

**Community Affairs Research Conference – Opening Remarks**  
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On behalf of the Federal Reserve System, I would like to add my welcome to the fifth Community Affairs Research Conference. These biennial meetings are a unique opportunity for academics, policy makers and community development professionals to gather together and consider new research findings that can inform our judgments on a variety of issues. I applaud the organizers for compiling such an interesting and provocative program.

This year's conference, on the *financing* of community development, focuses squarely on the ability of credit markets to deliver benefits to a broad spectrum of borrowers. This topic could not be more timely. The slowdown in the housing market we experienced in 2006, together with the increase in delinquencies on recent-vintage adjustable rate subprime mortgages has brought the difficulties experienced by many subprime borrowers and lenders into the spotlight. This has led some observers to question whether the expansion of credit we have experienced in recent years has been beneficial at all. The passionate commentary that these developments have provoked highlights, I believe, the value of careful, objective research on consumer financial markets.

I have spoken elsewhere of the secular expansion of consumer credit, including mortgage credit, and have argued that it has been the result of a broad wave of innovation. The evidence strongly suggests that most of this expansion of credit can be accounted for by falling transaction costs associated with lending and borrowing.<sup>1</sup> If instead consumer credit rose because of attitudinal shifts that reduced consumers' aversion to debt, then we would have seen rising risk premia (the additional interest rate consumers pay to cover default risk), which is contradicted by the evidence that risk premia have been trending down over the last several decades.

The cost reductions that have driven the growth of consumer credit can best be understood as the result of improvements in the ability of lenders to collate and analyze information about consumers, which in turn has allowed lenders to differentiate more finely among borrowers. As innovations progress, the allocation of credit moves "down the demand curve." The new borrowers brought into the market by these developments will, on the whole, have higher than average risks.

Financial innovation, like other sorts of innovation, creates opportunities for people to do things that they previously could not do. But innovation is also risky. There will inevitably be some uncertainty about the outcome of offering a new loan product, or of

offering a loan product to a new set of borrowers. In some cases, loan losses will fall short of expectations. In other cases, loan losses will exceed expectations. Either way, lenders will engage in some amount of experimentation and learning over time, as with any new product rollout.

Some borrowers, too, will at times be uncertain about how suitable a new lending product is for them. New financial arrangements will be unfamiliar and hard to understand for some users, and there inevitably will be some amount of learning required to use them appropriately. New classes of borrowers drawn into the market by innovative lending practices – first-time homeowners for example – may be less prepared to evaluate intricate mortgage products. So financial innovation might generate more frequent mistakes by borrowers, particularly when the new products and practices are more complex than the old. This problem is exacerbated to the extent that disclosure requirements are not well adapted to the new products and critical contractual features are buried in fine print.

These same conditions of uncertainty about innovations also create opportunities for the intentional exploitation of consumers' unfamiliarity. These opportunities may be even more prevalent in the case of innovative loan products, because of their complexity, than for other services or goods. As financial innovation expands the set of borrowers and the variety of borrowing instruments, unscrupulous lending and outright fraud may become more prevalent.

So there are really four interrelated narratives for explaining why an expansion of credit is followed by a rise in delinquencies and defaults – new classes of borrowers are genuinely higher risk, lenders may have difficulty assessing the risks associated with new products, new borrowers may be more prone to making mistakes with unfamiliar financial products, and new borrowers may be more vulnerable to exploitation and abusive practices. One important challenge for research in this area is to devise ways of determining the relative contributions of these factors to the market outcomes we observe. This is a difficult task, and one on which researchers have to date made limited progress. But the evident interest of the public in these issues implies that the social value of such research would be high.

Note that these four perspectives on the expansion of consumer credit have distinctly different policy implications. This isn't the occasion to go into these implications in any depth, but I will say that, in my opinion, the growth and development of the financial literacy of our general population has lagged behind the evolution of the financial markets they encounter. Everyone involved in the retail credit industry – policymakers, bankers, and industry critics alike – has an interest in increasing consumers' understanding of financial products and skill at managing their financial affairs. The Federal Reserve is strongly committed to the goal of improved financial literacy and better consumer understanding of financial market opportunities and risks. Financially literate consumers choose more wisely and make markets more effective.

