The Importance of Financial Literacy

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Relevance

A new economic landscape

Individuals are increasingly in charge of their financial well-being

- **Changes in the pension landscape**
  - **More individual accounts**
- **Changes in the labor markets**
  - **Increased mobility**
- **Changes in the financial markets**
  - **Increased complexity**
  - **More opportunities to borrow**

The “great risk shift”

Risk shift from the government and employers to individuals

How well-equipped are people to make these decisions?

More recently: Leading to the financial crisis

Before the financial crisis

1. Americans were saving very little, saving rate had been very low and reached zero
2. Household debt had been growing steadily
3. Opportunities to borrow became widely available

    3a. (Sub-prime) Mortgages

    3b. Credit cards

Question

Do individuals understand the basic concepts necessary to make sound financial decisions?

Aim: Assess knowledge of basic concepts, the *abc* of finance

Looking at 3 simple questions

Measuring Financial Literacy

To test numeracy and understanding of interest rates, we asked:

"Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?"

i) more than $102
ii) exactly $102
iii) less than $102
iv) don't know (DK)
v) Refuse to answer

Measuring Financial Literacy

To test understanding of inflation, we asked:

"Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, with the money in this account, would you be able to buy…"

i) more than today
ii) exactly the same as today
iii) less than today
iv) DK
v) refuse

Measuring Financial Literacy

Finally, to test understanding of risk diversification, we asked:

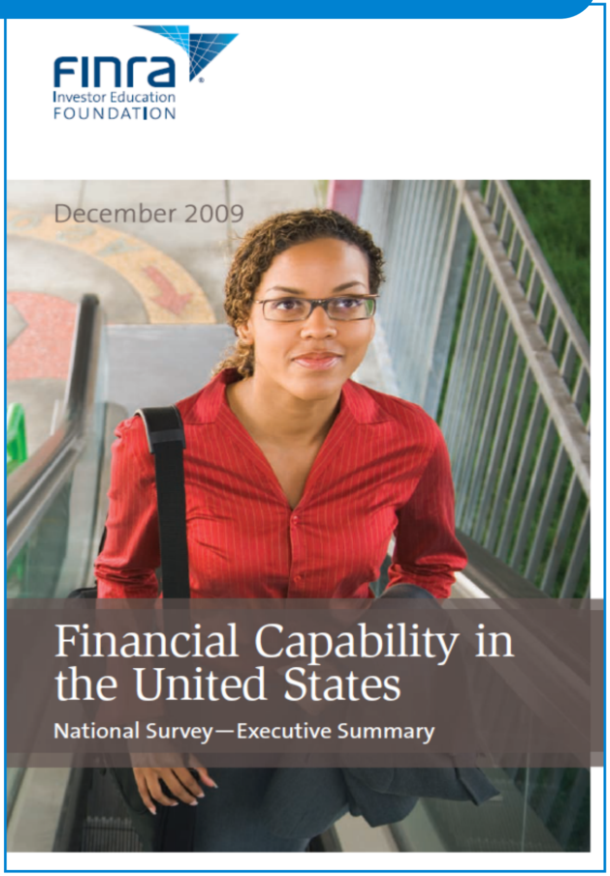
"Do you think the following statement is true or false? Buying a single company stock usually provides a safer return than a stock mutual fund."

i) true
ii) false
iii) DK
iv) refuse

2009 National Financial Capability Study

The National Financial Capability Study includes three linked surveys:

1. **National Survey**: Nationally projectable telephone survey of 1,488 American adults
2. **State-by-State Survey**: Online survey of approximately 28,000 respondents (roughly 500 per state + DC)
3. **Military Survey**: Online survey of 800 military personnel and spouses



How much do Americans know?

