



## Financial Education: No Substitute for Predatory Lending Reform

CRL Issue Paper No. 7  
September 13, 2004

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*One may receive the information but miss the teaching.*  
– Jean Toomer, scholar and writer

As consumers today enjoy more access to credit from a wider variety of sources, opportunities also have expanded for predatory lending in subprime markets. Education is one way to help people achieve financial literacy and avoid abusive loans, but it does not represent a panacea. In this paper, we provide a brief overview of literacy programs and discuss why education alone will not adequately address predatory lending issues. Obstacles to successful education efforts fall into three main categories:

- Low literacy rates
- Ineffectiveness of disclosure and over-disclosure
- Inherent challenges in creating effective programs

### **Existing Education Programs**

There appears to be general agreement on the broad goal of financial education: *give people the information and skills to make good financial choices*. However, there is no consensus on how to provide education and what to teach. Financial education programs are used for a variety of purposes, such as homebuyer counseling, consumer savings initiatives, worker retirement planning, consumer budget and credit repair, and student financial literacy. Programs also have a wide spectrum of features: courses may last anywhere from one to 120 hours, range from once-a-year events to ongoing efforts, and serve 10 to 50,000 people. These programs are offered by all kinds of organizations, with different motives, expertise, and resources.<sup>1</sup>

Given that about 75% of all financial education programs are fairly new,<sup>2</sup> the jury is still out on their effectiveness. In particular, efforts such as youth financial literacy programs, general financial education, and “customer friendly” payday loan disclosure forms have yet to prove beneficial. Other types of programs have demonstrated success, including new homebuyer training and counseling, workplace programs aimed at increasing employee retirement savings, “America Saves” local initiatives, and reputable credit repair programs.<sup>3</sup> However, even in these cases, the program timing and format affect the success of specific efforts.

### ***Low Literacy as a Barrier to Educational Efforts***

One of the major challenges is that half of U.S. adults have low levels of literacy. Literacy is often thought to refer solely to a person's reading ability, but it actually measures the ability to handle the documents and forms encountered in daily life. True literacy requires a person to read material in books and periodicals (prose literacy), apply arithmetic operations to numbers in written materials (quantitative literacy), and locate and use information in charts, manuals, and other texts (document literacy).

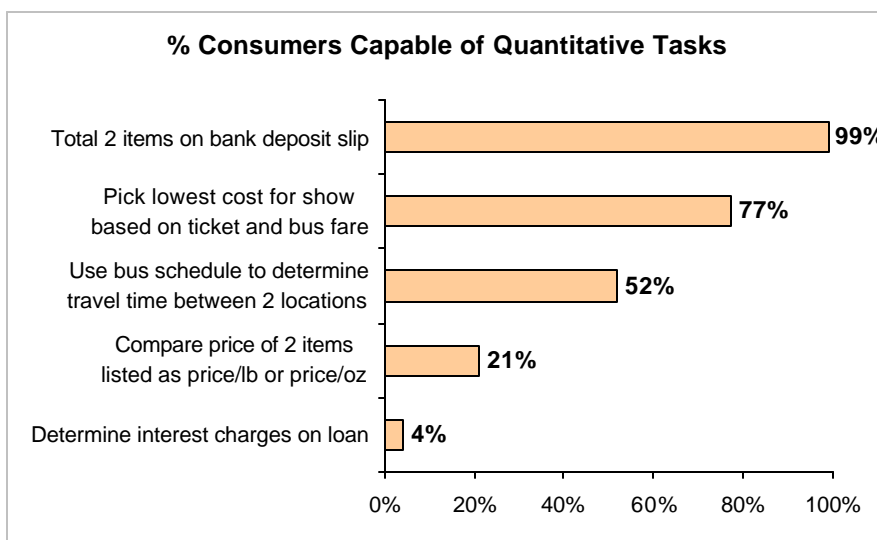
The most recent study of adult literacy was conducted by the U.S. Department of Education in 1992. The National Adult Literacy Survey (NALS) estimated that 94 million people in the U.S. (51% of the adult population) had very-low or low levels of literacy.<sup>4</sup> This percentage was even higher for youth, the elderly, and minorities.

