Financial Education in the Wake of the Crisis
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Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

The past year has been tumultuous for our nation's financial system, for our economy, and, of course, for many of our citizens. Financial transactions entered into by those citizens, and the financial market securities derived from those transactions, were at the heart of the turmoil. With the economy and financial markets apparently on a recovery path, this is a good time to reflect on the meaning of this whole episode for financial education. In particular, what lessons should educators take away to help people make more informed financial choices, not only today but throughout their lifetimes?[1]

I don't intend to prescribe specific curricula changes or pedagogical approaches. But I would like to offer some more general thoughts on what I think would be a useful direction to take as we learn more about the causes of the financial crisis – and about the decisions made by households during the period leading up to the crisis. As always, the views expressed today are my own and not necessarily those of the Federal Reserve System.

Before discussing potential new directions for financial education, I would like to pose a fundamental question: Why do we need financial education at all? This might seem obvious. But I don't think it necessarily is – and I think the answers may help us frame the broader discussion.

For many purposes, economists find it useful to assume that people are rational and that they will acquire the information necessary to make decisions that will benefit them and their families. And there certainly is plenty of financial information and advice out there – as anyone who has seen cable television knows. The problem is, not all that information is necessarily helpful, especially given the varying financial situations in which people find themselves. Moreover, many information providers are far from disinterested. As a result, it can be difficult for individuals to distinguish "good" information from "bad" information. Financial education can help consumers make well-considered judgments about the financial information they hear or read.

Related, when consumers buy durable goods, such as a car or a refrigerator, they are often able to rely on information from friends who have made similar purchases. What's more, these are products that they, themselves, will buy multiple times in their own lifetimes. So there is an opportunity for learning. In contrast, a home mortgage is a less frequent transaction – and one that people often don't discuss in detail with others.

In addition, the nature of many financial instruments is fundamentally different than that of many durable items. For instance, we don't need to understand thermodynamics to buy a suitable refrigerator. But we do need to know a fair amount about the terms of a mortgage contract – and what that will mean for our overall financial wellbeing in various circumstances – in order to make a sound decision about financing a home.

Finally, while a refrigerator is an expensive item, it is unlikely to be a purchase that will put someone in financial peril. This is unlike some financial products that can, indeed, have significant and long-lasting effects. So consumers need to pay careful attention to those decisions and seek out the requisite information to make a choice that is good for them. This is a point that I will return to later.

Education or Regulation, or Both?

As you know, there is a relatively widespread belief that a lack of regulation was to blame for the financial crisis – especially, perhaps, in mortgage lending. Proponents of this argument commonly argue that consumers would be made better off if there were tighter constraints on the set of financial products that they can obtain. To be sure, there were some unscrupulous mortgage lenders who did not act in the best interests of the borrowers and investors they were supposed to serve. But it is also the case that financial innovation – including innovation in the mortgage industry – has benefited consumers. It allowed many people to obtain credit who were previously unable to qualify for credit. This allowed them an expanded range of financial options for rearranging their spending over time in a way that best suited them.

But to many observers, some of those financial choices may seem to make little sense. Consider, for instance, a person with little savings who takes out a high-interest loan to fund car repairs. This will be a costly endeavor, one that might appear misguided. But it may be money well spent if the car is necessary to get to work, especially if the job provides health insurance. Someone with greater wealth may have been able to fund the repairs out of savings, clearly a more desirable option, but one that is not available to every consumer. So it is often difficult to judge the merits of an individual's financial decision without knowing the circumstances that household is facing.[2]

Still, people do make bad decisions at times, and a lack of information is often the root cause. Sometimes this information is what economists call "asymmetric"– that is, one party has far more information than the other party. With financial products, it is usually the provider that has more information about specific provisions in the contract, in which case they may have an incentive to distort or obscure that information.[3] This can place the consumer in a vulnerable position that may result in a choice that turns out poorly. How do we help solve such information asymmetries? I would suggest through a balanced combination of sensible regulation and financial education.

Disclosure requirements are an obvious place to start. Some financial products can be quite complex and difficult to understand, even for relatively savvy consumers. Making the terms of a contract, for instance, clear and explicit is likely to improve many consumers' ability to make an informed decision about that contract and to evaluate alternatives.

The Federal Reserve recently adopted a series of rule changes to improve disclosure requirements for a range of consumer financial products. Many of these changes were based on the results of consumer testing, a typical private sector practice in designing consumer communications. One common lesson of such testing is that, paradoxically, disclosure requirements may be most beneficial if *less* information is disclosed. Home mortgage disclosures are a case in point. After all, the current housing boom and decline occurred in an era when lenders were required to disclose a huge amount of information to borrowers. It is arguable that if only the most significant terms of those mortgages had been disclosed – or at least highlighted – consumers may have been able to more easily evaluate their merits.[4]

Well-designed disclosure requirements are likely to improve the functioning of markets rather than hindering them, and improve consumer welfare. But regulations that would limit consumers' ability to access financial products – even those products that may appear detrimental to some consumers at first blush, such as the high interest loan example I noted before – may harm the very people they were intended to protect. In addition, it is quite possible that, in the longer run, firms will develop new financial products to bypass existing regulations and households will be confronted with decisions regarding those products before the regulatory structure can catch up.

So I would prefer to see more emphasis on giving people the information they need in a clear and understandable format – especially targeted information that will help them to avoid making serious errors – rather than restricting their access to financial products.

