FYI - An Update on Emerging Issues in Banking

Financial Education in a Dynamic Banking Environment

November 5, 2003

Overview

The transformation of the consumer finance market has placed a new premium on financial education. While consumer credit is more available than ever, technological advances and an array of new consumer products and services have made modern banking more complex. In this arena, it is more important than ever for consumers to be educated about their rights and options regarding financial offerings. However, mounting consumer indebtedness and unprecedented high levels of bankruptcy filings raise questions about the state of consumers' financial knowledge; and persistently high numbers of unbanked households lead to questions about whether the financial system is effectively serving the needs of all Americans.

Increasing availability of credit and shifting U.S. demographics have together opened up large pools of potential banking customers. This change has presented financial institutions with plenty of opportunities, as well as challenges, as they work to reach new populations. In many ways, the extension of credit to previously underserved borrowers—and the trend towards the "democratization" of banking services in general—has produced notable benefits for both banks and their customers. There is a downside, however, since relatively inexperienced consumers may accept unfavorable financial arrangements, leading a few unscrupulous entities to engage in harmful practices such as predatory lending.

Financial education is the consumer's first line of defense against fraud, abuse, and mismanagement of their finances. Financial education can empower consumers to be better shoppers for financial products and services. Indeed, studies have shown that financial education can change financial behavior.[1] Many organizations—in both the public and private sectors—have developed financial education programs in an effort to help consumers. The FDIC introduced its own financial education curriculum in 2001. The FDIC's *Money Smart* program was specifically designed to meet the needs of low- and moderate-income adults, including the unbanked and underserved populations, introduce them to banking and financial concepts, and equip them to manage their finances safely and wisely.

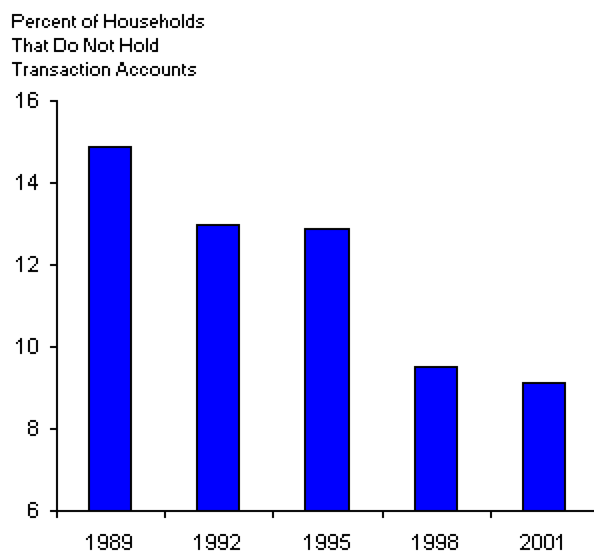
The Unbanked and Underserved Populations

In recent years, it has become clear that inadequate basic financial education has hindered millions of individuals from participating in the U.S. banking system and has depressed the economic well-being of households and communities. The efforts of policymakers and financial institutions alike have broadened the scope of our banking markets, resulting in an increase over the past decade in the percentage of households that maintain bank accounts. However, there are still more than 10 million individuals in the U.S. who fall outside of the financial mainstream and do not maintain traditional bank credit, savings, or investment accounts. Other individuals have taken advantage of newly granted access to a wide array of bank products, but find themselves unprepared to deal with the complexities that characterize today's financial services.