Clearly, these adults are not "illiterate" in the common sense of the word. In fact, most people in this category described themselves as functioning "well" or "very well," suggesting that they are able to handle most of the routine demands of daily life. However, these adults would be at a severe disadvantage in resisting a predatory lender's or broker's "push marketing" and in negotiating loan terms.

Similarly, most consumers have very low quantitative skills.

According to NALS, 79% of consumers cannot reliably handle moderately difficult or difficult quantitative tasks, and only 4% can consistently handle those that are most difficult.

This last fact is especially troubling since "most difficult" tasks include items such as using information from credit documents to compute the interest cost of a loan.<sup>5</sup>



### ***The Gap Between Disclosure and Communication***

A common fallacy is that borrowers consciously choose and accept the loan terms they get, because they read and sign an array of disclosure documents during the loan closing. In fact, most terms on a standard mortgage contract are buried in pre-printed loan documents, and are dictated by the lender, not negotiated by consumers. Further, the documents outlining critical loan terms are typically only three to five documents out of dozens in a standard loan closing.<sup>6</sup> As MBA President Couch explains, "Consumers rarely use these forms and disclosures to compare prices or identify the terms of the transaction because, quite simply, they cannot understand what they read nor what they sign. In addition, the mandated forms lack reliable cost figures, a fact that impedes prospective borrowers from ascertaining true total cost."<sup>7</sup>

To this confusion, add the typical rushed closing environment in which closing agents (often employees of the lender) have little time or inclination to encourage borrowers to read each disclosure document completely before signing it. Taken together, these factors create what The New York Times has called “The Mortgage Closing Nightmare.”<sup>8</sup>

### The Paper Blizzard: Typical Loan Closing Documents\*

▪ HUD 1 – Settlement Statement	▪ Addendum to HUD 1	▪ Assessor’s Letter
▪ Truth in Lending Disclosure	▪ Escrow Disclosure	▪ Assumption Disclosure
▪ Prepayment Letter	▪ Signature/Name Affidavit	▪ Mortgage or Deed of Trust
▪ Mortgage Note	▪ Termite Certificate	▪ Survey
▪ Survey Disclosure and Receipt	▪ Warranty Deed	▪ Flood Zone Disclosure
▪ Flood Insurance Authorization	▪ Lien Affidavit	▪ Real Property Disclosure Statement
▪ Standard Conditions and Acceptance of Escrow	▪ Occupancy Affidavit and Financial Status	▪ Notice of Assignment, Sale, or Transfer of Servicing Rights

\* Excludes items that may be required by state/local entities or by a specific lender

Another issue is that many “plain English” disclosure forms are difficult to comprehend. According to the Federal Trade Commission, over the past ten years a number of companies, including mortgage lenders, have voluntarily redrafted their consumer communications into “plain English.” Nonetheless, a review of sample loan documents shows how difficult it may be for borrowers to read and understand the terms of the credit they are taking on.

The most widely used measure of plain language is the Flesch Readability score. Developed in the 1940s, it is a measure of the length and complexity of text, based on the number of words per sentence and number of syllables per word. Even the SEC uses it to ensure companies’ financial disclosures are clear enough for investors. The Flesch scale runs from 0 (practically unreadable) to 100 (extremely easy to understand). So the lower the score, the harder something is to read. For example, a comic strip averages 90-100, understandable to a fourth-grader. Time magazine scores around 50, readable by a high-school graduate. A standard auto insurance policy scores about 10, and IRS publications score below 0, meaning they are understandable to, well, no one.<sup>9</sup>

### How Readable Are Disclosure Forms?

#### From Good Faith Estimate form:

*“The information provided below reflects estimates of the charges which you are likely to incur at the settlement of your loan.”*

Flesch Readability Score: 70.6  
Comparable to Reader’s Digest

#### From Truth in Lending form:

*“A prepaid finance charge is any finance charge paid separately to the financial institution or to a third party, usually by cash or by check, either before or at closing, settlement, or consummation of a transaction, whichever occurs last. A prepaid finance charge is also any finance charge that is withheld from the proceeds of the credit at any time. In effect, prepaid finance charges reduce the amount of funds available for the consumer’s use.”*

Flesch Readability Score: 44.9  
Comparable to Wall Street Journal  
and Harvard Business Review

The preceding table illustrates the readability of two excerpts from standard mortgage disclosure documents. The first excerpt is fairly readable, but the second would be understandable only to

someone at the level of a college graduate. This is especially troubling because prepaid finance charges often camouflage excessive fees charged by predatory lenders, and represent one instance where borrowers really need to understand the meaning.

