
FINANCIAL LITERACY, REGULATION AND CONSUMER WELFARE

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“Financial literacy” is the term of art that encompasses a number of activities intended to increase the knowledge of consumers with respect to personal financial management and the purchase and use of financial products and services. Financial literacy is often mentioned as an important tool for enhancing consumer welfare and for preventing predatory lending. Given adequate knowledge and information, it is argued, consumers will avoid predatory lenders and take optimum advantage of the credit available to them in the marketplace.²

This Article will review the developments in the financial services marketplace that form a background for the recent policy emphasis on financial literacy. It will then review policy responses to those developments and the place of financial literacy in relationship to such responses. On the basis of this review and analysis, it will discuss how financial literacy activities can and do enhance consumer welfare, but only in concert with laws and regulations that address consumer protection through regulation of conduct in the marketplace. The Article will also address why public policy needs to be more explicit in the funding of consumer financial literacy activities, particularly those targeted at potentially vulnerable borrowers.

1. North Carolina Commissioner of Banks. This article is an expression of the personal views of the author and is not a statement of policy of the State of North Carolina or the North Carolina Office of the Commissioner of Banks. The author wishes to thank Professor Lissa L. Broome and Stephanie R.E. Patterson for their assistance in the preparation of this article.

2. *See, e.g.*, Chairman Alan Greenspan, Financial Education, Remarks at the 33rd Annual Legislative Conference of the Congressional Black Caucus, Washington, D.C., (Sept. 26, 2003) at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030926/default.htm>; Comptroller of the Currency John D. Hawke, Jr., Financial Literacy: A Key to New Banking Markets, Remarks at the Consumer Bankers Association, (Apr. 8, 2002), at <http://www.occ.treas.gov/ftp/release/2002-32a.txt>; Governor Mark W. Olson, Increased Availability of Financial Products and the Need for Improved Financial Literacy, Remarks at the America’s Community Bankers 2003 National Compliance and Attorney’s Conference and Marketplace, (Sept. 22, 2003), at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030922/default.htm>.

I. BACKGROUND: THE CONSUMER FINANCIAL SERVICES REVOLUTION

A discussion of the need for enhanced consumer financial literacy begins, as do many policy discussions involving financial services, with the forces that have revolutionized the industry over the past twenty or more years: deregulation and advances in information technology (IT). In a recent analysis of the “consumer lending revolution,”³ writers from the Federal Deposit Insurance Corporation (FDIC) pointed out that these forces have profoundly changed consumer financial services in a number of ways including:

- *Rate deregulation* as a result of (i) the lifting of federally-imposed interest rate ceilings and (ii) removal through legal action of state limitations on the importation of higher rates from other jurisdictions.⁴
- *General purpose credit cards* that extend unsecured consumer credit to a wider range of consumers than previously had access to credit cards.⁵
- *Credit scoring*: a tool based on advanced IT that allows lenders to measure more accurately the creditworthiness of borrowers.⁶
- *Risk-based pricing* based on the information available through credit scoring.⁷
- *Securitization*: a funding and risk management tool, based on IT and credit scoring, through which risk-based funding and risk transfer is provided to credit originators by a variety

3. See FEDERAL DEPOSIT INSURANCE CORPORATION, EVALUATING THE CONSUMER LENDING REVOLUTION, available at <http://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html> (revised Sept. 23, 2003) (hereinafter FDIC).

4. See *Marquette Nat'l Bank of Minneapolis v. First Omaha Service Corp.*, 439 U.S. 299, 313-318 (1978); FDIC, *supra* note 3.

5. FDIC, *supra* note 3.

6. *Id.*

7. *Id.*

of capital markets participants.⁸

These developments have profoundly changed the structure of the consumer financial services marketplace and, in particular, the relationship of consumers to financial services firms.

Deregulation and the information technology revolution have been both good and bad for consumers of financial services: increasing competition and available credit, on the one hand, and increasing the potential for harm, on the other.⁹ This dual result comes from the impact of deregulation and the IT revolution on the structure of the market. The market effects include:

- *“Deconstruction” of banking activities.* The origination, funding, and servicing of loans are now viewed by virtually all market participants, whether banking organizations or not, as separate business activities.¹⁰ Financial services firms may conduct all of these functions, but by choice, not necessity.¹¹
- *Organization of separate firms, or separate profit centers within firms, to perform such functions.*¹² It is now unlikely that the firm that originates a consumer loan will own it for its term; rather, the loan (with or without servicing) will probably be sold. The final resting place of the loan will be determined by negotiation between the originator and other firms with which the borrower, in all likelihood, has had no contact.
- *Proliferation of origination competitors.* The good news

8. *See id.* In a securitization transaction, “credit card advances, mortgages, and other receivables are packaged into special purpose trusts and financed through bonds sold to investors all around the world.” *Id.* By this means, financial institutions increase their liquidity, reduce risk, standardize income, and reduce costs. *Id.*

9. Olson, *supra* note 2.

10. *See* Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of “Deconstruction” of Banking Functions*, 5 N.C. BANKING INST. 135, 136-40 (2001).

