The Federal Reserve Seeks To Protect Consumers

(PHOTO BY JOE RAEDLE/GETTY IMAGES)

Carol Mondesir participates in a protest in front of Ocwen Financial, a subprime loan servicer, Sept. 26, 2007, in West Palm Beach, Fla.

By Sharon K. Blei

Recent problems in the subprime mortgage markets highlight the importance of consumer protection in the financial services sector. Financial services are an essential part of everyday life. Deceptive and unfair financial practices can cause serious problems for consumers and threaten to undermine confidence in the financial services industry.

Nearly every aspect of this industry is covered by consumer protection laws that are designed to promote the availability of financial services to all consumers without discrimination, prohibit abuse of customers by financial institutions, and ensure effective and adequate disclosure of information to customers about the features and risks embedded in financial products.

Consumer protection laws are enforced by state regulators (mainly, state attorneys general) and a range of federal regulatory agencies.[1] These regulators differ with respect to jurisdiction, authority, budget, agenda and approach, producing a most intricate and multifaceted structure.

Federal regulatory agencies, including the Federal Reserve Board, have been entrusted with a certain degree of rulemaking authority under federal consumer laws; these agencies enforce compliance by financial institutions within their jurisdiction.[2]

The Federal Reserve's role in consumer protection consists of four pillars: rulemaking, enforcement, the Federal Reserve's Community Affairs program and consumer education.

Rulemaking

The Federal Reserve's Board of Governors has been entrusted by Congress with the exclusive mandate to write and interpret regulations designed to put into effect many of the major federal consumer protection laws. These regulations apply not only to the banks under the Board's jurisdiction, they also address mortgage brokers, finance companies and certain businesses, such as retailers and automobile dealers. The table lists major consumer protection laws that are implemented by Board regulations.

Under other federal laws, such as the Community Reinvestment Act, the Federal Reserve Board shares rule-writing responsibility with other regulators. In addition, the Board is responsible for crafting rules prohibiting practices that fall under the legal standards for "unfair or deceptive."

The formation of consumer protection regulations poses significant challenges due to the diversity and complexity of financial products and to the undesirable consequences of over-regulation. Overly simplistic regulations are also undesirable because they can easily be avoided. Given these challenges, the Board has often opted to adopt a case-by-case approach rather than use its rulemaking authority in tackling certain seemingly "unfair and deceptive" practices.[3]

The dynamic nature of financial markets poses yet another regulatory challenge. To keep up with financial innovation, marketplace developments and changes in existing legislation, as well as to address emerging circumstances and problems encountered by customers, regulations are being subject to recurrent revision and updating—mostly in the form of amendments to existing regulations (see table) or revised interpretations to existing regulations.[4]

In executing its role in consumer protection, the Board seeks the advice of consumer advocates and other supervisory agencies, reviews comments from the public, and conducts occasional consumer surveys and testing. The Board is also assisted by its Consumer Advisory Council.[5] Meetings of the council are held three times a year as public hearings at the Board's headquarters in Washington, D.C.

Enforcement

The Federal Reserve enforces compliance with more than 20 federal consumer protection laws by the financial institutions under its jurisdiction through examinations, handling of consumer complaints, investigation of alleged violations and punitive actions against delinquent institutions.[6]

On-site consumer compliance examinations are the responsibility of the Banking Supervision and Regulation division of each Federal Reserve bank, carried out by specially trained examiners. When examinations reveal consumer compliance deficiencies, the findings are communicated to the institution's management. In the rare cases where institutions do not address the deficiencies brought to their attention, the Federal Reserve can wield a variety of enforcement tools, ranging from informal supervisory actions to formal actions and cease and desist orders. In particularly severe cases, the Federal Reserve appeals for intervention by the Department of Justice.[7]

Depository institutions under the Federal Reserve's jurisdiction are also assessed for their performance under the 1977 Community Reinvestment Act (implemented by regulation BB); the CRA encourages depository institutions to help meet the credit needs of the communities in which they operate.