The Federal Reserve Board's 2001 *Survey of Consumer Finances* found that nearly 10 percent of U.S. families do not have transaction accounts and that over 12 percent lack checking accounts.[2] (See Chart 1.) Generally, these unbanked individuals have low incomes, do not own homes, are under 35 years of age, are non-white or Hispanic, are unemployed, are educated at the high school level or below, and have low levels of wealth.[3]

Chart 1

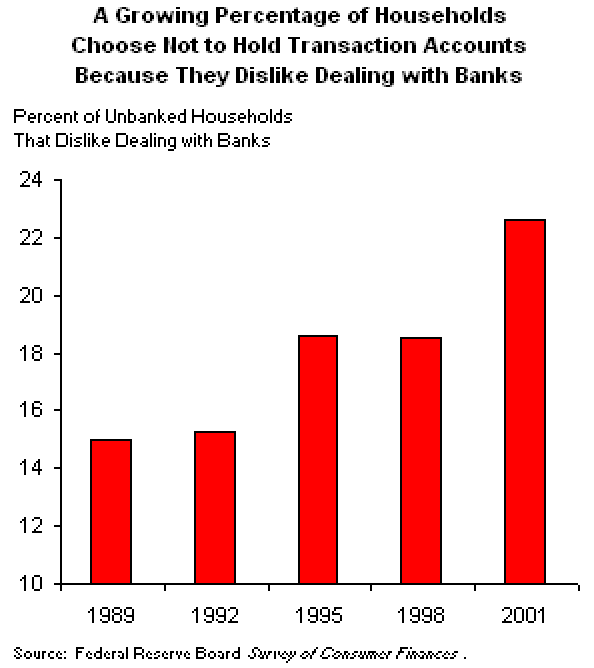
A Decreasing but Substantial Percentage of Households Do Not Hold Any Type of Transaction Accounts



Source: Federal Reserve Board *Survey of Consumer Finances* .

The unbanked population avoids traditional banking relationships for various reasons. A significant percentage of households without bank accounts report that they dislike dealing with banks. (See Chart 2). Often they are imbued with a cultural distrust of banks, and they may be concerned about privacy. Some feel that banks charge unreasonable fees, require unmanageable minimum balances, or provide banking services that do not meet their needs. Others are plagued with credit problems or feel that they do not have sufficient funds to justify having a bank account. Many also admit that lack of education is an obstacle, and over 10 percent of the unbanked population acknowledges that they cannot manage or balance a checkbook.[4]

Chart 2



Unbanked individuals use a variety of means and institutions to conduct their financial transactions. Like consumers in the financial mainstream, their financial affairs range from paying rent and utilities to cashing checks to periodically transferring money to individuals living in another country. However, instead of using mainstream financial institutions, the unbanked turn to "fringe banks" or "non-banks"—such as check-cashing outlets, wire transfer companies, payday lenders, and pawnshops. Many people use these fringe banks because they are unaware of other alternatives, especially in neighborhoods with few bank branches and in families that have never had bank accounts.

For millions of consumers, financial decisions may be hindered by a lack of understanding about the financial services available to them. Financial education could help consumers gain a better understanding of the wide array of services available in today's consumer banking environment, thus enabling them to make educated choices about what services are most advantageous for their household.

The Consumer Lending Revolution

Technological and financial advancements achieved over the last decade have revolutionized consumer banking. Some important changes include: deregulation of interest rates, expansion of the general purpose credit card market, improvements to credit scoring models, advancements in risk-based pricing strategies, and growth in loan securitization. The consumer lending revolution has indeed resulted in the democratization of credit, and consumers have access to new and innovative products.[5]

It is important to view efforts to engage the unbanked and underserved families in the context of today's consumer financial market. Specialized products and delivery methods are now being tailored to new subsets of the population that were previously not reached. Through these means, participants in the financial services industry hope to engage an increasing number of unbanked or underserved customers. For example, more banks are offering the U.S. Treasury Department's low cost Electronic Transfer Accounts so that federal payments recipients can take advantage of direct deposit.[6] Banks are also participating with employers to offer payroll cards, which provide the benefits of direct deposit and debit

cards but do not require the consumer to manage a checking account. Banks are enhancing bilingual services and marketing, offering low cost or free money orders and check cashing services even to non-account holders, and modifying personal identification requirements to better serve non-resident immigrants. In addition, financial institutions are lending to "riskier" individuals who might have been denied credit in the past. Subprime loans now routinely provide credit to those with blemished credit histories, and new mortgage products let borrowers purchase homes with little or no down payment. Offerings like these are greatly enhancing credit availability and expanding the reach of traditional banking services in general.