11. *See id.* at 140.

12. *See id.* at 137-38.

about the structural developments just mentioned is that there has been a proliferation of outlets for consumer credit. This has been particularly the case in the residential mortgage lending market, where the range of firms offering home mortgage products is virtually endless.¹³

- *Concentration of some types of consumer lending activities.* With regard to products such as credit cards and functions such as servicing, the forces mentioned above have resulted in the growth of large enterprises with large shares of these submarkets.¹⁴
- *Growth of the subprime market.* Credit scoring and risk-based pricing have given lenders the tools necessary to assess the risks of the subprime market, to price products that reflect such risk, and to obtain the necessary economic returns to take such risk.¹⁵ As a result, the flow of capital to the subprime market has increased substantially.¹⁶ This market expansion has made home ownership possible for a large number of consumers previously excluded from the market. It has also resulted in an increase in predatory lending.¹⁷

13. See generally Report from Joseph A. Smith, Jr., North Carolina Commissioner of Banks, to Michael Easley, Governor, State of North Carolina (Sept. 23, 2003), available at <http://www.banking.state.nc.us/reports/mla%20report.pdf> (detailing mortgage lending applications received and approved, and licensure requirements). The Office of North Carolina Commissioner of Banks licensed over 1,300 firms and 13,000 individuals to engage in mortgage lending during the first year the North Carolina Mortgage Lending Act was in effect. *Id.* at 1. These licensees did not include exempt entities under that statute, such as all insured depository institutions, but did include mortgage lenders, mortgage brokers, consumer finance companies and some insurance agents. *Id.* On a more global scale, it is of at least passing interest to note that in the first quarter of 2003, finance activities through General Mortgage Acceptance Corporation (a substantial portion of whose earnings are mortgage related) contributed more to the earnings of General Motors Corporation (\$699 million) than did automotive operations (\$548 million). *Mortgage Lending Again Saves GM*, TheStreet.com, at <http://www.thestreet.com/markets/stockwatch/10080412.html> (Apr. 15, 2003).

14. See Williams & Gillespie, *supra* note 10, at 157.

15. See FDIC, *supra* note 3.

16. *Id.*

17. Governor Edward M. Gramlich, An Update on Predatory Lending, Remarks at the Texas Association of Bank Counsel 27th Annual Convention, at <http://www.federalreserve.gov/BoardDocs/Speeches/2003/20031009/default.htm> (Oct. 9,

It is unquestionable that the developments just mentioned have materially increased competition in the retail financial services market with a resulting benefit to consumers. These benefits have been achieved at the cost of breaking up traditional relationships that had formerly been the basis for such services and a more arms-length and adversarial relationship between borrowers and the financial services firms with which they deal.

The benefits and potential harms to consumers from the forces mentioned above vary between the “prime” market, comprising borrowers deemed creditworthy under traditional lending standards, and the “subprime” market, which includes borrowers with no credit history or damaged credit.¹⁸ Prime borrowers have the benefit of a very competitive and relatively efficient market that gives them a very good chance of getting advantageous terms on products that are, by and large, commodities. Financial distress to prime borrowers is generally self-inflicted. The same cannot be said for subprime borrowers, where a combination of vulnerability on the part of borrowers and overreaching or, in some cases, fraud by lenders has resulted in damage that can fairly be said to have been externally inflicted.¹⁹

The revolution in consumer financial services has led to a number of federal regulatory and supervisory actions to protect consumers from the potential harms related to it. The Federal Reserve (Fed) amended regulations implementing the Home Ownership Equity Protection Act (HOEPA) to increase the number of high-cost home loans subject to HOEPA, require additional disclosures and forbid certain contract terms.²⁰ The Fed also amended regulations

2003); *see also* Olson, *supra* note 2.

18. The author acknowledges that this is a somewhat simplistic definition of these markets, given the ability of lenders to segment borrowers, including “prime” borrowers on a sophisticated and finely tuned (or “granular”) basis. That being said, the prime/subprime distinction is a useful one for this article, as the benefits of training and counseling activities are particularly important to subprime borrowers. *See generally* Joseph A. Smith, Jr., *The Federal Banking Agencies’ Guidance on Subprime Lending: Regulation With a Divided Mind*, 6 N.C. BANKING INST. 73 (2002) (discussing subprime lending).

19. *See* Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 112, 121-23 (2002); Joseph A. Smith, Jr., North Carolina’s Predatory Lending Law: Its Adoption and Implementation, Remarks at the National Conference of State Legislatures Annual Meeting, at 2 (July 26, 2002), *available at* <http://www.banking.state.nc.us/reports/ncslpaperx.pdf>.

