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FINANCIAL LITERACY EDUCATION: PANACEA, PALLIATIVE, OR SOMETHING WORSE?

KAREN GROSS*

INTRODUCTION

Everyone, it seems, is climbing onto the financial literacy education bandwagon. With increasing frequency, elementary and secondary schools, colleges, universities, community organizations, military installations and state and federal government agencies—among others—are developing and implementing programs designed to improve the financial management skills of their particular constituencies. Not to rain on the parade, and since I am marching in it, I will get soaked too, but there is a problem with the financial literacy boom.

Money education is being sold as a tool for consumer empowerment and a cure for all that ails our consumer credit economy: financial ignorance, unhealthy debt burdens, predatory lending, mortgage foreclosures, joblessness and susceptibility to savvy lenders and scam artists. This approach is fundamentally flawed. It leads to a "blame the victim" type mentality by erroneously assuming that individual knowledge acquisition alone will produce fundamental change in the consumer financial markets, an approach that also absolves a wide range of other entities, public and private, from responsibility.

WHY WE NEED FINANCIAL SMARTS

To be sure, there is a real need for financial literacy education, and we are vastly better with it than without it. The reasons are three-fold. As a nation, we lack money smarts. In our schools we teach more about sex than we do about money. Most of us do not even know our credit score, that all-important number that determines the price we pay to borrow money. Few of us read our own credit report, which details our repayment history, let alone know how to fix any mistakes. A great many of us neither read nor understand the small print on our bills, insurance policies, or student and other loan documents.

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Our financial illiteracy is measurable: only 4% of Americans have sufficient quantitative literacy skills to compare and contrast credit card offers or to calculate the total amount of interest from a home equity loan advertisement. According to the National Adult Literacy Survey, everyday financial transactions (which were included as questions within the Survey), such as writing a letter to challenge a billing error or determining the discount if a bill is paid early, are not easy for most Americans. And geography matters. If you live in the South, for example, your level of financial literacy is even lower than other regions of the country. Although the data demonstrate that those who are less well-off are, not surprisingly, less financially literate, lack of financial sophistication cuts across all genders, races, ages and ethnicities. Statistically, the more educated we are, the more financially literate we are. That said, just over half the college graduates fall into the three lowest levels for quantitative literacy, with only 17% of those pursuing or obtaining a graduate degree reaching the highest literacy level. Being highly educated is not synonymous with being financially sophisticated. It is safe to say that we have equal opportunity ignorance.

We need be financially literate because we are deeply in debt. Recent data demonstrate the extent of our debt problem. The Federal Reserve reports that consumer debt (not including mortgages) currently exceeds $2.03 trillion, and that number continues to rise. Credit card debt alone exceeds $742 billion. That means that every American household has, on average, in excess of $7,000 in credit card debt, and we pay approximately $60 billion annually in interest payments alone. We spend, on average, more than 18% of our after-tax income on debt payments, including credit cards, mortgage insurance and car and student loans. Average obligations, as a percentage of household disposable income, currently exceed 100%, meaning we spend more than we make just to manage. As an unfortunate corollary of that, we do not save: personal savings rates hover at or below 2%.

We also need money education because we are increasingly becoming the subject of scams and predatory lending schemes. A recent Federal Trade Commission study showed that 11.2% of all adults surveyed were victims of financial fraud over the survey year. For example, it is estimated that more than 4.5 million people offered a guaranteed loan or a credit card for an upfront fee are scammed and never get the promised financial product. Perhaps not surprisingly, a disproportionate number of those victimized are individuals carrying too much debt. The non-prime lending market has also grown exponentially over the past decade. The Center for Responsible Lending estimates that predatory lending strips $16 billion in wealth from consumers annually. In 2003, consumers paid $4.3 billion to borrow $25 billion from payday lenders. In the past two decades, the number of rent-to-own stores, a hugely expensive way to use and buy products, increased four-fold. And new ways to strip individuals of their hard earned cash come into the marketplace

frequently, with Internet payday lending being one of the newest kids on the block.

Smart people have created a myriad of financial literacy initiatives across the country. In late April 2004, Pennsylvania Governor Edward Rendell (who also supported additional educational funding within his home state) created an Office of Financial Education designed to promote economic literacy within families and in schools. Similarly, the North Carolina Attorney General's Office formed a statewide coalition to address financial literacy needs. In May 2004, the U.S Treasury's newly created Financial Literacy and Education Commission met for the second time to discuss websites and toll-free assistance for consumers and recently solicited public comments on financial literacy approaches. New York State adopted a mandatory economics course for high school seniors that includes a personal finance component. North Carolina recently passed legislation establishing a pilot financial literacy project in its schools, and the Florida Department of Finance has partnered with the Florida Council on Economic Education to teach basic financial skills to the state's youth. Under the auspices of the United Way NYC, a consortium has been created to leverage resources and coordinate financial literacy initiatives across New York City; similar initiatives exist in other locales including Philadelphia. Within my own law school, I teach a two day, fourteen hour, one credit, pass/fail course to law students titled "Financial Advocacy" intended to assist students and their future clients with a wide range of money troubles. Even Federal Reserve chair Alan Greenspan weighed in last year, remarking, "[a]n informed borrower is simply less vulnerable to fraud and abuse."

