Remarks by Governor Edward M. Gramlich

Financial literacy
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I am pleased to be here to address financial literacy, an issue that is very important to the Federal Reserve. We have a long history of involvement in economic education activities and have always considered them to be integral to our mission.

Historically, many of our programs have centered on promoting an understanding of economics and, in some cases, technical training in monetary policy. In the past few years, however, the Federal Reserve has increased its focus on financial literacy. Our Public Affairs and Community Affairs officers have embarked on a national initiative to highlight the importance of financial literacy education and increase the visibility of local programs.

The reasons are obvious. There is a strong link between financial literacy and our other economic objectives. All markets function best when participants are educated. If housing markets are working well, communities thrive. Additionally, our consumer protection responsibilities underscore the need for increased consumer education. As Chairman Greenspan stated in recent Senate testimony on this subject, "An informed borrower is simply less vulnerable to fraud and abuse."

Emergence of Financial Literacy as an Issue
Why has financial literacy become such an important topic? It is hard to believe that consumers are inherently less informed than they were several years ago. Rather, we find the explanation on the other side of the market: that the demands of the new financial services marketplace have created a greater need for financial literacy training. This need is not confined to people of any particular income or educational level. Americans of every income and educational background want additional tools and training to address the complexities of personal finance.

There are several reasons behind this phenomenon. First, the plethora of products now available in the marketplace force people to make complex decisions on products--even those for the simplest everyday transactions. Years ago, the average person had two basic banking products, a checking account and a passbook saving account. These were easy to open and maintain. Now, consumers may be offered six to twelve banking products--products with fees that pay interest; those with no fees but also no interest; those with no fees but with limits on the number of transactions each month; those with overdraft protection; and so forth. All these new features may improve potential consumer welfare, but they also increase the complexity of decisionmaking.

This product complexity also applies to savings instruments, which now include money market accounts, certificates of deposit, and other products with differing maturities and

yields, some of which may not be covered by deposit insurance. Again, potential consumer welfare has increased, but so has complexity.

Another major change in the marketplace relates to consumers' increased involvement with asset-building products. More people than ever before have stock portfolios and mutual funds and make their own long-term investment decisions. According to the Federal Reserve's Survey of Consumer Finances, from 1989 to 1998, the number of families with either direct or indirect stock holdings rose by 54 percent.[1]

Years ago, many people spent their entire careers in one job and then upon retirement received social security and, if they were lucky, a company pension. Generally, post-employment income streams were sufficient for retirement living. Now, most people do not rely on social security income alone to support them in their post-employment years. Most company pension programs include 401(k) or defined-contribution plans, for which individuals must evaluate several options for investment and make decisions that will affect the financial outcome for the rest of their lives. Additionally, debate continues about whether to give individuals investment options for their social security contributions. Offering consumer options such as these presumes an educated workforce and potentially exposes a broad array of workers to increased economic risk in making financial decisions.

Demographic shifts in our population also point to the heightened need for financial literacy. Aging baby boomers are becoming increasingly more responsible for their own retirement income security. Young people are nearing financial independence in many cases with limited education and with few role models and experiences to help them prepare for it. Young adults are emerging from college with degree in hand but with thousands of dollars in debt, not only student loans but also for credit cards and other liabilities. And new immigrant populations must learn how to manage many aspects of their adopted country's marketplace. The needs of all these groups argue for increased financial education.

Protection for consumers against fraud and abuse is another concern that underscores the need for education. With the proliferation of subprime housing markets and risk-based pricing, consumers today have increased opportunities for taking out home equity loans. In most cases this development has been positive, increasing credit access for low- and moderate-income borrowers. However, some lenders have used unscrupulous practices and products to prey upon vulnerable populations. Consumers with a basic knowledge of lending programs, of the credit process, and of their rights, may be better able to protect themselves against bad credit situations. Consumer education alone may not be the sole answer to predatory lending, but it is certainly an essential part of the solution.

Basic Principles

I would like to now discuss some principles, based on early research or program experience, that might be considered as we develop financial literacy training.

- Financial literacy training seems to work best when tied to a specific goal. Successful programs do not just inform participants but can actually foster changes in behavior. We know that people are more likely to modify behavior when the training has a focus or reward for example, when the outcome of the training is home ownership, savings for a college education, or the accumulation of assets in an Individual Retirement Account. A recent study showed that households with an identifiable "reason to save" are seven times more likely to save than those households without a tangible goal.[2]

- For most people, the attainment of financial literacy is a cumulative, lifelong process, not an event tied to a particular course of study. Most people knowledgeable about financial matters learned the foundations of money management early in life. Although few states, or even school districts, have formal financial literacy standards or curricula, information about handling money, budgeting, and savings built into math, social studies, and even literature courses raises awareness and promotes good habits. Curricula that foster critical thinking and analysis and use simulation, case studies, and other interactive techniques have the greatest success in fostering awareness and promoting improved understanding of financial principles. While not a perfect substitute for classroom instruction, Internet-based activities and practical exercises can be effective for adults and children alike. It is never too early, or too late, to get started.

- Financial literacy training is particularly necessary in certain communities. Finding ways to reach very low income, minority, and immigrant communities will continue to be important. Often language or cultural differences have implications for delivery systems and the production of materials. The Federal Reserve Bank of Minneapolis, for example, has worked with the Fannie Mae Foundation and the First Nations Development Corporation to develop a culturally sensitive financial literacy curriculum for tribes to address needs in Indian country, where issues of trust land and collateral exist. Some financial institutions are grappling with Islamic lending, as our nation's growing Muslim communities have religious prohibitions on paying interest or finance charges.