What Should Be the Focus of Financial Education?

You may remember the 1987 movie *Wall Street* with Michael Douglas as the ruthless Gordon Gekko and Charlie Sheen as the naïve but ambitious Bud Fox. In it, there is a scene where Fox is about to walk into Gekko's office for the first time and he says to himself, "Life all comes down to a few moments. This is one of them." Now, I am not advocating that *Wall Street* become required viewing in financial education classes. But there is a lot of truth in that quote, in the sense that a few key decisions have the potential to shape the future path of our lives. In those cases, it is important that we make the correct choice – or, perhaps more importantly, avoid a really bad choice. The same is true of personal finances as well. A lot rides on a few key decisions: whether or not to pursue higher education; whether or not to purchase a house and, if so, on what terms; and how to best save for retirement. I believe that financial education should focus on those key decisions, ones that will have large and potentially long-lasting effects on people's lives.

Consider education. Wage inequality has been growing in the United States since the late 1970s. While there are many potential causes of this trend, the one that I believe is contributing to it most significantly is skill-biased technical change.[5] That is, technological progress over the last few decades has increased the productivity of skilled workers more rapidly than it has of less-skilled workers. As a result, the financial returns to accumulating skills have grown significantly. Often – though not always – those skills are obtained through higher education. Investments in human capital can prove more useful if they are made at a relatively early age, giving people the opportunity to recoup their investment throughout the majority of their working lives. In addition, such training tends to build on itself, because acquiring skills early in life makes it easier to acquire additional skills later in life. The evidence is clear that, over time, higher education has become a more significant determinant of lifetime earnings. This suggests that it is particularly important that high school students fully understand these dynamics as they consider which path to take following graduation.

I already talked a bit about home purchases and the importance of properly evaluating the suitability of one's mortgage. But I think it is also important to note that homeownership itself is not a wise choice for everybody. For example, for those who value mobility and are apt to move relatively frequently to pursue better job opportunities, the search and transaction costs of purchasing a house can be prohibitively large. More critically, purchasing a home usually means sinking a considerable amount of a household's savings into a single asset that is often costly to trade. This move may be particularly risky for a household with a variable income stream and low levels of savings, as is true of many low-income households. When one considers such factors, I think it becomes clear that renting does not necessarily mean "throwing your money away," as is commonly suggested. It is simply another way to consume housing stock, one that is appropriate for some households, just as buying is for others. Given the financial risks associated with homeownership, as highlighted by the events of this decade, it should be clear that educating people about the homeownership decision is particularly important.

Planning for retirement involves a hard set of choices as well, which, if not done carefully, can lead to painful results. In the aftermath of this recession, which has seen many workers postpone their impending retirement, the importance of accounting for a range of plausible risks should be clear. Given the differences in how people wish to live in retirement – that is, whether they want more, less, or roughly the same annual spending as when they were working – it is hard to say much in the abstract about what is an "optimal" retirement plan. But I think everyone would benefit from understanding that there generally is good reason to shift your retirement portfolio from more risky to less risky assets as one grows older. This understanding might have helped prevent some of the considerable losses in retirement funds that some consumers have unfortunately experienced.

Financial Education as Economic Education

The three examples I gave above all involve overtly financial decisions, specifically those that will have a significant impact on nearly every household's financial wellbeing. But at their core, they are about fundamental economic principles. As such, I believe we should think of financial education and economic education as being inherently intertwined. How, for instance, does one adequately consider home buying versus renting without understanding the concept of opportunity cost? Or similarly, in order to understand why there is now a wage premium in the United States associated with greater skills, it is useful to understand the theory of comparative advantage. This isn't to say that financial education is only about economic education – clearly it isn't, but economic education is an important component.

Conversely, I might add, it's hard to imagine teaching about the recent financial crisis without coming across the opportunity to discuss financial decisions like financing a home, or saving for retirement. More generally, it's hard to teach economics without teaching about how to make financial decisions.

As for how best to implement such programs, my reading of the literature suggests that there is still no professional consensus. There are ongoing efforts within the Federal Reserve System to measure how some of the Fed's financial education programs have fared and which have been most successful in achieving their intended outcomes. I hope those results will be useful to people in this room as you continue your efforts to help people achieve their financial goals – and to avoid mistakes that could prove financially crippling.

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[1] I am grateful to Aaron Steelman for assistance in preparing these remarks.

[2] For example, see Edward S. Prescott and Daniel D. Tatar, "Means of Payment, the Unbanked, and EFT '99," Federal Reserve Bank of Richmond *Economic Quarterly*, Fall 1999, vol. 85, no. 4, pp. 49-70, for evidence that using a bank account can be costly for low income families.

[3] The usual focus of attention in lending markets is the opposite type of asymmetry, in which the borrower has more information about their own creditworthiness than does the lender. This gives rise to an array of considerations that are beyond our scope here.

[4] See Kartik B. Athreya and Anne Stilwell, "Rationalizing Financial Literacy Policy," Federal Reserve Bank of Richmond *Economic Brief* 09-03, March 2009, for a discussion of this idea and many other issues about improving financial literacy.

[5] Andreas Hornstein, Per Krusell, and Giovanni L. Violante, "The Effects of Technical Change on Labor Market Inequalities," Federal Reserve Bank of Richmond Working Paper 04-08, December 2004.