Alan Greenspan: Consumer finance

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington, DC, 8 April 2005.

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It is a pleasure to be here today as you conclude your discussions about our dynamic consumer finance market. Our nation's vibrant financial services industry is remarkable in many respects, with myriad providers offering consumers a broad range of transaction and credit options. The industry is central to the functioning of our robust consumer sector. Therefore, it is essential that policymakers, regulators, bankers, researchers, and consumer groups remain fully engaged in monitoring developments in the consumer finance market and continually seek to better understand the strengths and weaknesses of the financial services industry, including how well it serves lower-income and underserved consumers.

Evolution of the consumer finance market

A brief look back at the evolution of the consumer finance market reveals that the financial services industry has long been competitive, innovative, and resilient. Especially in the past decade, technological advances have resulted in increased efficiency and scale within the financial services industry. Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. Such developments are representative of the market responses that have driven the financial services industry throughout the history of our country.

From colonial times through the early twentieth century, most people had quite limited access to credit, and even when credit was available, it was quite expensive. Only the affluent, such as prominent merchants or landowners, were able to obtain personal loans from commercial banks. Working-class people purchased goods with cash or through barter, since banks did not make consumer loans to the general public.

However, more-intense industrialization and urbanization during the late nineteenth and early twentieth centuries dramatically changed the market for small consumer loans. Urban wage earners used credit to help them purchase the vast array of durable goods being produced by the new industrial economy, such as automobiles, washing machines, and refrigerators. Naturally, this growth in demand fostered increased competition for consumer credit, and, most important, the development of new intermediaries to supply it. Early in the twentieth century, many new organizations that focused exclusively on the needs of consumers entered the field, and the structure of consumer finance began to change dramatically.

Semi-philanthropic groups, called remedial loan societies, were formed to combat the high-rate cash lenders. "Morris Plan" banks, which made loans based on savings plans by borrowers, and the first credit unions, accessible exclusively to consumers with a common place of employment, soon followed. By the 1930s, a wide array of lenders served consumers, including credit unions, small local savings banks, and a nationwide network of state-licensed consumer finance companies. Savings and loans were created, in large part, because commercial banks and other local lenders would not make home mortgage loans. Hundreds of sales finance companies were formed to help manufacturers and retailers provide credit to their customers. Although commercial banks continued to finance merchants, manufacturers, and farmers, they were forced to turn more to consumer lending during the Depression, when their primary business sharply contracted.

As these structural changes continued, market demand and growing competition among this wider variety of lenders spawned further innovation. As early as 1900, some hotels began offering credit cards to their regular customers. By 1914, gasoline companies and large retail department stores were also issuing credit cards to their most-valued patrons. These first cards were simply a convenient way for good customers to run a tab with a particular retail business concern, since balances had to be paid in full each month. Later versions, introduced by retail giants Sears Roebuck and Montgomery Ward, allowed customers to pay their bills in installments, with interest charged on unpaid outstanding balances. This shift to revolving credit, and another innovation - allowing one card to be used at multiple businesses - later generated increasing competition in the card industry. In the 1950s, commercial banks entered into the credit card business.

Home mortgage loans, as we know them today, are a fairly recent product born of the failures of the mortgage finance system during the Great Depression. Clearly, radical change was needed. One of the most significant responses to this need was creation of the Federal Housing Administration, which instituted a new type of mortgage loan - the long-term, fixed-rate, self-amortizing mortgage - which became the model that transformed conventional home mortgage lending. A whole industry - thrift institutions - grew up around this one product.

The development of a broad-based secondary market for mortgage loans also greatly expanded consumer access to credit. By reducing the risk of making long-term, fixed-rate loans and ensuring liquidity for mortgage lenders, the secondary market helped stimulate widespread competition in the mortgage business. The mortgage-backed security helped create a national and even an international market for mortgages, and market support for a wider variety of home mortgage loan products became commonplace. This led to securitization of a variety of other consumer loan products, such as auto and credit card loans.

The current banking structure

Today's fiercely competitive market for consumer credit evolved into its present form slowly but persistently. Along the way, critical structural changes occurred, including entry of, and expansion through, new players.

Deregulation of U.S. banking markets has contributed to an approximately 50 percent decline in the number of banking and thrift organizations since the mid-1980s, when industry consolidation began. From 1995 to 2004, the ten largest U.S. banking and thrift organizations, ranked by the total assets of their depository subsidiaries, have increased their share of domestic banking and thrift assets from 29 percent to 48 percent.

However, according to most studies, this ongoing consolidation of the U.S. banking system has not reduced overall competitiveness for consumer financial services. When consolidation occurs, it is not uncommon for the merger to result in de novo entry to take advantage of any inefficiencies or transition difficulties of the newly consolidated enterprise. Over the past five years, for example, for every five bank mergers that have been approved, two de novo bank charters have been granted. Even in the face of consolidation, competition is fought on the battlefield of the local market, where most households obtain the majority of their banking services. And, it is noteworthy that our measures of local market competition have remained quite stable over the past fifteen years.

Deregulation and consolidation have also cultivated the expansion of the financial services marketplace, as evidenced by the proliferation of many nonbank entities that provide the credit and transaction services that were once mainly the province of depository institutions.

The impact of technology on financial services markets

As has every segment of our economy, the financial services sector has been dramatically transformed by technology. Technological advancements have significantly altered the delivery and processing of nearly every consumer financial transaction, from the most basic to the most complex. For example, information processing technology has enabled creditors to achieve significant efficiencies in collecting and assimilating the data necessary to evaluate risk and make corresponding decisions about credit pricing.

With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. The widespread adoption of these models has reduced the costs of evaluating the creditworthiness of borrowers, and in competitive markets cost reductions tend to be passed through to borrowers. Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.

For some consumers, however, this reliance on technology has been disconcerting. Credit-scoring models are complex algorithms designed to predict risk. Consumer advocates have raised concerns about the transparency and completeness of the information fit to the algorithm, as well as the rigidity of the types of data used to render credit decisions. Consumer advocates contend that the lack of flexibility in the models can result in the exclusion of some consumers, such as those with little or no credit history, or misrepresentation of the risk that they pose.

To address these concerns, some firms have worked to customize credit-scoring systems to include new data and to revalue the weight of the variables employed. Also, new organizations have emerged, developing new systems for collecting alternative data, such as rent payments and other recurring payments that will enable creditors to evaluate creditworthiness of consumers who lack experience with credit.

Improved access to credit for consumers, and especially these more-recent developments, has had significant benefits. Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services. Home ownership is at a record high, and the number of home mortgage loans to low- and moderate-income and minority families has risen rapidly over the past five years. Credit cards and installment loans are also available to the vast majority of households.

The more credit availability expands, however, the more important financial education becomes. In this increasingly competitive and complex financial services market, it is essential that consumers acquire the knowledge that will enable them to evaluate products and services from competing providers and determine which best meet their long- and short-term needs. Like all learning, financial education is a process that should begin at an early age and continue throughout life. This cumulative process builds the skills necessary for making critical financial decisions that affect one's ability to attain the assets, such as education, property, and savings, that improve economic well-being.

Conclusion

As we reflect on the evolution of consumer credit in the United States, we must conclude that innovation and structural change in the financial services industry have been critical in providing expanded access to credit for the vast majority of consumers, including those of limited means. Without these forces, it would have been impossible for lower-income consumers to have the degree of access to credit markets that they now have.

This fact underscores the importance of our roles as policymakers, researchers, bankers, and consumer advocates in fostering constructive innovation that is both responsive to market demand and beneficial to consumers.