Distribution of responses across the US population (2009 Financial Capability Study)

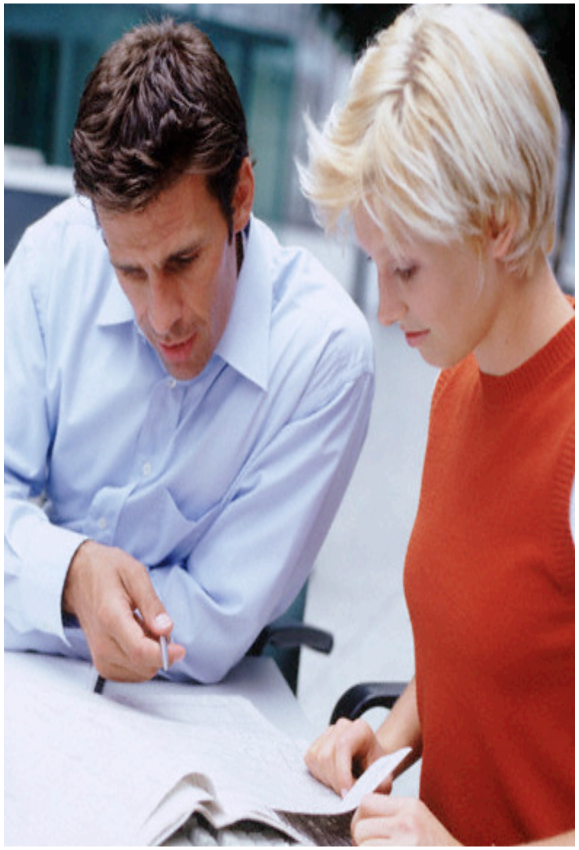
	Responses			
	Correct	*Incorrect*	*DK*	*Refuse*
Interest rate	65%	21%	13%	1%
Inflation	64%	20%	14%	2%
Risk diversif.	52%	13%	34%	1%

NB: Only 30% correctly answer all 3 questions correctly; less than half (46%) got the first two questions right.

How much do young adults know?

We measured financial literacy among young adults using these questions in the National Longitudinal Survey of Youth (NLSY) in 2007-2008

- **Respondents were 23-28 years old at the time of the survey.**



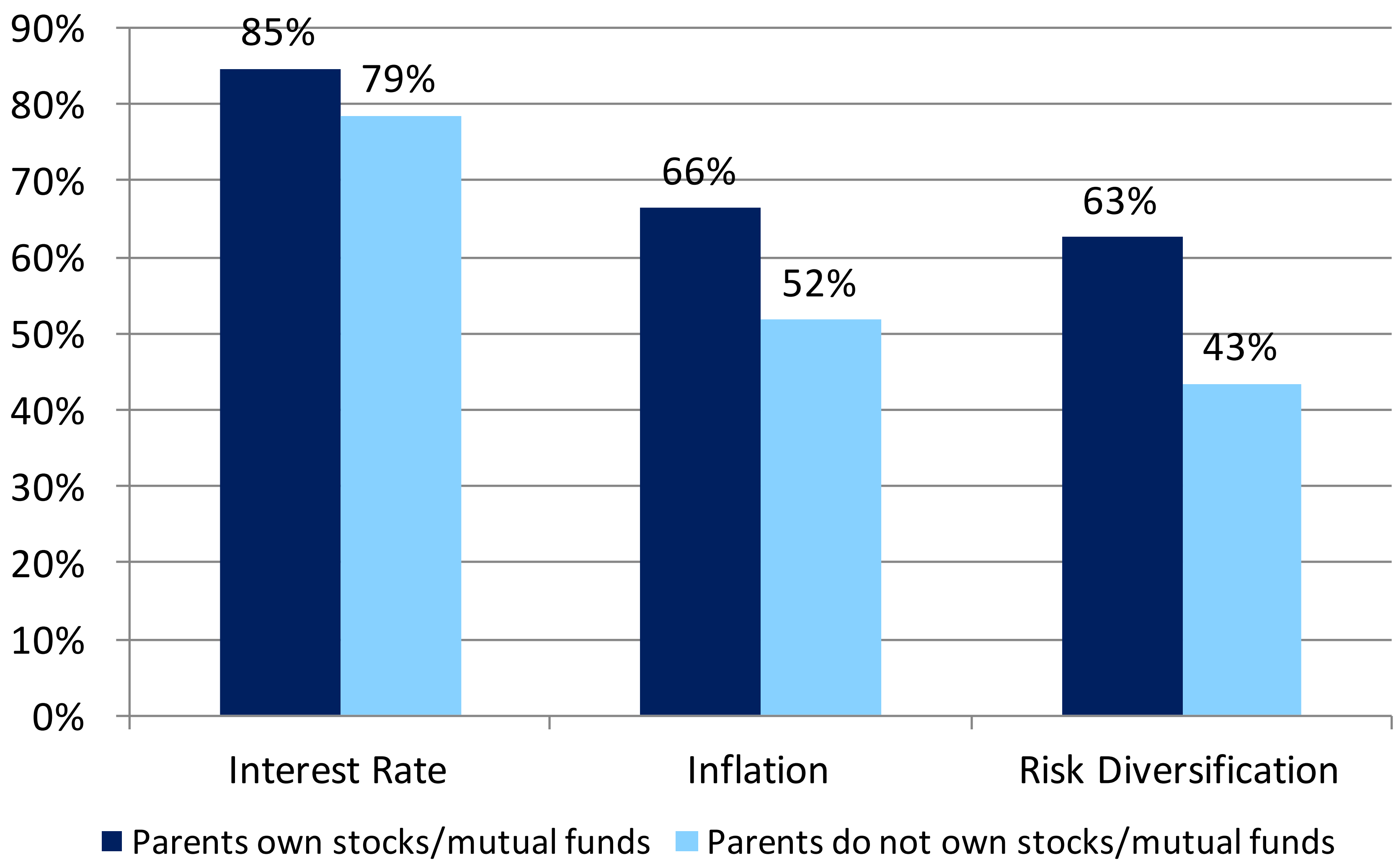
How much do young adults know?