An important tool for monitoring institutions between examinations is the analysis of consumer complaints. An established

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Major Federal Consumer Protection Laws and Their Implementation by the Board

FEDERAL LAW	PURPOSE/ REQUIREMENTS	IMPLEMENTATION
The Truth in Lending Act (1968)	Requires lenders to clearly disclose lending terms and costs to borrowers.	Regulation Z
The Fair Credit Billing Act (1974)	Enacted as an amendment to the Truth in Lending Act. Protects consumers from unfair billing practices by creditors and provides a mechanism for addressing billing errors, mostly in credit accounts, such as credit card or charge card accounts.	Regulation Z
The Fair Credit and Charge Card Disclosure Act (1988)	Enacted as an amendment to the Truth in Lending Act. Requires disclosures on credit and charge cards issued by financial institutions, retailers and others.	Regulation Z
The Home Equity Loan Consumer Protection Act (1988)	Enacted as an amendment to the Truth in Lending Act. Requires creditors to disclose the terms and costs for open-end credit lines secured by the borrower's dwelling. Restricts the terms of such credit lines and the circumstances under which creditors may modify or terminate the terms of a home equity plan once opened.	Regulation Z
The Home Ownership and Equity Protection Act (1994)	Enacted as an amendment to the Truth in Lending Act. Establishes rules and disclosure requirements and prohibits abusive practices in connection to certain types of mortgages that carry high rates or fees.	Regulation Z
The Fair Credit Reporting Act (1970)	Protects consumers from abusive credit reporting practices and requires credit reporting agencies to allow credit applicants to correct inaccurate reports.	Regulation V
The Equal Credit Opportunity Act (1974)	Protects consumers from discrimination by creditors on the grounds of familial status, sex, religion, race, national origin, age or because the applicant receives income from a public assistance program.	Regulation B
The Home Mortgage Disclosure Act (1975)	Requires the bulk of mortgage lenders located in metropolitan areas to collect data about home purchases, home purchase preapprovals, home improvement and refinance applications; to report the data annually to the government; and to make the information available to the public.	Regulation C
The Electronic Fund Transfer Act (1978)	Requires disclosure of the terms and conditions of electronic fund transfers. Protects consumers against unauthorized transfer.	Regulation E
The Consumer Leasing Act (1976)	Requires disclosure of information about the costs and terms of vehicle leases.	Regulation M
The Expedited Funds Availability Act (1987)	Standardizes hold periods on deposits made to depository institutions and to regulate their use of deposit holds.	Regulation CC
The Truth in Savings Act (1991)	Requires disclosure of terms and conditions regarding interest rates and fees associated with savings accounts. Establishes uniformity in disclosure standards.	Regulation DD

Public Comment Sought on New Mortgage Rules

In the wake of the recent subprime mortgage debacle, the Federal Reserve Board proposed and asked for public comment on changes to Regulation Z (which implements the Truth in Lending Act, or TILA) on Dec. 18, 2007.[10] The deadline for commenting is April 8, 2008.

The intent of the new rules is to better protect consumers from unfair or deceptive home-mortgage lending and advertising practices. When enacted—probably near the end of 2008—these changes will extend the guidelines of the Home Ownership and Equity Protection Act (HOEPA) to a much broader category of loans, defined as higher-priced mortgage loans. The proposed changes will require lenders to document and verify borrowers' ability to repay high-priced loans, restrict the implementation of prepayment penalties, and require lenders to establish escrow accounts for taxes and insurance bills. Additional changes will apply to all loans secured by a consumer's principal dwelling.

These changes would prohibit lenders from compensating mortgage brokers with yield-spread-premiums, prohibit lenders and brokers from coercing real estate appraisers to misstate a home's value, impose restrictive criteria on loan servicers and ban misleading advertisements. These new rules represent the most significant revisions to U.S. consumer-protection regulation in over a decade.

The impetus for revising Regulation Z's mortgage-lending provisions was a widespread perception that the subprime-mortgage market was malfunctioning. Federal Reserve Board Chairman Ben Bernanke summarized the case for more and stronger consumer protections, and the Board's intent to provide them, in his July 18, 2007, testimony before Congress:

> *[T]he recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. …By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. …[Also,] we plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive. …I expect that the Board will propose additional rules under HOEPA later this year.*[11]

ENDNOTES

1 The eight federal regulators that are involved in consumer protection are the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), the Federal Trade Commission (FTC), the Securities and Exchange Commission (SEC), the National Credit Union Administration (NCUA), the Office of Thrift Supervision (OTS) and the Commodity Futures Trading Commission (CFTC).

