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Remarks by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

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Consumer Credit and Financial Modernization

Introduction

I am pleased to be able to share some thoughts with you on the conference's topic of economic justice in the context of our changing financial system My meetings with Greenlining over the years have been most informative, covering a wide range of topics regarding how our markets function and the appropriate forms of banking regulation Although issues related to the CRA and fair lending often have been the focal point of our discussions, today I would like to extend the dialogue by looking at consumer credit availability from a somewhat broader perspective

With respect to credit availability, I believe there is general convergence of viewpoints on one critical matter That is -- that all of our citizens should be treated equitably in our credit markets, and have access to credit regardless of their race, sex, ethnic origin, or the location or make-up of neighborhoods in which they live This view responds not only to a sense of fair play, but also to the necessities of the financial marketplace At least one area of continuing concern is whether some groups of our citizenry, especially low- and moderate-income families, do have fair access In exploring that issue, perspective is quite important, so I want to put this issue into a broader historical context

The roots of our present financial system and the evolution of financial innovation in America, especially throughout the 20th century, provide valuable perspectives and lessons related to many of the issues we now face So in exploring the notion of credit availability and its relationship to today's changing banking structure and regulation, I believe it is useful to step back for a moment and review a little history

The Early Consumer Credit Marketplace

Our nation's experience with consumer credit is long, but at least in its earliest periods, not always illustrious From colonial times through the early 20th century, access to credit for most people was quite limited, and where available at all, quite expensive Purchase of durable goods, clothes, and even property for working-class people was done mostly on a cash or barter basis Only the economic elite were able to obtain personal loans from commercial banks, and then only on an accommodation basis because they were prominent merchants or landowners Commercial banks did not make consumer loans to the general public

To the extent that any type of instalment credit was used by ordinary consumers its primary sources were local pawnbrokers, or unlicensed lenders who even then were called loan sharks Other than short-term credit provided by neighbors or shopkeepers, only pawnbroking, and lending on the security of personal possessions such as furniture, clothes, jewelry and other personal items, were the sources of credit for most consumers Generally, the only credit extended to working-class consumers carried very high rates, commonly reaching 120 per cent and often as high as 240 per cent per year, and collection practices were often harsh

Attempts to regulate these lenders by some states in the mid to late 19th century largely failed, primarily because most regulation was based on usury laws that limited interest rates to levels that were uncompetitive, making profitable consumer lending difficult for more legitimate, licensed lenders Consequently, unlicensed, illegal, high-rate lenders

continued operation in response to the persistent demands of the marketplace of the day One study estimated that in American cities with populations of over 25,000, about one family in five was the victim of loan sharks Subject to wage assignments to these lenders for these burdensome payments, many lower-income wage earners were reduced to virtual serfdom

Market Demand and Structural Change

Alternatives did, however, begin to surface. More intense industrialization and urbanization during the late 19th and early 20th centuries dramatically changed the market for small consumer loans Urban wage-earners needed loans not only to help smooth out bumps in the their economic fortunes, but also to help them purchase the vast new array of durable goods being produced by the new industrial economy Automobiles, washing machines, refrigerators and other items carried costs that made lump-sum cash purchases difficult for working families

It was this growth in demand that fostered increased competition for less risky and hence, more profitable consumer loans, and, most importantly, the development of new intermediaries to supply it Beginning around 1910, new organizations that focused exclusively on the needs of consumers entered the field and the structure of consumer finance began to change dramatically

Semi-philanthropic groups, called remedial loan societies, were formed to combat the high-rate lenders But incomes were low and losses were high Hence, remedial groups, by

limiting their dividends and underwriting their risks carefully, were able to make loans at average rates *as low as* 30 percent per year Soon followed "Morris Plan" banks, which made loans based on savings plans by borrowers, and the first credit unions, tied exclusively to consumers with a common place of employment By the 1930s, a wide array of consumer lenders, including credit unions, small local savings banks and a nationwide network of consumer finance companies were licensed by the states Savings and loans were created, in large part, because commercial banks and other local lenders would not make home mortgage loans, which they perceived as too risky Hundreds of sales finance companies were formed to help manufacturers and retailers of automobiles and durable goods provide credit to their customers Although commercial banks remained largely on the sidelines, sticking to financing merchants, manufacturers and farmers, they were forced by the collapse of their primary businesses during the Depression to turn more seriously to consumer lending

