In the wake of a $7 trillion decline in the value of pensions and household portfolios, 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 unsustain-
able 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 bor-
rowers with adjustable rate mortgages, do not
understand the terms of their mortgages and
underestimate the impact of changes in their
interest rates. 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. Yet half of workers have not
attempted to determine how much savings
they will need for retirement. 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 vig-
orous 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 diffi-
cult to monitor every transaction. Financially
literate consumers who understand their
rights are critical to the success of a reformed
mortgage process—one that provides mean-
ingful and timely disclosures to consumers
and eliminates perverse incentives for provid-
ers 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. The sheer number and
variety of consumer decisions makes it diffi-
cult to put defaults everywhere, and we know
that people with less financial knowledge
are more likely to make adverse and costly
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.⁶

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.⁷ 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.⁸

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.9 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.10

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
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

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