Challenges

With an innovative, more accessible financial environment come new challenges. The expansion of the subprime lending market allows households with tarnished credit histories, weak incomes, and few asset holdings to obtain funds. However, extending credit to riskier consumers can also lead to deterioration in consumer credit quality; the U.S. is currently experiencing a structural shift upwards in indebtedness and bankruptcies. In 2002, U.S. households added over $750 billion in debt to their balance sheets, an increase of almost 10 percent from 2001.[7] Moreover, while households are increasing their debt loads, personal bankruptcies are at a record high—personal bankruptcy filings during the 12 months ending June 2003 were a record 1.61 million.[8]

In an effort to safeguard the interests of banking customers, Congress and the financial industry regulators have initiated a number of consumer protection measures.

Consumer Protection Measures

Consumer protection measures include both regulatory guidance and legislative action related to disclosure of financial information by consumer reporting agencies, clarity in loan documents and financial disclosure statements, unfair and deceptive practices, predatory mortgage lending, subprime lending, and payday loans.

The pending Congressional reauthorization of the Fair Credit Reporting Act (FCRA) is among the most prominent measures related to consumer protection this year. The FCRA protects consumers from inappropriate and inaccurate disclosure of personal information by consumer reporting agencies.[9] Currently, the FCRA preempts state and local laws in a number of areas relating to the use and disclosure of information contained in consumer reports.[10]

Regulators have also pushed for clarity in loan documents and financial disclosure statements by issuing the Truth in Lending and Truth in Savings regulations. These regulations establish standards that lenders must follow in disclosing the fees and interest rates they will charge on loans or pay on investment products, thus giving consumers sufficient information to shop for the best financial arrangements.

A significant increase in the volume of consumer complaints about marketing and collection practices has raised concerns among regulators about unfair and deceptive acts or practices, such as representations, omissions, or practices that are likely to mislead consumers and cause financial harm. In response, the FDIC has formally reminded institutions that they are subject to the Federal Trade Commission Act (FTC), which prohibits unfair and deceptive trade practices. Moreover, the FDIC is prepared to take enforcement actions against institutions under its regulatory control in cases where material misrepresentation affects choices made by consumers.

Increased regulatory attention has also been given to emerging consumer and regulatory issues associated with subprime lending and payday loans. In 1999 and 2001, the federal banking agencies issued guidance to address the risk and supervisory concerns associated with subprime lending.[11]

Subprime lenders serve consumers whose credit history would not permit them to qualify for the conventional "prime" market.[12] These loans carry a higher rate of interest than prime loans to compensate for increased credit risk. Regulators recognize that a well-managed subprime lending program, with appropriate capitalization and loan terms and conditions, provides an important source of credit for these consumers that otherwise may not be available to them. However, they also recognize that a subset of subprime lenders may engage in abusive or predatory practices that are harmful to consumers. The agencies have cautioned the financial institutions they supervise that such practices would be subject to criticism both on safety and soundness and consumer protection grounds during examinations.

The rapid growth of payday lending—a subset of subprime lending—and the entrance of financial institutions into this arena has given rise to increased regulatory attention. Payday loans are small dollar, short-term, unsecured loans extended to consumers with few, if any, lower-cost borrowing alternatives.[13] In light of the high-risk nature of payday loan products, the FDIC recently issued guidelines describing the agency's expectations for prudent risk management of payday lending activities and consumer protection. The guidance states that payday loans to consumers who do not have the ability to repay, or that may result in repeated renewals and fee payments over a short span of weeks, do not help meet credit needs in a responsive manner. During FDIC bank compliance examinations, payday lending programs will be subject to scrutiny under a number of statutes, including the Equal Credit Protection and Truth in Lending Acts, as well as the Community Reinvestment Act.