Market Innovations

As these structural changes continued to evolve, market demand, and growing competition among this wider variety of lenders also spawned considerable financial innovation One such innovation had its roots as early as 1900, when some hotels began experimenting with an innovative way to help their regular customers It was called a credit card, and by 1914 gasoline companies and large retail department stores were also issuing credit cards to their most valued patrons These first cards had to be paid in full monthly

and were simply a convenient way for good customers to "run a tab" with a particular retail business concern Later versions, spearheaded by retail giants Sears Roebuck and Montgomery Ward, added the innovative option allowing customers to pay their bills in installments, with interest charged on unpaid outstanding balances This shift to revolving credit, and another innovation allowing one card to be used at multiple businesses, later induced increasing competition in the card industry and entry of commercial banks into the credit card business in the 1950s

Though commercial loans secured by real estate were made by all types of lenders since colonial times, home mortgage loans, at least as we know them today, are a fairly recent innovation Most home purchase mortgage loans were made only to persons of significant means and they typically carried very short-terms of one to five years, with interest only payments, and large balloon payments at the end Loan-to-value ratios were typically quite low, owing to the vicissitudes of the market By the 1920s it was also not unusual for home buyers to need several mortgage loans to finance a home purchase, since the first mortgage typically financed only half of the value Obviously, this was not a financing scheme conducive to creation of a broad home purchase market for average consumers

Because this system utterly collapsed during the Great Depression, the housing finance system underwent radical change One of the most significant changes was creation of the Federal Housing Administration, or FHA, which instituted an innovative type of mortgage loan -- the long-term fixed-rate, self-amortizing mortgage -- that became a model

for transformation of conventional home mortgage lending A whole industry, thrift institutions, grew up around this one product innovation

But development of a broad-based secondary market for mortgage loans was an equally important innovation that greatly expanded consumer access to credit By reducing the risk of making long-term, fixed rate loans and ensuring liquidity for mortgage lenders, the secondary market helped stimulate widespread competition in the mortgage business Competition spawned diversification of the mortgage lending industry, and helped create specialized mortgage banking companies, and specialists in originating, funding, or in servicing mortgage loans

Further efficiencies were created when the secondary market agencies began experiments in the securitization of mortgages The mortgage-backed security helped create a national and even international market for mortgages, and market support for a wider variety of home mortgage loan products, such as home equity loans, second mortgages, adjustable rate mortgages, and reverse mortgages, became commonplace This led to securitization of a variety of other consumer loan products, such as auto and credit card loans

Effects of the Consumer Finance "Evolution"

This has been a brief overview of just a few of the more salient changes in our consumer finance system I recount them, however, because I believe it is instructive in several ways

First, the present market for consumer credit is fiercely competitive and highly innovative, but we should be mindful that it evolved to its present form slowly but inexorably   There were critical structural changes along the way, which included entry or expansion through new players   From remedial loan societies to local savings banks and credit unions, from thrift institutions, to commercial banks, to a nationwide network of consumer finance companies, the organizations providing and supporting consumer credit have become increasingly diverse, and include highly specialized lenders   More recently, innovative public-private partnership financing arrangements and new community development intermediaries, in which many of you have played direct roles, have helped low- and moderate-income families purchase and repair homes, start small businesses and repair credit problems to enable them to participate more fully in our economy

Second, we should note that these structural changes heightened competition, resulting in market efficiencies that continued to help drive down costs   Where early institutions specialized in only certain types of consumer credit products, such as instalment loans, or in mortgage loans, virtually all institutions entered the wide variety of business lines that previously had been occupied only by specialists   That process increased competition and created cost reductions that helped make possible the development of innumerable innovative processes, products and services   Most of these had the effect of vastly expanding the opportunity of ordinary Americans to enjoy the benefits of having access to consumer credit At least one lesson here is that we should not only welcome, but encourage the continuing evolution of our financial system, as it responds to changes in the marketplace

Third, it is important to remember that most of the financial innovations I've touched on -- from the self amortizing mortgage loan to the universal credit card with revolving credit features, to the home equity line of credit -- evolved from previous forms, and were primarily market driven. They were responses to consumer demand and private efforts to collect and direct capital in a way that could meet that demand on a profitable basis. This suggests that we should be quite cautious in enacting legislation or creating regulations that unnecessarily fetter market development.

Fourth, where government played a positive role, it was primarily an ameliorative one, to help create a fair playing field for both lenders and consumers. Those government interventions in consumer credit relationships that were successful were those that facilitated market development by providing maximum flexibility for private initiative and innovation, along with appropriate protections that supported consumer confidence. Those that failed, such as uncompetitive usury restrictions, did so because of failure to consider and respond to the strength, and the mutability, of the marketplace.

