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How Can Financial Literacy Improve Retirement Planning?

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A new economic landscape

Changes in many sectors of the economy

Increased individual responsibility for financial well-being

- **Changes in the labor market**
  - Investment in education and skills
  - People change jobs often
- **Changes in financial markets**
  - Greater complexity
  - More opportunities to borrow & in large amounts
- **Changes in pensions**
  - DC pensions and individual accounts

Changes in the pension landscape

Individuals make many decisions

- **How much to save for retirement**
  - Incentivized by employer matches and tax benefits of pensions
- **How to invest retirement wealth**
  - Returns and fees matter a great deal over a long horizon
- **Whether and how much to borrow from pension accounts**
  - It is possible to tap into pension wealth
- **How to transfer pensions from job to job**
  - Labor mobility; people change jobs often

Changes in the pension landscape (cont.)

Individuals make many decisions

- **How and when to withdraw retirement wealth**
  - Including when to withdraw Social Security
  - Make sure wealth lasts a lifetime
- **How to meet other needs**
  - Saving for emergencies
  - Saving for children's education
  - Repay student loans and other debt

The growing importance of financial literacy

Decisions about pensions are complex and consequential

- **How much do people know?**
  - Financial literacy and other knowledge
- **How large are differences in knowledge?**
  - Look also at differences in behavior
- **Are people on a path to retirement security?**
  - From some simple indicators, such as retirement planning
- **What can be done to promote retirement security?**
  - Some scalable initiatives

How much do people know?

1. **"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?"**
   - ❑ More than $102
   - ❑ Exactly $102
   - ❑ Less than $102
   - ❑ Don't know
   - ❑ Refuse to answer

2. **"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…"**
   - ❑ More than today
   - ❑ Exactly the same as today
   - ❑ Less than today
   - ❑ Don`t know
   - ❑ Refuse to answer

3. **"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*."**
   - ❑ True
   - ❑ False
   - ❑ Don`t know
   - ❑ Refuse to answer

Financial Literacy around the World
(FLat World)

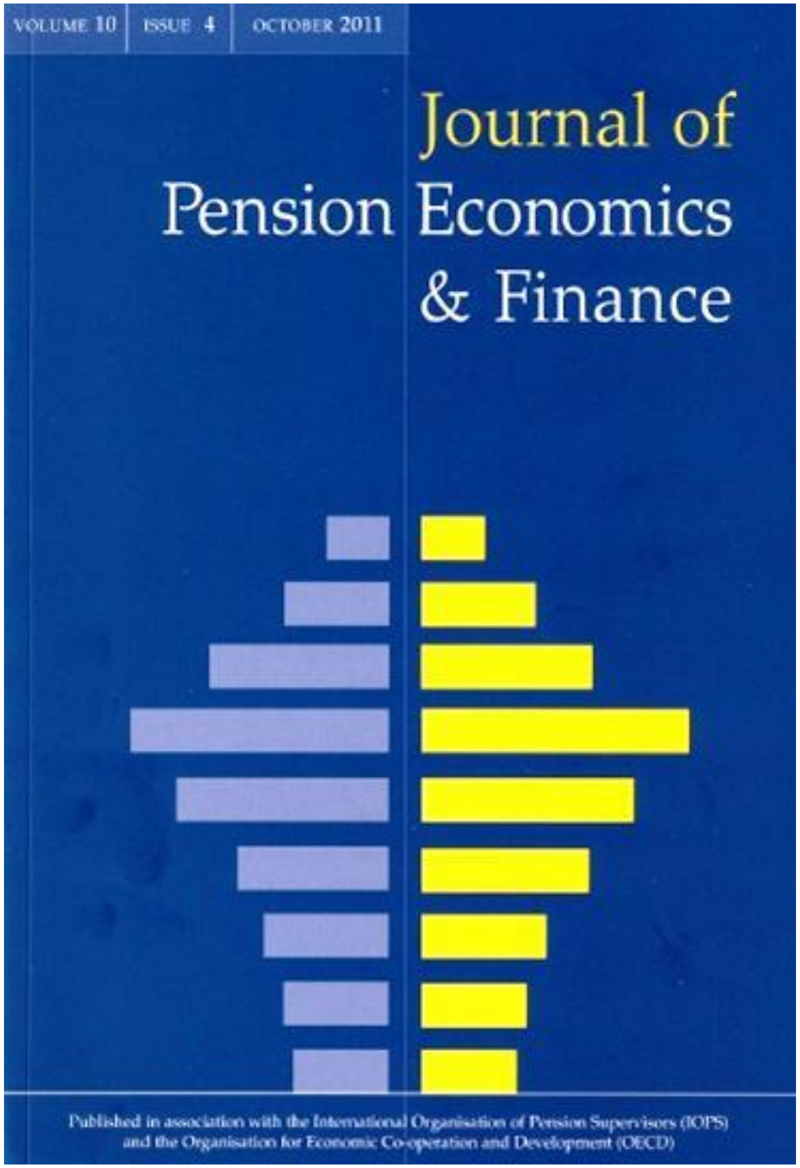
Evidence from 13 countries:

- ❖ USA
- ❖ The Netherlands
- ❖ Germany
- ❖ Italy
- ❖ Russia
- ❖ Sweden
- ❖ New Zealand
- ❖ Japan
- ❖ Australia
- ❖ France
- ❖ Switzerland
- ❖ Romania
- ❖ Canada

