

6.1: A Critical Examination of Financial Literacy Education

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Introduction

Markets, like species, evolve as a result of external and internal forces. The evolution of the U.S. consumer financial services (CFS) industry was pushed by strong external forces, particularly the policy environment and demographic shifts of the population served by the industry. Internally, the industry evolved due to increasing competitive pressures of globalizing finance markets and technological advances that reshaped delivery and processing systems.

A combination of external and internal pressures led financial services providers to expand into markets in which they had little or no experience. This expansion, particularly when coupled with changing demographics in communities throughout the U.S., required the rethinking of customary ways of developing, marketing, and delivering products. Regulatory policies like the Community Reinvestment Act (CRA) mandated financial institutions to serve communities from which they drew deposits. Within the industry, market competition that constricted profit margins led to increasing consolidation, while lowered regulatory barriers permitted vertical integration of industry players. As financial institutions grew in size and scope, they needed to increase their volume of business, leading to an increasing need for CFS providers to penetrate new, emerging markets to foster growth. However, the needs of these new markets did not conform to the products or business practices that had evolved to serve the more uniform middle-class market.

Market competition also motivated the adoption of new technologies to reduce transaction costs and increase overall efficiency of delivery systems. These technological innovations included: automated lending systems to underwrite, service, and process loans; the development of credit scoring systems to provide a standardized tool with which to measure creditworthiness of customers; and automated systems to manage banking and other transactions.

One of the first improvements in the delivery of credit, however, was not very technical. It involved the standardization of credit instruments so that they could be pooled, sold, and securitized. In many ways, standardization lurks behind most, if not all, of production-side advances in the CFS industry. Standardization requires that products conform to explicit specifications so that they would look, essentially identical for the purposes of pooling them into investment packages.

The evolution of the CFS industry resulted in significant changes in the relationship between CFS providers and their clientele. Automation and standardization reduced personal contact between providers and clients and required that clients themselves exhibit standardizable attributes. For example, borrowers could only be underwritten using automated methods if their credit histories could be captured by a single scoring system. Similarly, to be an educated consumer in modern financial markets required a different skill set to transact successfully. And unlike years past, where providers of “high touch” financial services took it upon themselves to help consumers understand the products that they were selling, it became the job of consumers to navigate through the “high tech” marketplace without much assistance.

Standardization also erected barriers to serving new markets, because the new markets varied in salient ways from the markets for which the standard products were developed. Moreover, demographic shifts in the population, particularly changes in age structure, ethnic diversity, and the distribution of wealth and income of the U.S. population, required new products, services, and marketing approaches to meet market demand. These demographic changes led to a bifurcation of the CFS industry as subprime lenders and “fringe” service providers arose to fill the gap left between standardized, mainstream CFS providers, and non-conforming populations on the demand side.

Unfortunately, many of these fringe providers saw market imperfections—asymmetric information and uncompetitive markets due to credit rationing—as an opportunity to command supernormal profits (Engel and McCoy, 2001). Many of these CFS providers used their market power to provide inferior products, priced at what the market could bear, and generated significant negative externalities. For example, the asset-stripping that resulted from predatory mortgage lending alone was estimated to be responsible for transferring \$9.1 billion in assets from the poor to lending institutions (Center for Responsible Lending, 2000). This estimate does

not even include the secondary negative externalities borne by neighborhoods and communities through widespread foreclosures.

Other institutions arose to address these negative externalities and to help non-conforming customers to conform to the products and services of the mainstream market through the provision of financial literacy education (FLE). This paper will take a critical look at the economics and industrial organization of the FLE industry through case studies of the homeownership education and counseling (HEC) and the consumer credit counseling (CCC) industries. The assumption is that these industries evolved to provide financial education to fill information and training gaps that kept many individuals from participating effectively in financial markets. For the purposes of this paper, both HEC and CCC will be considered parts of the FLE industry, although one could argue that FLE is actually a component of HEC or CCC.

Delivery of FLE

Financial literacy education is provided in a variety of formats: face-to-face, individually or in group settings; via home study, through distance learning, or over the telephone. The principal providers are nonprofit organizations, often supported by government or quasi-government agencies, and to a lesser extent, the CFS industry.