In a disturbing development, there is now a tendency to use disclosure laws (originally meant to protect consumers) to defeat consumer claims of fraud or deceptive practices.<sup>10</sup> For example, some courts have held that it is not fraudulent for a lender or broker to misrepresent or fail to mention provisions in a loan contract if those terms are accurately described somewhere in disclosure documents. Courts also have held that consumers have a “duty to read” disclosure forms, even if they get them after agreeing to a contract.

Moreover, while brokers and lenders are required to provide a mortgage borrower with a “good faith estimate” (GFE) of closing costs that supposedly must bear a reasonable resemblance to actual charges, there is no liability if the GFE is inaccurate or incomplete, or even not provided at all. Recent efforts by the U.S. Department of Housing and Urban Development to strengthen GFE disclosure accuracy were defeated by industry trade groups and others.

The ability of unscrupulous operators to alter, conceal, or misrepresent crucial loan information from consumers is often compounded by borrowers’ misplaced reliance on loan officers or brokers to help them pick the best loan. As one observer noted:

*[T]he lender-borrower relationship has never been viewed as a place where all bets are off relating to disclosure, sales practices, and complications after the sale is made.... When it comes to consumer lending ... people expect more than the law of the jungle to prevail.<sup>11</sup>*

Finally, increased availability of information does not always translate into good financial decisions. Studies show that even with reliable and credible information, households do not always act in their best interests. In exploring this “nonrational” behavior, the National Bureau of Economic Research determined that the risk (real or perceived) of trying something new would cause many people to remain in sub-optimal situations. The NBER identified several “economically self-destructive” factors common among consumers, including overconfidence, overreaction, and loss aversion.<sup>12</sup>

Further, it is a mistake to conclude that these behaviors are limited to low-income consumers—one need only think back to 2002 and the behavior of many Americans who had invested in the stock market:

*With the stock market down for a third straight year, many American workers have stopped opening the statements they get for their retirement savings accounts. They're just too depressing.<sup>13</sup>*

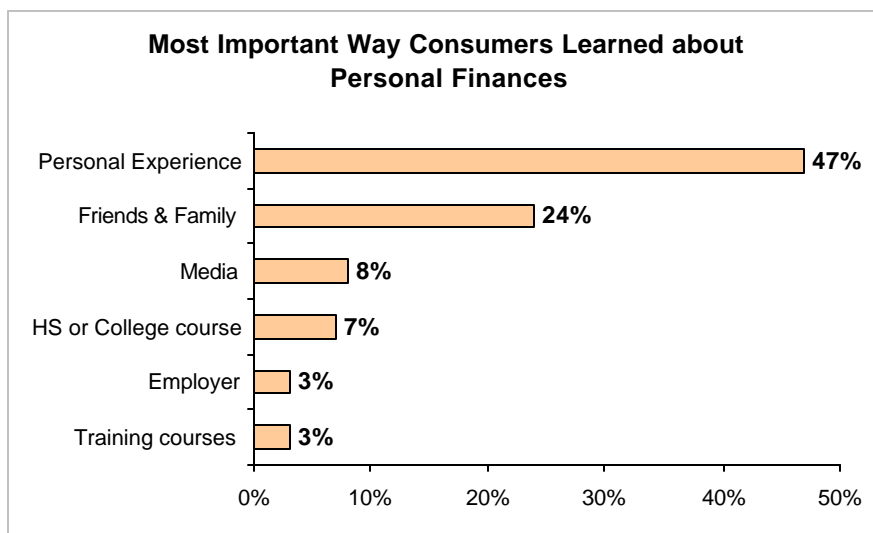
### **Obstacles to Effective Programs**

Most people who propose education programs do not discuss the specifics of such programs, and it is the specifics that make them effective ... or not.

