Randall S Kroszner: Creating more effective consumer credit disclosures

Remarks by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the George Washington University School of Business, Financial Services Research Program Policy Forum, Washington DC, 23 May 2007.

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Information is critical to the effective functioning of markets. A core principle of economics is that markets are more competitive, and therefore more efficient, when accurate information is available to both consumers and suppliers. When information on alternatives is readily available, product offerings will have to meet customers' demands and offering prices will have to reflect those of market competitors.[1] In addition, information helps individual consumers by improving their ability to compare products and to choose those that will help them meet their personal goals.

These arguments are not just theoretical. There is systematic evidence that in practice, changes in disclosure affect both consumer and supplier behavior in a number of consumer product markets.[2] In 1968, Congress passed the Truth in Lending Act (TILA), which significantly changed a number of consumer credit disclosure practices. For example, it required that creditors disclose an "annual percentage rate." These disclosures are generally believed to have improved competition and helped individual consumers.[3]

Today, we face the challenge of ensuring that disclosures for consumer credit remain effective. To be effective, disclosures must give consumers information about credit pricing at a time when it is relevant, and in language consumers can easily understand. The information must also be in a format that allows consumers to pick out and use the information that is most important to them. Effective disclosures give consumers information they notice, understand, and can use. Better credit disclosure permits better-informed credit decisions and, hence, more effective competition among credit card issuers. In a nutshell, effective disclosure empowers consumers and enhances competition.

The Federal Reserve Board has recently undertaken an innovative approach to improve the effectiveness of disclosure – namely, surveying and responding to consumers through consumer testing. Having taught at a business school for many years, I am well aware of the types of consumer testing that firms have long employed: surveys, focus groups, and so-called "mall intercepts" in which shoppers are interviewed at random. Systematically using such techniques to improve the effectiveness of disclosure requirements set out in the regulations of the Federal Reserve and other financial regulators, is, however, relatively novel.

Consumer testing can help the Federal Reserve address the considerable challenge of making disclosures more effective. Consumers increasingly face more-diverse and more-complex financial products, including nontraditional mortgages and credit cards with multiple features. Given this complexity, we have to be mindful of the dangers of information overload. We must seek to carry out the responsibilities Congress has given us to design disclosures that are not only accurate, but also clear and simple enough that they are meaningful and useful to consumers.

In other words, pages and pages of fine print may provide comprehensive descriptions that lawyers might love but that consumers find confusing, or, worse, useless. We need to translate legalese into something consumers can use. This requires the Board to make judgments about which credit terms are most important to highlight and which could be eliminated. However, we plan to make these judgments with the benefit of feedback from actual consumers gathered through surveys and testing.

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1 See, for example, George J. Stigler (1961), "The Economics of Information," Journal of Political Economy, vol. 69 (June), pp. 213-25.

2 Alan D. Mathios (2000), "The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market," Journal of Law and Economics, vol. 43 (October), pp. 651-675; Ginger Zhe Jin and Phillip Leslie (2003), "The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards," The Quarterly Journal of Economics, vol. 118 (May), pp. 409-451.

3 Board of Governors of the Federal Reserve System (1987), Annual Percentage Rate Demonstration Project (Washington: Board of Governors of the Federal Reserve System). See also Consumer Credit in the United States: The Report of the National Commission on Consumer Finance (GPO 1972).

We recently completed several rounds of consumer testing for credit card disclosures, and that testing was critical to our effort to redesign and, I believe, dramatically improve those disclosures.

Just this morning, the Board took a major step toward making credit disclosure more effective, by voting to seek public comment on proposed revisions to the Board's Regulation Z, which implements the Truth In Lending Act – revisions that will improve credit card disclosures. I will share with you some of the results of our consumer testing, how they influenced our newly issued proposal concerning credit card disclosures, and how consumer testing will influence future proposals for improvements of mortgage loan disclosures.

The Board's recent actions related to mortgage loan disclosures

First, however, I want to note that the Board has already taken some steps to improve disclosures concerning mortgages, including subprime mortgages, which is the topic of this forum. Last summer, the Board held a series of four public hearings on home-equity lending, where we gathered views on the impact of federal and state predatory lending laws and on the adequacy of mortgage disclosures, particularly those concerning nontraditional mortgage products. Following those hearings, the Board revised the consumer handbook that creditors are required to provide with applications for adjustable-rate mortgages, or ARMs. As you well know, a substantial majority of recent subprime mortgage originations have been ARMs. The revised handbook gives consumers a better explanation of the features and risks of nontraditional ARMs, especially "payment shock" and the risk of increasing loan balances, also known as "negative amortization."

