The Federal Reserve Board

# Remarks by Governor Mark W. Olson

**At the America's Community Bankers 2003 National Compliance and Attorney's Conference and Marketplace, San Antonio, Texas**
**September 22, 2003**

## Increased Availability of Financial Products and the Need for Improved Financial Literacy

I am pleased to be here today as you begin your meetings that relate to a wide range of retail banking issues. The breadth and scope of the topics to be addressed at this conference reflect the rate of change in the banking industry, as well as the ever-increasing role of the consumer in this industry. Certainly, the world of financial services has transformed since I began my banking career nearly forty years ago. Perhaps even more remarkable is the pace at which these changes have occurred, with many taking place over the course of the past decade. Technology, deregulation, and product innovation have redefined the way in which financial institutions conduct every aspect of their business, from originating loans to delivering products and services. Today, I would like to offer some compelling information on the nature and scope of these changes, as well as their impact on the availability of financial services to consumers. Finally, I will address how the current marketplace for financial services has brought about shared responsibilities and increased opportunities for the users, providers, advocates, and regulators of financial services.

Although my topic today is somewhat more broad than the general theme of this conference, I believe it is appropriate for two reasons. First, your industry is in continual evolution and I want to give this group the benefit of the implications of these changes from my vantage point. Second, marketplace changes often generate either new regulations or suggestions for new regulations. The collective response of your members to these changes may well help determine the agenda topics for future meetings of this group.

**Evolution of the Consumer Financial Services Industry**
Many of the changes in the delivery and production of financial services are directly attributable to advances in technology and telecommunications. Just as it has in nearly every other area of the economy, technological progress has dramatically increased organizational efficiency and enhanced consumer convenience in the financial services industry. Take, for example, automated teller machines (ATMs), which emerged about twenty years ago as one of the first means for electronic service delivery in banking. Today, ATMs are ubiquitous and continue to gain acceptance by consumers. Data from the Federal Reserve's most recent Survey of Consumer Finances (SCF) indicate that 57 percent of families with banking relationships use ATMs to access their accounts, a proportion that increased by nearly 67 percent from 1995. Similarly, consumers have increased their usage of automated clearinghouse services, with the number of families using electronic deposit and debit services increasing by about 20 percentage points between 1995 and 2001. In addition, consumer use of computers to conduct financial activities continues to grow in popularity: The 2001 SCF data revealed that 19 percent of families accessed at least one of their accounts via the Internet, which is five times more than the number of families responding to this question on the 1995 SCF.

Technological advances in account access and processing mechanisms have had considerable impact on the delivery of financial services. However, the development of credit scoring technology has had the most significant effect on the evolution of the financial services industry. The widespread use of computer models to evaluate and predict credit risk has had a tremendous impact on institutions' ability to reduce underwriting costs and has increased opportunities for identifying new customers. Because of the efficiencies and consistency in risk profiling that credit scoring offers, creditors have continually sought to apply this technology to new areas of lending. The use of credit scoring models has migrated from its origins in unsecured consumer credit to its application in mortgage lending and, more recently, small business credit and insurance underwriting. In addition, the use of credit scoring technology has created other important efficiencies within the industry, most notably, enabling lenders to more effectively price for risk and package loans for sale in the secondary market. The use of credit scoring technology has made the credit approval process increasingly impersonal. At the same time, however, credit approvals are increasingly age- race- and gender-blind, which has contributed to what my predecessor Federal Reserve Board member Lawrence Lindsey referred to as the "democratization" of credit.

Coinciding with the technological advancements, significant policy changes have contributed to greater efficiency and competition in the financial services market. Low interest rates have increased the affordability of credit, and deregulation has significantly broadened the number of credit-product providers. In fact, the number of sources for credit now available to consumers is so broad that it is difficult to quantify. In a recent effort to identify the number of institutions offering credit in today's marketplace, Federal Reserve Board staff estimated that more than 75,000 lending institutions extend consumer credit, ranging from banks and credit unions to mortgage companies and payday lenders.