FLE is typically delivered in two ways. The first is general education designed to equip clients with the skills needed to understand financial transaction and financial markets, and to develop money management skills to help them manage their income and wealth. The second, more specific FLE, is designed to help clients reach particular goals, for example, becoming a homeowner, accessing Individual Development Accounts, digging themselves out of debt problems, or avoiding bankruptcy. Although this paper focuses specifically on the latter category, a short discussion of general FLE is offered below.

Broad-spectrum FLE

To the extent that it was ever a prominent feature of public education, financial literacy training virtually disappeared from public school curricula from the 1970s-1990s. It is beyond the scope of this paper to account for the reasons that public education decided not to focus much attention on financial literacy, but the fact that “consumers lack a working knowledge of

financial concepts and do not have the tools they need to make decisions most advantageous to their economic well-being” (Braunstein and Welch, 2002) is both a policy and a market concern.

Because bad decisions, bad products, and bad processes in financial markets often generate significant negative externalities, policy makers promote FLE as a first line of defense—a prophylaxis designed to protect borrowers and others from bad borrower decisions. In recent years as predatory lending, payday lending, and other exorbitantly priced CFS services resulted in the siphoning of assets from low-income communities, FLE was considered by many policy makers the best remedy to these problems. In theory, a more educated consumer would be less likely to voluntarily enter into an improvident contract and, thus, FLE, like a broad spectrum antibiotic, might inoculate the population of consumers from the pestilence of these CFS providers. More educated consumers would also alleviate the burden placed on regulators to develop and enforce regulations that would curtail bad market practices.

This broad-spectrum approach to FLE has gotten widespread support from a number of public and private organizations. Regulators like the Federal Reserve and the FDIC promoted and helped to develop FLE curricula that could be offered broadly. Mortgage insurers and other private enterprises helped to develop and distribute FLE curricula and materials and even advocated for their adoption in public schools. For example, Republic Mortgage Insurance Corporation (RMIC) in collaboration with Louisiana State University developed a financial literacy curriculum and distributed more than 250,000 textbooks through partnerships established with public school systems across the country.

While efforts to promote better general financial literacy are commendable, it did little to curtail expanding use of fringe CFS or the pursuant negative externalities. This was due mainly to the fact that consumers of the fringe services were unlikely to be reached by these FLE programs. Further, because consumers of fringe services did not see any immediate value of FLE programs, which often required significant effort and time commitment, they rarely sought this education voluntarily. Many providers of FLE recognized the need for “teachable moments”—periods during which students had a strong incentive to seek assistance to effectively engage in CFS transactions. For example, the purchase of a home, or a debt crisis, are both key teachable moments for the delivery of FLE.

HEC

Homeownership education and counseling is most often provided by non-profit housing organizations that work in partnership with lenders and/or the public sector. For example, the NeighborWorks network of the Neighborhood Reinvestment Corporation supports more than 220 HEC providers nationally. These organizations help potential home buyers gain the skills to purchase a home, and to manage their home and finances after purchase. Many HEC providers also offer post-purchase assistance for homeowners facing foreclosure—helping these homeowners to avert foreclosure or to manage the foreclosure process with minimum damage.

HEC introduces clients to the steps involved in home purchase and financing. It is generally delivered in a group setting or over the phone. More comprehensive HEC programs combine general education with more intensive one-on-one counseling. Because pre-purchase counseling focuses on overcoming obstacles to homeownership (such as a poor or non-existent credit history or the lack of savings for a down payment and closing costs) it may involve direct intervention in clients' lives and can be time-intensive, sometimes stretching over several years. One-on-one counseling is time consuming and costly; it rarely generates enough revenue to cover program costs. Although comprehensive HEC is generally regarded as the most important, and transformative, FLE training program offered, programs are difficult to provide and maintain.

When done properly, HEC provides a sound basis for potential homeowners to decide whether homeownership is right for them and helps them determine the best house to purchase. Too often, this evaluative component is missing from HEC, because services are offered after a buyer has signed a purchase and sale agreement. In these cases, the education is offered to comply with requirements associated with affordable mortgages offered to first-time home buyers—helping to bridge the conformity gap—who consider HEC a form of credit enhancement.