We analyzed the knowledge of people between the ages of 23 and 28:

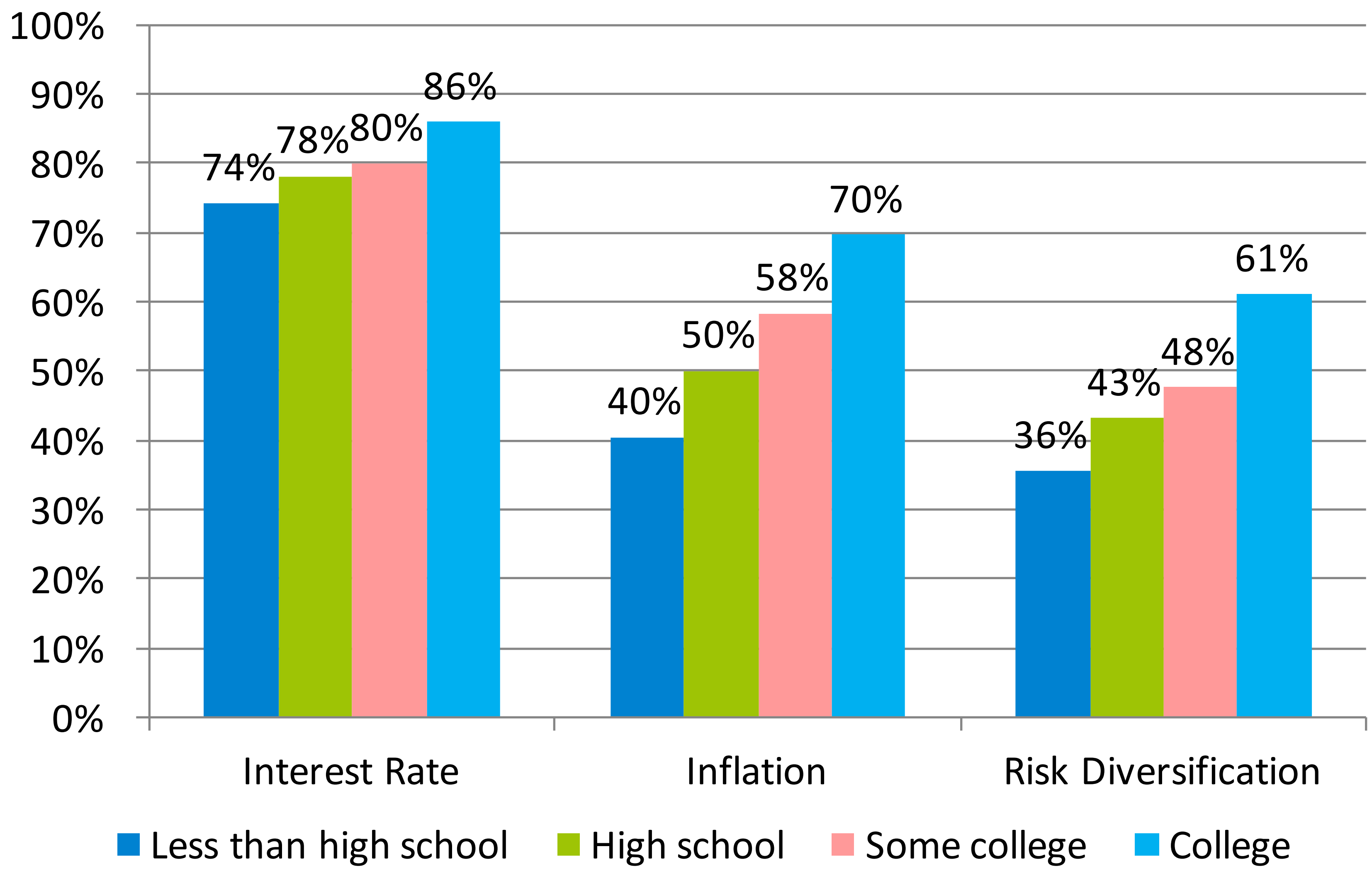
	Responses			
	Correct	*Incorrect*	*DK*	*Refuse*
Interest rate	79.3	14.7	5.9	0.1
Inflation	54.0	30.4	15.4	0.2
Risk diversif.	46.7	15.8	37.4	0.07