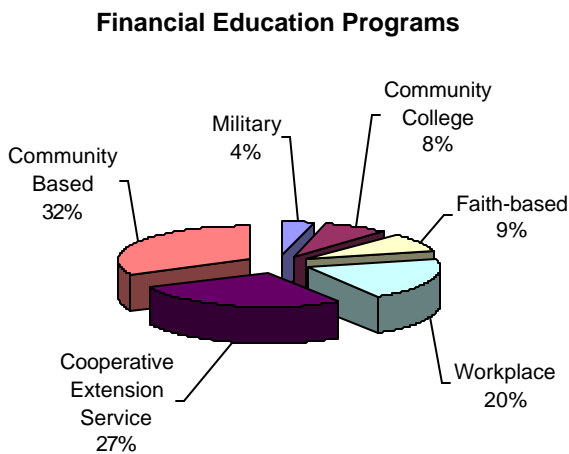
Financial education programs aimed at helping consumers achieve specific goals (e.g. homeownership, retirement savings, credit repair) have proven more successful than programs aimed at building consumers' general financial literacy. A 1999 Freddie Mac survey concluded that consumers benefit most from practical, applied learning,<sup>14</sup> and a recent study by the US General Accounting Office (GAO) concluded that "even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms...And the consumers who are often the targets of predatory lenders are some of the hardest to reach with educational information."<sup>15</sup>

The effectiveness of financial education also depends on the way information is presented and how well it reflects participants' prior experience, cultural background, and financial status. "One size fits all" courses are generally not effective in reaching consumers, especially those with limited financial

experience or resources. A 2001 Federal Reserve survey found that most of these consumers relied on personal experience or friends and family to learn about financial issues (see chart).<sup>16</sup>



Another issue is that programs lack common quality standards and measures of success. There are numerous financial education providers in the U.S., each with their own goals, target audience, resources, and level of success. A 2000 study by the Institute for Socio-Financial Studies sampled 90 programs, and found that they were sponsored by a wide array of institutions.<sup>17</sup>



The study also found that roughly half of the programs had been started within the past five years, and only 22% had track records of 10 years or more. Further, there were wide variations in program content and delivery methods, criteria used to assess a program's success, and subsequent follow-up with participants to measure a program's long-term effectiveness.

Given the short life span of most programs, these results are perhaps not surprising. (For example, standards for homeowner education

programs were not implemented until 1999, even though affordable housing programs had been in place for several years.) Still, in the absence of established standards and quality control practices, consumers remain “at risk” for getting abusive loans.

### ***Education as Part of a Larger Strategy***

In spite of the difficulties surrounding educational efforts, consumer financial literacy is more important than ever. As consumer debt reaches record highs (just over \$2 trillion, or \$19,000 per household, excluding mortgage debt<sup>18</sup>), good and bad financial decisions have more impact on household financial status and stability. Many low-income consumers lack relationships with mainstream lenders and turn instead to non-conventional “fringe” lenders, paying higher costs for services. At the same time, technology has made it easier for lenders to target and market to potential customers, while the related growth of credit scoring has limited the ability of consumers to understand how their credit is evaluated.

Financial education can help fight predatory lending abuses in several ways. It can help borrowers understand their credit rating and adopt strategies to maintain or improve it, enabling them to qualify for lower-cost conventional loans. It can familiarize borrowers with financial concepts and the mortgage process. And it can provide pre-transaction counseling on “high cost” loans, helping consumers avoid loans with unfair terms.

However, despite the good intentions and best efforts of lenders, community groups, lawmakers, and others, financial education by itself will not keep consumers from being victimized by predatory lenders. Education can and should be part of a multifaceted approach. The problems posed by abusive lending practices are pernicious and complex, and they will not be solved with one “cure all” strategy. Instead, policymakers must implement an array of tactics to fight abuses, including (1) state and federal laws to restrict unfair practices, (2) consumer education and awareness, (3) improved disclosure of loan terms, and (4) stronger enforcement of current laws.