In my opening remarks to the 2005 conference, I included one of my pet appeals to the research community. I talked about the essential value of research that sheds light on borrowing and other household financial decisions from an *ex ante* point of view. This does *not* mean that we should ignore the *ex post* outcomes – including adverse outcomes – resulting from household participation in credit markets. Rather, it means that we should try to get as complete a picture as possible of the full distribution of outcomes, and the relative likelihood of those outcomes. This is the only coherent way to understand whether any particular choice made by a consumer was reasonable at the time and whether any particular credit market product or practice is beneficial on net. Moreover, such a perspective is essential for evaluating proposed measures to reduce the incidence of adverse outcomes. If, as is sometimes the case, such measures restrict the availability of credit to borrowers who would *not* have suffered adverse outcomes, then one faces a trade-off. Does the benefit of preventing adverse outcomes for some outweigh the cost of restricting beneficial credit to others? We would do well to recognize the limits to our ability to make such judgments.

This is really just another way of saying that we should seek to understand credit market behavior in the context of a broader field of study, which John Campbell has labeled *household finance* in his presidential address to the American Finance Association. Household finance is the study of the full range of consumer savings and borrowing decisions and seeks to understand them in the context of the theory of a consumer trying to maximize the lifetime benefits of the consumption of goods and services, under conditions of uncertainty about the course of income over his or her lifetime.

Much of the work to be presented here over the next two days adds to our understanding of the distribution of outcomes from household financial behavior, both from the point of view of households themselves and from the point of view of lenders' credit granting and pricing decisions. This relates to another theme I sounded at the last conference. It is *people*, not neighborhoods or loans, that matter to our assessment of the effectiveness of credit markets. One implication of this premise is that viewing credit markets through the lens of lender data would always be inherently limiting, because such datasets do not, by themselves, provide information about outcomes of household credit market experiences. I commented two years ago that further refinements of HMDA data were unlikely to yield information that is of much use in making inferences about the well-being of individual households or the effectiveness of credit markets. Although the new HMDA pricing data have produced some fascinating information, I view the experience with that data thus far as confirming my earlier pessimism about the policy usefulness of expanded quantities of such lender-supplied data.

While longitudinal data on household financial experiences is obviously ideal, a potentially worthwhile alternative research strategy would be to collaborate with credit rating bureaus in ways that respect the privacy of individual consumers and the proprietary interests of the companies. This could be particularly valuable because the files underlying credit scores and lending decisions comprise much of the borrower-specific information that is missing from studies based on lending-outcomes data, like the HMDA reports. Merging these files with household data from other sources would

provide a much more consumer-centric and policy-relevant view of credit markets. My understanding is that there is work of this type under way at the Board of Governors.

Such problems with measurement present formidable challenges to the field of household finance, which is to say they represent opportunities for productive further research. I am reasonably confident that the community of dispassionate researchers and practitioners will find new and innovative ways of shedding light on borrower and lender behavior, and will thereby further our understanding of the costs and benefits of market practices and government interventions. The fact that popular policy discussions in this area are so prone to error also points to the social value of good solid research.

At the Federal Reserve, we are deeply committed to understanding the functioning and effectiveness of the financial sector. Credit markets clearly play an important role in community development. The Community Affairs offices of the Federal Reserve Banks were founded to gather and disseminate information about community development, and to foster contacts between lenders and community organizations. As the community development industry has grown and matured, it seems natural for the Fed's Community Affairs functions to focus increasingly on promoting and disseminating good credible research into the fundamental forces that affect the credit market behavior and the well-being of the people who make up the communities of interest. Conferences like these play a constructive and vital role in that endeavor. So I will watch the work discussed at this and future conferences with great interest.

*John Weinberg contributed to these remarks.*

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<sup>1</sup> Athreya, "Shame as it ever was: Stigma and Personal Bankruptcy" Richmond Fed EQ, Spring 2004 Vol 90 No 2.