**Impact of Industry Changes on Consumers**

The culmination of improvements in information processing technology, product innovation, the relaxation of regulatory restrictions, and enhanced competition has helped lower costs and increase accessibility to credit. The expansion of the consumer lending market has created new opportunities for households to match their short-term spending needs with their longer-term stream of income, helping them to achieve their broader financial and life goals. Consumers who have traditionally had difficulty gaining access to credit from mainstream financial institutions have particularly benfitted. Over the past two decades, the proportion of households using credit has risen dramatically. Evidence from the Federal Reserve's SCF shows that the proportion of all households with outstanding debt increased 5 percentage points between 1983 and 2001. During the same time, the median debt level of households more than doubled, to about $40,000, with most of this volume increase relating to mortgage debt.

The SCF findings indicate that one result of the ongoing financial-market changes has been the democratization of credit. A review of the use of credit across income groups over the past two decades shows the level of debt has increased sharply in all income groups, and the median level of debt has doubled for each group. Notably, the strongest growth in the proportion of families having any debt occurred in the lowest two quintiles of the income distribution, with the proportion increasing by about 20 percent in each group.

Given such trends, some observers have expressed concern that recent increases in the use of credit among lower-income and less financially sophisticated households could lead to financial distress for these possibly more vulnerable households. However, data from the SCF may alleviate some of these concerns. Over the 1992-2001 interval, households' payment-to-income ratio, an expression of debt burden, increased by less than a percentage point at the median. Although this ratio grew more strongly in the lowest-income bracket, by 4 percentage points, the most recent level for lower-income households is still not much higher than that for all households.

Perhaps more revealing as an indicator of financial distress is the proportion of households with very high debt burdens--that is, those households dedicating more than 40 percent of their income to debt payment. This measure rose only slightly over the period for debtor households overall, as well as for lower-income debtors. However, the proportion of low-income debtor households with high payment burdens was more than two times higher than that of all debtor households. A similar picture emerges from the examination of the incidence of late payments. The SCF data show an increase of 1 percentage point in the frequency of late payments made by all debtor households from 1992 to 2001. The rate of late payments by low-income debtor households increased by 2.4 percentage points during this time frame, and the rate of payments late by sixty days or more was nearly twice as high for lower-income households. Although these financial struggles are very difficult for the households involved, it is important to bear in mind that such late-payment performance is a pressing problem for only a small proportion of overall debtors in any given year.

More important than just knowing the increased levels of debt that have resulted from the democratization of credit is understanding how access to credit has increased households' capacity for achieving asset accumulation. Home ownership, of course, is perhaps the best illustration of how access to credit can create new wealth-building opportunities. The 2001 SCF data show that the percentage of families owning their primary residence increased by 1.5 percentage points since 1998. Similarly, gains in home ownership in the two lowest income groups increased by 1.8 and 2.0 percentage points, respectively. The benefits that the democratization of credit have conveyed can also be seen by looking at the growth in consumers' holdings of nonmonetary assets, including homes, automobiles, and businesses. Between 1983 and 2001, the percentage of all families holding these assets increased by 6.4 percentage points. More noteworthy is the proportion of families in the lowest income category owning such assets--this group grew by 16.4 percentage points during this time, more than 2.5 times the rate for all families.

**Role of Consumers in Retail Banking Portfolios**

Given the proliferation of consumer products and the democratization of credit, it comes as no surprise that consumers account for an increasing share of assets and profits for commercial banks, which experienced a three-decade high in return on assets in 2002. Household borrowing was a significant contributor to banks' positive financial performance last year, particularly in residential mortgage lending. For commercial banks, this asset class grew by 20 percent in 2002, and home equity loans expanded by nearly 40 percent. Further, consumer installment loans in commercial bank portfolios grew by 7.3 percent. Consumer activity also contributed significantly to banks' profit margins in 2002. Fees generated by mortgage lending was a factor in the 6.6 percent growth in non-interest income by banks last year, while revenue generated from deposit accounts expanded at a double-digit rate for the third consecutive year.