Only 27% correctly answer all 3 questions correctly; less than half (46%) got the first two questions right.

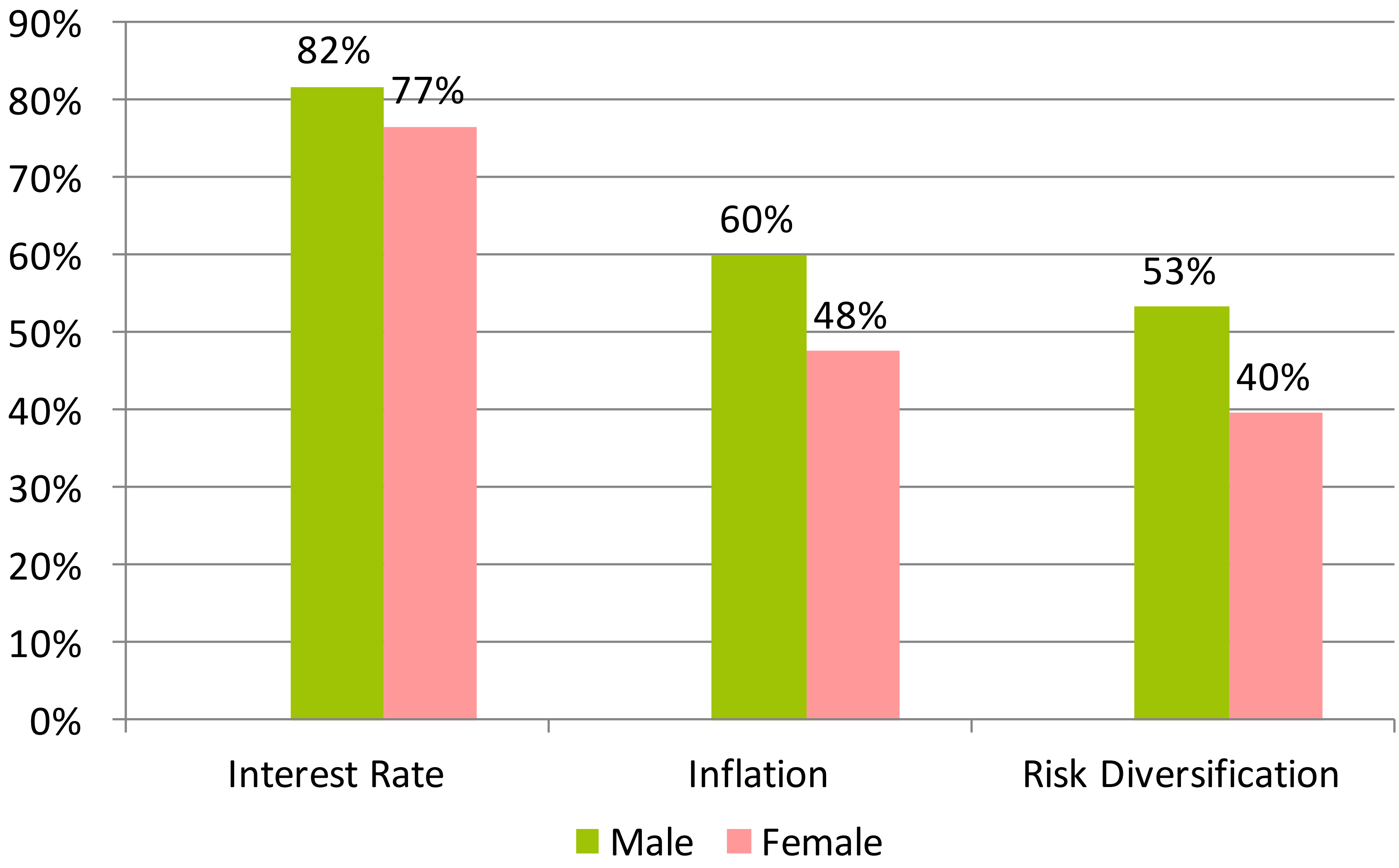
NLSY: Correct responses by parents owning stocks when respondent was a teenager



