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VIEWPOINTS

Disclosure Better than Limiting Credit

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Last week Sen. Dodd offered a brief summary of his Credit Card Accountability Responsibility and Disclosure Act.

The Federal Reserve Board of Governors, the Office of Thrift Supervision, and the National Credit Union Administration have issued similar proposed regulations to prohibit certain "unfair or deceptive acts or practices" involving credit cards. The proposals include specific prohibitions and limitations on products and practices, rather than focusing on enhanced disclosure and consumer education.

People can and will debate the specific terms in each of the proposals for the next few months, but there is a far more troubling aspect to them — namely, the recent trend in Washington to impose substantive restrictions on consumer credit products in lieu of developing and implementing more meaningful and effective disclosures on the cost of credit and the pertinent account terms.

This trend is clearly evidenced by the credit card proposals and the Fed's recently proposed changes to Regulation Z under its rulemaking for the Home Ownership and Equity Protection Act of 1994. Specifically, the proposed changes include substantive restrictions on prepayment penalties and mortgage broker compensation. These two areas were previously regulated through extensive federal disclosure requirements and state limitations.

In his remarks last week about the Fed's proposed regulations concerning unfair and deceptive practices, Chairman Ben Bernanke indicated that the growing complexity of credit card products has increased the risk that consumers will not understand key terms affecting their accounts. This statement is undoubtedly true.

There are at least two ways to address the problem. The proposal to limit certain practices through the Fed's unfair and deceptive practices rulemaking is one, but it is predicated upon the belief that consumers do not understand the existing disclosures, and that there is no way to improve them. Instead of endorsing this dubious belief and supporting more substantive restrictions, Congress and the federal banking regulators should develop more effective disclosures under the Truth-in-Lending Act and promote consumer education and accountability.

People may wonder why a shift from a disclosure-based system to one where certain practices are prohibited and underwriting terms are prescribed by regulation should be a concern to politicians, regulators, consumers, and creditors. The reason is that innovation and competition, two hallmarks of the U.S. consumer financial services industry, depend largely on effective disclosures to permit informed choices.

Choosing substantive restrictions and prohibitions over disclosure is a bad long-term solution for several reasons.

First, prohibiting or limiting practices — the easiest way to handle the complexity of financial products and the potential failure of consumers to understand key terms — does not empower consumers or help them make informed choices. Congress and the federal banking regulators should revise disclosures to give consumers the necessary information to make these informed choices.

Admittedly, this is a difficult task and will require changes that go beyond simply increasing the type size of the initial or default APR in card solicitations.

Second, prescriptive regulations generally result in a number of unintended consequences as parties try to address the prohibitions and restrictions set forth. The potential consequences from these proposals will likely include the elimination of balance transfer opportunities and "same as cash" financing programs.

Limiting interest rate adjustments may help some consumers initially, but restrictions on risk-based pricing ultimately will decrease the availability of credit by reducing initial approvals and shrinking credit lines.

Finally, everyone is opposed to unfair and deceptive practices, but identifying them remains a difficult and highly subjective exercise. The recent proposals label many long-standing, legal, and thoroughly disclosed practices as "unfair," partly on the belief that consumers do not understand the information contained in their disclosures.

Enhanced disclosures may not address all the targeted practices, but in certain instances they may eliminate or reduce the perceived problem. For example, the Truth-in-Lending Act defines various balance computation methods for open-ended credit, and the applicable method is identified in each card solicitation. If simply noting the application of two-cycle billing is not adequate disclosure, the Fed can require issuers to provide additional information.

Enacting the changes under consideration by Congress and the federal banking agencies will result in another missed opportunity to address the underlying disclosure problems presented by increasingly complex credit products. Empowering consumers to make informed decisions and holding them accountable for those choices is a tougher but more appropriate challenge.

The proposed legislation and regulations offer little help with this challenge. Instead, they support the flawed view that better disclosures and increased accountability for credit decisions are unattainable goals, and that limiting choices and credit availability are the best ways to protect the majority of consumers.

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