Special issue of JPEF, project ongoing

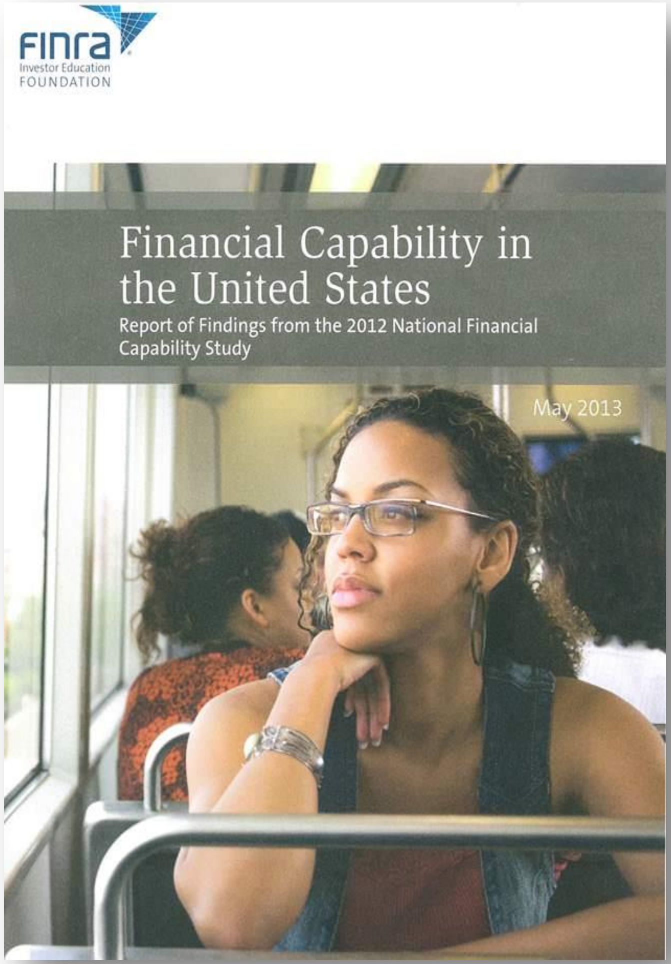
- ***Financial Literacy and Retirement Planning***

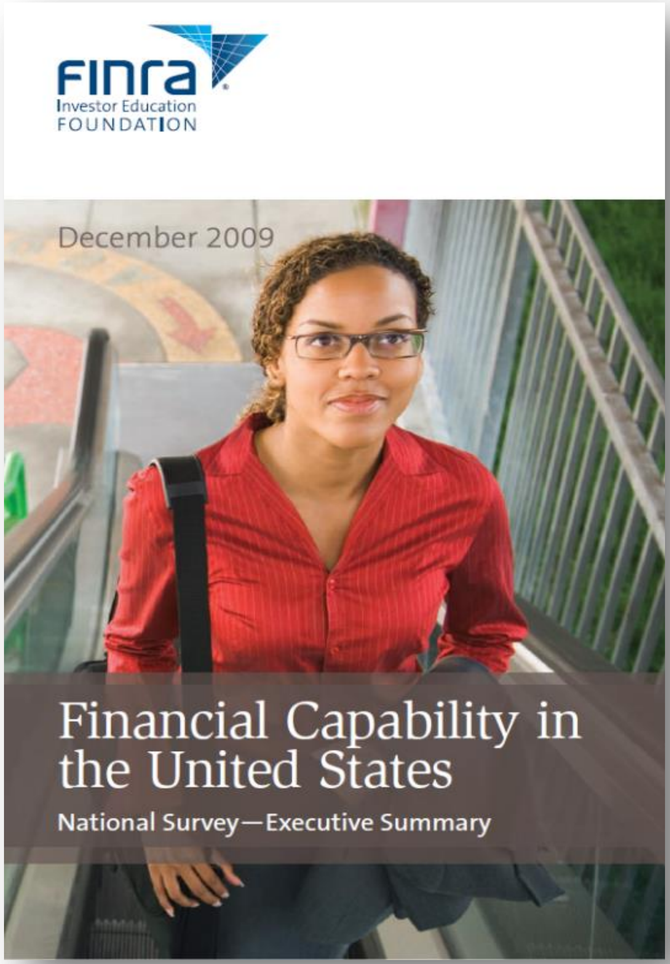
- **We published a paper for each participating country**



Data for the United States

The 2009 & 2012 National Financial Capability Study (NFCS)





Supplemented by other data

- **Large survey on financial literacy in the American Life Panel**
  - Many questions
- **TNS survey on specific financial knowledge**
  - Debt literacy
  - Risk literacy
- **Targeting specific age groups**
  - Older population (HRS) and young adults (NLSY)
- **Surveys done at big employers**
  - Knowledge of pensions

Four important findings

1. **Levels of financial literacy are very low**
   - Only 1/3 of Americans can answer these 3 questions
2. **Knowledge of risk and risk diversification is lowest**
   - Very low levels of risk literacy
3. **Differences in financial literacy are very large**
   - Women
   - Young people
4. **Disconnect between self-assessed and actual knowledge**
   - Not aware of lack of knowledge

Financial literacy across age groups (2012 NFCS)

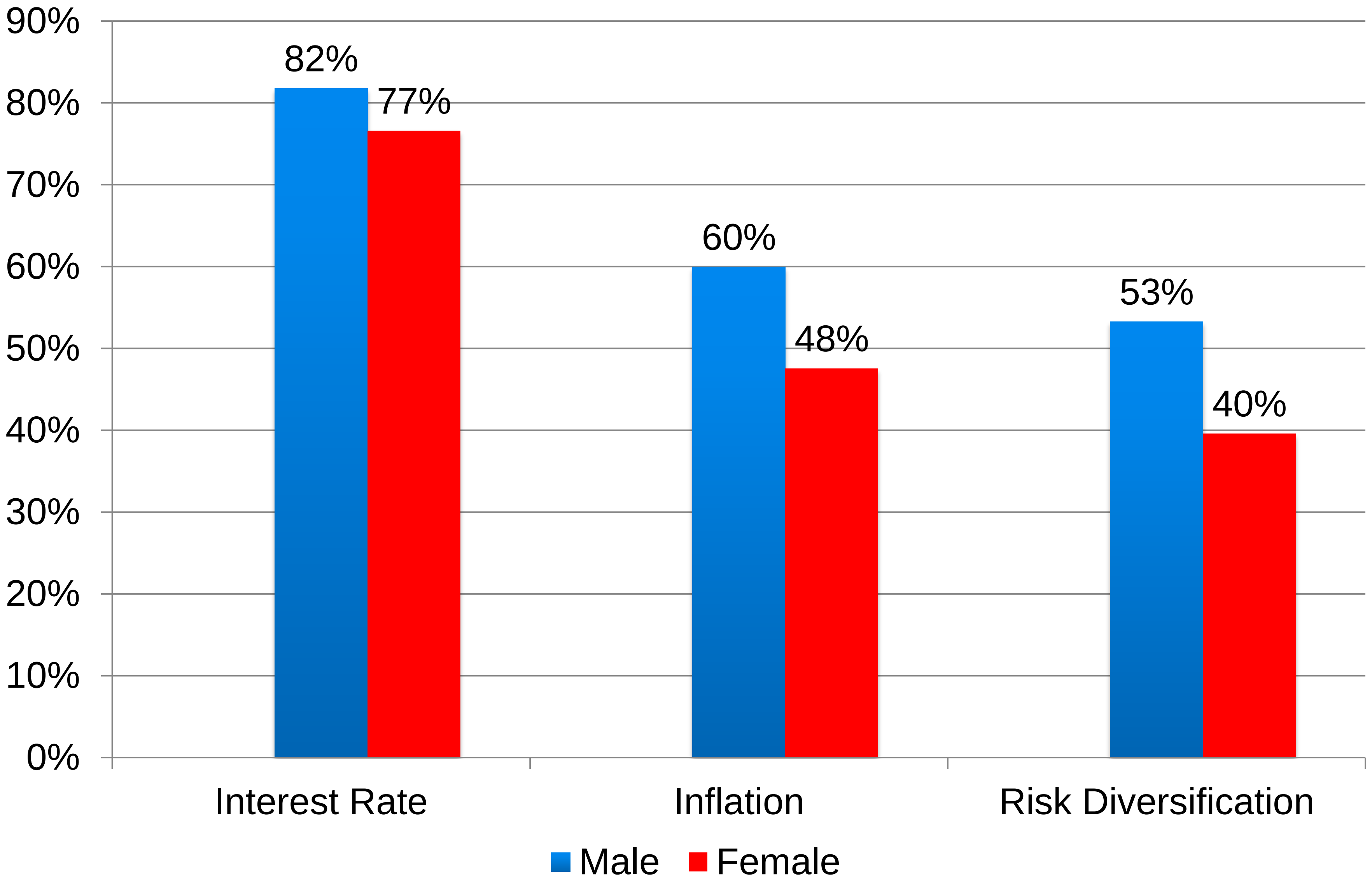
The widespread lack of financial literacy