NLSY: Correct responses by mother's education



NLSY: Correct responses by gender



Linking Financial Literacy to Behavior

Debt and debt management

Investments

Planning and wealth accumulation

Financial literacy and mortgages

Studies show that those with low literacy are more likely to be delinquent and default on sub-prime mortgages (Gerardi, Goette, and Meier, 2010)

Those with low education are less likely to refinance mortgages during a period of falling interest rates (Campbell, 2006)

Consumer Financial Protection

The new Consumer Financial Protection Bureau

- **Individuals are not well equipped to make savvy financial decisions**
- **Individuals have to make decisions facing complex financial instruments**
  - Individual responsibility
- **There are macro costs of financial illiteracy**
  - Ex: Bailing out borrowers and banks

Case Study: Choosing a Mortgage

A case for intervention

- Reduce search costs
- Reduce the incidence of foreclosures that have spillover effects
- Reduce macroeconomic instability

Case Study: Choosing a Mortgage

What to do?

- **A standard mortgage offered as default ("plain vanilla" mortgage)**
- **Disclosure requirement to facilitate comparisons**
- **Focus on mortgage brokers: set standards for licensing mortgage originators**
- **Focus on mortgage modification as an alternative to foreclosure**

Making a case for Financial Education

Limitations of regulation

- **One size does not fit all**
  - Individuals have different needs and economic circumstances
- **Individuals make many financial decisions**
  - Regulating one market (mortgages) is not enough
- **Financial decisions are interrelated**
  - No easy solutions. Ex: automatic enrolling people into pensions

Individuals need to know some basic principles of economics/finance to make decisions

Financial education in practice

Ideal venues to provide financial education

Employer-provided financial education

- Most people are at work

Financial education in school

- Most young people are in school
- We need education *before* individuals engage in financial contracts

Financial education by the Treasury/Central bank/Regulatory authority

- Interest in good functioning of financial markets

Some initiatives

U.S. Treasury National Financial Capability Challenge:

http://www.challenge.treas.gov/

- **Test to measure financial knowledge in participating schools**

Web site to provide financial information:

http://www.mymoney.gov

Recommendations for the CFPB

Only getting started

- **Allow and foster financial innovation**

- **Evidence-based policies**
  - Data is available: National Financial Capability Study

- **Evaluate effectiveness**
  - **We do not know enough about what works**

- **Promote financial literacy**
  - **Equip individuals to make decisions**

Concluding comments

Financial *literacy* is a necessary skill, like reading and writing

- **Need to equip individuals with tools to make decisions**

  - Individuals are increasingly in charge of their financial well-being

- **Cost of financial illiteracy at both the individual and macro level**