Although the first HEC programs were rooted in post-purchase foreclosure-prevention as part of the FHA assignment program, today pre-purchase programs are the most common type of HEC. Post-purchase programs offer both general education on topics like home maintenance skills or budgeting, and personalized counseling on how to avoid delinquency or default. Foreclosure Prevention programs are typically crisis interventions aimed at preventing homeowners from losing their homes. Foreclosure Prevention counseling usually does not begin

until a homeowner is already delinquent for an extended period and focuses on developing a workout plan acceptable to both lender and borrower.

Foreclosure prevention is considered the most difficult and most costly component of a HEC program. Because homeowners come into the programs in considerable financial distress and, often, under considerable pressure to resolve a mortgage default quickly, programs need to be nimble, responsive, and creative. Successful programs offer intensive one-on-one counseling, budget training, support classes, and even provide low-interest loans to bring borrowers current on their mortgage payments.

HEC providers mediate relationships between borrowers and lenders, seek forbearance, negotiate loan modifications or low-cost refinancing, and help to develop reasonable workout plans that help borrowers get current on debt repayment and stay in their homes. In the cases when the best solution is the loss of the home, HEC providers help to minimize losses for lenders and the impact of foreclosure on the families. The best foreclosure prevention programs maintain contact with clients for years, helping to reinforce successful workout plans.

The desire to foster asset-building through homeownership has turned the attention of many HEC providers to non-crisis post-purchase support for homeowners. These efforts focus on managing family assets, including the home, to maximize family wealth accumulation. These HEC components focus principally on home maintenance and improvement, and financial planning. Many of these post-purchase programs are also gateways into other forms of family support including job training programs, language training, small business incubators, and social supports like pre-schools or day care centers.

CCC

Consumer credit counseling is most often provided by non-profit organizations working in partnership with lenders and the public sector. CCC providers concentrate mostly on assisting consumers having trouble managing unsecured debt, like credit cards and revolving credit lines. Most CCC providers focus their activities around one-on-one counseling sessions, although many providers have begun to dabble in telephone-based counseling and distance learning through the internet. Confidential ninety-minute counseling sessions are the core of most programs. Clients are charged a nominal fee for these sessions, which are available for as many times as a client needs help. During an initial counseling session, a debtor meets with a

professional credit counselor (presumably, with third party accreditation) who evaluates the client's financial status and helps to develop a budget for the client to cover living expenses and to make payments to creditors. For families who do not have enough money left to pay all of their creditors, Debt Management Plans (DMPs) are established. CCC providers derive a significant portion of their revenues directly from creditors who provide a share ("fair share") of the debt collected from delinquent borrowers through DMPs back to the counseling agency.

Some CCC providers offer workshops and books to reinforce clients' finance management skills. Many also offer foreclosure prevention assistance. For example, Consumer Credit Counseling Services of LA is the largest HUD-approved housing counseling agency in Los Angeles. Most counselors cannot offer legal advice, but might refer clients to others who might guide them through a bankruptcy process.

Why Support FLE?

FLE is a costly, labor-intensive, process. The diversity of program methodology and content, combined with a lack of consensus over how program "success" should be defined, impedes efforts to establish an empirical body of evidence to document the benefits of FLE. However, both theoretical and empirically measured benefits of FLE suggest that it is worth supporting. Unfortunately, as a public good – its benefits are numerous and disparate, and no simple exchange can be fashioned to manifest these benefits – FLE is unlikely to garner sufficient support in the marketplace.

A recently emerging body of research indicates that both HEC and CCC can in fact generate significant and measurable benefits for clients and stakeholders. For example, Hira and Zorn's 2001 analysis of nearly 40,000 Freddie Mac Affordable Gold mortgages¹ found statistically significant evidence that pre-purchase counseling provided strong credit enhancement. Affordable Gold borrowers who received pre-purchase HEC were less likely to experience serious delinquency than clients with similar observable characteristics who were not counseled. When they compared the impact of different types of counseling, the authors also found that face-to-face counseling provided in classroom or individual settings diminished the

propensity for serious delinquency more than indirect forms of HEC, provided over the telephone or by mail.

