Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
on
The Federal Government's Role in Empowering Americans to Make Informed Financial Decisions
before the
Subcommittee On Oversight Of Government Management, The Federal Workforce, And The District Of Columbia of the Committee On Homeland Security And Governmental Affairs;
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Chairman Akaka, Senator Voinovich and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the federal government's role in empowering Americans to make informed financial decisions.

My testimony will discuss a number of specific programs undertaken by the FDIC aimed at improving financial literacy and enabling individuals and families to build wealth. In particular, my testimony describes the FDIC's *Money Smart* program and the results of a recently completed survey of the program's effectiveness. This study substantiates the long term beneficial changes in behavior that result from financial literacy education. In addition, my testimony will discuss the importance of integrating financial education into school curriculums and FDIC activities in this area. Finally, my testimony will briefly touch on FDIC efforts to increase access to financial services and to provide alternatives to predatory lending for consumers.

The Importance of Financial Literacy

Today's financial landscape is far more complicated than just a generation ago when many individuals' financial transactions were limited to checking and savings accounts and perhaps a home mortgage with their local bank. Deregulation and technological and market innovations over the past forty years have vastly expanded the types and providers of financial services available to the average consumer. In the current financial marketplace, transactions are increasingly occurring outside of bank branches, electronic payments are usurping cash and checks, and new credit products are being created to reach all sectors of society.

A consequence of the growth in new financial products and services that have facilitated the "democratization" of credit is that financial knowledge has become an essential ingredient for intelligent consumer choice. While innovations in the financial services industry have dramatically improved many households' access to credit, this improved access has not always resulted in improvements in household welfare. Lack of adequate financial knowledge can lead consumers to make poor financial decisions.

Recent problems in the subprime mortgage market illustrate how increasingly complex products can lead to poor product choices for consumers who do not fully understand them. Beginning in 2003, complicated new financial products -- particularly, the so-called “2/28” or “3/27” mortgages and other hybrid adjustable rate mortgages (ARMs) -- exploded in popularity in the subprime market. These loans are characterized by a low initial starter rate that increases significantly after the first two or three years under complex formulas, creating a “payment shock” of 30 percent or higher and rendering the loan unaffordable for many borrowers. In some cases aggressive or misleading marketing of the lower starter rates, without full disclosure of the significantly higher costs, obscured key features and costs of the loans. Moreover, there often existed other options than a hybrid ARM -- such as a fixed rate loan with the same lender -- that would have avoided the payment shock altogether for only a marginally higher payment in the early years of the loan.[1]

In a July 2004 study,[2] the Consumer Federation of America (CFA) concluded that the consumers most likely to purchase complex ARMs were among the least likely to understand these products. In a 2006 follow-on study,[3] the CFA found that consumers using interest-only and payment-option ARMs were more likely to be from a middle- to lower-income population segment, minorities, and have weaker than average (less than 700 FICO) credit scores. These findings, while inconclusive, raise questions about the marketing of these products and are consistent with other research that raise issues about the level of understanding of some consumers regarding sophisticated mortgage products. Better informed consumers could have recognized that the tradeoffs presented by these products -- a lower payment during the first few years with a later reset to a high, if not unaffordable payment -- did not make financial sense in their situations and that the long term costs of these products were much more expensive than more appropriate fixed rate products, in spite of the low starter rate.

The rapid proliferation of hybrid ARMs versus other options suggests that many borrowers either did not understand or were not told about other, less volatile, products. While financial literacy is not a panacea and does not excuse irresponsible lending, a more informed consumer population might have recognized the problems with these products and demanded appropriate fixed rate products -- limiting the issues we confront today in the subprime mortgage market. I have called for national standards to address many of the problems and abuses that are now coming to light in the subprime mortgage market. These standards could impose underwriting based on the borrower's ability to repay the true cost of the loan, especially among the non-bank lenders currently operating with little or no regulatory oversight. It should also address misleading or confusing marketing that prevents borrowers from properly evaluating loan products. However, even with new national standards, there is only so much regulators and the legal system can do. A comprehensive solution requires consumers who have sufficient financial educational tools to protect themselves against inappropriate or, in some cases, predatory products.

