SPEECHES

Financial Capability and the Role of Trust

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Key Points

- Federal Reserve Bank of Atlanta President Dennis Lockhart said that there is a difference between financial capability and financial literacy. Literacy is knowing the best ways to handle money. Capability is not just knowing but also acting wisely and consistently with money within the formal financial system.
- Lockhart believes individuals should take part in and trust the nation's formal financial system. In order to do that, Americans must see a financial system that is well governed and well managed.
- A recent survey found that one in four Americans trust the financial system. To ensure trust, Lockhart believes there are five key areas in which regulators and company managers must be responsible. These areas are regulatory oversight, ensured liquidity, controlled leverage at the system and firm level through adequate capitalization, sound lending and business practices along with healthy incentives for managers, and transparent markets and institutions.

Thank you for the opportunity to participate in this conference and speak about financial capability. The term "financial capability" strikes me as being open to a number of definitions and, therefore, a number of topics I could address. I will give you my definition of the term for the purposes of my remarks today.

I think the term financial capability is most relevant to the individual citizen. This is clearly the intent of the President's Advisory Council on Financial Capability. The executive order setting up the Council called it "the capacity, based on knowledge, skills, and access, to manage financial resources effectively."

I see three dimensions to financial capability at the level of the individual. First, a financially capable individual has an income stream or money saved. Second, that individual is financially literate and proficient in managing his or her own financial affairs and responsibilities. And, third, the individual participates in and trusts the country's financial system.

This third element—trusting participation in the formal financial system—largely depends on the effectiveness of both public authorities and private-sector leaders of financial institutions. Both entities are responsible for ensuring that the system overall is stable. Also, both are responsible for ensuring that the firms that make up the financial system operate safely and soundly.

Safety and soundness is, in fact, the term used to describe the intent of supervision and regulation in the Federal Reserve System. We are safety and soundness regulators as opposed to investor protection regulators or market regulators. Of course, we share this responsibility with other federal and state banking supervisors.

Today, I want to offer some thoughts on individual financial capability from both perspectives—the perspective of individual responsibility and that of a safety and soundness regulator's responsibility.

As always, my comments are my views only and might not be shared by my colleagues in the Federal Reserve System.

Personal capability and responsibility

Let me start with the perspective of the individual. As I just noted, there is a difference between financial capability and financial literacy. In general, financial literacy is knowing the concepts and principles that underlie money matters—for example, personal debt capacity, compound interest, and mortgage amortization. Capability is not just knowing but also acting wisely and consistently with money within the formal financial system.

There are many groups working to advance financial literacy and financial capability, including the Federal Reserve. In fact, the Fed is a key player in teaching Americans about the economy and money. For example, here in the Atlanta Fed's Sixth District, we will conduct about 200 workshops and presentations for teachers this year. The teachers who attend these, in turn, reach more than half a million students each year with lessons on economic and financial topics. As part of this effort, we have developed assessment tools to determine the effectiveness of our programs, and we apply these tools on an ongoing basis.

But, as I said, other groups also advance financial literacy and capability, including our host today, the Economic Empowerment Initiative. The Initiative trains high school and college students to manage money, focusing on credit, debt, and investing. Other nonprofits like Operation Hope provide financial literacy education and empowerment for underserved communities, and CredAbility (formerly Consumer Credit Counseling Services) helps debt-burdened Americans work down their debt, taking control of their money and future.

Inadequate individual financial capability, particularly in the dimension of financial literacy, was a root cause of the market turmoil and financial crisis of 2008. Many lessons were learned during that time by the Federal Reserve and others. Millions of Americans bought homes they could not afford, signing mortgages they did not understand. Of course, homeowners certainly did not cause all the problems. In retrospect, it's clear many obtained loans that banks and other lenders should never have offered them in the first place. And the bundlers of these loans constructed securities that did not hold their value as conditions changed. When housing prices stopped rising and began to fall, many homeowners faced underwater mortgages, foreclosures, short sales, or personal bankruptcies.

These were people who were participants in the country's formal financial system. No doubt, many have been discouraged and lost faith. This is understandable, but I still believe the goal should be for everyone to operate within the formal financial system, to be "banked" as opposed to "unbanked." Many today do not operate within the formal

financial system. And in the aftermath of the financial crisis and recession, many others do not trust the system.

In January 2009, the University of Chicago's Booth School of Business and Northwestern University's Kellogg School of Management began a Financial Trust Index, asking Americans whether they trusted the financial system in the wake of the economic crisis. That first poll showed that only 20 percent of respondents did trust the system. Today, the number is higher, but not by much. The most recent survey, published this past July, found that 25 percent of respondents, only one in four Americans, trust the financial system.