The Board will be holding a fifth hearing on June 14, here in Washington, D.C., and I will chair that meeting. We will focus on how the Board might use its rulemaking authority under the Home Ownership and Equity Protection Act, or HOEPA, to address concerns about abusive mortgage lending practices.

The purpose of the hearing is to gather information to evaluate how the Federal Reserve can prevent predatory lending in a way that also preserves incentives for responsible lenders. A robust and responsible subprime mortgage market benefits consumers by allowing borrowers with non-prime or limited credit histories to become homeowners, access the equity in their homes, or have the flexibility to refinance their loans as needed. Following the hearing, we will consider whether there are lending practices that should be prohibited under HOEPA. The Federal Reserve will do all that it can to prevent fraud and abusive mortgage lending practices. However, any new rules should be drawn clearly to avoid creating legal or regulatory uncertainty that could have the unintended consequence of restricting consumers' access to responsible subprime credit.

As I mentioned earlier, effective disclosure can make markets more competitive and weed out abuse. Therefore, we will also consider how mortgage disclosures can be improved to ensure a robust subprime market and responsible subprime lending. In fact, the Board is conducting a comprehensive review of all Truth in Lending Act disclosures. As the Board reviews mortgage disclosures, it will consider a variety of recent suggestions. For example, given the large volume of documents presented to consumers at mortgage loan closings, the Board will consider whether creditors should be required to provide disclosures for home-refinance loans and home-equity loans within three days of application instead of at consummation, as currently required for home-purchase loans. The Board will also review the requirements concerning advertisements, to ensure that when lenders promote low initial rates and low monthly payments they also adequately disclose the limits of those low rates and payments and the potential payment shock. Our review of mortgage disclosures is now under way.

I would now like to turn to the initial phase of the Board's review of credit disclosures, which has focused on credit cards and other revolving credit accounts. The substantial investment we have made in developing and testing revised credit card disclosures has given us insights that will surely contribute to our ability to make mortgage disclosures more effective.

The challenges of disclosing credit card costs

In our effort to create more effective credit card disclosures, we face several challenges. First, disclosing the cost of revolving credit to facilitate consumer shopping is inherently challenging because key variables are not known in advance, such as the amount of credit that the consumer will use and the timing and amount of the consumer's payments. Creditors' solicitations disclose only a nominal APR based on the periodic interest rate, and they list any fees separately. Related variables, such as the grace period and balance calculation method, also have to be explained. On periodic billing statements, an “effective APR” can be disclosed after the credit is extended, but even then assumptions must be made about the consumer’s payments. For example, the effective APR assumes that transaction fees are amortized over one billing cycle, regardless of how long the credit is actually outstanding.

The increasing complexity and diversity of credit card features and pricing present a second challenge. Because creditors use risk-based pricing, their solicitations might disclose a range of possible rates for which the consumer could qualify. Creditors discount their initial interest rates, sometimes deeply. While competing on the initial rate, creditors compensate with “back-end” pricing.[4] Temporary introductory rates are followed by a higher rate, and penalty rates and fees have increased and are now easier to trigger. Consumers might not focus on costs that are contingent on future events, and it can be challenging to explain clearly how these contingencies can increase consumers’ costs.

A third major challenge is crafting disclosure rules that are, on the one hand, clear and specific enough to facilitate compliance and promote consistency among creditors but, on the other hand, flexible enough to accommodate market developments as products and pricing continue to change. We have a responsibility to avoid undue burdens that would hinder innovation and raise costs without producing sufficient offsetting benefits in the credit card market.

Faced with these developments, the Board’s challenge is to determine what information should be highlighted for consumers. How much information is enough, and how much is too much? How can we encourage plainer language, recognizing that there may be a trade-off between simplicity and accuracy? What formats work best in presenting the information? When is the best time to present information so it will be most relevant and useful to consumers? How can we craft disclosure requirements that are flexible enough to accommodate innovation and change and to enhance competition?

