Financial Literacy and Long Term Financial Security

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Director, Global Financial Literacy Excellence Centre (GFLEC)
The growing importance of financial literacy for financial security

Changes in pension systems
- More individual and private accounts

Changes in labor markets
- Divergence in wages – skills are critical

Changes in financial markets
- Greater complexity
- More opportunities to borrow & in large amounts
Some questions given these new challenges

1. How well-equipped are people to make decisions about their future?

2. Does financial literacy matter for retirement planning?

3. How can we improve financial literacy and financial security?
Question 1

How well-equipped are people to make decisions about their future?
Assessing knowledge of basic concepts, the abc’s of personal finance
How to measure financial literacy?

Theory: Saving (borrowing) and investing

- Life-cycle model of saving
- Portfolio choice

Concepts:

- Numeracy and interest compounding
- Inflation
- Risk diversification

*These theories/concepts apply everywhere (work of Nobel Prize Winner Angus Deaton)*
A simple measure of financial literacy

The Big Three

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?”

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…”

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.”

More than $102
- Exactly $102
- Less than $102
- Don’t know
- Refuse to answer

More than today
- Exactly the same as today
- Less than today
- Don’t know
- Refuse to answer

True
- False
- Don’t know
- Refuse to answer
Evidence from 15 countries:

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

These 3 questions are now in the 2016 US Survey of Consumer Finances
➢ FLAT World project
➢ Examine the link between financial literacy and retirement planning
➢ We published papers for 8 participating countries, including Sweden
Collecting data: The US National Financial Capability Study
**How much do Americans know?**

Distribution of responses across the U.S. population (2009 National Financial Capability Survey)

<table>
<thead>
<tr>
<th>Distribution of Responses to Financial Literacy Questions (%)</th>
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<tbody>
<tr>
<td>Responses</td>
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<tr>
<td></td>
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<td></td>
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<tr>
<td>Interest rate</td>
</tr>
<tr>
<td>Inflation</td>
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<tr>
<td>Risk diversif.</td>
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</table>

NB: Only 30% correctly answer all 3 questions; less than half (46%) got the first two questions right.
How much do Swedes know?

Distribution of responses across the Swedish population (2010 Swedish Financial Supervisory Consumer Survey)

<table>
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<tbody>
<tr>
<td>Responses</td>
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<tr>
<td></td>
</tr>
<tr>
<td>Correct</td>
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<tr>
<td>Interest rate</td>
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<tr>
<td>Inflation</td>
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<tr>
<td>Risk diversif.</td>
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</tbody>
</table>

NB: Only 21% correctly answer all 3 questions; 27% got the first two questions right.
A more complex question, regarding interest rates, was included in the 2010 Swedish Financial Supervisory Consumer Survey.

Suppose you have 200 SEK in a savings account. The interest is 10% per year and is paid into the same account. How much will you have in the account after 2 years?

- ......
- Do not know
- Refuse to answer
How much do Germans know?

Distribution of responses across the German population (2009 SAVE)

**Distribution of Responses to Financial Literacy Questions (%)**

<table>
<thead>
<tr>
<th></th>
<th>Correct</th>
<th>Incorrect</th>
<th>DK</th>
<th>Refuse</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>82%</td>
<td>7%</td>
<td>11%</td>
<td>0%</td>
</tr>
<tr>
<td>Inflation</td>
<td>78%</td>
<td>5%</td>
<td>17%</td>
<td>0%</td>
</tr>
<tr>
<td>Risk diversif.</td>
<td>62%</td>
<td>6%</td>
<td>32%</td>
<td>0%</td>
</tr>
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</table>

NB: About half (53%) correctly answer all 3 questions; 72% got the first two questions right.
Distribution of responses in the Japanese population (2010 SLPS)

Distribution of Responses to Financial Literacy Questions (%)

<table>
<thead>
<tr>
<th></th>
<th>Responses</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Correct</td>
</tr>
<tr>
<td>Interest rate</td>
<td>71%</td>
</tr>
<tr>
<td>Inflation</td>
<td>59%</td>
</tr>
<tr>
<td>Risk diversif.</td>
<td>40%</td>
</tr>
</tbody>
</table>

NB: Only 27% correctly answered all three questions; less than half (49%) got the first two questions right.
Findings: The world is *flat*

- **Financial illiteracy is widespread in the population**
  - Less than half of the population can answer three basic questions
  - Even in countries with well developed financial markets
  - People lack knowledge of fundamental financial concepts (even among «investors»)

