



*By George Gaberlavage  
Director of Consumer and  
State Affairs  
AARP Public Policy  
Institute*



## FINANCIAL LITERACY: MORE IMPORTANT THAN EVER

In the wake of a \$7 trillion decline in the value of pensions and household portfolios<sup>1</sup>, is a discussion about financial literacy relevant? Absolutely! Workers—especially those nearing retirement—and retirees are likely to face a number of challenging questions due to the effects of the financial crisis. These include:

- > Do I need to work longer or go back to work?
- > Should I modify my asset allocations and retirement account portfolios?
- > Should I refinance my mortgage, carry it into retirement or pay it off?
- > Do I need to purchase an annuity or a reverse mortgage to assure that I don't outlive my assets?

For a person without financial knowledge, these questions are much more difficult to answer. As a result, they are more likely to make a costly mistake or just do nothing.

Strengthening financial literacy must be a part of international efforts to spur economic recovery.

### **WHY FINANCIAL LITERACY IS IMPORTANT**

Financial literacy is increasingly important as reliance on defined contribution plans shifts responsibility for retirement security from employers to individuals. In today's highly complex financial marketplace, workers and retirees must be knowledgeable to make

informed choices. This is critical not only to the financial well-being of individuals, but to the proper functioning of financial markets.

The consequences of not being financially literate are very severe from both an individual and a societal standpoint. The meltdown of the mortgage market is a dramatic example. During the housing bubble, many borrowers were persuaded to take risks that endangered their financial health. These individual problems quickly became systemic ones as unsustainable mortgages were bundled into securities sold across the globe. High foreclosure rates among older homeowners as well as instability in the banking system are the consequences of ignoring what we have known for a long time: many borrowers, especially low-income borrowers with adjustable rate mortgages, do not understand the terms of their mortgages and underestimate the impact of changes in their interest rates.<sup>2</sup> But changes to disclosures and the mortgage sales process that would take this reality into account have not been made.

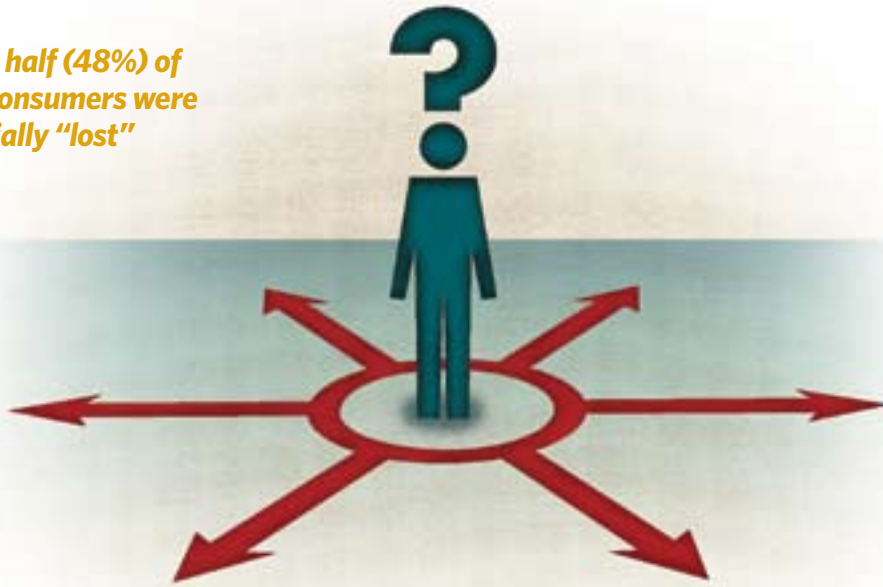
Similarly, research shows that there is a strong link between financial literacy and retirement planning. People who are more financially literate—especially those who understand key concepts like interest compounding—are more likely to plan for retirement. And planning is a powerful predictor of wealth accumulation.<sup>3</sup> Yet half of workers have not attempted to determine how much savings they will need for retirement.<sup>4</sup> According to the Center for Retirement Research at Boston College, almost 45 percent of working age households (ages 36 to 62) are at risk of being unable to maintain their pre-retirement standard of living in retirement unless they increase their pre-retirement savings. This situation puts even greater pressure on

national retirement systems that are already facing solvency problems.

Financial literacy is not a substitute for vigorous oversight of risk practices by financial institutions and enforcement of strong consumer protection policies that root out predatory financial practices. The regulation of mortgage transactions in the United States is notoriously weak. But even with strong regulations and enforcement, it will be difficult to monitor every transaction. Financially literate consumers who understand their rights are critical to the success of a reformed mortgage process—one that provides meaningful and timely disclosures to consumers and eliminates perverse incentives for providers to push the riskiest products on the most vulnerable borrowers. The same is true for other financial products.

Some advocates and researchers question an emphasis on financial literacy because financial education programs have varied in effectiveness. They would concentrate on building automatic defaults into key financial decisions to overcome consumer illiteracy and inertia. AARP has long supported auto-enrollment into retirement plans as a way of boosting participation and strongly supports an auto IRA proposal to tap the power of regular, automatic payroll deduction for that half of the American workforce without an opportunity to save at work. In fact, the two approaches complement each other. For example, increasing financial literacy has been shown to reduce quit rates in automatic enrollment plans.<sup>5</sup> The sheer number and variety of consumer decisions makes it difficult to put defaults everywhere, and we know that people with less financial knowledge are more likely to make adverse and costly

**Nearly half (48%) of older consumers were financially “lost”**



decisions. This increases the importance of raising levels of financial literacy.