Using indirect or inferential methods, one can also provide a ballpark estimate of the marketing value of HEC to CRA lenders. During the 1990s, Milwaukee led the nation in disproportionate mortgage application denials based on race. This embarrassment led the city to develop the “New Opportunities for Homeownership in Milwaukee” initiative (NOHIM) that formalized agreements between mortgage lenders and HEC providers through the good offices of the mayor. In the negotiations between the lenders and HEC providers, it was agreed that lenders would pay \$450 to HEC providers per counseled borrower at the loan closing, offering one measure of how much it is worth to lenders to avoid the use of application denial as a screening technique.

To quantify the research findings of Hirad and Zorn, it was shown that prepurchase HEC provided in face-to-face settings, reduced the propensity of borrowers to become seriously delinquent by about one-third. GSE informants estimate that losses through foreclosure average around \$30,000 and about one percent of mortgages go into foreclosure over the life of the loan. This suggests that the value, *measured solely as savings from averted foreclosure losses*, to the GSEs of HEC is about \$300 per mortgage.

On the post-purchase side, the estimated costs of a foreclosure range from roughly \$30,000-\$80,000 when all stakeholders are taken into account.² The costs of foreclosure include: the direct losses to whomever holds the loan when the principal outstanding balance is not collected through resale, transaction costs associated with the legal process, direct losses to private or public (FHA) mortgage insurers, unpaid taxes and increased costs for the localities when homes lie vacant and deteriorate. In contrast, an assessment of the Family Housing Fund’s foreclosure prevention program in Minnesota estimated the cost of a successful foreclosure intervention to be around \$6,000.³

¹ Hirad, Abdighani and Peter Zorn. “Prepurchase Homeownership Counseling : A Little Knowledge is a Good Thing” in Retsinas, Nicolas and Eric Belsky, eds., *Low-Income Homeownership: Examining the Unexamined Goal.* Brookings Institution Press, Washington, DC: 2002.

² Moreno, Ana. *Cost Effectiveness of Mortgage Foreclosure Prevention: Summary of Findings.* Family Housing Fund, Minneapolis, MN: 1995 (reprinted 1998).

³ Moreno, Ana. *Mortgage Foreclosure Prevention: Program and Trends.* Family Housing Fund, Minneapolis, MN: 1998.

Over the period of 1991 to 1997, program costs, including counseling and financial assistance, totaled \$2.5 million. During this same period, 841 mortgages were reinstated (731 of which were in default at the time the intervention

The long term benefit of CCC to clients was demonstrated in an evaluation by Elliehausen, Lundquist, and Staten (2003). The researchers show that credit counseling has a long term beneficial effect on clients and, indirectly, CFS providers. Three years after receiving CCC, clients had lower risk profiles, reductions in both the number of active credit accounts and outstanding debt balances. Clients also exhibited better repayment behavior on their existing accounts. Moreover, measured benefits were most profound for borrowers who began counseling with the riskiest profiles and the worst debt situations. Thus, the study substantiates the transformative role of CCC: helping clients to better conform to the needs of mainstream lending.

The importance of sound financial decisions was underscored in a recent study by Belsky, Retsinas, and Duda (2003). They simulated housing tenure scenarios in four US cities over two decades to determine whether homeownerships generated a higher return on investment than renting and investing the downpayment. They found that the financial returns to homeownership were critically sensitive to the terms of the mortgage used at purchase, and whether an owner exercised the option to refinance when the option was in the money. Sound financial decisions like shopping for the best mortgage at the time of purchase and evaluating refinance options during the course of a mortgage require significant financial savvy—clearly, one impact of a successful FLE effort. Indeed, there is strong evidence that low-income homeowners do not shop for the best mortgages at purchase—suggested by a study done by Zorn(1999), and later corroborated by Fannie Mae, that up to 35-50% of mortgagees with subprime loans had underwriting characteristics that should have qualified them for prime credit. Further, Zorn and Van Order (2001) show that low-income homeowners exercise the refinance option less frequently than wealthier owners, especially when the option is in the money, and show that the lower propensity to prepay mortgages exhibited by low-income owners more than offsets their higher default risk.