Regulatory and legislative action is not the only safeguard available to consumers, however. Consumers should work to protect themselves against those few creditors who may skirt around the regulation.

The Changing Need for Financial Education

New customers who are less familiar with traditional banking products and practices are likely more vulnerable to excessive interest rates or fees and disadvantageous terms. These consumers may also have access to more credit than may be manageable, which can make them vulnerable to short-term fluctuations in their finances as their indebtedness grows. Although increased credit availability is generally positive, unfettered credit access can also be problematic if consumers do not use this access wisely. Education is essential to help families evaluate the expanding array of services available to them in a rapidly changing financial market.

Financial education is also increasingly important to the broader economy. Continuing innovation in banking practices has resulted in an increasingly market-based banking system that relies vitally on timely and accurate information to operate efficiently. Educated consumers shape what services financial institutions deliver and how they deliver them. As a result, consumers that are unaware of innovations in banking will be increasingly left behind as the market continues to innovate. Innovative financial institutions responding to educated consumers will allocate capital through the economy most efficiently.

Financial Education Initiatives and the Money Smart Program

Although financial education programs, like other education policy initiatives, are difficult to measure in terms of lasting impact and usefulness, studies have shown that financial education efforts can foster positive changes in financial behavior. For example, a Federal Reserve Board study found that financial knowledge can be statistically linked to financial practices, such as cash-flow management, credit management, saving, and investment.[14] A study by Freddie Mac found that homebuyers who obtain structured homeownership education have reduced rates of loan delinquency.[15] When the National Endowment for Financial Education evaluated its high-school-based programs, it found that participation in financial-planning programs improved students' knowledge, behavior, and confidence about personal finance, and that nearly one-half of the participants began to save more after participating in the program.[16]

Financial education enables consumers to make responsible financial decisions both as individuals and

as market participants. Educated market participants contribute to the stability of the financial system and the well-being of the national economy. Thus, the federal bank regulatory agencies—charged with maintaining stability in the nation's financial system—have an intrinsic responsibility to provide financial education opportunities to the public.

Financial Education Initiatives

The bank regulatory agencies have initiated a wide variety of financial education programs. The Office of Thrift Supervision promotes financial education through its community affairs activities and partnerships with various financial education organizations, and the Office of the Comptroller of the Currency encourages bank participation in financial education initiatives. The National Credit Union Administration (NCUA) offers its "Access Across America" initiative under which the NCUA partners with federal departments and agencies to aid communities with the resources and technical assistance to provide financial services, affordable housing, and economic development opportunities. The NCUA also works with credit unions to provide opportunities for economic empowerment and access to low-cost financial services.

The Federal Reserve System recently launched a financial education initiative which includes a public service announcement by Federal Reserve Chairman Alan Greenspan.[17] The public service announcement refers consumers to the Federal Reserve's personal financial education web site which has links to additional education resources. The Federal Reserve System also created an online repository for financial education research on the web site of the Chicago Federal Reserve Bank's Consumer and Economic Development Research and Information Center (CEDRIC). In addition, the Federal Reserve Bank of Dallas offers a program to help individuals and families develop a plan for building personal wealth.

The Financial Services Education Coalition—formed by the Department of the Treasury—published a guide, "Helping People in Your Community Understand Basic Financial Services," to help financial educators teach consumers about choosing and using financial services and accounts.

Other federal agencies have developed financial education initiatives, the majority of which are geared toward school-age children. A few other educational programs are tailored to specific topics, such as homeownership, investing, and retirement preparation.