	Total sample (age 23-61)	Millennials (age 23-35)	Mid-career (age 35-50)	Pre-retirees (age 51-61)
Interest Q correct	80%	75%	81%	83%
Inflation Q correct	65%	50%	68%	79%
Risk Q correct	54%	44%	56%	62%
All 3 Qs correct	**41%**	**28%**	**43%**	**51%**

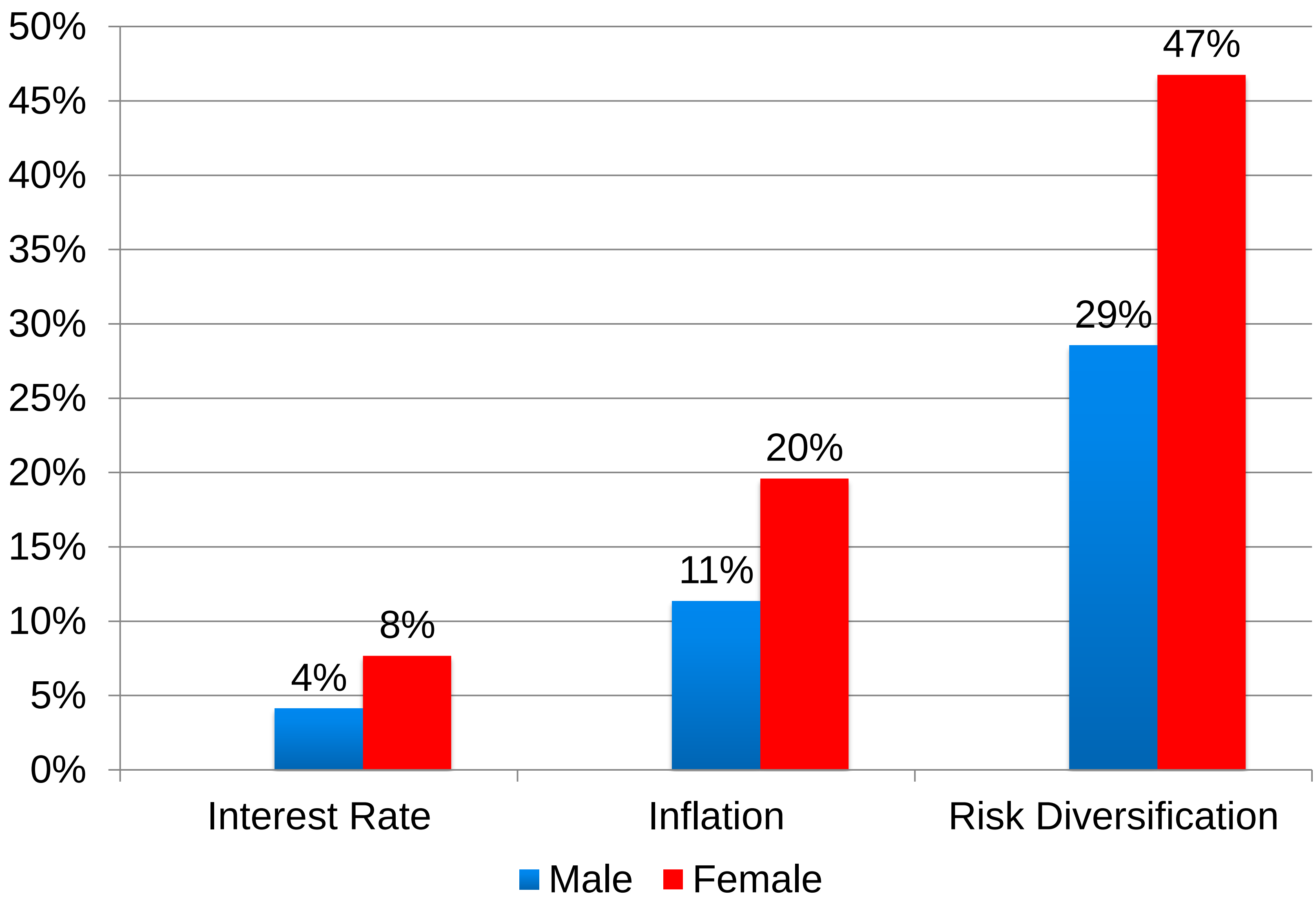
Note: Respondents age 23 to 61 and employed at the time of the survey.

Young people know the least.