Survey evidence suggests that inadequate financial knowledge is pervasive among many segments of society. The April 2007 National Foundation for Credit Counseling (NFCC)[4] consumer financial literacy survey finds that many American consumers do not follow basic sound financial management practices. In particular, of those surveyed:

- Only 39 percent track expenses;
- Less than half have ordered their credit report;
- 38 percent do not pay credit card bills in full each month; and,
- One-third do not know where to go for financial advice.

In addition, low- and moderate-income families who lack basic financial skills are exposed to magnified financial hardships when they are forced to manage financial shocks from unexpected healthcare emergencies, death, or household job loss.

Money Smart

Money Smart was developed by the FDIC in 2001 to help low- and moderate-income adults enhance their money management skills, understand basic mainstream financial services, avoid pitfalls and build financial confidence to use banking services effectively. This summer, the FDIC will be issuing an updated version of the *Money Smart* training program that will include a component to help consumers evaluate and compare different types of mortgage products, in particular those that can create problems for subprime borrowers such as hybrid ARMs. More than 864,000 adults have attended at least one financial education class using the *Money Smart* curriculum.

To augment the *Money Smart* program, the FDIC has worked to establish partnerships with community and banker coalitions to blend a strong financial curriculum with service programs and proven asset-building strategies. Also, the FDIC encourages financial institutions to develop partnerships with community-based organizations and other local entities, such as housing authorities, to offer *Money Smart* classes.[5] Research suggests that established community organizations that understand local community needs are in a strong position to deliver effective training even where there may be a cultural distrust of financial institutions.[6]

Quantifying the Benefits of *Money Smart*

Measurement is an important aspect of determining the success of financial literacy programs and their efficacy in improving consumers' ability to make informed financial decisions. A number of studies have shown that financial education efforts can foster positive changes in behaviors and better equip people to make appropriate financial decisions.

A 2001 study found that participants in a state-mandated financial education high school curriculum had measurably larger asset holdings in adulthood.[7] In another example, a study by the National Endowment for Financial Education (NEFE)[8] found that, three months after completing a financial education course, high school students positively changed their spending and savings patterns in response to the course. About 30 percent of students began to save, 37 percent reported improved self-monitoring of their spending, and almost 50 percent indicated that they were better prepared to analyze credit costs. These findings were consistent with prior studies on the efficacy of high school financial curriculum.[9]

One 2002 study of the literature on the effectiveness of financial literacy training concluded that the type of training, the timing, and participants' comfort with change and other behavioral factors are important determinants of whether individuals are able to adopt better financial behaviors. The study also concludes, however, that "while financial literacy training programs have clearly proliferated, research measuring the effectiveness of the training has not kept pace."[10] It is especially true that most research like the data cited above does not fully measure the long-term impact on adult behaviors.

To address this gap in the research, the FDIC has just completed a major multi-year study designed to measure the effectiveness of financial literacy training, specifically training using the *Money Smart* curriculum. The goal was to measure, over time, not only whether trainees' knowledge of financial matters improved, and whether they *intended* to change their financial behaviors, but also whether, months after the training, they had actually acted on their intentions. The study was conducted to determine the effect of financial education on participant behavior regarding basic banking, saving, budgeting, and credit.

This study, which was conducted in cooperation with NeighborWorks America, consisted of a three-part survey of participants in *Money Smart* courses across the country. The FDIC engaged The Gallup Organization to assist with the development of the survey questions and to administer the survey. The assessment used a pre-training survey to gather baseline data on students' knowledge, behaviors and confidence, a post-training survey to gather data on changes in participants' knowledge, behaviors, confidence and their future intentions, and a telephone follow-up survey six to twelve months after the conclusion of the training to identify changes in those factors.

The findings suggest that *Money Smart* financial education training, covering the basics of checking, saving, budgeting, and credit, can positively change consumer behavior and improve financial confidence. The six to twelve month follow-up survey determined that, after taking the *Money Smart* training, participants were more likely to open deposit accounts, save money in a mainstream deposit product, use and adhere to a budget, and have increased confidence in their financial abilities. Among the key findings, the survey determined that immediately after completing the course:

- 69 percent of respondents reported an increase in their level of savings,
- 53 percent reported their debt decreased, and
- 58 percent stated they were more likely to comparison shop.