Data on the increasing level of consumer financial activity and its positive impact for both households and banking institutions demonstrate the mutually beneficial relationship that exists between consumers and retail banking institutions. Such information also underscores that, in today's current market, the success of consumers and the performance of financial institutions are directly correlated. As credit use by consumers continues to grow to historically high levels, and as bank profits associated with consumer lending reach new heights, concerns over the potential negative side effects of the democratization of credit are likely to grow as well. Further, the financial stability of consumers and banks has tremendous implications for the success of communities and markets. With such broad consequences come widespread responsibilities for facilitating efficiency and effectiveness in the retail financial services market. As such, I believe that there are four points of responsibility for ensuring positive outcomes in consumers' financial experiences: (1) the consumer, (2) financial service providers, (3) community groups, and (4) regulators.

**Relationship between Innovation and Education**

As history has shown, the rate of change and the pace of innovation will only continue to increase within consumer retail markets. This is true of retail financial markets as well. The net result of these changes is that an ever-increasing number of consumers will be able to access an ever-increasing number of financial products. That scenario suggests both increasing benefit and increasing risk for consumers of financial products. When they are appropriately evaluated and used financial products allow an increasing number of people to achieve financial goals previously considered out of reach. In contrast, inappropriate or careless use of financial products can put a consumer in a deep financial hole from which it can be both difficult and time consuming to recover.

The weight of the responsibility for supervising one's personal financial circumstances is enormous and unrelenting. Consumers must be vigilant in revisiting their decisions, reassessing priorities as their life circumstances change, and modifying their strategy accordingly. Consumers should regard access to credit as one of their most valuable assets and take care not to abuse or overuse it, so that credit will be available to them as they seek to realize future financial and life goals.

The second point of responsibility in consumer markets resides with financial service providers. With the myriad of products and services available, the financial service providers offer the most sophisticated retail goods in the service sector. Consequently, both banks and nonbanks bear a fundamental duty to provide consumers with information that accurately represents the terms and conditions associated with their products and should take care to avoid deceptive language in marketing materials. In addition, financial service providers have an implicit obligation to serve customers in good faith by extending products that are appropriate to their financial position. For example, granting a loan to an uncreditworthy borrower has negative consequences for both the customer and the creditor. Today, many consumers, including college students, are inundated with offers for credit, ranging from direct mail solicitations to store sales promotions. Lenders must remain committed to due diligence and underwriting standards that will result in reasonable levels of debt for a consumer. In their efforts to bolster profits generated from fee-based products and services, financial service providers should be mindful of associated consumer protection implications when pricing their products. Many benefits can accrue to institutions that are attentive to their customers, whether institutions seek to enter new markets, such as immigrant populations in which language and cultural considerations present new challenges, or when institutions seek to deepen their financial relationships with existing customers. In addition, acting in good faith can reduce the likelihood of new regulatory requirements designed to ensure fair practices.

The third point of responsibility in the oversight of the consumer financial services market resides with consumer and community groups. With close ties to their constituencies, these groups are uniquely positioned to understand the needs for financial products and services and to aid in the development of products to meet them. Their mission to increase opportunities for economic success in their neighborhoods makes community groups effective advocates to ensure that economic opportunities are extended to groups that are often underrepresented and underserved. Over the past 30 years, these organizations have been instrumental in helping lower-income families purchase homes, start businesses, and accumulate savings to help them gain control of their personal finances. As credit becomes more readily available in previously underserved markets, community groups should help respond to the corresponding need for greater financial education.

The final point of responsibility lies with the agencies that regulate financial service providers. Given their perspective and authority, regulators play an essential role in ensuring that pertinent and accurate information is provided to consumers who are contracting for financial services. In performing this role, the goal is also to help consumers understand the fundamental aspects and implications of financial transactions, including their associated costs and contractual terms. By defining standard terminology, regulators enable consumers to comparison shop for their financial services. By establishing the boundaries of acceptable practices and taking action against institutions that violate these standards, regulators help protect consumers from unfair and unscrupulous policies. For financial institutions, agencies offer guidance that assists them in developing policies and products that are safe and sound and fair to consumers. With concern for the viability of financial institutions and the well-being of consumers, regulators seek to create regulations, policies, and guidance that achieve adequate protection for consumers without creating undue regulatory burden that could restrict the provision of credit and other banking services.