Charles Handy, founder and long-time professor of the London Business School, said, "Markets rely on rules and laws, but those rules and laws in turn depend on truth and trust. Conceal the truth or erode trust and the game becomes so unreliable that no one will want to play." As individuals, we must see a financial system that is well governed and well managed. In other words, we must see a system we can trust.

Principles (imperatives) of financial system leadership
So let me now turn to the question of how that trust is earned, to a regulator's perspective on the fundamentals of system and firm-level management to ensure trustworthiness.

Financial systems have inherent fragilities. They are networks with complex, intricate webs of interaction and interdependence. They perform what financial economists call maturity transformation. This means financial institutions transform short-term liabilities, like deposits that can be withdrawn at any time, into longer-term funding of assets, like loans to businesses and consumers. Also, modern financial systems involve significant financial leverage. That is to say, financial institutions—banks, brokerages, and the like—finance their activities with one part shareholders' equity and multiple parts debt in one form or another.

Financial systems are also giant information systems with substantial, but not complete, transparency. Information moves constantly in these systems to help people make decisions about risk. And, in today's world, a financial system operates on a digital electronic backbone, vulnerable to computer and security failures.

For the public to have and keep faith in this country's financial system, I believe the parties at the top must meet their responsibilities in five key areas:

First, regulatory oversight. Here's how I think of my responsibility as a banking supervisor: collectively, the community of regulators must judiciously supervise individual institutions and vigilantly monitor the health of the overall system, to guard the public trust and, above all, avoid a systemic crisis. This is not to say that regulators can or should guarantee that individual firms will not fail.

Firms will fail. That reality can't be regulated or legislated away. But good oversight can prevent some failures.

The system we should work toward is one in which no institution is too big to fail. Much is being done in the aftermath of the Fed's and the Treasury's emergency interventions of 2008 to get to this state of affairs, but, in my view, this is a longer-term aspiration at this moment. I will point out, however, that in 2008 regulatory authorities effectively had no resolution mechanism. But Dodd-Frank now provides a framework for the orderly unwinding of a large, complex financial institution.

Second, ensured liquidity. The Fed is the lender-of-last-resort for the American banking system—that is, after banks have exhausted private-sector sources. The central bank stands ready to provide temporary liquidity to solvent banks and other regulated entities on terms that involve no credit risk to the Fed. That is, this credit is fully secured by good collateral. I believe the Fed performed this role very effectively during the financial crisis.

Third, controlled leverage—at the system and firm level—through adequate capitalization. Firm-level capital (and high-quality capital) is a buffer against losses that can lead to failure. Maintaining this buffer is especially important for the larger, systemically-important institutions for which government intervention in a crisis might otherwise be the only response to a threat to the entire system. We absolutely must get to a state in which private shareholders and creditors bear the risks of failure, not taxpayers. The public and their elected representatives were justifiably outraged at the interventions of 2008. As Chairman Bernanke said, the Fed intervened "holding its nose."

Fourth, sound lending and business practices along with healthy incentives for managers. The principles of sound management of financial institutions are straightforward. They are to maintain adequate capital, diversified sources of funding, diversified assets, rigorous standards for underwriting risk, and solid risk management processes.

Furthermore, top managers of banks and financial institutions bear the responsibility of cultivating an internal culture of healthy incentives (and disincentives) for employees. Just as moral hazard exists when managers, shareholders, and creditors believe the government will bail out a particular firm, there is moral hazard when the income and wealth accumulation ambitions of employees are shorter term than the business aims of top managers and directors. In my opinion, a disconnect exists in this regard, and this is an enduring condition that simply has to be managed into acceptable bounds.

And fifth, transparent markets and institutions. I believe the aim should not be to "de-risk" our financial system. A former boss of mine wrote a book about this titled *Risk & Other Four-Letter Words*. The book's theme was that taking risks is the business of banks and financial firms—and, for that matter, all private-sector businesses. There's no moving forward without taking risk. But risk decisions should not be blind guesses or herd-following impulses. They should be based on sufficient information about the working of markets and the condition of market participants. And protection on the part of regulators against severe disruptions in systemically important financial markets requires a high degree of transparency of trading, position taking, and settlement.

These, then, are essential elements of the responsibilities of both government authorities and top firm management as stewards of the financial system. They are, in my mind, required to achieve a high degree of resilience in an innately fragile system and preserve public trust.

Thank you again to Samuel Jackson and the supporters of this event for exploring the theme of financial capability. I think improvement in this area requires efforts at both the individual level and the system and institution level. We learned over the last decade that the lack of financial literacy in our citizenry imperils the system, and failings of high-level supervisors and managers can result in considerable harm to the economy and the general public.

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