The follow-up survey also revealed:

- 13 percent of participants who already had a checking account after the training opened a different type of account at the same institution and 22 percent opened a checking account at a different financial institution by the time of the follow-up survey, thereby evidencing the participants' ability to comparison shop,
- 43 percent of those without a checking account opened a checking account after completing the course,
- 37 percent of those without a savings account opened a savings account after completing the course,
- 28 percent of those with checking accounts and 22 percent of those with savings accounts began using direct deposit for the first time at the end of the course,
- 61 percent of those not using a spending plan/budget at the end of the course used one by the time of the follow-up survey,
- 95 percent of those who used a spending plan/budget at the end of the course still used it at the time of the follow-up survey, and
- There was a 12 percentage point increase in those who "always" pay bills on time between the beginning of the course and the time of the follow-up survey.

The findings of the survey demonstrate that financial education programs can have a positive impact and, hopefully, will act as an incentive for more banks to offer financial education programs as a means to open accounts and build long term customer relationships. While the FDIC is proud of the improvements in financial literacy indicated by the *Money Smart* survey, there is still much work to be done in this area.

Expanding Financial Education in Schools

Building on the verified success of the *Money Smart* program, the FDIC has embarked on a pilot project to further integrate the *Money Smart* curriculum into public schools. Responsible and prudent financial practices should start early to teach good habits to young consumers. Therefore, to increase the availability of financial education for students, the FDIC will contact 120 school systems and related government entities during 2007 to recommend the use of the *Money Smart* curriculum, which has been unanimously endorsed by the Board of Directors of the National School Boards Association (NSBA), for use in public schools. At the same time, we are distributing -- through schools, churches, and other venues -- copies of a special edition of the FDIC's consumer newsletter for teenagers, and another newsletter for young adults becoming financially independent.

A number of states have already integrated *Money Smart* into their educational programs. Allegany County, Maryland high schools use *Money Smart* in business education and family and consumer science classes. In Virginia, many schools are utilizing *Money Smart* in middle and high schools to comply with state legislation mandating economic and personal financial education instruction performance standards. Some jurisdictions, such as Blairsville, Georgia and Long Island, New York, require completion of a financial education program as a condition for graduation and *Money Smart* has been approved for this purpose. In Hawaii, the Department of Education's Adult Education Program incorporated two *Money Smart* modules into their computer-based High School Diploma Program.

School based financial education can also include guest lecturers. For example, the Hawaii Division of Financial Institutions has a pilot program to train their bank examiners to teach *Money Smart* modules to elementary and middle school students at public schools in Honolulu. A New York bank used *Money Smart* to develop a financial education curriculum for elementary and middle schools. In Kansas, the FDIC has coordinated *Money Smart* classes for an *Upward Bound* summer program for at-risk high school students for the past three years.

In addition, many states such as Massachusetts have developed school banking programs that provide practical financial lessons for students. Building on these programs, the FDIC is developing school based initiatives as part of its Alliance for Economic Inclusion (AEI), a new national initiative to establish broad-based coalitions of financial institutions, community-based organizations and other partners in nine markets[11] across the country to bring more unbanked and underserved populations into the financial mainstream. In these initiatives, the FDIC provides technical assistance to financial institutions and others interested in establishing student-run bank “branches” in high schools. This model has a number of potential positive outcomes including integrating financial education into core classes and/or career pathways; job-training and resume building for students; and expanded access to mainstream financial services for students, faculty and their families.

For example, FDIC staff facilitated the opening of a student-run bank “branch” in a metro-Chicago area high school that, since its inception, has opened 270 accounts and has deposits of over $200,000. In addition, a bank is working to establish a student-run bank “branch” in a central California high school. In Los Angeles, AEI members hope to partner with the Los Angeles Unified School District to promote a “Junior Banker Savings Account” in elementary schools for students between the ages of 8 and 13. The account can be opened with just $1, students will not have to pay fees, and every deposit earns a stamp that can be used toward a reward -- a gift certificate from merchants such as McDonalds or Barnes and Noble.

Other Financial Education Activities

The FDIC partnered with NeighborWorks America to produce and deliver a financial education and housing recovery curriculum for those affected by the 2005 Gulf Coast Hurricanes. This curriculum, *Navigating the Road to Housing Recovery*, provides practical information for families faced with financial decisions related to building, rehabilitating, selling or buying a home after the hurricanes.