20. Truth in Lending, 68 Fed. Reg. 16,185, 16,188-90 (Apr. 3, 2003) (to be codified at

implementing the Home Mortgage Disclosure Act (HMDA) to require additional disclosure with regard to certain high-cost loans.²¹ Federal agency guidance on subprime lending includes express guidance on predatory or abusive lending practices.²² In addition, the Office of Comptroller of the Currency (OCC) has used its examination powers and its authority under the Federal Trade Commission Act (FTCA) to address unfair or unethical conduct in financial services.²³ The OCC has also added regulations prohibiting a national bank from engaging in an unfair or deceptive trade practice as defined by section 5 of the FTCA²⁴ and its accompanying regulations.²⁵

State and local governments have also taken action to address abuses in the retail mortgage market through statutes commonly called “predatory lending laws.”²⁶ These statutes have generated significant policy debate, particularly where they are actually or potentially applied to the activities of national banks and their non-bank subsidiaries.²⁷ The Office of Thrift Supervision and National Credit Union Administration have exercised their statutory powers to preempt these laws²⁸ and the OCC has expressly preempted one such statute²⁹ and just finalized its regulation that lays the foundation for further preemption in the future.³⁰

12 C.F.R. pt. 226); Olson, *supra* note 2.

21. See Home Mortgage Disclosure, 67 Fed. Reg. 7222, 7228-30, 7236-38 (Feb. 15, 2002) (codified at 12 C.F.R. pt. 203); Olson, *supra* note 2.

22. See, e.g., OCC Advisory Letter AL 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices (Feb. 21, 2003), available at <http://www.occ.treas.gov/ftp/advisory/2003-2.pdf>; Olson, *supra* note 2; Smith, *supra* note 18, at 105-07.

23. See News Release 2003-88, Comptroller of the Currency, OCC Takes Action Against Texas Bank Engaged in Abusive Lending (Nov. 13, 2003), available at <http://www.occ.treas.gov/NewsRelease.asp?Doc=QIX949V6.xml>.

24. See 15 U.S.C. 45(a)(1) (2002).

25. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1916-17 (Jan. 13, 2004) (to be codified at 12 C.F.R. §§ 7.4008(c), 34.3(c)).

26. See Smith, *supra* note 19, at 2.

27. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1906-11; see generally Saunders, *supra* note 19 (discussing the issue of predatory lending and appropriate responses).

28. See 12 C.F.R. § 560.2(a) (2002) (enacting OTS regulations pursuant to 12 U.S.C. §§ 1463(a) and 1464(a)); 12 C.F.R. § 701.21 (2002) (enacting NCUA regulations pursuant to 12 U.S.C. §1757(5)).

29. See Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,266 (Aug. 5, 2003).

30. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1916-17 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34).

If there is significant disagreement about prescriptive legislation, there is virtually no disagreement about the importance of enhanced financial literacy to consumers in the current financial services marketplace. What “financial literacy” means in this context varies, depending on who is proposing it and for what purpose.

II. DEFINING FINANCIAL LITERACY

In assessing efforts to promote consumer financial literacy, it is important to distinguish between the various activities that are included in that term. For purposes of this discussion, I will make the following distinctions:

- *Financial Education* refers to the teaching of general financial and personal finance information, without reference to specific goals. Examples include inclusion of personal finance in the academic programs of schools, either in courses explicitly devoted to the topic or through the use of financial issues to teach other subjects (e.g. mathematics).
- *Financial Training* refers to the teaching of financial skills necessary to achieve particular goals. Examples include retirement planning programs presented by the sponsors of defined contribution plans and homeownership training commonly associated with affordable housing programs.
- *Financial Counseling* refers to the providing of financial advice, information, and training to persons either in financial distress or who have been found to be potentially financially vulnerable. Examples include lender-sponsored programs for distressed borrowers and the mandatory counseling required under statutes such as state predatory lending laws.³¹

Although financial education, training, and counseling have

31. See, e.g., N.C. GEN. STAT. § 24-1.1E(c)(1) (2003) (prohibiting high-cost home loans without first counseling borrower “on the advisability of the loan transaction and the appropriate loan for the borrower”).

many common aspects, it is helpful to distinguish between them because they are offered to differing audiences at different times for different purposes.

These various financial literacy activities are justified in a number of ways, including:

- *Providing consumers with the information necessary to extract optimum value from the modern financial services marketplace.* Federal Reserve Chairman Alan Greenspan presented this rationale as follows:

Fostering [financial] education that will enable individuals to overcome their reluctance or inability to take full advantage of technological advances and product innovation in the financial sector can increase economic opportunity. As market forces continue to expand the range of providers of financial services, consumers will have more choice and flexibility in how they manage their personal finances. They will also need to learn ways to use new technologies to make wise financial decisions.³²

[E]ducation is the primary means for creating new economic and financial opportunity for everyone. If we are able to boost our investment in people, ideas, and processes, just as we do in machines and technology, consumers and the economy can readily adapt to change, providing ever-rising standards of living for all Americans.³³

- *Prevention of misuse of financial services and attendant financial distress.* The liberalization of consumer credit has

32. Chairman Alan Greenspan, Financial Education, Remarks at the JumpStart Coalition's Annual Meeting, (Apr. 3, 2003) at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030403/default.htm>.