- **Risk diversification is most difficult concept to grasp**
  - Similar pattern of response across countries
  - Prevalence of “do not know” answers

- **These findings are robust**
  - Evidence from bigger surveys and different questions
    - 2014 Global FinLit Survey
    - 2016 Allianz Survey in 10 European countries

**Similar patterns across countries**
Does financial literacy matter?
Connecting financial literacy to retirement planning
Planning ahead: most workers don’t

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

- Yes, 48%
- No, 48%
- Don’t know, 3%
- Prefer not to say, 1%

Note: Respondents age 23 to 61 and employed at the time of the survey. 2015 NFCS.
Retirement planning and wealth holdings

Median Net Worth, 2004 Health and Retirement Study, age: 51-56
Does financial literacy matter for retirement planning?

Empirical model:

\[
\text{Planning} = \alpha + \beta \text{ Fin Literacy} + \theta X + u
\]

Financial Literacy is a choice variable:

• How to assess causality: does financial literacy cause retirement planning?

✓ Exposure to financial education in high school
### Financial literacy and retirement planning (US)

<table>
<thead>
<tr>
<th></th>
<th>OLS estimates</th>
<th>OLS estimates</th>
<th>IV estimates</th>
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<tbody>
<tr>
<td>All 3 correct</td>
<td>0.091***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td></td>
<td></td>
</tr>
<tr>
<td># of correct answers</td>
<td></td>
<td>0.051**</td>
<td>0.277**</td>
</tr>
<tr>
<td></td>
<td>(0.02)</td>
<td>(0.14)</td>
<td></td>
</tr>
<tr>
<td>Demographics</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

Source: National Financial Capability Study 2009
The link between financial literacy and retirement planning across countries

Financial literacy is an important determinant of retirement planning across countries (JPEF issue)

- Financial literacy affects retirement planning, having a saving plan, participation in pension plans, and retirement expectations
- Knowledge of risk diversification is most important for retirement planning
- Empirical estimates are higher in the Netherlands
Financial literacy and investment behavior

- The financially literate are more likely to participate in and contribute to their retirement accounts.

- Individuals with higher levels of financial knowledge not only plan more, but are more likely to participate in the stock market and invest in stocks.

- Financially knowledgeable investors
  - hold more equity in their pension accounts
  - earn higher excess returns (adjusted for risk)
Financial behavior: wealth accumulation

- Consider a life cycle model with financial literacy

- Financial literacy affects the return on savings

- Financial literacy is an important determinant of wealth and wealth inequality

- Important finding: 30-40% of U.S. retirement wealth inequality can be attributed to difference in financial knowledge
How can we improve financial literacy and financial security?
Evidence from our programs at GFLEC
What we learn from research

This research has inspired our current work, aimed to improve financial literacy and retirement planning.

➢ Financial literacy levels are low
  • Need to improve knowledge of the abc of personal finance

➢ People do not plan for retirement
  • Financial education programs that help people make financial decisions

➢ Young are an important target and can use time in their favor
  • Start in school, widespread financial illiteracy requires robust interventions
Ideal venues for financial education

➢ **In schools**
  • Easier to reach the young
  • Need a base on which to build

➢ **In the workplace**
  • Easier to reach the adults
  • Growing importance of retirement accounts

➢ **In libraries, local communities, museums**
  • Where people go to learn
Personal finance course at the George Washington University

• GFLEC designed the curriculum joint with a mathematician
• Using a rigorous quantitative approach
• It covers saving and investing, retirement planning, personal taxes, insurance, etc.
• Material available for free on our website
Five steps to planning success: experimental evidence from US households

**Set-up:**
- Design of a low-cost, easily-replicable financial education program called «Five Steps»
- Covering five basic financial planning concepts that relate to retirement
- Delivery models: written narratives and online videos

**Program:**
- Targeted to young workers
- Kept the message free of economic/finance jargon
- Covered concepts that people know the least, for example risk, in a simple story
After being exposed to videos, the performance on financial literacy improved.

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

25-33% of the knowledge gain is still observable 8 months after the intervention.

Simple program has effects both in the short and medium run.
We designed a program that targeted individuals who wanted to save but were limited by a lack of knowledge.

The aim of the program was to:
- Simplify financial decisions
- Provide information when needed by individuals
- Target specific groups
- Use communication that does not rely on figures and numeracy

New ways to make people save: the Dartmouth project
Planning Aid

We have outlined 7 simple steps to help you complete the application.

1. Select a 30 minute time slot right now to complete the online contribution to your Supplemental Retirement Account (SRA) during the next week.