Financial literacy and gender (age: 23-28, NLSY)

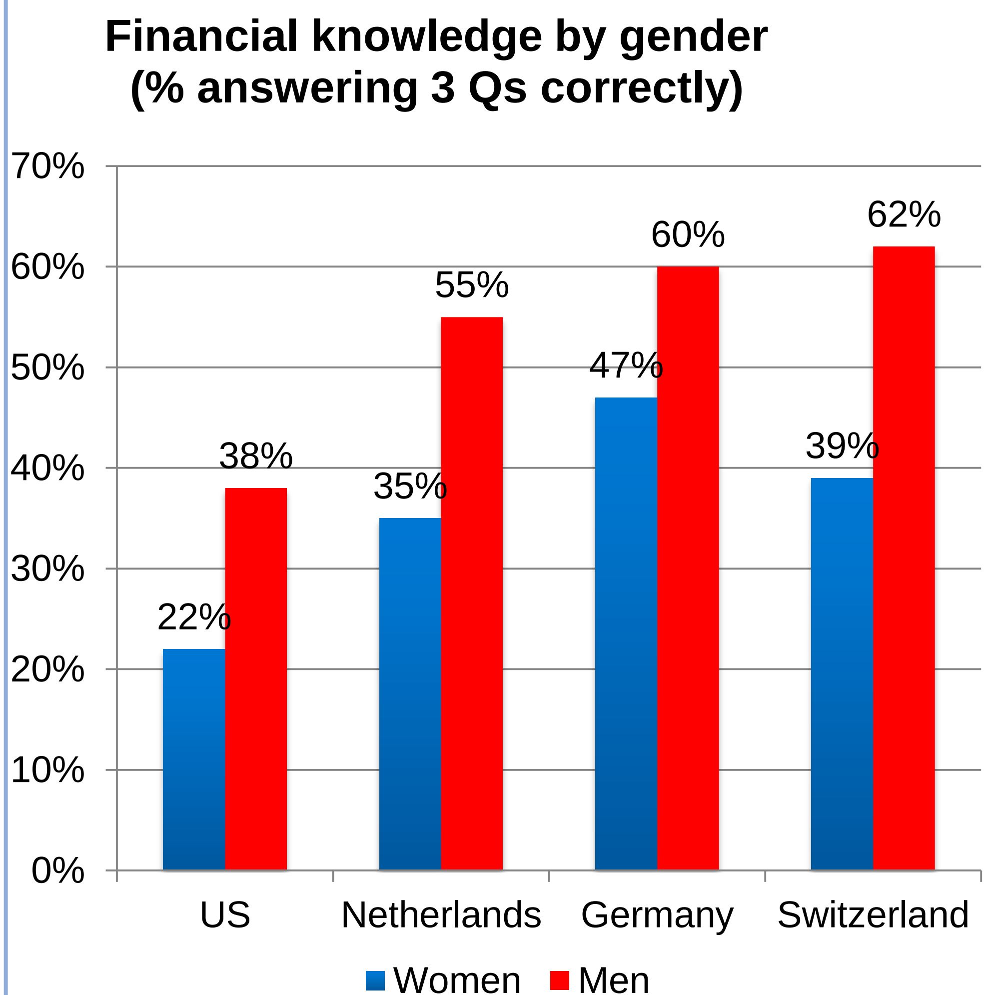


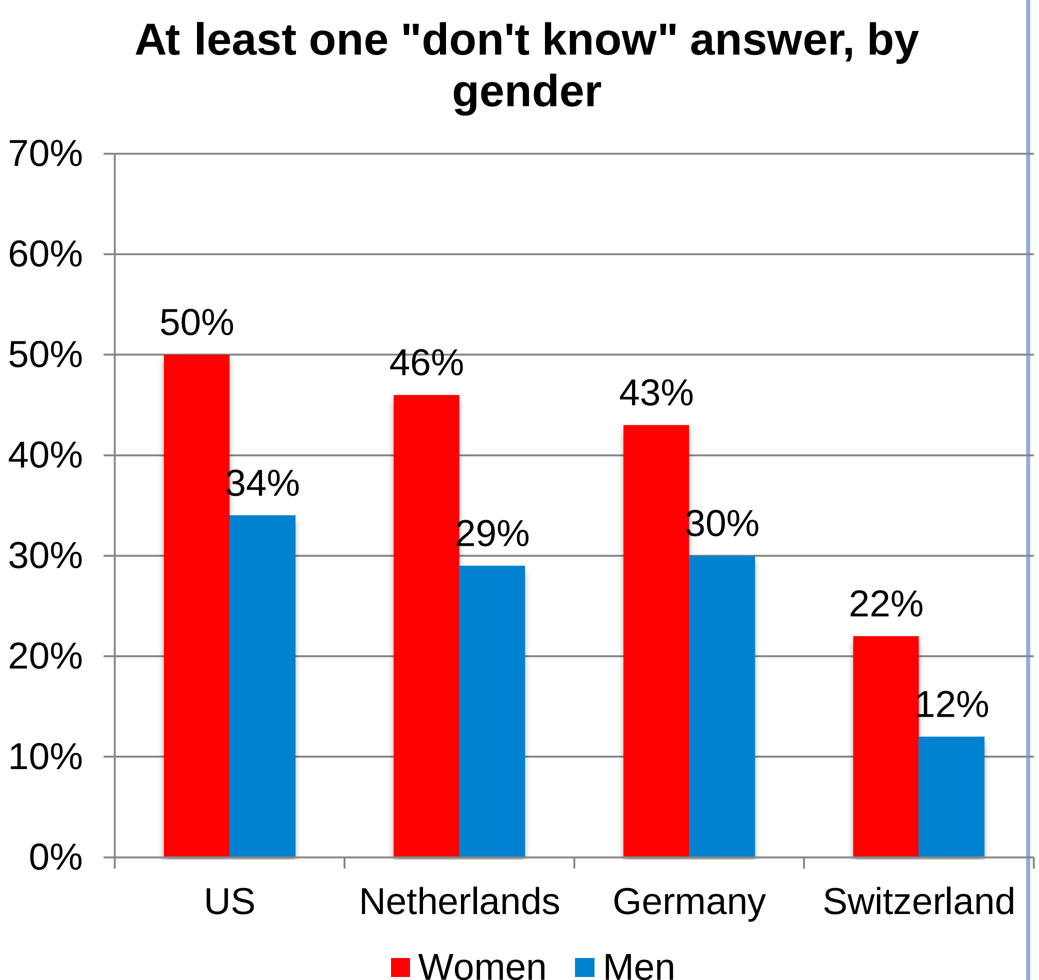
“Do not know” responses by gender (age 23-28, NLSY). Same finding in all 13 countries