Using consumer testing to improve credit card disclosures: highlights of the proposal and lessons learned

Although the Board has used consumer focus groups in the past, this is the first time that we have conducted extensive, in-depth interviews with individual consumers to study the effectiveness of disclosures. The first step was using both focus groups and one-on-one interviews to evaluate how well consumers understand and use the current credit card disclosures. With a consultant’s help, we then redesigned the disclosures and conducted more one-on-one interviews using the revised formats. We went through this process several times, each time adjusting our designs to incorporate the lessons learned. We plan to follow the same testing process with mortgage disclosures. In addition, there were other sources of information, such as public comment letters and informal input from industry and consumer groups, discussions by the Board’s Consumer Advisory Council, a study by the Government Accountability Office, and data from consumer surveys.

As I noted earlier, our task is to take a complex credit product and design disclosures that can explain the terms not only accurately but also clearly enough to be meaningful and useful to consumers – all while enhancing, not stifling, competition and innovation. I will briefly describe the highlights of the proposal issued by the Board this morning and use them to illustrate some general lessons we have learned about making disclosure more effective for consumers.

First, we learned firsthand what information consumers find useful when making credit decisions and what information they ignore. Second, we learned what information consumers comprehend and what information they do not. Third, we saw the impact that different formats and presentation can have on consumers’ ability to notice and use the information.

The first significant lesson from our consumer testing was that there are some disclosures that consumers just do not find useful. Most participants acknowledged that they do not read the cardholder agreements that contain their account-opening disclosures because they are often written in small print and dense prose. At the same time, they wanted some sort of disclosure they could use, before opening an account, to confirm that the terms are what they expect. Participants also said that

[4] Furletti, Mark (2003), "Credit Card Pricing Developments and Their Disclosure," discussion paper, Payment Cards Center, Federal Reserve Bank of Philadelphia.

often they do not carefully read their change-in-terms notices because they are frustrated by the format and technical language.

With this information in hand, we explored how we could improve the disclosures to change consumer behavior. Under the proposed rules, when an account is opened, the consumer would receive a summary of the credit agreement in the form of a table, which they can compare with the original solicitation.

Creditors would also have to provide a disclosure table with their change-in-terms notices, to summarize the changes. In our tests, such a table was very effective in making the change-in-terms notice more usable, and consumers were more likely to correctly identify the changes to the terms of their accounts. The Board's proposal also would require creditors to give consumers more advance notice before increasing the interest rate or making changes to other key terms. Creditors would have to send a notice to consumers 45 days in advance of a rate increase, compared with the current 15 days. The intent is to give consumers more time to make other credit arrangements, if necessary, before the higher rate becomes effective. The Board is expressly seeking comment on whether 45 days is the appropriate amount of time.

The second lesson learned from our consumer testing was which disclosures consumers comprehend and which they do not. Before deciding that the core information was not useful, we explored other ways to explain complex information and to improve consumers' understanding. We explored whether consumers would benefit from using different terminology or whether particular terms need to be accompanied by an explanation. This is a particular challenge in the case of the term "effective APR." We experimented with terminology and explanatory language as well as formats. The proposed changes for disclosing the effective APR have shown promise, but this is an area where we will be conducting additional consumer testing.

The test participants also often did not correctly understand what creditors meant by the term "fixed rate." They equated this with the fixed rate on their mortgage. Thus, under the proposed rules we would allow creditors to describe their rates as "fixed" only if there is a specified period during which the rate cannot be increased for any reason. If no period is specified, the term "fixed" could be used only if the rate cannot increase while the credit plan is open.

Consumers in our tests also did not understand the term "default APR." We would therefore require creditors to refer to the "penalty APR" rather than the "default APR," which improved consumer understanding in our tests. Consumers also did not consistently understand the term "grace period," which is significant considering the cost implications of not paying on time. Based on language we tested with consumers, we are proposing to add an explanation of the term.

The third lesson of our consumer testing was the impact that different formats and presentation can have on consumers' ability to notice and use the information. Our testing confirmed that one of the most effective ways to present credit card disclosures is in the table provided with solicitations, commonly known as the "Schumer box." Although this table is effective, we were nevertheless able to use the one-on-one interviews to improve both the content and format. For example, when a creditor uses risk-based pricing, solicitations may show a range of rates, and many test participants had trouble understanding how a card issuer would select an initial APR. We are therefore proposing to add a simple explanation that consumers' initial rate is based on their creditworthiness. We also reformatted the Schumer box into two major sections, to separate information about rates from the information about fees. This seemed to enhance consumers' understanding and improve the usability of the disclosures.