Specific regulatory and supervisory actions taken in recent years demonstrate how these tools are applied to address both consumer protection and safety-and-soundness issues. In response to increased concerns about abusive lending practices in the home equity market and the detrimental impact they have on consumers, the Federal Reserve amended regulations implementing the Home Ownership Equity and Protection Act (HOEPA) and the Home Mortgage Disclosure Act (HMDA). HOEPA's provisions are triggered by high rates or fees, and changes in the regulation have increased the number of high-cost loans subject to the law, required additional disclosures to consumers, and prohibited the use of certain contract provisions. Recent HMDA amendments require the reporting of pricing data on loans with rates that exceed a level defined by the Federal Reserve Board, as well as require the identification of loans subject to HOEPA. The collection of these data will enable regulators to gain new insight into trends in subprime lending and conduct research on the implications of the cost of credit for various groups and communities.

In addition, interagency guidance was issued to banks on managing risks relating to subprime and credit card lending. The guidance issued on subprime lending clarifies the characteristics of a subprime loan program and what factors should be considered in determining adequate capital levels to support subprime lending. A list of potentially predatory or abusive lending practices that could be subject to criticism by examiners is also provided. In managing an institution's risk profile for credit card lending, the agencies have stipulated that bank management should adopt policies and procedures that consider the repayment capacity of borrowers, direct the timely repayment of over-limit amounts, and require minimum payments that will amortize the current balance over a reasonable period of time.

The four points of responsibility for consumers' financial experiences I've discussed bring about a dynamic, productive tension within our banking system. While the tension among these four groups can be contentious at times, effective collaborations often emerge that result in positive outcomes for consumers, financial institutions, and markets. The topic of financial education is one example of how cooperation and partnership among all of these parties has increased the resources devoted to improving consumer financial literacy.

In recent years, the importance of financial education has received increasing attention from policymakers and consumer interest organizations. High-profile consumer issues, such as predatory lending and the record levels of personal bankruptcy filings, have illustrated the devastating consequences that abusive and inappropriate contract terms, coupled with insufficient financial acumen, can have on individuals and families. As a result, many effective initiatives and collaborations by the stakeholders that I noted previously have been established to help increase the availability of financial education resources. Results of a recent survey conducted by the Consumer Bankers Association indicate that 98 percent of the banks responding to the survey sponsor or support financial literacy programs that range from mortgage and home ownership counseling to efforts to combat predatory lending and assist unbanked populations. The National Community Reinvestment Coalition, a community advocacy organization, has undertaken a financial literacy campaign in partnership with banks to provide materials and training to community leaders, bankers, and government agencies to further financial education for adults, youth, and businesses in lower-income neighborhoods. Other nonprofit organizations, such as the Jump$tart Coalition and the National Endowment for Financial Education, actively promote financial education to youth through collaborations with schools. The Federal Deposit Insurance Corporation developed a comprehensive financial education curriculum that it offers to organizations seeking to provide training courses to their audiences. This past spring, the Federal Reserve launched a national financial education awareness campaign in both English and Spanish that includes a public service announcement, a brochure highlighting fundamental strategies to improve financial behavior, and a web site to help consumers identify additional education and information resources.

These activities represent only a small variety of the financial education efforts under way throughout the country. Many other organizations and partnerships that have embraced their responsibility to further financial education and are providing critical support to consumers. All of these efforts make an important contribution to the ongoing evolution of the financial services industry by creating informed and educated customers who can effectively choose and demand products that further their economic and life goals.

As you begin your meetings, I urge you to think creatively about ways to leverage your role by capitalizing on the responsibility of the other players in this industry and in your communities. As we have seen happen in financial education efforts, tapping into the commitment of each group--consumers, financial institutions, consumer groups, and regulators--can result in new opportunities for all.

Return to top

2003 Speeches

---