Gender differences are similar across countries

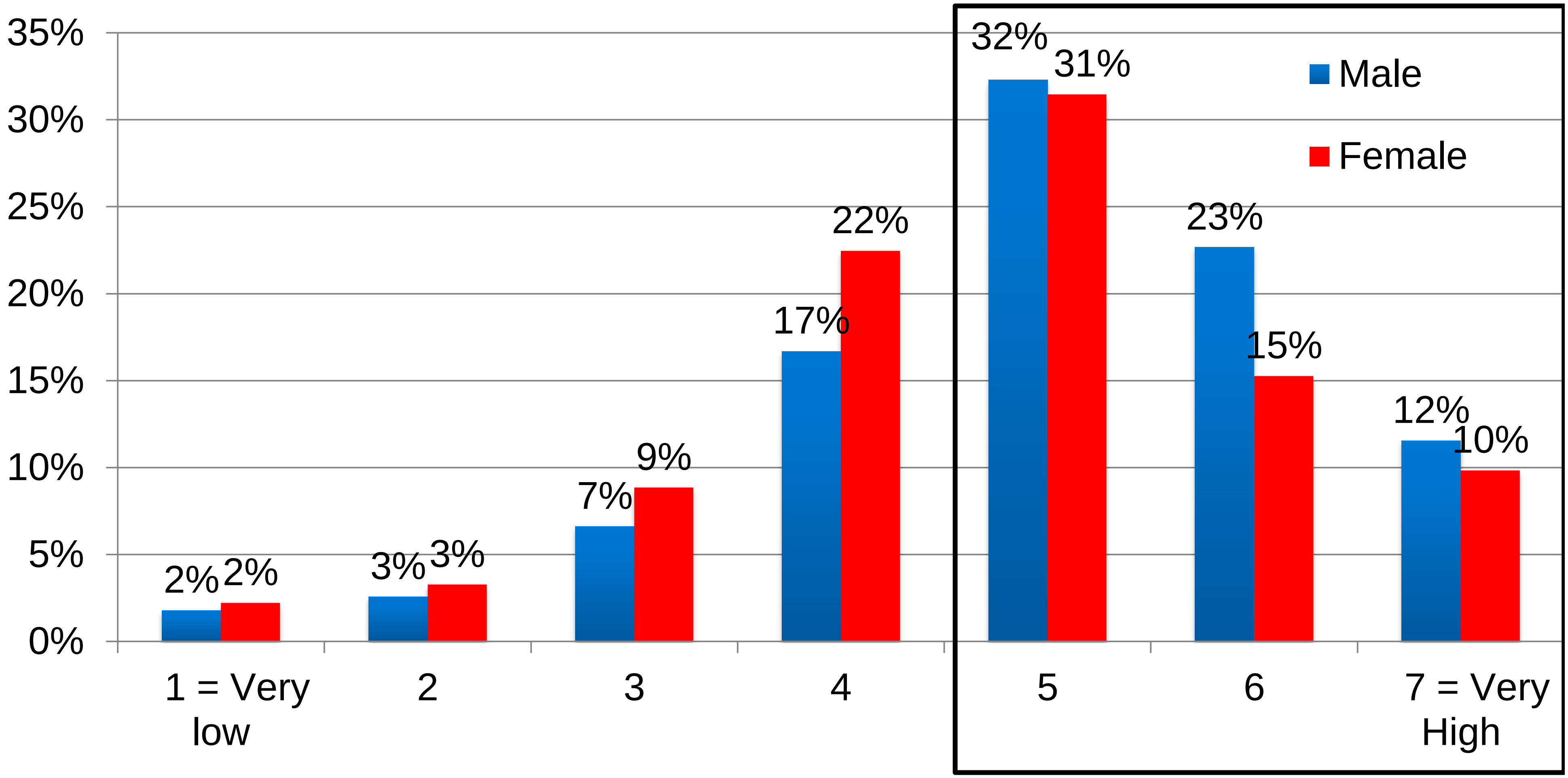
- Women are much more likely to say “I do not know”





Gender differences in self-reported literacy (TNS data - 2009)

On a scale of 1 (very low) to 7 (very high), how would you assess your overall financial knowledge?



Questions related to pensions

Asked to employees of a large financial institution

1. **Tax Offset:** **Assume you were in the 25 percent tax bracket (you pay $0.25 in tax for each dollar earned) and you contributed $100 pretax to an employer's 401(k) plan. Your take-home pay (what's in your paycheck after all taxes and other payments are taken out) will then:**

- ❑ Decline by $100
- ❑ Decline by $75
- ❑ Decline by $50
- ❑ Remain the same
- ❑ Don't Know

2. **Match:** **Assume that an employer matched employee contributions dollar for dollar. If the employee contributed $100 to the 401(k) plan, his account balance in the plan including his contribution would:**

- ❑ Increase by $50
- ❑ Increase by $100
- ❑ Increase by $200
- ❑ Remain the same
- ❑ Don't Know

Findings on pension knowledge

- **Low level of pension knowledge**
  - Levels of knowledge are low

    Tax offset: 45% correct

    Match: 78% correct

- **Large differences across employees**
  - One size does not fit all

Implications: What the research suggests

- **Need to improve levels of financial literacy**
  - Levels of knowledge are low
- **Need for more targeted programs**
  - One size does not fit all
- **Women are an ideal group for fin education programs**
  - They know what they do not know
- **Many employees are unlikely to participate in financial education programs**
  - Unaware that they need it

Linking financial literacy to behavior

We have looked at several outcomes

- **Retirement planning**
  - An important determinant of wealth
- **Investing**
  - Returns on investment, accounting for risk
- **Borrowing**
  - Many types of debt

Main message: Financial literacy matters!

A quick look at debt close to retirement

- **Data**
  - Health and Retirement Study (HRS): 3 cohorts (age 56-61) at three different time periods: 1992, 2002, and 2008.
  - National Financial Capability Study, 2009 & 2012
- **Empirical analysis**
  - Evaluate if/why patterns changed over time.
  - Evaluate factors associated with debt/debt management for those on verge of retirement

The increase in debt across cohorts

Total debt/Total assets > 0.5	
First HRS cohort (1992)	9.6%
War Babies (2002)	16.0%
Baby Boomers (2008)	22.9%

Home loans/home value > 0.5	
First HRS cohort (1992)	17.0%
War Babies (2002)	26.4%
Baby Boomers (2008)	29.3%