What has been the effect of this process? In less than 100 years, this evolving structure and chain of financial innovations have dramatically improved consumer access to credit, transforming the American economy and stimulating the flow of capital around the world. In 1900, there were no consumer instalment loans available at reasonable rates, no credit cards, no affordable home mortgage loans for working people, and certainly no home equity lines of credit. Consumers had virtually no access to reliable, affordable forms of credit.

By 1995, the year of the most recent Federal Reserve Survey of Consumer Finance, 75 percent of all households carried some form of consumer debt, 41 percent had home mortgages or home equity lines of credit and about 48 percent had credit card debt outstanding

As important, the distribution of debt holders by income level has been significantly altered as the marketplace continued to provide increasing access to low- and moderate-income households. In 1962, the Federal Reserve's initial consumer finance survey indicated that of households in the *lowest* income quintile, 36 percent had outstanding consumer loans, by 1995, 50 percent of lower income households, those with incomes of less than $10,000, carried some form of consumer debt

Overall, we have to conclude that at no time in American history has credit of all kinds been so available to so many

Recent Developments

But what about the future? A variety of lenders are now regularly experimenting with new, innovative ways to assess and mitigate risk for borrowers who in the past might have been considered uncreditworthy This rapid pace of change is creating new mortgage products with ever-lower down payment requirements Acceptable loan-to-value ratios and debt-to-income ratios continue to rise Some lenders are even offering loan products that will provide home-secured financing far exceeding a home's value.

The drive to stretch traditional underwriting criteria is intensifying Recently, there

has been a boom in so-called "subprime" lending, offering a variety of types of mortgage and other loans to borrowers who have less than good credit, such lending is priced for risk and the favorable pricing of securities backed by subprime loans have found acceptance with investors Just last month, a few lenders announced plans to offer home owners with impaired credit a credit card secured by home equity, with part of the rationale being that responsible use of such credit cards could help such consumers repair their credit ratings And some lenders are aggressively marketing loans in the form of checks that can be cashed to activate the credit line

Improved access to credit for consumers, and especially these more recent developments, reflects a good news/bad news story The good news is that market specialization, competition and innovation have vastly expanded credit availability to virtually all income classes. Access to credit is essential to help families purchase homes, deal with emergencies and obtain goods and services that have become staples of our daily lives Home ownership is at an all time high, and the number of home mortgage loans to low- and moderate-income families has risen at a rapid rate over the last 5 years Credit cards and instalment loans are available to the vast majority of households

The bad news is that under certain circumstances this may not be entirely good news, either for consumers in general, or for lower-income communities Along with unprecedented credit access, some problems are occurring that should alert us all to potential dangers While every potential problem doesn't result in disaster, it's important to recognize the risks and take protective steps

Some loans to low- and moderate-income families with multiple underwriting flexibilities, layered subsidies and high loan-to-value ratios have been showing unfavorable delinquency and default trends Large mortgage lenders, secondary market agencies, and private mortgage insurers are conducting studies of their portfolios to determine how more relaxed underwriting standards are affecting delinquencies and defaults Although more study is required to determine which risk factors are most important in particular lending situations, the results of these portfolio studies bear watching.

Although legitimate lenders may be able to manage the risks associated with the overall expansion of lending, the same may not be true of many consumers, especially those with limited means to weather a storm, or who have been encouraged to borrow improvidently Should economic or personal difficulties occur, such as the temporary loss of a job, illness or unexpected car or house repairs, those with limited incomes and without significant savings may easily find themselves in financial trouble

Last quarter, credit card delinquencies racheted up to just short of the all-time high and consumer bankruptcies continue at a record pace We also have heard first hand at the Federal Reserve about the use of "equity stripping" by some unscrupulous mortgage lenders who have made loans to lower-income home owners that have no reasonable prospects of repayment

So while we should applaud the "democratization" of our credit markets over the years, we must be vigilant to the risks of excess, both by lenders and by consumers.

Conclusion

In considering the evolution of consumer credit in the United States, I would have to conclude that both structural change and financial innovation have been critical to success in providing expanded access to credit for the vast majority of consumers, including those of limited means Without such structural changes and innovative products and services that responded to changes in the market, the degree to which lower-income consumers now have access to credit markets would have been impossible

So as we consider the present state of our financial system, recent changes such as interstate branching, and the need to further modernize the structure of our financial services system, I hope we will all be mindful of the importance of innovation and competition in consumer lending as reflected by our history and the accomplishments I have described It is critically important that the structure of our financial system reflect the realities of the marketplace, and its capacity to increase efficiency and control costs We all benefit from that process

Thank you.