Additionally, over the past four years, FDIC has conducted numerous financial education outreach and training events on military bases around the country to teach the fundamentals of money management, ways to avoid the pitfalls of high cost loans and strategies for steering clear of predatory lending. Beginning last year, the FDIC expanded these efforts by providing financial education to military families through collaboration with the Department of Defense, the Corporation for Public Broadcasting, New River Media, and local PBS stations.

Activities Beyond Financial Literacy

Offering a financial education program does not compensate for lenders offering high cost products that do not benefit consumers, particularly low- and moderate-income consumers. It does little good to encourage consumers to comparison shop if alternatives to high cost products are not available to them. The FDIC is actively involved with integrating financial education into broader initiatives that are designed to promote asset-building and access to mainstream financial services. Along with financial institutions and other partners, the FDIC is working to bring currently unbanked and underserved populations into the financial mainstream through innovative low cost products and services, and expanded financial education efforts. These include savings accounts, affordable remittance products, small dollar loan programs, targeted financial education programs, alternative delivery channels, and other asset-building programs.

Affordable Small Dollar Loans

High cost loan products can push consumers deeper into debt. Unfortunately, many people who use high cost products, such as payday loans, already have checking accounts but do not turn to their banks for potentially lower cost forms of credit. Banks, in particular, can do more to expand financial services to underserved consumers by providing affordable small dollar loans with a savings feature and other services such as financial education.

The FDIC is encouraging institutions to use the Affordable Small Dollar Loan guidelines proposed last year by the FDIC, to develop low cost, small dollar loans coupled with savings vehicles. Many lower income families have few alternatives when faced with a financial shortfall. Through this type of lending, banks can help families manage their short term credit needs and build a savings cushion for emergencies.

The FDIC also has started to explore incentives for banks that offer wealth-building products targeted to the underserved. FDIC-supervised banks that offer low cost alternatives to payday loans in a manner consistent with our guidelines, including a savings component, will receive favorable consideration under the Community Reinvestment Act as an activity responsive to the credit needs of the community.

Subprime Adjustable Mortgages

As was discussed earlier in this testimony, many low- and moderate-income homeowners are struggling to make payments on high priced ARMs with rising payments. Repeat refinancings have taken equity from their homes and adjustable rate features have challenged their ability to continue making payments. In previous years, many of these borrowers could have refinanced their mortgages or sold their homes at a profit to repay their debt in full. Now, as home prices have stagnated or even declined in many areas of the country, more borrowers find themselves trapped in mortgages they cannot afford to pay.

Subprime borrowers are particularly at risk because they already have very little financial cushion. Subprime borrowers spend nearly 37 percent of their after-tax income on mortgage payments and other costs of housing -- roughly 20 percentage points more than prime borrowers spend. Of ARMs originated in 2006, a full 24 percent have negative home equity -- in other words, they owe more than their homes are worth. Financial stress on subprime borrowers with adjustable rate mortgages will increase further as rates reset.

The evolving problems in the subprime mortgage market are a major concern of the FDIC. In March, the FDIC and the other federal banking agencies issued for comment supervisory guidance to address the underwriting and marketing of subprime adjustable rate mortgages.[12] While the recent supervisory guidance is directed at preventing future abuses, there remains the urgent issue of how to address the current circumstances of many borrowers who have mortgages they cannot afford and have little prospect of refinancing given today's real estate and loan market conditions. As industry dialogue continues regarding what other steps are needed, we intend to work closely with the NeighborWorks America Center for Foreclosure Solutions and others on expanding targeted financial education and housing counseling efforts to help consumers.

The Center is already convening and supporting a coordinated foreclosure prevention and intervention strategy in communities nationwide. One such effort the FDIC has supported is in Chicago. Through a partnership with the city of Chicago and financial institutions, Neighborhood Housing Services of Chicago has prevented more than 700 foreclosures in the past 18 months. Other "hotspots" for foreclosure intervention include Ohio, where foreclosures have more than doubled in the last five years, and metropolitan Atlanta, where the number of failed mortgages has more than doubled between 2000 and 2005. Efforts for these cities will include deploying triage strategies to help as many homeowners as possible avert foreclosure.