- Partnerships with financial services providers can be effective. Financial education alone will not serve these communities unless financial institutions have products that also address the cultural issues. Financial institutions can work creatively with community organizations to develop products and services for financially literate populations.

Forming partnerships with community organizations that can facilitate outreach to communities that are prey to unscrupulous lenders can be an especially challenging task. For example, the Neighborhood Reinvestment Corporation (NRC), through its national NeighborWorks network of grass-roots community organizations, carries out extensive outreach activities targeting potential predatory lending victims. NRC has developed remediation programs for those who have become embroiled in bad credit situations. Reaching homeowners before they assume a home equity loan is critical. Thus, in addition to very active home ownership counseling programs, NRC encourages constituents to bring loan documents into their offices before they sign contractual agreements. This way, a counselor can review the documents and ensure they contain nothing unfair or deceptive and that the terms are affordable for the homeowner. The NRC programs also show consumers how they can get alternative sources of funds on better terms.

Financial educators have often partnered with community development and housing organizations with good results, but the future may dictate that collaborations expand to include nontraditional partners. By working with financial institutions, faith-based organizations, social service groups, youth clubs, and mentoring programs, educators are better able to reach consumers who otherwise would not be aware of available services. It is often important for educators to work with organizations that have already established contacts and relationships with the community. For example, evaluations from one New York State program show that the low-income audience preferred learning from a "trusted source," such as a key community leader or a peer, rather than from "outsiders" or formal education programs.[3]

- The workplace is a natural point of entry for improving financial literacy. It is especially good for reaching single parents and people working several jobs. Many people just do not have enough time in the day to attend classes after work or even on the weekends. Bringing this training to the workplace and providing time for attendance can be a win/win situation for the employee and employer. A financially prepared worker is a more productive worker: A 1999 study concluded that financial health is positively correlated with worker productivity and physical health.[4]

At the Federal Reserve Board, we have taken the opportunity to use the workplace for literacy training. Over the past year, we have offered three lunch-and-learn programs for our employees. The topics included homeownership training for potential first-time homebuyers, managing credit, and basic budgeting. We also offered seminars on retirement savings which incorporated information about our benefits structure. All the programs were well attended and highly rated.

- New technology can be used to promote financial literacy. The use of technology for financial literacy presents both a challenge and an opportunity. The rapid development of electronic delivery systems has resulted in sophisticated interactive programs, which allow users to construct budgets and enter their personal data. The Federal Reserve Banks of Dallas and Chicago have used such technology to develop interactive web-based programs on financial literacy and money management.

With the proliferation of home computers, the use of technology will continue to offer options for consumers to increase their knowledge of financial services and products. The flip side of this opportunity is the challenge of reaching those who lack the technological access or capability to participate in these efforts. We need alternative methods of disseminating information to those living on the other side of the digital divide.

- For our efforts to succeed, we must have more research on how people absorb financial education. Survey research shows that the primary way people learn about financial topics is "through experience."[5] This finding could tie into my earlier assertion that a concrete goal facilitates behavioral change. It could also mean that those respondents who had experienced trouble with credit card debt, mortgage delinquencies, or other financial problems "learned" while working to mitigate the problem.

When asked about learning preferences, two-thirds of the respondents said they prefer to learn via the media (brochures, television, radio, magazines, or newspapers).[6] One concern about this finding is whether consumers have the critical thinking skills to separate the infomercials and advertising from sound financial information. Half of the survey participants said that informational seminars held in the community or formal courses at a community school would be "effective for [me] to learn about money management." Interestingly, among Hispanics, the first preference for learning was the Internet.

The survey also showed that consumers who are financially knowledgeable are more likely to behave in financially responsible ways.[7] These consumers shop for financial products and services. They pay their bills on time. They do more financial planning. They have an emergency fund and a recordkeeping system. They save more--and more regularly.

These results suggest the need for more research and information on the efficacy of financial

literacy programs--what works and what does not work. Recognizing this need, the Federal Reserve has requested research on the effectiveness of financial literacy programs in the call for papers for its Community Affairs research conference next March. Many new studies are forthcoming. Especially useful will be longitudinal studies that follow financial literacy graduates for several years to see how the information was used, or not used, to improve the quality of life.

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It is obvious that a rapid stream of financial innovations will be a feature of the new information-oriented economy. We must provide a conducive atmosphere for these innovations. But we must also work to keep average people literate about the innovations--so people can use innovations, not be confused by them.

Notes

1. Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 86 (January 2000), pp. 1-29. Return to text

2. Jeanne M. Hogarth and Chris E. Anguelov, "Can the Poor Save?" *Proceedings of Association for Financial Counseling and Planning Education* (2001). Return to text

3. Jeanne Hogarth, Josephine Swanson, and Jan Baker Segelken, "Building an Understanding of Credit Services," *Cornell Cooperative Extension* (1994). Return to text

4. E. Thomas Garman, Jinhee Kim, Constance Y. Kratzer, Bruce H. Brunson, and So-Hyun Joo, "Workplace Financial Education Improves Financial Wellness," *Association for Financial Counseling and Planning Education*, vol. 10 (1) (1999). Return to text

5. Jeanne M. Hogarth and Marianne A. Hilgert, "Financial Knowledge, Experience and Learning Preferences: Preliminary Results from a New Survey on Financial Literacy," *Consumer Interest Annual*, vol. 48 (2002). Return to text

6. Hogarth and Hilgert, "Financial Knowledge." Return to text

7. Hogarth and Hilgert, "Financial Knowledge." Return to text