2. 3 minutes. Check to see if you have the following materials: a) worksheet in your benefits packet, and b) the name and social security number of a beneficiary.

3. Select the amount you want to invest for 2006 (minimum: $16/month, maximum: $1,666.67/month), even if you don't know your take-home pay in your first month. If you want, you can change this amount at a later date. This voluntary contribution is tax-deferred, you will not pay taxes on it until you withdraw the funds.

4. 5 minutes. Select a carrier. If you do not select a carrier, Dartmouth will invest the non-voluntary portion of your college funds in a Fidelity Freedom Fund, a fund that automatically changes asset allocation as people age.

5. 5 minutes. Now you are ready to complete your worksheet. Complete the worksheet even though you may be unsure of some options. You can change the options in the future.

6. Take your completed worksheet to a computer that is available for 20 minutes. If you like, you can use the one in the Human Resources office at 7 Lebanon Street, Suite 203.

7. 15-20 minutes. Log on to Flex Online and complete your online SRA registration within the 20 assigned minutes. Be sure to click on the investment company (TIAA-CREF, Fidelity, or Calvert) to complete the application. You need to set up your account – otherwise your savings will not reach the carrier.

Development of a comprehensive, cost-effective planning aid to improve participation in and contribution to Supplementary Retirement Accounts (SRAs)
In their own words: four videos

Topics discussed:

Hopes for retirement
Why they save
How they save
Planning for the future
Their recommendations
There was a large increase in savings enrollment within 30 and 60 days of hiring among participants who received the brochure.

<table>
<thead>
<tr>
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<th>30 days After Hire</th>
<th>60 days After Hire</th>
<th>Number of Observations</th>
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<tbody>
<tr>
<td>Control Group</td>
<td>7.3%</td>
<td>28.9%</td>
<td>210</td>
</tr>
<tr>
<td>Planning aid</td>
<td>21.7%</td>
<td>44.7%</td>
<td>166</td>
</tr>
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Videos generated an increase in enrollment of 56%.
Employee financial literacy and retirement plan behavior: a case study

Program:

- Conducted with employees from the Federal Reserve System
- Study of the participation and contributions of employees to their employer sponsored plan
  - DC plan (Thrift Saving Plan)
  - Employees could complete a learning module about retirement planning

Findings:

Most financially knowledgeable employees

- are more likely to participate
- contribute 3 percentage points more of their earnings to the DC plan
- hold more equity in their pension accounts
Higher levels of financial literacy levels are linked to greater retirement readiness

Employees who completed the learning module were
- more likely to start contributing to their DC plan
- less likely to have stopped contributing post-survey
- More likely to boost contributions and equity allocations after the intervention

Evidence that employer-provided educational programs do have positive effects on employees’ behavior
Impacting business: Our research reaches the New York Stock Exchange

We built a toolkit for NYSE to promote financial wellness in the workplace

The success of employee benefit programs depends on employee participation rates! Nearly four in five employees claim they would benefit from financial advice and answers to everyday questions. Improve employee participation rates, employee wellness, and your company’s bottom line by using our customizable employer and employee financial fitness toolkits.

Did You Know?

- Bills were introduced on the NYSE when continuous trading was initiated in the 1970s.
- Orioles and Chicago White Sox used, but brass bells have been used since the Exchange moved to its current location in 1980.

Visit our website to learn more fascinating facts!

Ringing the bell at the NYSE
An International Federation of Finance Museums (IFFM)

“… the International Federation of Finance Museums (IFFM) is committed to promoting financial literacy globally, raising awareness that every individual in every country is in need of financial literacy.”
A saving museum in Turin, Italy
Last July, I was appointed by Italy’s Minister of Economy and Finance, Pier Carlo Padoan, as director of the Financial Education Committee.

For GFLEC, it reflects a step forward in improving financial literacy around the world.
Financial literacy is like reading and writing

- It is an essential skill for the 21st century
- Everyone deals with finance, and finance is sufficiently complex that we cannot leave it to the individual to learn by himself/herself
- It is very important to be financially literate as early as possible
- Financial literacy is a stepping stone for financial security
“Knowledge is in every country the surest basis of public happiness.”

George Washington, First President of the United States (1789–97)
“(Financial) knowledge is in every country the surest basis of public happiness.”

George Washington, First President of the United States (1789–97)
Definition of financial literacy: A vision for the future

Which future do we want to build?
Thank you!

Questions? Contact us at gflec@gwu.edu