33. Greenspan, *supra* note 2; *see also*, Governor Edward M. Gramlich, Economic and Financial Education, Remarks at the Georgia Summit on Economic and Financial Education, Federal Reserve Bank of Atlanta (Sept. 4, 2003), at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030904/default.htm>.

also brought an increase in the magnitude of consumer financial distress. As the FDIC has recently noted:

Certain segments of the population are showing signs of financial vulnerability. Perhaps the most alarming statistic is the record 1.61 million personal bankruptcies that were filed in the 12 months ending in June 2003 Consumer and mortgage loan losses have risen in relation to the increase in bankruptcy filings. Credit card charge-offs at FDIC-insured institutions rose 33 percent in 2002 to an all-time high of 6.6 percent of average loan balances. Foreclosures of conventional mortgages reached an all-time high of 0.27 percent in the first quarter of 2003, while the portion of subprime mortgages 90 days or more past due has tripled since the end of 2001 to 3.74 percent.³⁴

Financial literacy programs to educate consumers on increasingly available credit can be part of the solution to this growing problem.

- *Reduction or elimination of predatory lending.* Because the market abuses commonly known as “predatory lending” involve, among other things, asymmetry of both knowledge and information between lender and borrower, financial education has been proposed as a counter-measure.³⁵ For example, Comptroller of the Currency, John D. Hawke, Jr., has stated that:

Studies also tell us that financial education is an indispensable element of any strategy to combat the rise of predatory lending. . . . One of the best ways [to oust “bad actors” from the market] is through education, with programs that focus on the most common victims of predatory lending—particularly the poor, the elderly, and minority groups—programs that provide

34. FDIC, *supra* note 3.

35. See Greenspan, *supra* note 2; Olson, *supra* note 2.

information on predatory practices and on non-predatory financial options.³⁶

Each of the goals mentioned above is laudable, but it will be noted that different activities included in the term “financial literacy” are required to achieve them. Financial education and financial literacy are often used interchangeably, however, financial training and counseling are the activities most likely to address issues of financial distress and predatory lending. The stakeholders in consumer financial services apparently understand this need, as is shown by their support of financial training and counseling activities.³⁷ Homeownership counseling (“financial training” under this article’s analysis) accounts for a significant part of this activity.³⁸ Credit counseling is also supported by a number of stakeholders, particularly creditors.³⁹

Financial literacy activity is clearly supported by government and the financial services industry. Is it effective? As a result of increased interest in the topic, there is a growing body of research that is beginning to offer answers to this question.⁴⁰ The research suggests the following preliminary conclusions:

- *Financial education has some positive effects that are limited and that vary depending on the audience for education classes.* The research suggests that the teaching of financial concepts may have some effect on subsequent financial behavior, but the correlation is a weak one.⁴¹ This

36. Hawke, *supra* note 2; *see also* Greenspan, *supra* note 2; Gramlich, *supra* note 17.

37. *See, e.g.*, CONSUMER BANKERS ASSOCIATION, 2003 SURVEY OF BANK-SPONSORED FINANCIAL LITERACY PROGRAMS (Apr. 2003), *available at* <http://www.cbnet.org/SURVEYS/literacy/documents/2003%20Survey%20Overview.pdf> (reviewing various activities of banks in supporting financial literacy) (on file with the North Carolina Banking Institute).

38. *Id.* at 3-6; *see also* ABDIGHANI HIRAD & PETER M. ZORN, A LITTLE KNOWLEDGE IS A GOOD THING: EMPIRICAL EVIDENCE OF THE EFFECTIVENESS OF PRE-PURCHASE HOMEOWNERSHIP COUNSELING 2-5 (May 22, 2001), *available at* http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/zornpeter.pdf (detailing the history and effectiveness of homeownership counseling).

39. GREGORY ELLIEHAUSEN ET AL., THE IMPACT OF CREDIT COUNSELING ON SUBSEQUENT BORROWER CREDIT USAGE AND PAYMENT BEHAVIOR 2 (Jan. 2003), *available at* http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/statenmichael.pdf (describing creditor subsidies of counseling services).

40. Greenspan, *supra* note 2; Gramlich, *supra* note 33.

41. *See* Sandra Braunstein & Carolyn Welch, *Financial Literacy: An Overview of*

does not mean education is without value; rather, “a ‘one size fits all’ approach to financial education will be less effective than more targeted, tailored approaches.”⁴²

- *Financial training can have significant impact on credit performance.* Research on Freddie Mac’s Affordable Gold® program shows a significant reduction in delinquencies for first-time homeowners who have had pre-purchase counseling.⁴³ There is also some evidence that financial programs regarding saving are effective.⁴⁴
- *Financial counseling can have a significant impact on the correction of the financial situation of borrowers in distress.* A recent study of persons in credit counseling concludes that “one-on-one credit counseling has a positive impact on borrower behavior over an extended period.”⁴⁵ Among the demonstrated effects were: (i) a positive impact on credit scores, particularly for those with low scores at the time counseling began; (ii) improvement in a broad range of specific credit characteristics relative to those not counseled; and (iii) improved delinquency rates for those who have been counseled relative to those who have not been counseled.⁴⁶
- *The channel of communication through which financial literacy activity is delivered may have a significant impact on its success.* The research supports individualized and