These findings offer preliminary confirmation of the value of FLE as a credit enhancement tool—mitigating risk and improving overall lending performance. However, even without empirical evidence of its risk mitigation effect, a solid case can be made in support of FLE, as it offers benefits to the CFS industry, as well as general social benefits, that go beyond

began). A successful intervention is defined as one in which the homeowner was still current on his or her mortgage two years after the intervention. The study found that 50% of reinstatements were still current after two years.

loss reduction. FLE also provides valuable marketing and screening services that help CFS providers to gain a foothold in new and emerging markets.

For example, to comply with the Community Reinvestment Act (CRA), all federally regulated depository institutions are required to serve the credit needs of the entire community in which they operate, including low and moderate-income populations. The government sponsored enterprises (GSEs), particularly Fannie Mae and Freddie Mac, must comply with affordable lending mandates, established through federal oversight, to provide mortgage services to “underserved” markets and populations. Because they cannot originate mortgages directly, they rely on lending partners, both CRA-regulated banks and unregulated mortgage lenders, to originate enough conforming mortgages to satisfy the mandates. FLE programs offer important benefits to CFS providers striving to reach underserved markets:

- **Marketing & Outreach:** The CRA calls for lenders to meet the credit needs of the underserved markets that fall within the institution’s service area. To comply, lenders must tailor loan products to the needs of what may be, for them, new markets or subsectors. FLE providers, particularly community-based nonprofits, are ideally positioned to collect market data to support lenders in their efforts to increase market penetration of underserved communities. Furthermore, while undergoing FLE, potential buyers become aware of the range of financial products available, saving CFS providers significant marketing costs.
- **Market Intelligence:** The consolidation of the CFS industry, combined with a rise in out-of-area lending, has contributed to the physical distance between lenders and their clients. This trend only increases the importance of the market data gathering function performed by FLE providers, particularly if lenders seek to improve price discrimination through more precise market segmentation.
- **Triage:** The CRA does not require lenders to assume additional risk when entering new markets, but rather states that such communities should be served soundly. Mitigating the risks of serving a new client base, particularly those whose underwriting characteristics do not conform to mainstream products, calls for alternative means of assessing the risk profile of this population. FLE provides an important service to the CFS industry, as the education and counseling process offers an opportunity to screen

potential borrowers, identifying credit-ready clients from amongst those who need significant developmental work to conform to mainstream products. If lenders were to perform triage function themselves, it would likely lead to higher denial rates for historically underserved populations. Credit application denials are more costly to process, and high numbers of denials hurt regulated institutions when they are evaluated in terms of their service to the community.

- ***Credit enhancement through loss prevention/resolution of delinquency:*** As described above, both HEC and CCC can make considerable inroads in terms of preventing or resolving delinquency, actions that might be considerably more costly for a lender without a personal client relationship.
- ***Credit enhancement through transforming borrowers:*** Another benefit received by CFS providers when accepting clients who have undergone FLE relates to the pool of clients who require significant help to conform. The FLE may help to repair or build credit history, or it may support the client's effort to save through better money management. Regardless, in these cases FLE spares lenders considerable time and effort, whether in terms of reviewing and denying a weak application or in terms of recruiting clients once the better candidates have been creamed off.
- ***Comingled risks:*** Overextension in one CFS markets might seriously threaten a borrower's ability to repay credit another CFS market. Thus bad decisions in one market might create negative spillovers in another. By helping clients to develop budgeting skills and teaching them how to manage debt, risk is reduced for all CFS providers.
- ***Others?***

The benefits and beneficiaries of FLE are presented in Table 1.

Table 1: FLE functions, beneficiaries, and benefits

Beneficiary	Access/ outreach to new markets	Triage: Screening of clients	Delinquency/ foreclosure prevention	Transformation of borrowers
GSEs and CRA mortgage lenders	Satisfying affordable lending mandates/ CRA service tests	Sorting market to find most creditworthy and minimizing need to screen through mortgage denial.	Averted losses from mortgage foreclosure	Expansion of market to harder to reach households, reducing origination costs Lower risk of cross-default
Mortgage insurers	Increased market for borrowers purchasing with high LTV loans	Averted losses from foreclosure	Averted losses from mortgage foreclosure	Increased size of market
Loan servicers	Increased share of business in growth markets;	Lower servicing requirements	Averted losses from mortgage foreclosure; reduced collection costs for unsecured debt	Lower servicing requirements, lower costs
National policymakers	Expansion of homeownership, increased access for LMI to savings opportunities, reduction in bankruptcies	Better citizens through homeownership; more functional households	Better overall performance of mtg lending markets	Expansion of low-cost methods for delivering federal support (EFT)
Municipalities	More options for community development efforts through small business and mortgage lending		Lower incidence of tax delinquency; fewer homeless families	Increased demand for high quality services attract better CFS providers/ displace bad providers
Neighborhoods	Increasing house price appreciation	Less problematic neighbors, more stable neighborhoods	Averted home value losses associated with abandoned local properties	Averted home value losses associated with abandoned local properties
Clients	Better access to higher quality CFS including housing finance	Improved chances of success in CFS transactions; better wealth building opportunities	Improved long-term credit prospects	Lower cost, higher quality CFS available