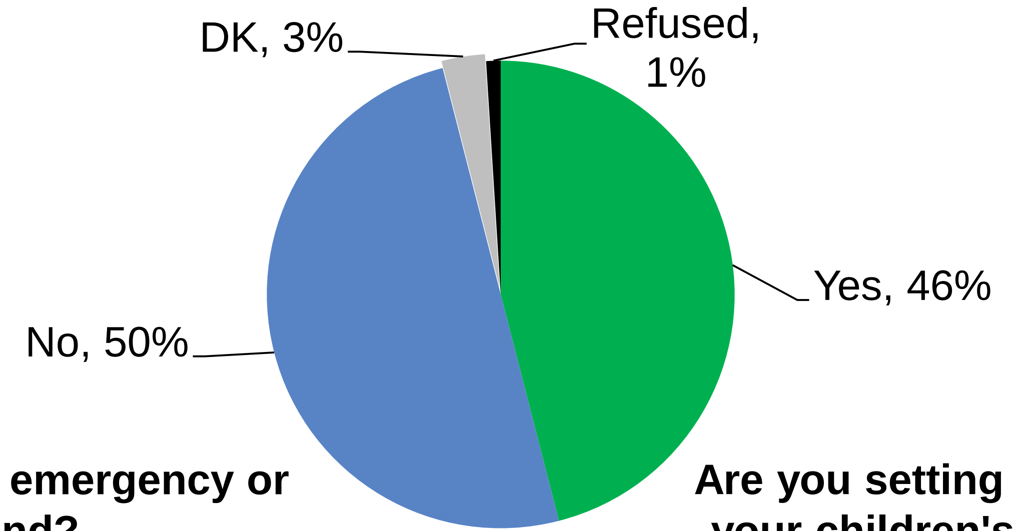
Respondents with < $25,000 in savings (in $2012)	
First HRS cohort (1992)	18.0%
War Babies (2002)	16.4%
Baby Boomers (2008)	24.3%

What the research suggests

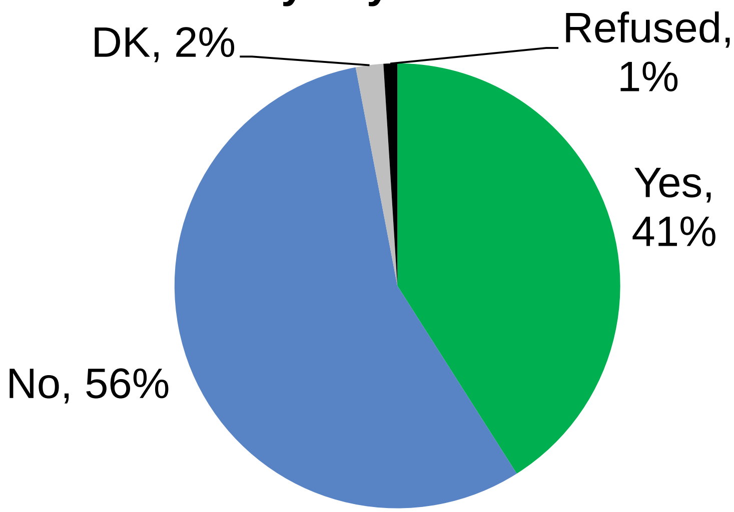
- **Baby Boomers carry debt close to retirement**
  - Recent old cohorts have borrowed more
  - They will have to manage debt into retirement
- **Debt and financial literacy are closely linked**
  - Using NFCS data, we confirm results from HRS about borrowing and can link borrowing to financial literacy
  - Financial literacy has an effect above and beyond income, education, and other demographics
- **The link between debt and financial literacy holds true for other forms of debt and age groups**
  - High cost borrowing and borrowing on retirement accounts

Planning ahead: Most workers don't

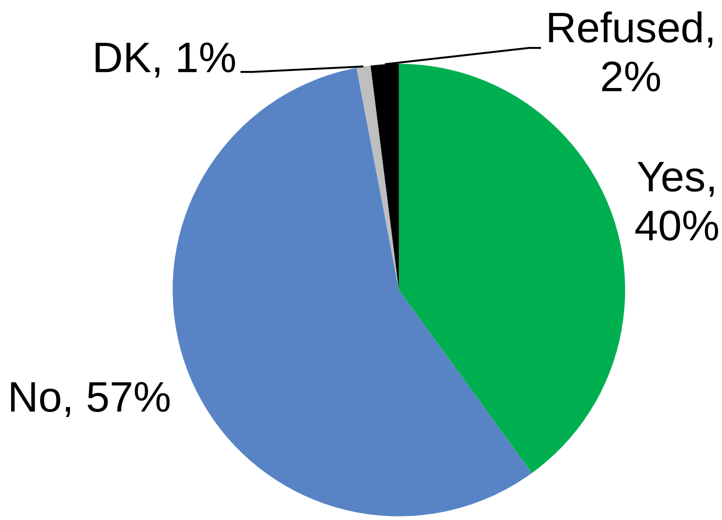
Have you ever tried to figure out how much you need to save for retirement?



Have you set aside an emergency or rainy day fund?



Are you setting aside any money for your children's college education?