2 A table of regulatory authorities and their responsibilities is available with the online version of this article. See www.stlouisfed.org/publications/re.

3 The most recent example is alleged predatory lending practices in the subprime mortgage market.

4 The Home Ownership and Equity Protection Act, for example, is a 1994 amendment to the Truth in Lending Act.

5 The Consumer Advisory Council is a Congress-established council consisting of 30 members with diverse backgrounds; they have staggered terms and represent the interests of consumers, community groups and financial institutions.

6 Institutions under the Federal Reserve's jurisdiction include state member banks, bank holding companies, nonbank subsidiaries of bank holding companies, edge and agreement corporations and branches, and agencies of foreign banking organizations operating in the U.S. and their parent banks.

7 The Department of Housing and Urban Development (HUD) provides litigation assistance in cases pertaining to home loans.

8 To help consumers identify the agency they should address their complaints to, the Federal Reserve has launched an online consumer complaint system that automatically dispatches complaints to the appropriate supervisory agency. The Board is also planning to establish an administrative center with a toll-free telephone number for handling consumer complaints.

9 These publications focus on selected topics, such as bank accounts and services, credit cards, credit scores, identity theft, mortgages, vehicle leasing, checks, etc., and target consumers' special needs as indicated by consumer behavior research, surveys and testing. Many of these publications are also available in Spanish. See www.federalreserve.gov/consumers.htm.

10 The press release, background information and a form for submitting public comments are available at www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm.

11 Bernanke's semiannual Monetary Policy Report to Congress normally is dedicated to macroeconomic issues alone. The fact that nearly one-third of his July testimony discussed the subprime-mortgage market and planned reforms to consumer-protection regulation underscores the high priority the Federal Reserve assigns to its consumer-protection responsibilities. The testimony is available at www.federalreserve.gov/newsevents/testimony/bernanke20070718a.htm.

REFERENCES

The online version of this article includes a lengthy list of web sites related to consumer protection. See www.stlouisfed.org/publications/re.

policy framework specifies the procedures for addressing consumer complaints by trained staff of the Federal Reserve banks.[8]

To address emerging issues, or in cases where strict rules might do more harm than good, the Federal Reserve uses principle-based supervisory guidelines, sometimes including best practices.

Community Affairs Program

The Federal Reserve's Community Affairs activities promote community development and fair and impartial access to credit to traditionally underserved markets. The Federal Reserve launched community development programs designed to advance financial institutions' engagement in servicing their entire communities, educate low- and moderate-income consumers, and encourage cooperation among local governments, community leaders, financial institutions and nonprofit organizations with whom it collaborates closely and to whom it provides assistance, information and educational resources. In so doing, the Federal Reserve studies and analyzes the special needs of underserved consumers—both at the national and the district levels. The Federal Reserve also holds a community development research conference, designed to present studies and discuss current trends and developments, every two years. Another activity in which the Federal Reserve partakes (and sometimes hosts) is the National Consumer Protection Week: a yearly symposium for consumer professionals, designed to highlight consumer protection and education efforts and to discuss recent developments in consumer laws, policies and practices.

Consumer Education

Informed consumers who know their rights and responsibilities and who understand their options can make better choices when shopping for financial services. The promotion of consumers' financial literacy is, therefore, part and parcel of the Federal Reserve's consumer protection responsibilities. Consumer education resources are released in the form of brochures and handbooks, which are also available on the Board's web site.[9] Ω

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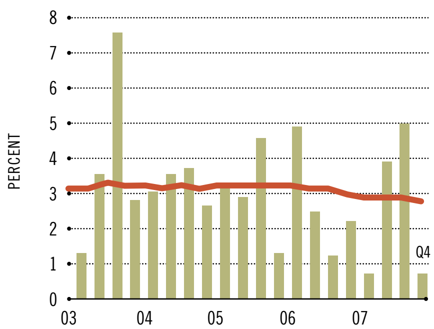
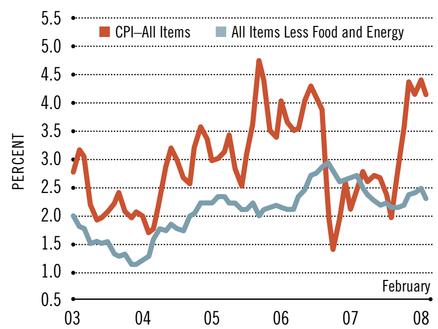
Eleven more charts are available on the web version of this issue. Among the topics they cover are agriculture, commercial banking, housing permits, income and jobs. Much of the data is specific to the Eighth District. To go directly to these charts, use this URL: www.stlouisfed.org/publications/re/2008/b/pdf/4-08-data.pdf.

