Remarks of Michael E. Staten
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Intro:

Let me confess up front to being someone who thinks that consumer education is the answer for the majority of what ails lending markets. I don't think these markets are fundamentally different from other product markets. Consumer credit markets have become highly competitive in recent years, even in traditionally underserved segments. With the advent of free credit reports and credit score disclosure, buyers of consumer financial services no longer need be at a greater informational disadvantage than buyers of other types of products. However, I do think that prior experience in credit markets matters a great deal in helping consumers make good decisions going forward. Product sophistication and availability have developed more rapidly than the financial savvy of many of our less experienced borrowers, and many consumers are unaware of the new tools that are available to assist them in choosing the best loan. As a policy issue, that implies that we have some catching up to do in giving many borrowers the tools they need to understand today's products and make wise choices when shopping and using them. So, for me this set of papers is the highlight of this conference because each attempts to measure the extent to which financial education efforts are effective in changing borrower behavior.

The four papers presented this morning are excellent, even pioneering, examples of the next wave of research related to financial literacy. I strongly encourage researchers in the field to direct their creative energy to designing more tests like these for the myriad programs that have been created and implemented over the past decade. The more we know about what works and quantify how well it works, the more effectively we can design policies that help consumers help themselves.

The two papers I was assigned to discuss are good examples of the approach that I think will be most effective in quantifying the impact of financial literacy and counseling programs, namely, the measurement of outcomes in terms of objective measures of credit performance. These two papers use credit bureau data and loan account performance data to do just that.

In thinking about the first paper (by Valentina Hartarska and Claudio Gonzalez-Vega), I'm reminded of the advice offered by the gambler in the old Kenny Rogers song: "You gotta know when to hold em' and know when to fold 'em." Now, I don't know the extent to which pre-purchase homeownership counseling programs discuss the advantages to defaulting on a mortgage. I'm certain that they talk about the disadvantages to default, and I imagine that the majority of time is spent on steps to take to try to minimize the chance of default. But certainly one of the objectives of a thorough pre-purchase counseling program should also be to educate the borrower to recognize when it is time to refinance. This paper is the first I've seen in the literature to empirically follow up on that idea. There are several reasons why this is an important question. Of course, prepayment behavior is at the heart of policy concerns over the practice of "loan flipping," the too frequent refinancing of a mortgage loan that piles up fees and eats up borrower equity in the collateral. More broadly, the decision to prepay addresses an even more fundamental question of whether some borrowers adequately recognize their own creditworthiness and marketability to lenders as candidates for refinanced loans at better rates. Presumably, counseling can raise borrowers' awareness that prepayment is an option and can help borrowers sort their way through the decision so as to recognize when prepayment of a loan is to their advantage.

As housing market policy increasingly shifts its focus from mortgage availability to mortgage affordability and the consequences of homeownership for building wealth, an empirical paper that looks at how borrowers adjust their mortgage behavior to affect their wealth is certainly a welcome addition to the literature. In essence Valentina and Claudio's paper sets up a model in which counseling refines the wealth-maximizing instinct in borrowers. With this in mind, I turned to their empirical work with much anticipation. In that empirical work, at least part of their sample has counseling administered somewhat randomly, which is a good thing, since it avoids the self-selection problems that usually plague studies of counseling effectiveness. As a consequence, counseled borrowers, by virtue of their counseling, become more cognizant of when market values of both home prices and interest rates have moved against them, and how exercising their option to either default on the mortgage or prepay it (by selling or refinancing) can boost their wealth. This generates a very interesting set of testable hypotheses about how counseling interacts with the economic calculations to drive the decision to default or prepay.

Now with all the appropriate caveats – small sample, acknowledged omission of some important variables, etc.—what they find is pretty interesting and frankly the opposite of what my intuition led me to expect. With regard to default, all borrowers are more likely to default when confronted with negative equity. But, in addition, counseled borrowers are more likely to act in that situation than *uncounseled* borrowers. I actually find this somewhat surprising because one of the attributes of counseling that I expected would offset an apparent opportunity to boost net worth would be a greater emphasis on the consequences and costs of default, what it means for future credit opportunities, etc.