How is FLE Supported?

FLE in its various forms can be a costly, labor-intensive process, with average costs per client estimated at \$200-\$1500, depending on the scope of services offered. The history of, and current state of, support for FLE programs vary widely. Taking the cases of HEC and CCC as examples, understanding the differences in the industrial organization and evolution of the FLE industry might give us some insight into more efficient and effective ways to support it.

The current method of supporting HEC is a pastiche of small public subsidies, coupled with token and episodic private support. It does not invoke the participation of the diverse set of stakeholders that share in the benefits offered by the industry. While a general consensus supports the notion that FLE delivers valuable services to a diffuse set of public and private individuals and institutions, the industry overall has operated for decades with minimal, and often inadequate, support. And while the evidence has begun to accumulate that estimates benefits to significantly exceed costs, the resources available to support FLE programs have shrunk. This is primarily due to evolutionary forces driving the CFS industry (the consolidation of lenders; the segmentation of mortgage lending markets; and the increasing reliance of the lending industry on automation) and increased competition from less reputable providers of FLE.

In their 2001 study, the Joint Center for Housing Studies (JCHS) reports that from 1993-97, 2,829 banking institutions were obtained in merger or acquisition while only 431 were formed during the same period.⁴ The consolidation in the banking industry gutted a key source of funding for HEC providers: CRA agreements with lenders. As banking institutions merge or are acquired, HEC providers frequently find that the increased market share of the resulting institution does not correspond to growth in the level of its support. Instead, a parent company may continue to provide the same level of support of a single lending partner while withdrawing the support of the other institutions that have been acquired, and which previously had their own funding agreements with the HEC provider.

The usefulness of CRA obligations as a tool to lobby for HEC funding is further eroded by the fact that increasing numbers of both conventional and nonconforming loans are not subjected to CRA scrutiny, either because they are made by unregulated institutions or because

⁴ Apgar, William and Mark Duda. "The Twenty-fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." Joint Center for Housing Studies, Cambridge, MA: 2001.

they are made by regulated institutions outside their CRA area. The provisions of the CRA were predicated upon a strong link between mortgage lending and the collection of deposits at neighborhood branches or ATM's. However, the rise of securitization as a means of capitalizing mortgage funds has led to the decreased importance of deposits as a source of capital. Combined with technologies that remove the need for face-to-face interaction with borrowers, the number of loans – and lenders – that fall outside CRA regulation has grown rapidly. The JCHS reports that the largest 25 banking organizations in the country make only about 25% of their loans inside their CRA assessment areas, while more than 95% of subprime refinancings are made by independent mortgage companies and out-of-area lenders.⁵ Moreover, “less than 30% of all home purchase loans are subject to intensive review under the CRA. In some metropolitan areas, this share is less than 10%.”⁶ When lenders are not subject to CRA obligations they may not see any reason to support HEC. However, these organizations should be encouraged to see themselves as stakeholders in the HEC debate, given the benefits that they, too, receive from HEC.

Lenders have also taken the position that the development of risk-based pricing techniques has made FLE all but obsolete as a risk mitigation tool. Risk-based pricing seeks to set prices for individual loans on the basis of risk characteristics as opposed to assigning price to an entire category of loans (e.g. adjustable rate mortgages versus balloon payments, versus thirty year fixed rate mortgages) based on the category's average risk profile. Under this framework, the large differential between prime and subprime mortgage rates would be replaced by a gradual price curve. Since as much as 35% of clients served by the subprime mortgage market could actually qualify for prime rate home loans,⁷ this change could indeed mean substantial savings for many borrowers, and it would tend to disproportionately benefit low income and minority borrowers, who form the bulk of the subprime market.