Practice, Research and Policy, FED. RES. BULL. 445, 449, 452 (Nov. 2002), available at <http://www.federalreserve.gov/pubs/bulletin/2002/1102lead.pdf>. *But cf.* Richard M. Todd, *Financial Literacy Education: A Potential Tool for Reducing Predatory Lending?*, THE REGION, at 6 (Dec. 2002), available at <http://www.minneapolisfed.org/pubs/region/02-12/literacy.cfm?js=0> (arguing that broad-based education courses improve aggregate welfare by benefiting students whose families are not financially responsible).

42. JEANNE M. HOGARTH ET AL., PATTERNS OF FINANCIAL BEHAVIORS: IMPLICATIONS FOR COMMUNITY EDUCATORS AND POLICY MAKERS 22 (Discussion Draft Feb. 2003), available at http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/hogarthjeanne.pdf.

43. HIRAD & ZORN, *supra* note 38, at 17-19.

44. Braustein & Welch, *supra* note 41, at 450-51.

45. ELLIEHAUSEN ET AL., *supra* note 39, at 31.

46. *Id.* at 32.

personal counseling most strongly⁴⁷ and suggests that some forms of indirect counseling, particularly telephone counseling, are of little or no value.⁴⁸

The research referenced above is well-done and helpful, suggesting that most financial literacy activities are beneficial and that some focused and individualized activities are very beneficial. It is also significant to note that neither the public statements of industry and governmental leaders nor the relevant research suggests that financial literacy is a panacea for the distress that some consumers incur through misuse of financial products and services or as a result of predatory practices by financial services firms. Accordingly, it remains the task of policy makers to determine what, if any, normative protections should be in place to protect consumers from abusive lenders and from themselves.

III. FINANCIAL LITERACY IN NORTH CAROLINA

Given the current state of learning about financial literacy activities, how should they relate to normative policies that seek to limit or eliminate unfair or abusive business practices of financial services firms? While there is significant agreement about the importance of financial literacy, there is significant disagreement about normative policies. This disagreement is most fully developed in the debate about state and local predatory lending laws, of which North Carolina's was the first. That statute and North Carolina's law regarding reverse mortgages both provide for financial counseling⁴⁹ and, accordingly, may provide some further insight into the relationship of normative regulation and financial literacy.

North Carolina's predatory lending statute was adopted by the North Carolina General Assembly in 1999 to address perceived abuses in the retail mortgage lending market.⁵⁰ The statute's most debated

47. *See id.* at 31.

48. HIRAD & ZORN, *supra* note 38, at 2 (including finding of "no evidence that telephone counseling mitigates credit risk").

49. *See* N.C. GEN. STAT. §§ 24-1.1E(c)(1), 53-270(6) (2003).

50. *See* Predatory Lending Act, 1999 N.C. Sess. Laws 332 § 2; Smith, *supra* note 19. North Carolina's predatory lending statute became effective on and applies to loans made on or after July 1, 2000. *See* § 24-1.1E (historical and statutory notes).

aspects relate to its prohibitions of various loan provisions generally and its limitations of certain fees and charges with respect to high cost home loans over a statutorily-determined ceiling.⁵¹ North Carolina defines “high cost loans” as those loans:

other than a reverse mortgage transaction in which:

- a. The principal amount of the loan (or, in the case of an open-end credit plan, the borrower’s initial maximum credit limit) does not exceed the lesser of (i) the conforming loan size limit for a single-family dwelling as established from time to time by Fannie Mae, or (ii) three hundred thousand dollars (\$300,000);
- b. The borrower is a natural person;
- c. The debt is incurred by the borrower primarily for personal, family, or household purposes;
- d. The loan is secured by either (i) a security interest in a manufactured home (as defined in G.S. 143-147(7)) which is or will be occupied by the borrower as the borrower’s principal dwelling, or (ii) a mortgage or deed of trust on real estate upon which there is located or there is to be located a structure or structures designed principally for occupancy of from one to four families which is or will be occupied by the borrower as the borrower’s principal dwelling; and
- e. The terms of the loan exceed one or more of the thresholds as defined in [section 24-101E(a)(6)].⁵²

The thresholds in the statute look to the loan’s annual percentage rate at the time the transaction is entered, the total points and fees to be paid by the borrower in connection with the loan closing, and the terms and conditions of any prepayment penalties.⁵³ A much less noted feature of the statute is its inclusion among “prohibited acts” of the following:

51. See § 24-1.1E.

52. § 24-1.1E(a)(4).