MONEY EDUCATION ALONE IS NOT ENOUGH

As beneficial as financial literacy programming is, it is not enough. Indeed, I worry that the education actually serves to mask the root cause of the societal dilemmas at issue and undercuts alternative or complementary solutions. Beyond providing consumers with a basic toolbox of financial skills, we need to craft solutions to the underlying causes of our ignorance, our debt, and our susceptibility. We need to build assets and credit in low-income communities, stop predatory lending and curb growing mortgage foreclosures. We need to eliminate the misleading marketing messages pitched by sophisticated sellers of financial products. We need to keep unscrupulous vendors, like those who frequent military bases or senior citizen residential enclaves, from preying on the vulnerable. In short, despite the financial literacy craze, we need to address the deeper issues that affect those who are financially illiterate.

Many of the solutions to these identified needs call for complex systemic societal change, and as such, are not easily achieved and certainly cannot be accomplished quickly. We should create lasting jobs that pay a living wage,

provide affordable healthcare, childcare and eldercare, and move those who rent into homes where they can build equity and strengthen community ties. We should develop micro lending programs that help create sustainable small businesses, particularly in low-income neighborhoods. We should develop incentives for individuals to save for the future and create viable financial products that are priced to reflect real, not inflated, risk. There is no shortage of academic, private sector and government talent thinking about these very ideas, and there are initiatives, both public and private, in the works, albeit on a relatively small scale.

CHANGING THE CREDIT SCORING MODEL

As important as these larger issues and the small remedial steps being taken are, I have a more modest proposal—one that is more doable, relatively immediate and quite cost effective: we need to change our credit scoring system. The credit score governs how creditors view us within the financial markets and sets the price at which we can obtain money; it can also control our insurance and employment opportunities. In lieu of the current scoring model that dominates the market, we should institute four significant changes: (1) add variables to the current scoring model so that non-traditional payments count; (2) mandate credit reporting of most if not all payments, leading to increased and hopefully more accurate reporting; (3) require disclosure of the variables that comprise and then drive the scoring model; and (4) change the weighting of some of the variables as a means of incentivizing some, while discouraging other, behavior. Together, these changes would enhance the fairness of credit scoring—something that would inure to the benefit of all Americans.

Let me explain. We need a credit scoring system that recognizes and rewards a broad range of sound financial behavior, like making timely and regular rental, local vendor and childcare payments or sending money to one's native country, things the existing system does not regularly collect or assess (although change is in the wind through Fair Isaac's new scoring model and new companies like PayRentBuildCredit). We should also recognize less traditional regular payments, such as rent-to-own payments, payday lender payments, and pawn shop payments. These latter additions would help a wide range of individuals—recent immigrants, members of minority groups, newly divorced or widowed women—who may not be participating in the conventional lending marketplace.

The foregoing suggested change will, however, have limited impact under the current system, as credit reporting is completely voluntary. Unless reporting is made mandatory, smaller creditors will be unwilling to incur the cost and liability of reporting. Most payday lenders or rent-to-own stores will be unlikely to report absent legislative change. There is a less cumbersome alternative—have the consumer report non-traditional payments and then have

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them verified by a trusted third party, which is precisely the system that PayRentBuildCredit has instituted.

We also need to make the present system transparent so we can determine what elements contribute to our current score. More specifically, we need to know the precise variables that compose the score, the weighting of these variables and the impact of the interaction among these variables. Citing proprietary concerns, this information is not even made available to the Federal Reserve. If we cannot see the scoring model, we cannot fully assess our own score (including how to improve it), and we cannot evaluate the scoring model itself to determine its fairness. At the very least, Fair Isaac's, the leading scorer, should reveal its model to the Federal Reserve, which would allow for a modicum of independent assessment and oversight.

Finally, we need to consider changing the weight that existing and prospective variables have within the scoring model. For example, if we want to encourage payment of child support, we should give those payments greater weight within the system. Moreover, if we consider certain types of borrowing to be preferable to other borrowing, we should make that indebtedness less harmful for scoring purposes. The current system actually does this already by treating borrowing from a bank credit card company more favorably than borrowing from a finance company or a retail store. Student loans may be the perfect example of payments that reflect a wiser choice than others. Still, because the model is designed to assess risk of default, one does not want to completely alter the weighting to underestimate risk.

CONCLUSION

Hernando De Soto wisely observed that in developing nations there is too much "dead" capital—property that exists in the hands of the poor that is not made a part of the legal or financial system. As a consequence, there is continued poverty and economic stagnation, which could be reversed by recognizing this underutilized resource. Similarly, we have American consumers with "dead" credit, because the payments they make are not widely recognized and certain types of debt, like childcare payments, are not appropriately weighted in our common scoring system. As a result, we perpetuate individuals' low credit status when we should recognize their true borrowing potential. Non-traditional payments are assets, and we currently undervalue them in our financial markets to the detriment of the involved individuals and society as a whole.

Paolo Freire objected to what he termed "educational banking," where teachers just "deposit" information onto students. I think he was correct: good education is reciprocal and dialogic. Banking on education is particularly objectionable in the context of economic literacy because it posits that individuals alone can right their plight. Of course, financial literacy education is important. An educated consumer will, more often than not, make better

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financial choices. And as Paolo Freire suggests, the education itself, if done well, can embolden and empower students—many of whom can then be mobilized to address the deeper social issues that account for their plight. Financial literacy education, then, may lead to diminution of social injustice. That said, the real challenge rests in finding ways to diminish the financial burdens individuals bear and improve the financial opportunity for all Americans. In so doing, we will build wealth and an educated populace. If we did that, then the financial education we dispense would have real and lasting meaning. Until then, financial literacy education is only a palliative.