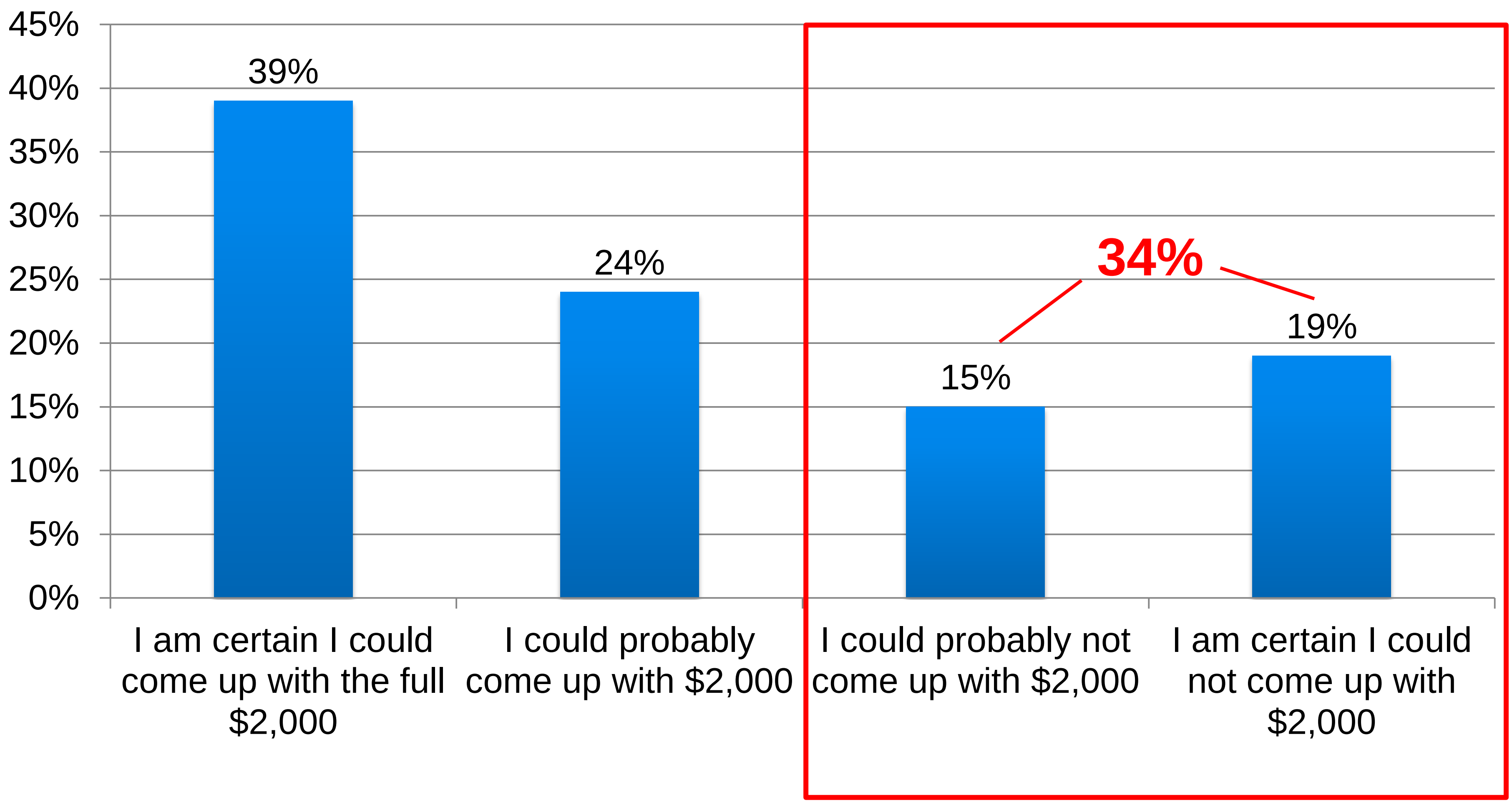
Note: Respondents age 23 to 61 and employed at the time of the survey.

Why no long-run vision? Dealing with short run

A simple measure of financial fragility developed by Lusardi, Schneider, and Tufano (2011):

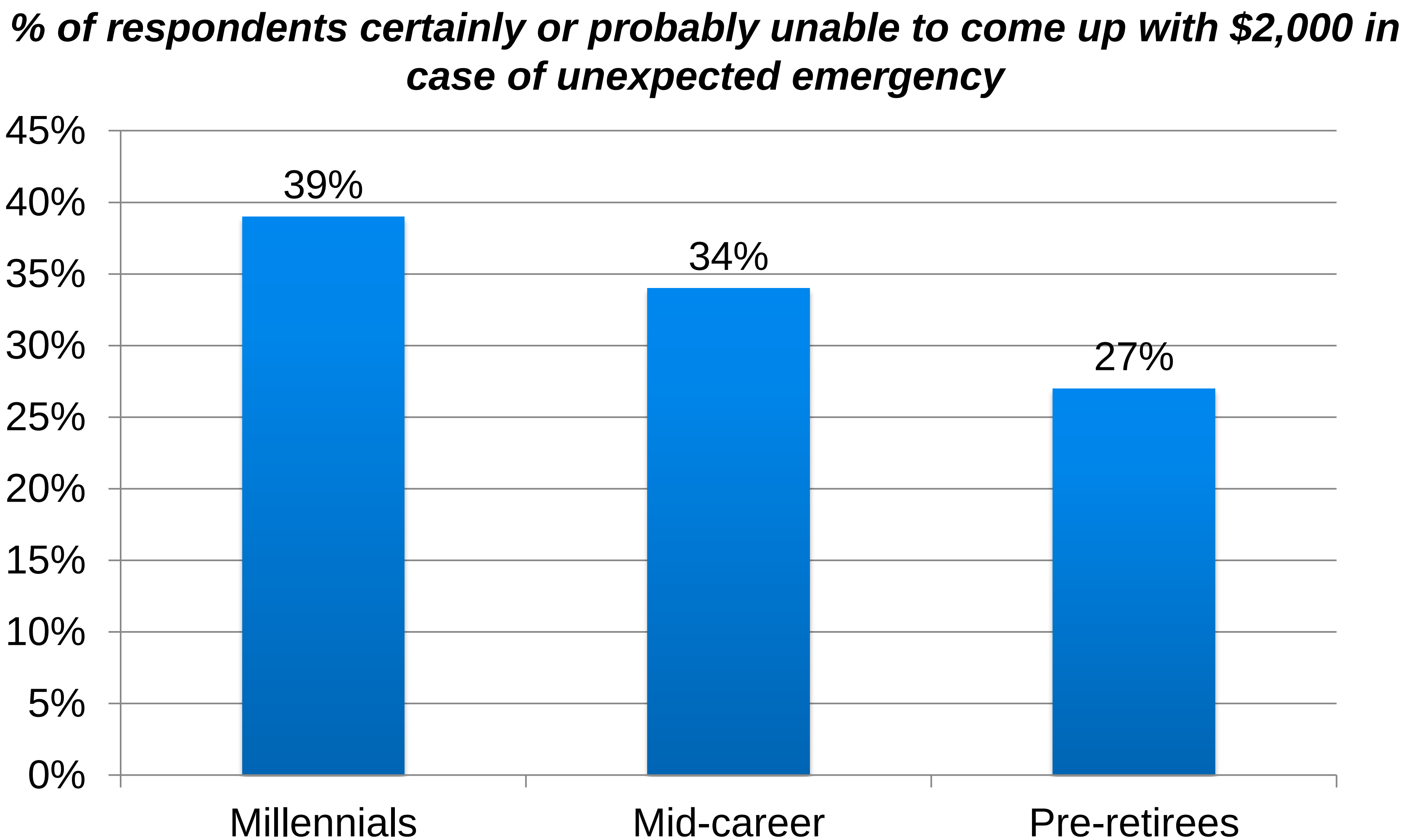
- *How confident are you that you could come up with $2,000 if an unexpected need arose within the next month?*
  - I am certain I could come up with the full $2,000
  - I could probably come up with $2,000
  - I could probably not come up with $2,000
  - I am certain I could not come up with $2,000
  - Don’t know / Prefer not to say

Financial fragility: Evidence from 2012 NFCS
Age: 23-61 and employed



Note: Respondents age 23 to 61 and employed at the time of the survey.