53. See § 24-1.1E(a)(6).

A lender may not make a high-cost home loan without first receiving certification from a counselor approved by the North Carolina Housing Finance Agency that the borrower has received counseling on the advisability of the loan transaction and the appropriate loan for the borrower.⁵⁴

The clear intention of the statute is to require that consumers who are about to enter a potentially disadvantageous transaction review it with an independent third party to assess their need for the loan and the other alternatives available to them. Prevention of harm is the goal and the proposed corrective action – one-on-one counseling – has proven effective. Whether the counseling provision of the North Carolina law has been effective, however, is difficult to determine because it has only been used a dozen times.⁵⁵ As best my colleagues in government and I can determine, this is because subprime lenders have altered their business practices and product mix to avoid making “high-cost home loans” rather than because of willful non-compliance. There is at least anecdotal evidence that the counseling that did occur resulted in a number of borrowers electing not to enter high cost home loans.⁵⁶

The General Assembly has also enacted legislation regarding reverse mortgages,⁵⁷ financing vehicles under which seniors may borrow a substantial portion of the equity in their homes, generally to be repaid when the house is sold by the senior or his or her estate. As a policy matter, the potential benefits of such transactions to seniors must be weighed against the potential for fraud and overreaching with respect to a borrower class some of whose members are especially vulnerable. The North Carolina reverse mortgage statute highlights in its preamble the potential benefits and concerns regarding these transactions as follows:

It is the intent of the General Assembly that reverse mortgage loans be available so that elderly homeowners

54. § 24-1.1E(c)(1).

55. Telephone interview with Mary Reca Todd, North Carolina Housing Finance Agency (Dec. 22, 2003).

56. *Id.*

57. See N.C. GEN. STAT. §§ 53-255 to -272 (2003).

may use the equity in their homes to meet their financial needs. . . . The purpose of this Article is to authorize reverse mortgage transactions . . . and to provide protection for elderly homeowners who enter into reverse mortgage transactions.⁵⁸

The reverse mortgage statute seeks to provide protection for potential borrowers in a number of ways, including registration of lenders, disclosure requirements and mandatory counseling. As is the case in the anti-predatory lending statute, the reverse mortgage statute provides for counseling by including among its “prohibited acts”:

Closing a reverse mortgage loan without receiving certification from a person who is certified as a reverse mortgage counselor by the State that the borrower has received counseling on the advisability of a reverse mortgage loan and the various types of reverse mortgage loans and the availability of other financial options and resources for the borrower, as well as potential tax consequences.⁵⁹

The statute describes with particularity who qualified counselors are, how they are certified, and where a list of such counselors is available.⁶⁰ It also requires disclosure of the need for counseling along with other mandatory disclosures to reverse mortgage borrowers.⁶¹ Like the predatory lending statute, which it preceded, the reverse mortgage statute uses a targeted counseling approach to ensure that a potentially vulnerable borrower thinks carefully, and on a fully-informed basis, about a significant financial transaction.

Unlike high-cost home loan counseling, reverse mortgage counseling has been used extensively. During the last year, counselors have worked with over 350 potential borrowers.⁶² I am not aware of problems with loans originated under the statute, but that is not to say

58. § 53-256.

59. § 53-270(6).

60. *See* §§ 53-257(4), 53-269, 53-270.

61. *See* § 53-264(b).

62. Todd, *supra* note 55.

there are none. What is clear is that North Carolina has less of such loans outstanding per capita than do a number of other states.⁶³ Whether the requirement of in-person counseling has resulted in a substantial reduction of loans outstanding and, if so, whether that is a bad thing, remains to be determined.

The counseling requirements of the North Carolina predatory lending and reverse mortgage statutes apply to state chartered financial institutions and to non-bank lenders or brokers operating in North Carolina. Under a literal (and correct) reading, these statutory provisions also apply to federally chartered depository institutions. Federally chartered credit unions and thrifts are, according to their federal supervisors, exempt from these requirements because the statutes in question are preempted under the field preemption granted to such supervisors by federal law.⁶⁴ The OCC's final rule on preemption for real estate loans indicates its clear intention to find state statutes related to predatory lending in conflict with its new rule.⁶⁵ Although the OCC has not yet addressed the North Carolina laws; it is virtually certain that, if asked, the OCC would do the same.⁶⁶

The OCC has staked out an aggressive position on this point through two recent regulatory actions: (i) preemption of the Georgia

63. Helen Savage, Advocacy Director of the North Carolina AARP, testimony before the North Carolina Banking Commission (March 19, 2003). For the year 2002, 203 reverse mortgages were made in North Carolina, accounting for 1.56% of 13,049 reverse mortgages made nationally that year. *Id.* North Carolina had fewer than average of these loans made on a simple arithmetic basis among the states and significantly fewer than average on a per capita basis. *Id.*

64. See OTS, Preemption of Georgia Fair Lending Act, P-2003-1, at www.ots.treas.gov/docs/56301.pdf (Jan. 21, 2003) (citing 12 C.F.R. § 560.2(a) as authority for preemption by OTS); 12 C.F.R. § 702.21 (citing 12 U.S.C. § 1757(5) as authority for preemption by NCUA); Thomas H. Staton, *Federal Supervisions of Safety and Soundness of Government-Sponsored Enterprises*, 5 ADMIN. L.J. 395, 414 (2001) (noting that the charters of federally chartered institutions "preempt a variety of state laws"); Alternative Mortgage Transaction Parity Act; Preemption, 67 Fed. Reg. 60,542, 60,543-44 (Sept. 26, 2002) (noting areas in which the NCUA has preempted state laws).

65. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 *passim* (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34).

66. *Cf.* Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,277 (Aug. 5, 2003) (preempting the Georgia Fair Lending Act's counseling requirement). The counseling requirement contained in the Georgia Fair Lending Act and preempted by the OCC, which purported to bar making high cost loans until a lender received certification that the borrower had "received counseling on the advisability of the loan transaction," was even less restrictive than the North Carolina counseling provision, which requires that the borrower be advised regarding the transaction's advisability and "the appropriate loan for the borrower." See GA. CODE ANN. § 7-6A-7 (2003); N.C. GEN. STAT. § 24-1.1E(c)(1).

Fair Lending Act (GFLA)⁶⁷ and (ii) a new final rule regarding preemption, which governs a variety of matters, including real estate lending.⁶⁸ In the GFLA ruling, the OCC expressly preempted a provision of that statute forbidding a creditor from making a high cost home loan “unless it receives a certificate from a counselor approved by the United States Department of Housing and Urban Development or the Georgia Housing and Finance Authority that the borrower has received counseling on the advisability of the loan transaction.”⁶⁹ The ruling includes this provision of the statute with a number of others that “though based on laudable motives . . . impermissibly seek to impose requirements that a national bank would have to satisfy before being permitted to exercise powers authorized under Federal law.”⁷⁰ Given the public statements of the Comptroller regarding the importance of focused financial education in the fight against predatory lending⁷¹ and the absence of a comparable federal requirement of education or counseling, readers of this article will be forgiven for a certain confusion about why preemption was necessary or appropriate in the Georgia ruling or would be appropriate if the same standard were applied to North Carolina’s laws. They join the author of this article in that unhappy state. In the new final rule, the OCC did not include mandatory counseling provisions in its list of state statutes to be preempted, but does provide generally that “state laws that obstruct, impair, or condition a national bank’s ability to fully exercise its powers to conduct activities under Federal law do not apply to national banks.”⁷²

In addition to the predatory lending and reverse mortgage statutes mentioned above, the current North Carolina state budget provides for the funding of a pilot program on financial literacy in its public schools. The State Board of Education is directed to

establish a pilot program authorizing and assisting up to

67. See Preemption Determination and Order, 68 Fed. Reg. at 46,277.

68. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1916-18.

69. Preemption Determination and Order, 68 Fed. Reg. at 46,277.

70. *Id.*

71. See Hawke, *supra* note 2.

72. See Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) (to be codified at 12 C.F.R. § 7.4009(b)).

five local school administrative units in the implementation of programs on teaching personal financial literacy. The purpose of the pilot program is to determine the best methods of equipping students with the knowledge and skills they need, before they become self-supporting, to make critical decisions regarding their personal finances. The components of personal financial literacy covered in the pilot program shall include, at a minimum, consumer financial education, personal finance, and personal credit.⁷³

The legislation goes on to instruct the State Board of Education to develop the necessary curriculum and to advise local school boards on matters of implementation, including “securing private grant funds and on using other public and private assets to implement the instructional programs.”⁷⁴ In this regard, it should be noted that Congress has included financial literacy funding in the *No Child Left Behind Act* and is considering further legislation to address and fund other financial literacy programs.⁷⁵

Financial literacy also is crucial to achieving one of the major goals I have set for the North Carolina Office of Commissioner of Banks for the next four years: financial services for poor and working poor people, who are either unbanked or marginally banked.⁷⁶ With the approval of and funding from the North Carolina Banking Commission, I have formed a working group to address this issue by: (i) enhancing efforts of various volunteer groups to ensure that low-wage workers obtain the full benefit of the federal earned income tax credit (“EITC”); (ii) encouraging EITC recipients to use all or a portion of the tax refund they obtain to establish a bank account or add to an already existing account; (iii) developing products and services to meet the needs of this market at a reasonable cost; and (iv) using the prospect of a positive net

73. An Act to Appropriate Funds for Current Operations and Capital Improvements for State Departments, Institutions, and Agencies, and for Other Purposes, and to Implement a State Budget that Enables the State to Provide a Sustainable Recovery through Strong Educational and Economic Tools, 2003 N.C. Laws S.L. 2003-284 § 7.35 (H.B. 397).

74. *Id.*

75. CONSUMER BANKERS ASSOCIATION, *supra* note 37, at 13.

76. See Joseph A. Smith, Jr., Remarks at Swearing In, 4, at http://www.banking.state.nc.us/reports/Swearing_In.pdf (Aug. 21, 2003).

worth as the basis for financial literacy activities for this segment of the market. Work toward this important goal has just begun and, accordingly, the financial literacy activities necessary to achieve it have not yet been developed. In all likelihood, the activities will involve training with an emphasis on saving. It is my hope that the substance of such financial literacy activities will flow from our understanding of the poor and working poor as we work with them.