#### **About the Center for Responsible Lending**

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

For additional information, please visit our website at [www.responsiblelending.org](http://www.responsiblelending.org).

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#### **NOTES**

<sup>1</sup> L.Vitt, C. Anderson, J. Kent, D. Lyter, J. Siegenthaler, and J. Ward, “Personal Finance and the Rush to Competence: Financial Literacy Education in the U.S.” Institute for Socio-Financial Studies, 2002.

<sup>2</sup> Ibid, p. xiv.

<sup>3</sup> S. Braustein and C. Welch, “Financial Literacy: An Overview of Practice, Research, and Policy.” Federal Reserve Bulletin, November 2002.

<sup>4</sup> The National Adult Literacy Study (NALS) consisted of surveys with approximately 26,000 individuals across the U.S. Based on the survey responses, NALS puts people in one of five literacy skill levels, with Level 1 being the lowest, and Level 5 the highest. 23% of people have Level 1 literacy skills, and 28% have Level 2 skills. Total = 51% of adult population. For more details, see the National Center for Education Statistics report “Adult Literacy

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in America: A first look at the findings of the National Adult Literacy Survey.” <[www.nces.org](http://www.nces.org)> These results are also available for states, counties, congressional districts, and cities with populations over 5,000 at the National Institute for Literacy website at <[www.nifl.gov](http://www.nifl.gov)>.

- <sup>5</sup> Based on NALS measures of consumer quantitative literacy. The skills shown in the chart are examples of the tasks at each level, starting with the easiest (level 1). The NALS showed the following quantitative literacy levels for the US: Level 1-22%, Level 2-25%, Level 3-31%, Level 4-17%, Level 5-4%
- <sup>6</sup> “Joint Report on Recommendations to Curb Predatory Home Mortgage Lending,” U.S. Department of the Treasury & U.S. Department of Housing and Urban Development. June 2000.
- <sup>7</sup> R. Couch testimony before U.S. House of Representative Financial Services Subcommittee, Nov 2003.
- <sup>8</sup> The New York Times editorial, August 24, 2003.
- <sup>9</sup> R. Flesch “How To Write Plain English” <<http://www.mang.canterbury.ac.nz/courseinfo/AcademicWriting/Flesch.htm>>
- <sup>10</sup> A. White and C. Mansfield, “Literacy and Contract,” 13.2 Stanford Law & Policy Rev. 233 (2002).
- <sup>11</sup> Professor G. Marsh, University of Alabama School of Law. Comments before U.S. Senate Special Committee on Aging hearing March 16, 1998. <<http://aging.senate.gov/events/hr14gm.htm>>
- <sup>12</sup> S. Mullainathan and R. Thaler, “Behavioral Economics” National Bureau of Economic Research working paper w7948, October 2000.
- <sup>13</sup> E.A. Powell, “Many Depressed by Retirement Accounts.” AP Online, October 24, 2002.
- <sup>14</sup> Based on data for more than 12,000 individuals with household incomes less than \$75,000. Study is discussed by D. Bradley, A. Hira, G. Perry, and P. Zorn in “Is Experience the Best Teacher? The Relationship Between Financial Knowledge, Financial Behavior, and Financial Outcomes,” submitted to the University of Penn Workshop on Household Financial Decision Making, March 2001.
- <sup>15</sup> United States General Accounting Office Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate “Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending” January 2004 <<http://www.gao.gov/new.items/d04280.pdf>>
- <sup>16</sup> J. Hogarth, M. Hilgert, and J. Schuchardt, “Money Managers —The Good, the Bad, and the Lost.” Paper presented at the Association for Financial Counseling and Planning Education Conference, November 2002.
- <sup>17</sup> L. Vitt and others. “Personal Finance and the Rush to Competence: Financial Literacy Education in the U.S.”
- <sup>18</sup> Federal Reserve Statistical Release, July 8, 2004. <<http://www.federalreserve.gov/releases/g19/current>>