Conclusion

The FDIC considers financial education to be an essential component of our activities on vital issues facing consumers, markets and communities today. Not only is financial literacy essential to evaluate the multitude of choices available to consumers, but this knowledge serves to protect informed consumers from bad products and scams. A consumer who knows the right questions to ask, understands economic fundamentals and has the confidence to challenge products and practices that seem "too good to be true" is a regulator's best weapon in consumer protection.

The recent survey results demonstrate that programs like *Money Smart* can be effective in changing and improving the financial lives of consumers. While the FDIC is pleased with the survey results, we are not satisfied. Many populations still need improved education and services to enter the financial mainstream. As a member of the Financial Literacy and Education Commission, the FDIC will join with our governmental colleagues to continue working to achieve this goal.

This concludes my testimony. I would be happy to answer any questions from the Subcommittee.

[1]Testimony of Chairman Shelia C. Bair on “Subprime And Predatory Lending: New Regulatory Guidance, Current Market Conditions, And Effects On Regulated Institutions” delivered to the Subcommittee On Financial Institutions And Consumer Credit Of The Committee On Financial Services U.S. House Of Representatives on March 27, 2007.

[2]“Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Rate Mortgages,” Consumer Federation of America, July 26, 2004. At the time of the study, 64 percent of respondents preferred fixed rate mortgages. Those that preferred fixed rate mortgages provided answers that indicated an understanding of the risks of ARMs. Many that preferred fixed rate mortgages expressed concern that interest rates and mortgage payments would increase over time. The 25 percent of sample respondents that preferred ARMs were poorer, younger, and less-well educated than those that preferred fixed rate mortgages.

[3]“New Analysis of Non-Traditional Mortgage Borrowers Shows Less Wealthy, Weaker Credit Than Industry Suggests,” Consumer Federation of America, May 24, 2006.

[4]“A Teachable Moment’ and a New Mission,” The National Foundation for Credit Counseling, April 23, 2007.

[5]FDIC-regulated institutions received a letter from the FDIC making them aware of Money Smart (FIL-58-2001, July 8, 2001), and federal credit unions were made aware by a letter sent by the National Credit Union Administration (Letter No.: 01-FCU-06, September 2001).

[6]Jacob, K., Hudson, S., and Bush, M. (2000). Tools for Survival: An Analysis of Financial Literacy Programs for Lower-Income Families, Woodstock Institute. Toussaint-Comeau, M., and Rhine, S. L. W., 2000. Delivery of Financial Literacy Programs, Federal Reserve Bank of Chicago Policy Studies.

[7]Bernheim, B. Douglas & Garrett, Daniel M. & Maki, Dean M., 2001. "Education and Saving: The Long-Term Effects of High School Financial High School Curriculum Mandates," July 1997, NBER Working Paper No. W6085.

[8]Danes, S. M. 2003-2004 Evaluation of the NEFE HSFPP, http://www.kdcms.com/nefe/company1/content/273/2003-2004%20nefe%20hsfpp%20evaluation.pdf 1.22MB (PDF Help)

[9]Danes, Sharon M., Catherine A. Huddleston-Casas and Laurie Boyce. 1999. Financial Planning Curriculum for Teens: Impact Evaluation. *Financial Counseling and Planning*, Volume 10 (1).

[10]Braunstein, Sandra and Carolyn Welch. 2002. Financial Literacy: An Overview of Practice, Research, and Policy. *Federal Reserve Bulletin*, November, page 449.

[11]Chicago, Illinois; Baltimore, Maryland; Austin/South Texas; Louisiana and Mississippi Gulf Coast areas; semi-rural areas of Alabama; Greater Boston, Massachusetts; Wilmington, Delaware; Los Angeles, California; and Kansas City, Missouri.

[12]The guidance focuses on two fundamental consumer protection principles. First, a loan should be approved based on a borrower's ability to repay according to its terms (not just at the initial rate, for example). Second, borrowers should be provided the information necessary to understand a transaction at a time that will help them decide if the loan is appropriate for their needs. The FDIC and the federal and state banking agencies feel strongly that clear, common sense standards regarding the underwriting and marketing of subprime adjustable mortgages are necessary to protect consumers and reinforce market discipline, while preserving a flow of capital to fund responsible lending.

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