In addition, disclosures inside the Schumer box were more readily noticed than when the same information was placed just beneath it. We propose to move information that was more important to consumers – such as the circumstances that trigger a penalty APR – inside the Schumer box. The creditor's balance-calculation method, however, was removed and located beneath the Schumer box, because our testing showed that consumers do not use the information to shop.

A related finding concerning format is that regrouping information in the Schumer box improved consumers' ability to use the disclosures. Specifically, we found that grouping certain information together on periodic statements made it easier to understand. For example, consumers more easily determined the number and amount of fees when they were itemized, grouped together, and totaled. So the revised rules would require creditors to locate the fees and interest charges in one place on the statement. Fees would have to be grouped together with a total dollar amount instead of listed chronologically with purchase transactions, as they are today. Interest charges would also be grouped together, with a total dollar amount.

Finally, most consumers said that they throw away any inserts included with their periodic statement, including any inserts that describe changes to their account terms. To alert consumers to the significance of the insert, creditors that insert a change-in-terms notice with the periodic statement would have to summarize the changes on the front of the periodic statement rather than on the insert.

Similar challenges in improving mortgage disclosures

As I mentioned earlier, the Board also plans to conduct consumer testing as part of its review of mortgage disclosures. Like credit cards, mortgage products have become more diverse and more complex. In some cases, creditors are using pricing strategies similar to those used for credit cards, for example, offering customers discounted introductory rates that will be replaced in a short time by a much higher rate, often a variable rate. Of course there is an inherent difficulty in adjustable-rate mortgage disclosures because future interest rate changes are not known. Consumer testing is needed to determine whether consumers would find disclosure of the maximum rate and a worst-case payment example useful, given that these might not occur for several years or more and that the consumer’s own financial circumstances may change.

The wider marketing of payment-option mortgages presents another challenge. Consumers have the choice of making low minimum monthly payments that increase the overall cost of the credit and may ultimately lead to longer amortization periods. Just as with credit cards, however, disclosing a consumer’s repayment obligation and the cost of the credit is more complex when there are unknowns – such as the rate, the amount of the consumer’s monthly payment, and the possibility of negative amortization. When the Board reviews mortgage disclosures, it will consider these developments and conduct consumer testing to determine how the features and risks of today’s mortgage products can be communicated effectively.

The Board’s upcoming hearing on mortgage lending practices

As I mentioned earlier, in June the Board will be conducting another public hearing on mortgage lending, which will focus on how the Board might use its rulemaking authority to prevent abusive lending. Some of these concerns may call for more-effective disclosures.

Last year, the federal agencies that supervise depository institutions issued guidance on nontraditional mortgage products, and they recently proposed similar guidance for subprime mortgages. Both guidance statements discuss underwriting practices as well as the need for lenders to give consumers more complete and balanced information while they are still shopping for a mortgage, before they apply for the loan.

Prepayment penalties as well the use of “stated-income” or “low-doc” loans will also be discussed at the upcoming hearing. We will hear arguments about such practices and consider whether disclosures can be made more effective to adequately inform consumers about how penalty clauses operate and the implications of not documenting their income.

Conclusion

In fulfilling its responsibility to protect consumers, the Federal Reserve will do all that it can to prevent fraudulent and abusive mortgage lending practices. Because information is critical to more competitive, and thus more efficient, markets, effective disclosure also has the capacity to weed out abuses. Consumers who do not have accurate information and an understanding of what that information means will have difficulty choosing among competing products and making decisions that are in their best interest. This is true in both credit card and mortgage markets. Accordingly, we will consider how mortgage disclosures can be more effective and empower consumers to make better-informed decisions and achieve their financial goals. Better-informed consumers will strengthen market competition. The Federal Reserve also will consider how we might use our rulemaking authority to address predatory practices without restricting consumers' access to responsible subprime credit.

By using consumer testing systematically, the Federal Reserve is taking an innovative approach to revising its regulations and improving the effectiveness of disclosures. We are finding that it is tremendously beneficial to listen to consumers so that we can learn more about how they use information and how we can simplify disclosures and enhance consumers' understanding. Surely, the lessons we have already learned from consumer testing for credit cards will also help us improve mortgage disclosures and contribute to a more robust, competitive, and responsible subprime market.