In this sense, the mortgage industry argues, the importance of HEC in moving people into the prime market is also diminished by risk-based pricing. However, it is far from clear that the potential benefits of risk-based pricing will be easy to realize. As Carr points out, even automated processes still involve a certain degree of human intervention, particularly during the crucial application phase. And this human intervention has often disadvantaged underserved

⁵ Ibid.

⁶ Ibid., p. 1.

communities, particularly with regard to the “selective coaching of and provision of information to loan applicants.”⁸ Several authors point out the danger that risk-based pricing may further systematize the biases incorporated into automated credit scores.⁹ Thus, when the mortgage industry offers risk-based pricing as a replacement for prepurchase counseling, it is worth questioning how other stakeholders, specifically disadvantaged borrowers, would benefit from such a change.

Risk-based pricing does not promise to suddenly correct information asymmetries: thus the continued importance of FLE in terms of providing information about the range of differently-priced CFS products to unsophisticated consumers. Similarly, while risk-based pricing would reduce the cost of lending to many subprime borrowers, it lacks built-in mechanisms to help borrowers attain additional savings by improving their creditworthiness. Rather, that remains a function that only FLE providers are equipped and willing to take on.

In contrast to the HEC industry’s haphazard development, the CCC industry was created from whole cloth in the mid-1960s by the CFS industry. Credit card companies who sought to recover delinquent debts established non-profit CCC agencies as a less costly alternative to for-profit bill collectors. A trade organization called the National Foundation for Consumer Credit (NFCC) was also established to set standards and enforce codes of conduct for member agencies. Today, approximately 1500 offices are affiliated with the NFCC, many of which came into existence with the explosion of consumer debt during the last decade.

The expansion of consumer debt, and the concomitant rise in the number of debtors having trouble managing debt, attracted many new entrants to the CCC industry. Unfortunately, some of these new entrants were only nominally non-profit and rarely operated in customers’ best interests. Instead they pursued the fair share arrangements of creditors for revenue and only adopted practices that increased the likelihood of repayment of debt. So, for example, these CCC providers would convince homeowners with debt problems to secure unsecured debt by combining mortgage refinance with debt consolidation. Many of these CCC providers failed to reveal that debt secured by real estate, unlike unsecured debt, is not dischargeable in bankruptcy.

⁷ study by Freddie Mac, cited in *The New York Times* March 18, 1998

⁸ Carr, James H., “Risk-Based Pricing: Automation’s Benefits are not Automatic,” *The NeighborWorks Journal* 17, no. 3 (Summer 1999): 11.

⁹ In addition to Carr: Madison, Juliette B., “Risk-Based Mortgage Pricing: A New Approach Raises Old Concerns,” *The NeighborWorks Journal* 17, no. 3 (Summer 1999).

Mahoney, Peter, “Counseling’s New Role,” *The NeighborWorks Journal* 17, no. 3 (Summer 1999).

Thus these homeowners risked losing their homes while unsecured creditors became bankruptcy-proof.

New entrants to the CCC field also increased competition for fair share revenues and consequently drove down the share sizes. During the 1980s and early 1990s, fair shares paid to CCC providers averaged around 15% of the debt collected. Today, the fair share is about half of that, averaging about 8% of the collected debt. Many reputable, mission-driven, CCC providers used their fair share revenues to cross-subsidize their other assistance to debtors. Therefore, the decline in revenues from broader competition has reduced the amount of unpaid services these organizations can provide (Hasson, 2002, private correspondence).

The CFS industry has developed smart servicing as an alternative to the delinquency prevention provided through FLE. Smart servicing uses complementary software modules to analyze payment patterns and resolve delinquencies. The first module tracks payment patterns of individuals, flagging cases that show signs of becoming problematic (due to variation from a habitual payment pattern, for example). By alerting servicers before these loans actually become seriously delinquent, and by establishing expected behavior patterns for individual borrowers, the software frees servicers to focus on true problem customers as opposed to minor yet chronic slow payers. When borrowers do become delinquent, the second module seeks to resolve delinquencies by cross-referencing information regarding the borrower's situation against the terms of the loan agreement. The result may be a workout plan, refinancing, or a negotiated settlement. It also, very often, involves referral to a FLE provider who can help get delinquent borrowers to establish disciplined budgeting, and even collect payments to settle the renegotiated debt.