### **THE LEVEL OF FINANCIAL LITERACY IS SHOCKINGLY LOW**

The Organization for Economic Cooperation and Development (OECD) reviewed survey results on financial literacy from 12 nations and found that they indicate the level of financial literacy of most consumers is “very low”. The lack of financial literacy was particularly apparent among minorities and those with less education and lower incomes.<sup>6</sup>

Financial illiteracy among older consumers is a major concern. In the United States, AARP’s Public Policy Institute (PPI) found that older consumers were less knowledgeable than their younger counterparts, especially regarding savings and investments. Looking at a number of key financial behaviors and money management skills, PPI also found that nearly half (48 percent) of older consumers were “lost”—that is they ranked low on financial product ownership as well as

financial behaviors—compared to 38 percent of all consumers.<sup>7</sup> Research using the *Health and Retirement Study* demonstrates similar literacy deficits and indicates that many workers do not know what type of pension they have and are not aware of expected Social Security benefits.<sup>8</sup>


Workers are often dangerously overconfident about their readiness for retirement. A 2008 survey by the Employee Benefit Research Institute found that 33 percent of workers who have not saved for retirement still feel very or somewhat confident that they will have a comfortable retirement. The OECD reported similar findings.

### **BOOSTING FINANCIAL LITERACY**

Fortunately, we are learning a lot about what works in boosting financial literacy and achieving needed behavioral changes. The OECD just released a compendium of policies and best practices for promoting consumer education. For example, a number of countries including Belgium, Chile, the Czech

Republic, Denmark, France, Ireland, Japan, Korea, Mexico, New Zealand, the Slovak Republic, Spain, Sweden, Switzerland, Turkey and the United Kingdom have developed education programs focused on reducing the vulnerability of older consumers to fraud. In addition, Korea has developed a “competence index” to measure consumer knowledge, track changes in behavior, and determine the effectiveness of consumer education efforts.<sup>9</sup> Research shows that tying financial literacy efforts to key events and decisions such as starting a new job, purchasing or refinancing a home, and delivering public benefits is effective. The positive impact of workplace programs on increasing the savings of workers with lower incomes is particularly important.

But access to such programs is limited. In the United States, a recent forum on financial literacy sponsored by the Government Accountability Office recommended making financial literacy a national priority, fostering public private partnerships to increase availability of literacy programs, and delivering financial education on a broad range of topics at “teachable moments” when the information is most relevant to a person’s life. Targeting literacy efforts to certain populations—the unbanked, those with lower incomes, women and minorities—is also essential for an enhanced national effort to increase financial literacy. Further, integrating key financial principles, such as interest compounding and risk diversification, into school curriculums would help many people save and avoid excessive debt.<sup>10</sup>

Financial literacy is more important than ever. Along with regulatory reform and sound monetary and fiscal policies, it is an essential element in constructing a solid foundation for future economic growth and prosperity. 

## Footnotes

- 1 *Are Retirement Savings Too Exposed to Market Risk?* Center for Retirement Research at Boston College, A. H. Munnell and D. Muldoon, October 2008. Losses in value are for the period October 9, 2007 to October 9, 2008.
- 2 *Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education*, Business Economics, A. Lusardi and O.S. Mitchell, January 2007.
- 3 *How Much Do People Know About Economics and Finance? Financial Illiteracy and the Importance of Financial Education*, A Lusardi and O.S. Mitchell, University of Michigan Retirement Research Center Policy Brief, March 2008 Number 5 and *Financial Literacy: An Essential Tool for Informed Consumer Choice?* A. Lusardi, Joint Center for Housing Studies Harvard University, February 2008 UCC08-11.
- 4 *2008 Retirement Confidence Survey Fact Sheet*, Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc.
- 5 *Do Financial Literacy and Mistrust Affect 401(k) Participation?* Center for Retirement Research at Boston College, J.R. Agnew, L. Szykman, S.P. Utkus, and J. A. Young, November 2007.
- 6 *Improving Financial Literacy, Analysis of Issues and Policies*, Organization for Economic Cooperation and Development (OECD), 2005.
- 7 *Beyond 50.04 A Report to the Nation on Consumers in the Marketplace*, AARP Public Policy Institute, G.Gaberlavage, S. Hermanson, C. Baker, K.K. Kim-Sung, N. Walters, M. Ng-Baumhackl, and A. McLarty-Jackson, 2004
- 8 *Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education*, A. Lusardi and O.S. Mitchell.
- 9 *Promoting Consumer Education, Trends, Policies and Good Practices*, Organization for Economic Cooperation and Development (OECD), 2009.
- 10 *Financial Literacy Strategies: Where Do We Go From Here?* The Urban Institute, R.I. Lerman & E. Bell, 2006; Highlights of a GAO Forum: *The Federal Government’s Role in Improving Financial Literacy*, Government Accountability Office (GAO), 2006 and *Improving Financial Literacy, Analysis of Issues and Policies*, OECD.

## George Gaberlavage

---

George Gaberlavage is the Director of the Consumer and State Affairs Team in AARP’s Public Policy Institute. This team focuses on marketplace practices affecting the ability of older persons to obtain essential products and services.