I expected the reverse for prepayment and was surprised and disappointed that it didn't turn up in the results. The authors find that all borrowers are more likely to prepay when market interest rates fall below their contract rate. But counseled borrowers are no more likely to act on this information than uncounseled borrowers – which I find disappointing, because my expectation is that part of the greater financial savvy that is the goal of homeownership counseling, especially for low-income or credit-impaired borrowers, would be a greater sensitivity to when it pays to refinance. At the very least, I'd expect borrowers to be more aware of the difference between a "good" refinance and a costly refinance. But there is no indication of that in the results.

In summary, I would say the authors have taken a very good first step with this innovative paper, but I hope the jury is still out with regard to the prepayment question. I would certainly recommend additional work with new samples and maybe also some tweaking of this specification to see whether the results are robust.

The second paper by Marsha Courchane and Peter Zorn makes a very commendable and ambitious attempt at framing a comprehensive empirical approach for measuring the effectiveness of financial literacy programs. At the outset the authors set forth a simple conceptual framework for investigating how financial literacy efforts may translate into better credit outcomes. They hypothesize that *learning* builds *knowledge*, which changes *behavior* and generates *better credit outcomes.* The beauty of the paper is that with its wonderfully unique database, the authors can demonstrate the linkage through that entire conceptual chain.

The authors' empirical approach merges data from a detailed financial attitude and literacy survey with credit report information so as to examine two distinct phenomenons: 1) literacy level and credit attitudes vs. actual credit outcomes, and 2) a respondent's perceived creditworthiness vs. actual creditworthiness. Regarding the first set of questions, the authors develop indices of consumer knowledge in a couple of ways. One category of questions measures self-assessed knowledge – measures of the respondent's own comfort level with financial issues, belief about how much they know, and where they think they picked up financial tidbits. But rather than take them on their word, the authors also ask a series of questions that measure objective knowledge (e.g., does applying for multiple credit cards help or hurt your credit rating? If you eventually pay your bills, do a few late payments along the way matter?)

The database created from the survey is enormous. By my count there are approximately 200 distinct items on the consumer questionnaire, and they have responses from 12,000 consumers. To this the authors have merged detailed credit report information. The potential analyses that could be supported by this database far outstrip what can be covered in one paper. These data can be mined for many papers to come.

Let me offer you a few observations that I found particularly compelling:

1. As a general finding, the authors conclude that there does seem to be a linkage between programs that would improve consumer financial knowledge and an improvement in credit outcomes.
2. Having a credit card significantly boosts both self-assessed and objective knowledge measures, and so does having a card at a younger age (making an apparent case for learning by doing).
3. Making only minimum payments on cards with balances under $1,000 is associated with little financial knowledge (both self-assessed and actual). Paying more than the minimum, and especially a lot more than the minimum, is associated with greater financial knowledge (both self-assessed and actual).
4. Experiencing credit counseling boosts both kinds of knowledge, even if counseling occurred more than five years earlier.

On the issue of perceived vs. actual creditworthiness, a striking finding is the extent to which African-American respondents underestimated their own credit standing. One of many unique features of the database was the presence of both the respondents' self-assessment of their credit standing and the objective credit bureau information. African-American consumers correctly self-assessed their own good credit standing only 65 percent of the time, compared to 75 percent for whites, 74 percent for Hispanics, and 80 percent for Asians. It seems to me that this has powerful implications for credit market and asset-building behaviors, such as shopping for mortgage loans. If African-American applicants perceive themselves as more likely to be turned down for a mortgage loan, they are less likely to shop across a variety of lenders. With a higher expectation of being told no, they may be more comfortable sticking with the lender who has told them "yes" in the past, especially if that lender has invested in building a good customer relationship. All of this gives incumbent subprime lenders an advantage in doing business with them. This is clearly a case for promoting "check your credit report and credit score" educational programs among minority groups. And I don't think the new availability of a free annual credit report is enough. We have to get the message out that a) not knowing your credit score can cost you big money, and b) statistics show that many people with good credit standing don't recognize it.

In closing, I want to reiterate my contention that the measurement of the effectiveness of financial literacy programs is the most pressing research issue for those working in the consumer education area. I want to congratulate all of the authors of the papers in this session on a fine job of tackling this difficult task. I hope that many of you in the audience will follow their lead.