevention of future violations

The primary aim of the special examination program is the prevention of future violations. Thus, banks generally are not required to correct specific past violations that may be discovered in the course of an examination. Rather, they are required to correct procedures, forms and so forth that might cause future violations.

There are exceptions to this general rule, however. For example, when violations that involve overcharges are discovered, banks are required to make reimbursements. Also, banks must remedy any discovered failure to comply with the disclosure statement provisions of Regulation C. And, if an examination discloses that flood insurance for real estate located in a flood hazard area has not been obtained as prescribed in Regulation H, flood insurance must be obtained.

Helps protect against civil liabilities

A positive aspect of the program, from the point of view of commercial banks, is that it will help banks protect themselves from civil liabilities that could arise if they fail to comply with consumer regulations.

Prior to an examination, the examiner reviews the commercial bank's consumer complaint file. In the course of the examination, all the bank's administrative procedures are reviewed with particular attention given to a review of the bank's forms.

Forms review particularly important

The forms review is of particular importance and forms violations are particularly serious because the use of improper forms may create violations in all transactions in which they are used. Thus, a forms violation may create a whole class of violations, which may expose the bank to class action liability.

Because forms violations are expensive to correct, examiners carefully distinguish between violations that necessitate reprinting and those that may be corrected by "patching up" existing forms until supplies are depleted.

Examinations also include an analysis of a sample of loans and associated records. However, since the purpose of the analysis is not to uncover each specific violation but rather to establish whether significant violations or possible sources of violations do exist, the samples analyzed are relatively modest in size.

Separate consumer affairs report

Both Federal Reserve and national bank examiners prepare a report of the consumer affairs examination that is separate from the report of the commercial examination. Formerly, any comments examiners may have had regarding violations of consumer regulations were made as part of the regular commercial examination report.

The Fed's report is in a "yes or no" question and answer format. Each "no" response is followed by a comment. National bank consumer examination reports are narrative reports.

prevention of future violations primary aim of special examination program

A copy of the Consumer Affairs Report of Examination is sent to the commercial bank's board of directors.

The final phase of the examination is a discussion of violations with the bank's senior management.

Problems with B and Z reported

A consumer affairs specialist in a Midwest national bank district reported that, since the special examination program for national banks began in November, the most numerous compliance problems found have involved Regulations B and Z.

Regulation B violations typically have involved improper questions about applicants' spouses, the regulation's signature provisions, and the regulation's new notification requirements.

Most Regulation Z violations discovered in national bank examinations in that district have involved incorrectly stated annual percentage rates, the consumer affairs specialist said.

Regulation B cosigner provisions

The Bank receives many questions about the cosigner provisions of Regulation B. Most relate to applications for unsecured credit by individuals who own property held jointly or subject to a marital interest.

Some creditors maintain that Regulation B permits them to require, when granting credit to such an applicant, that the non-applicant joint owner or the spouse holding the marital interest become personally liable for the debt.

Cite Regulation B section

They point out that Section 202.7(d)(2) of Regulation B permits the creditor, in establishing the value of jointly held property, to consider state property laws to determine if the property is susceptible to attachment, execution, severance or partition. They further point out that the creditor is permitted to require the signature of the joint owner on "such instruments as may be necessary to make the property available to the creditor in the event of default." The note itself, they contend, is such an instrument. Thus, they conclude, they are permitted to require the joint owner to cosign the note and become personally liable for the debt.

They apply similar reasoning to cases in which property is subject to a marital interest and conclude that they may require the spouse who holds the marital interest to cosign the note.

In general, this bank does not agree.

One of the main purposes of the Equal Credit Opportunity Act is to ensure that creditworthy persons can obtain individual credit regardless of marital status. Section 202.7(d) establishes a general rule prohibiting creditors from requiring a cosigner on any credit instrument where the applicant is creditworthy in his or her own right.

State law may be considered

However, if an applicant seeking unsecured credit is unable to qualify based on his or her own income and individually held property, the Regulation requires that the creditor consider the value of any property jointly held. In such circumstances, Section 202.7(d)(2) does, indeed, permit the creditor to consider state property law to determine if, in the event of default, the creditor's access to the property would be impaired. And, the Regulation does permit the creditor to require the signature of the joint owner on such instruments as may be necessary to make the property available to the creditor in the event of default. But, it would appear, the creditor could ensure such access to the property by requiring the joint owner to execute a pledge,

pledge, subordination agreement or waiver should provide unimpaired access

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subordination agreement or other instrument that operates as a waiver of rights without insisting that the non-applicant party assume personal liability for the debt by signing the promissory note.

Similar protection for marital interests

Similar protection may be available to the creditor when a married applicant seeks unsecured credit as an individual relying on property that is held individually but may be subject to a marital interest.

Most states have abolished the common law forms of dower and curtesy, but these marital interests have usually been replaced with a statutory right on the part of a spouse to a pro rata share of a deceased spouse's estate, even though the assets of the estate may have been pledged by the decedent to secure a debt.

Unlikely to affect lender's position

In most cases, the possibility seems remote that these rights will affect the lender's position. Therefore, the existence of such rights does not seem to justify the imposition of blanket cosigner requirements on married persons who rely on property to establish creditworthiness. However, if a creditor is considering an extension of credit to a married applicant who is relying on assets subject to a marital interest and who appears to be a high mortality risk, it would be appropriate for the creditor to require the spouse to subordinate his or her marital interests to the creditor's claim. Or, a creditor could properly use the existence of such rights as a reason for lending on a wider than normal margin.

Agreement ensures access

Generally, then, it seems the Equal Credit Opportunity Act prohibits the practice of using cosigner requirements to ensure access to assets supporting extensions of credit when alternative forms of protection are available to the creditor. A pledge, subordination agreement or waiver of marital interests should provide unimpaired access to assets supporting an unsecured extension of credit without interfering with the Act's purpose of ensuring that creditworthy persons can obtain individual credit.

Creditors should note this discussion pertains to cases in which an applicant seeks individual credit relying on his or her own ability to repay. When an applicant seeks credit based partly on a spouse's or other person's income, Regulation B permits a creditor to require that the spouse or other person become a joint obligor. Also, if a married couple wants to become jointly obligated for a debt, the Regulation requires that the creditor permit them to do so.

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