The FDIC's Money Smart Program

In late 2001, the FDIC launched its own financial education program targeted at low- and moderate-income adult consumers who are already market participants. The goal of the *Money Smart* program is to help adults enhance their money management skills, understand basic financial services offered by the financial mainstream, and build their financial confidence to use banking services effectively. The *Money Smart* curriculum is comprised of ten comprehensive instructor-led modules that cover basic financial topics, including an introduction to bank services and information on obtaining credit and buying a home. One of the benefits of *Money Smart* is its flexible curriculum; the ten learning modules can be introduced sequentially, or participants can choose specific topics to address their particular needs. This deviates from a "one size fits all" approach.

Money Smart is designed to be a formal course offered through partnerships between financial institutions and local community organizations. This delivery method was chosen in an effort to reach low- and moderate-income households, who have shown a preference for learning in a communal environment.[18] Research suggests that well-respected and well-connected community organizations have a greater understanding of the community's needs and can better communicate with prospective participants, thus helping dispel some of the cultural distrust of financial institutions.[19]

Money Smart Program Milestones

Since the introduction of *Money Smart*, the FDIC has provided over 93,000 copies of the curriculum to more than 26,400 financial institutions, faith-based and community organizations, and government agencies in cities and towns across the nation. Approximately one-fourth of the curriculum copies were provided to FDIC-insured financial institutions and to credit unions. *Money Smart* is being taught in community colleges, in churches, on Indian reservations and military installations, in pre-marriage counseling classes, in welfare-to-work programs, in prisons, and in schools.

To date, over 460 organizations throughout the nation—in both urban and rural communities—have joined in the FDIC's Money Smart Alliance. The FDIC has also entered into formal partnerships with 22 major public and private sector organizations that have a nationwide capability to deliver *Money Smart*. The organizations represent a wide spectrum of delivery systems for the financial education program-social services, financial institutions, housing services, educational services, community organizations, as well as government, faith-based, and employment services. These partnerships are a critical component in the FDIC's strategy to broaden the delivery of financial education to more consumers. Money Smart Alliance members and partners facilitate implementation of the financial education program by making contributions in a variety of ways, including promoting, delivering, translating, funding, and evaluating the program.

Money Smart is available in Spanish, Chinese, and Korean; Vietnamese-language and web-based interactive versions of the curriculum will be available soon. Over 70 train-the-trainer workshops held across the country have been attended by more than 2,000 instructors who now are qualified to teach the program.

The FDIC, assisted by the Gallup organization, undertook a survey of over 9,000 organizations to evaluate the *Money Smart* program from the perspectives of instructors. Preliminary results from a survey of *Money Smart* instructors show that 85 percent of the survey participants rated the overall quality of *Money Smart* as "very good" or "excellent." The survey also indicated that over 13,000 *Money Smart* students went on to initiate a banking relationship as a result of the program. The FDIC plans to use the results of the program assessment to determine how to improve and expand the Money Smart program in the future. The results of the Money Smart survey will be discussed in an upcoming issue of *FYI*.

Conclusion

With financial education at such a premium in today's consumer market, one would expect to see further expansion of financial education initiatives in the years ahead. Financial education can help secure the economic future of households, strengthen communities, and enhance the integrity of our financial system. Although there is a wider array of financial products and services available to consumers now than ever before, a large segment of the population still has no relationship with a bank, and households are struggling to manage debt. Financial education is a clear remedy to address these important issues.

For more information on the FDIC's *Money Smart* program, go to: http://www.fdic.gov/consumers/consumer/moneysmart/index.html.

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[1] Braunstein, Sandra, and Carolyn Welch. "Financial Literacy: An Overview of Practice, Research, and Policy." *Federal Reserve Bulletin*. November 2002. http://www.federalreserve.gov/pubs/bulletin/2002/1102lead.pdf.

[2] Transaction accounts include checking, savings, and money market deposit accounts, money market

mutual funds, and call accounts at brokerages.

[3] Aizcorbe, Ana M., Arthur B. Kennickell, and Kevin B. Moore. *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, Federal Reserve Board. 2001. http://www.federalreserve.gov/pubs/oss/oss2/2001/bull0103.pdf.