REAL GDP GROWTH



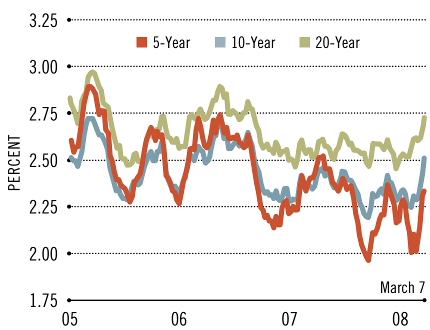
NOTE: Each bar is a one-quarter growth rate (annualized); the red line is the 10-year growth rate.

CONSUMER PRICE INDEX



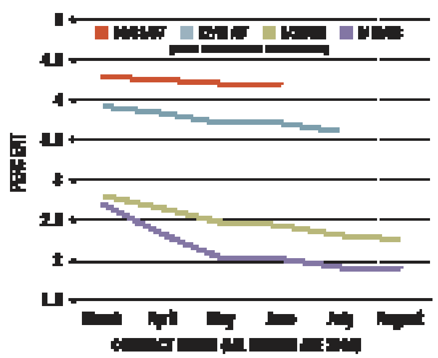
NOTE: Percent change from a year earlier.

INFLATION-INDEXED TREASURY YIELD SPREADS

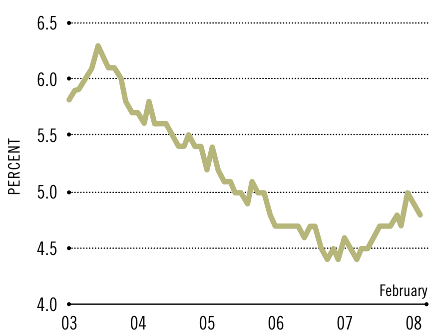


NOTE: Weekly data.

RATES ON FEDERAL FUNDS FUTURES ON SELECTED DATES

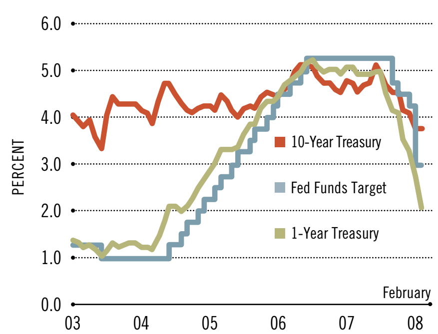


CIVILIAN UNEMPLOYMENT RATE



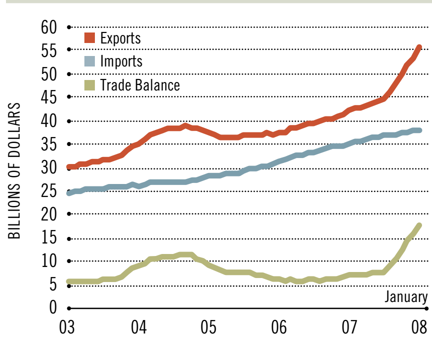
NOTE: Beginning in January 2003, household data reflect revised population controls used in the Current Population Survey.

INTEREST RATES



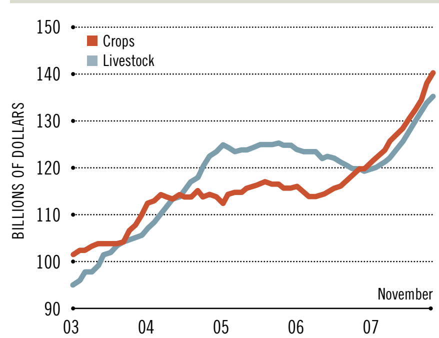
NOTE: Except for the fed funds target, which is end-of-period, data are monthly averages of daily data.

U.S. AGRICULTURAL TRADE



NOTE: Data are aggregated over the past 12 months.

FARMING CASH RECEIPTS



NOTE: Data are aggregated over the past 12 months.