This project is not the first of its kind. Rather, it is modeled after a groundbreaking project by ShoreBank in Chicago: the Extra Credit Savings Program.⁷⁷ The project was directed at low income people in Chicago and included: (i) a no-fee, no minimum balance saving account; (ii) free tax preparation and direct deposit of refund (including EITC) in the account; (iii) market interest on balances; and (iv) ten percent bonus interest for balances at year end.⁷⁸ The program does not appear to have included financial literacy activities and one paper on the program suggests that financial education is helpful, but not necessary.⁷⁹ The results from the ShoreBank project are daunting: (i) fourteen percent of program participants had a significant average balance in the account a year after it was opened; (ii) twenty-two percent made frequent deposits and withdrawals, using the account as a transaction account; (iii) twenty-two percent spent down the account slowly and had low or no balances at year-end; and (iv) forty-one percent depleted their accounts soon after receiving their tax refunds and such accounts were dormant thereafter.⁸⁰ Even if our results are similar, the impact of the project in North Carolina can affect the lives of a substantial number of people.⁸¹ I believe that development of an

77. See generally SHOREBANK & THE CENTER FOR LAW & HUMAN SERVICES, MONEY IN THE BANK: THE EXTRA CREDIT SAVINGS PROGRAM (2001), at <http://www.shorebankadvisory.com/resources/moneyinthebank.pdf> (discussing bringing more low-income households into financial institutions and reviewing the Chicago Extra Credit Savings Program).

78. See SONDR A. G. BEVERLY ET AL., LINKING TAX REFUNDS AND LOW-COST BANK ACCOUNTS: EARLY LESSONS FOR PROGRAM DESIGN AND EVALUATION 2-3 (Aug. 2003) (on file with the North Carolina Banking Institute).

79. See SHOREBANK & THE CENTER FOR LAW & HUMAN SERVICES, *supra* note 77, at 3.

80. *Id.* at 7.

81. According to information provided to the author by MDC, Inc., based on studies by the Brookings Institution, North Carolinians made 633,480 filings claiming EITC in 2001. Additional EITC filings that were eligible, but not made, could raise that number to between 750,000 and 850,000. Since a substantial ground for the receipt of EITC is responsibility for children, it is likely that the total number of people whose lives are affected by the EITC

effective financial training program will be crucially important to our success.

IV. CONCLUSION

In a theoretically perfect world, consumer financial services transactions (like all other transactions) would be socially optimal because they would be made by rational consumers with perfect information and bargaining power sufficient to get the best deal possible. The flesh and blood world, of course, is not perfect: individuals are not always rational; information between consumers and firms is asymmetric in favor of the firms; and the size and market position of many financial services firms gives them significant bargaining power relative to consumers. The imbalances in the marketplace can be corrected, if they are corrected at all, by a number of means. Governmental intervention is one such means; consumer financial literacy is another. Governmental intervention and consumer financial literacy activities are not alternatives, rather they complement each other. In fact, as noted in a number of instances above, financial literacy activities can be an important part of the public policy response to undesirable outcomes of the consumer finance revolution.

The available evidence on financial literacy activities suggests that almost all of such activities are beneficial, but that some are more valuable than others. Financial education has a modest and general long-term benefit to society as a whole and is thus worthy of public funding of the kind discussed above by state and federal governments. Financial training has a measurable and immediate benefit to both the consumers who receive it and to lenders (including both originating firms and the ultimate holders of the loans). It seems that those stakeholders should pay for the training; the policy question is whether and when it should be required. The success of homeownership training in the case of first time homebuyers should certainly make the case for such training for low income borrowers, and possibly for all first-time buyers. Expansion of this activity should not require governmental intervention, except perhaps for enhanced Community Reinvestment

is between 1.2 million and 1.7 million North Carolinians, of whom an estimated 250,000 to 400,000 have not yet received it.

Act credit for depository institutions that fund it. A requirement by the secondary market funders of home loans would be a preferable and more effective incentive.

Financial counseling has a demonstrable positive effect on the circumstances of potentially vulnerable borrowers and debtors in distress. Further, experience under the North Carolina predatory lending and reverse mortgage statutes strongly suggests that pre-transaction counseling also works, if for no reason other than that it discourages potentially vulnerable borrowers from entering transactions that are not right for them. Given these effects, it seems that the best policy requires such counseling and that creditors fund it — certainly in the case of home loans and probably in the case of other consumer loans.

Financial literacy activities cannot make the consumer marketplace perfect, but they can and do make it better. The continued development and support of such activity in all of its forms, including support by mandate where necessary, is in the public interest. All of the stakeholders in this issue would do well to accompany their expressed support of financial literacy activities with concrete funding proposals that allocate the benefits and burdens equitably among them. A consistent and relatively uniform approach to this issue by governments, financial services firms and non-profit organizations will improve the functioning of the market and reduce the need for governmental intervention. Surely we can all agree that that's a good thing.