[4] Ibid.

[5] See Susan Burhouse, "Evaluating the Consumer Lending Revolution," FDIC: *FYI*, September 17, 2003. http://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html.

[6] The Debt Collection Improvement Act of 1996 (Public Law 104-134) includes a provision for mandatory electronic funds transfer (EFT) for most federal payments effective January 1, 1999. One of the purposes of this provision was to provide incentives for consumers to receive federal payments electronically through direct deposits and increase their access to accounts at federally insured financial institutions.

[7] Federal Reserve Board *Flow of Funds*.

[8] News Release, Administrative Office of the U.S. Courts, August 18, 2003.

[9] A bank may be considered a consumer reporting agency if it engages in certain types of information sharing practices.

[10] The FCRA preemption provisions are due to expire on January 1, 2004. However, the U.S. House of Representatives has passed a bill to permanently extend the preemptions, as has the Senate Banking Committee, and the full Senate is expected to take up the measure shortly.

[11] Interagency Guidelines on Subprime Lending, FDIC FIL-20-99, March 1, 1999. Interagency Expanded Guidance for Subprime Lending Programs, FDIC FIL-9-2001, January 31, 2001.

[12] "Subprime" is often confused with "predatory" or "abusive" lending practices. "Predatory lending" refers to those lenders who use certain marketing tactics, collection practices, or loan terms that, when combined, deceive and exploit consumers. The term does not apply to well-managed subprime loan programs.

[13] For more information on payday lending, see Hodson, Michelle, Serena Owens, and Steve Fritts, "Payday Lending," FDIC: *FYI*, January 29, 2003. http://www.fdic.gov/bank/analytical/fyi/2003/012903fyi.html.

[14] Hilgert, Marianne A., and Jeanne M. Hogarth. "Household Financial Management: The Connection between Knowledge and Behavior." *Federal Reserve Bulletin*. July 2003. http://www.federalreserve.gov/pubs/bulletin/2003/0703lead.pdf.

[15] Hirad, Abdighani, and Peter M. Zorn. *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling*. Freddie Mac. May 22, 2001. http://www.freddiemac.com/news/archives2001/empiricalstudy.htm.

[16] Boyce, Laurie, Sharon M. Danes, Catherine Huddleston-Casas, Mindy Nakamoto, and Amy B. Fisher. "Evaluation of the NEFE High School Financial Planning Program 1997-1998." National Endowment for Financial Education. October 1998.

[17] In the public service announcement, Chairman Greenspan states, "No matter who you are, making

informed decisions about what to do with your money will help build a more stable financial future for you and your family." http://www.federalreserve.gov/boarddocs/press/other/2003/20030519/default.htm.

[18] Hogarth, J.M., and J.A. Swanson. "Using Adult Education Principles in Financial Education for Low-Income Audiences." *Family Economics and Resource Management Biennial*, 2, 139–146. 1995.

[19] Jacob, Katy, Sharyl Hudson, and Malcom Bush. *Tools for Survival: An Analysis of Financial Literacy Programs for Lower-Income Families*. Woodstock Institute. January 2000.
Toussaint-Comeau, Maude, and Sherrie L.W. Rhine. "Delivery of Financial Literacy Programs." *Federal Reserve Bank of Chicago Policy Studies*. December 2000.

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

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Last Update date 11/05/2003

A Decreasing but Substantial Percentage of Households Do Not Hold Any Type of Transaction Accounts

Year	Percent of Households That Do Not Hold Transaction Accounts
1989	14.9
1992	13
1995	12.9
1998	9.5
2001	9.1

A Growing Percentage of Households Choose Not to Hold Transaction Accounts Because They Dislike Dealing with Banks

Year	Percent of Unbanked Households That Dislike Dealing with Banks
1989	15
1992	15.3
1995	18.6
1998	18.5
2001	22.6