Financial fragility by career stage



Note: Respondents age 23 to 61 and employed at the time of the survey.

Financial literacy and retirement planning

Financial literacy is an important determinant of retirement planning

- Financial literacy affects retirement planning
  - Those who are financially literate are 9 percentage points more likely to plan
  - Causality goes from financial literacy to planning
- Knowledge of risk diversification is most important for retirement planning
- Findings hold true across different measures of planning and across countries
- Financial literacy also linked to financial fragility

Scalability: Reaching the population

Venues for financial education

- **In schools**
  - Easier to reach the young

- **In the workplace**
  - Easier to reach the adults

- **In libraries, local communities, museums**
  - Where people go to learn

Financial education in school

Need to prepare the new generations

Financial education in school is critically important:

- More rigorous learning than provided by family or friends or experience
- Need to be financially literate *before* engaging in financial decisions
- Provide an equal opportunity to learn

Financial literacy in college

New Personal Finance course at GW

- **Cover personal finance with a rigorous approach**
  - A quantitative approach to personal finance
  - Teaching takes into consideration gender differences in financial literacy
- **It incorporates macro, accounting, and risk management**
- **Writing a textbook on personal finance**
  - Joint with a mathematician and a professional writer

A program to promote financial planning

Five steps to planning success

- Designed using findings from research
- Used videos
- Kept the message free of economic/finance jargon
- Covered concepts, such as risk diversification, with a simple story
- Other concepts are interest compounding, inflation, employer matches, and tax benefits of retirement accounts

We measured whether it worked

- Tested interventions using an Internet panel
- Baseline questions on 5 concepts
- Randomly assigned
  - Intervention group
    - Video only, narrative only, video & narrative
  - Control group
    - No intervention
- Repeated 5 concepts questions

Findings

- After being exposed to videos, the performance on financial literacy questions and hypothetical choices improved substantially

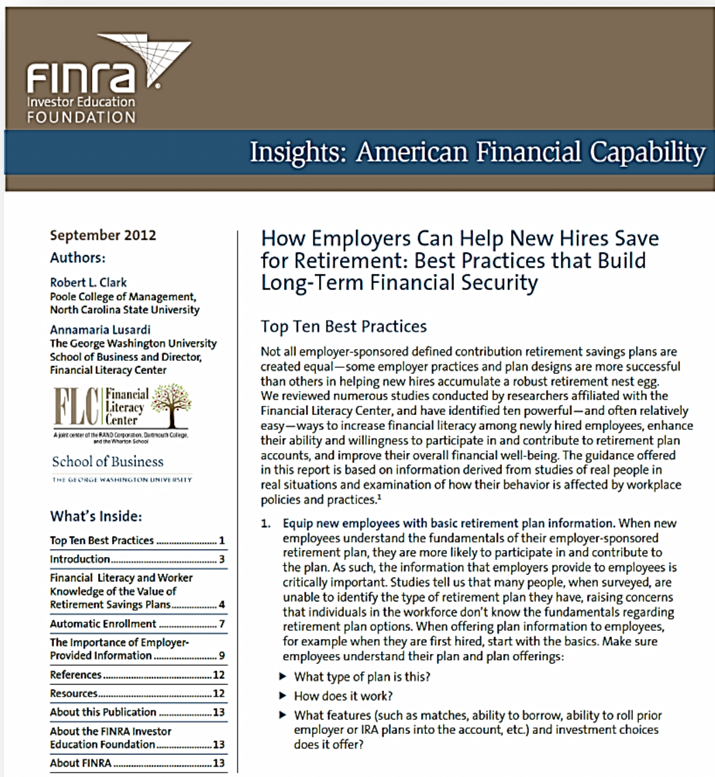
- While young were targeted, the videos affected all age groups

Thinking outside the box: A saving museum

Building long-term financial security

Best practices

How employers can help new hires save for retirement: *Best practices that build long-term financial security*


FINRA Investor Education FOUNDATION

Insights: American Financial Capability

September 2012

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FLC Financial Literacy Center
A joint center of the RAND Corporation, Dartmouth College, and the Wharton School

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What's Inside:

How Employers Can Help New Hires Save for Retirement: Best Practices that Build Long-Term Financial Security

Top Ten Best Practices

Not all employer-sponsored defined contribution retirement savings plans are created equal—some employer practices and plan designs are more successful than others in helping new hires accumulate a robust retirement nest egg. We reviewed numerous studies conducted by researchers affiliated with the Financial Literacy Center, and have identified ten powerful—and often relatively easy—ways to increase financial literacy among newly hired employees, enhance their ability and willingness to participate in and contribute to retirement plan accounts, and improve their overall financial well-being. The guidance offered in this report is based on information derived from studies of real people in real situations and examination of how their behavior is affected by workplace policies and practices.[1]

1. **Equip new employees with basic retirement plan information.** When new employees understand the fundamentals of their employer-sponsored retirement plan, they are more likely to participate in and contribute to the plan. As such, the information that employers provide to employees is critically important. Studies tell us that many people, when surveyed, are unable to identify the type of retirement plan they have, raising concerns that individuals in the workforce don't know the fundamentals regarding retirement plan options. When offering plan information to employees, for example when they are first hired, start with the basics. Make sure employees understand their plan and plan offerings:
   - What type of plan is this?
   - How does it work?
   - What features (such as matches, ability to borrow, ability to roll prior employer or IRA plans into the account, etc.) and investment choices does it offer?

We prepared a report documenting best practices for improving financial decision making in the workplace.

- Based on studies of many employer-provided financial education programs
- Goal of the report is to help employers improve retirement saving choices of newly hired workers

FinLab: A Financial Innovation Lab

- **Addressing current needs**
  - Advance understanding of what works in financial education
  - Integrate financial education and technology
  - Improve financial education programs' effectiveness
  - Customize financial education: one size does not fit all

- **Our Aim:** Drive change in financial education by identifying and fostering the strategies and innovations that promise to transform the financial education landscape

We have set up a Financial Education Innovation Fund

Concluding remarks

Shifting paradigm

- **Equipping people to make saving and retirement decisions**
  - Financial literacy is an essential skill for the 21st century
- **Need to start early**
  - The importance of financial literacy in school. These are not separate topics. Pension providers should speak to the Department of Education
- **Need targeted approach**
  - Workers are very different
- **Cannot focus on retirement savings only**
  - Other decisions are important and affect retirement security

Contact and further information

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