Similar to the automated underwriting, smart servicing offers potential improvements to the lending process without making a convincing case for the obsolescence of FLE. Smart servicing is inadequate as an exclusive means of resolving delinquencies simply because remote servicing often fails to make contact with delinquent borrowers. For example, mortgage industry respondents report that between one-third and one-half of delinquent borrowers are never reached by smart servicers (Cordell, et al 2002; Stegman 2003—unpublished correspondence). In contrast, FLE providers, particularly HEC providers who offer a full-cycle approach, are much better placed to maintain contact with clients, given the nature of the relationships that are built during the counseling and education processes. Moreover, the solutions offered by smart

servicing may not reflect the full range of options or access the full range of resources available to resolve delinquencies. Indeed, some servicers have begun to establish partnerships with non-profit providers of FLE to help resolve delinquencies, to prevent recidivism, or to help borrowers to access other sources of relief, such as public or private grant support.

Foreclosure prevention and debt relief assistance offered by FLE providers has an important edge over a fully automated approach: it is more likely to consider the interests of all parties, including the debtor. Because smart servicing systems are not transparent, it is not clear at first blush whose interests are protected. Does smart servicing overemphasize short-term resolution of delinquency rather than a durable intervention that helps customers manage debt over the long haul? It is difficult to imagine a smart servicing module that would include the advice to seek bankruptcy relief to resolve debt problems, or that would consider the essentially unquantifiable damage that losing a home can wreak upon a family as a variable in its algorithms.

Conclusion

The failure to fund FLE adequately is an illustration of the general problem of public goods, where no market can naturally emerge to provide a good or service that offers a diffuse set of benefits to numerous beneficiaries. It also poses the key challenge for advocates who know the benefits of FLE: making the business case for supporting FLE to the various stakeholders and establishing an institutional framework to permanently support the FLE industry.

The FLE industry offers a diverse set of products and services that improve the overall functioning of the nation's financial markets. Over the course of three decades, millions of families have been helped to resolve debt problems, purchase a home, to keep a home in the face of foreclosure, or to seek bankruptcy relief when debt burdens prove to be unsustainable. The total benefits of FLE are actually more far-reaching than the number of families served, given the large group of individuals and institutions who reap considerable direct and indirect benefits. However, the diversity and extent of both the beneficiaries and the benefits they receive work against the sustainability of the industry itself. As the lending industry evolves and funding

sources dry up, the survival of FLE programs, particularly HEC and CCC, is increasingly uncertain.

Many of the benefits of FLE are not quantifiable. It is less important to worry about the exact dollar value of the benefits of FLE – although it is our hope that opening this conversation will spark ideas of how to better capture these benefits – than it is to establish that significant benefits from the provision of FLE flow to a diffuse set of stakeholders. Because each stakeholder only garners a portion of the overall benefits, and since the number of stakeholders is large, there is a heavy incentive for stakeholders to “free-ride,” e.g. garner the benefits of FLE with little or no compensation to providers. Unraveling this problem is a difficult, but not intractable, challenge; it calls for the intervention of a disinterested party, or “honest broker,” to establish a redistribution mechanism; one way to solve a public goods problem is by creating a market for the good in question. CFS providers and other “unconscious” beneficiaries must be made conscious of the degree to which they do, in fact, benefit from the provision of FLE in order for them to consider it a commodity for which they should pay market price.

The challenge for practitioners and advocates is clear: if we want to expand and preserve the FLE industry and the concomitant public benefits it provides, it is incumbent on us to fully account for the costs, benefits, and beneficiaries of FLE. We must then find a way to institutionalize mechanisms that compensate FLE providers for the true and total value of the services they deliver. Beneficiaries must be brought to a full awareness of the benefits they reap, and they should be asked to pay a fair price for them. If not, the FLE industry will be suffocated by free riders and will be replaced by risk-based pricing, smart servicing, or other significantly inferior alternatives. The challenge then will be to determine the historical value of what was lost.