Financial Literacy: A Behavioural Economics Perspective

David de Meza

London School of Economics

Problem &Solution?

- According to a Mori poll, nearly four out of five people do not know that APR refers to the interest and other costs of a loan.

- As part of the new compulsory PSHE curriculum, all pupils from the age of 5 to 16 will be taught about handling money, savings and the financial skills they need as adults. Ed Balls, Jan 3 2010

The Issues

- Can education improve financial literacy?

  Minimally

- Does improved financial literacy lead to better decisions?

  Minimally

- Evidence of extensive financial illiteracy and irrationality (even amongst Wharton MBAs and Harvard faculty).
- Conflicts and confusion lead people to behave passively; a status quo bias with people doing whatever easiest at the time.
- Education, disclosure, and financial incentives have weak effects on behaviour.
- Consistently with the “passivity” bias, defaults are more influential than other interventions that have been studied

Knowledge Matters VS. Attitudes Matter

Homoeconomicus

"I am not aware of anyone who fits that description, Captain"

Homereconomicus

“path of least resistance”

*“Perhaps more distressing than low levels of financial literacy is the consistent finding that those who have taken a high school class designed to improve financial literacy tend to do no better or little better than those who have not had such a course… **We just find no connection between education and financial literacy, measured, in most cases, within a year after taking such a course**.” Mandell (2006)*

"[A large U.S. firm]…offered its employees a financial education program free of charge. The employer measured the effectiveness of this education by administering a before-and-after test of financial literacy. The quiz used a True/False format, so random answers would receive, on average, a score of 50 percent. ***Before the education, the average score of the employees was 54; after the education, the average score jumped to 55. As professors know, teaching is hard****"* Benartzi & Thaler, (2007)

A major hypothesis going into the survey was that investment fraud victims do not know as much about investing concepts as non-victims and would therefore score lower on financial literacy questions. In fact, the study found the exact opposite: **investment fraud victims scored higher than non-victims on eight financial literacy questions**.

NASD FOUNDATION FRAUD STUDY FINAL REPORT 5 (2006).

Financial education

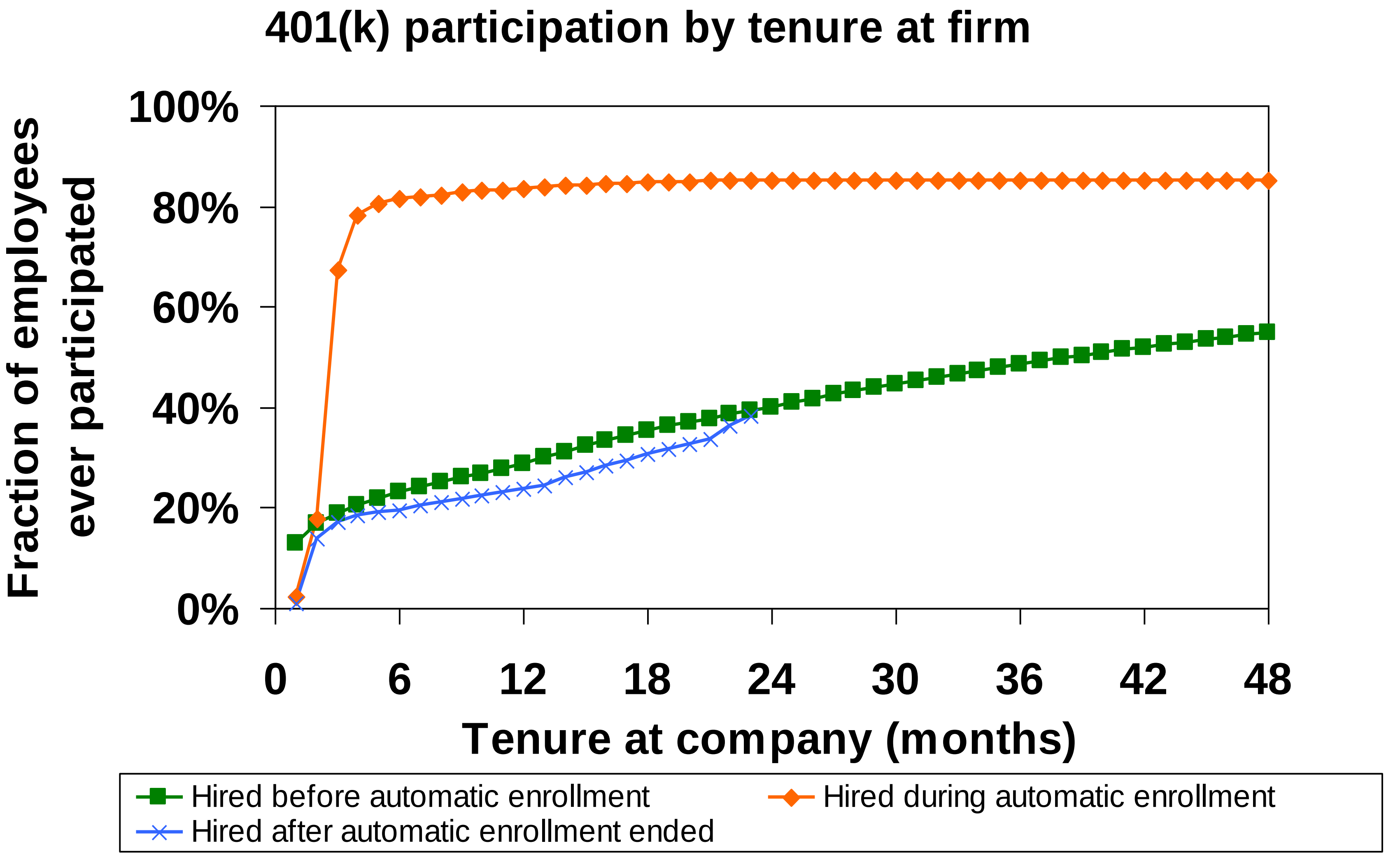
Choi, Laibson, Madrian, Metrick (2006)

- Seminars presented by professional financial advisors to employees large US corporation.
- 17% chose to attend
- Curriculum: Setting savings goals, pension planning, asset allocation, managing credit and debt, insurance against financial risks
- Seminars offered throughout 2000
- Linked data on individual employees' seminar attendance to administrative data on actual savings behaviour before and after seminar

Effect of education is positive but small

	Seminar attendees		Non-attendees
	% planning to make change	% actually made change	% actually made change
Those not in 401(k)			
Enroll in 401(k) Plan	**100%**	**14%**	**7%**
Those already in 401(k)			
Increase contribution rate	**28%**	**8%**	**5%**
Change fund selection	**47%**	**15%**	**10%**
Change asset allocation	**36%**	**10%**	**6%**

Evidence that default options matters for pension scheme. Take up if default enrolled (orange) rather than unenrolled (green). In either case status can reversed by a phone call. [Madrian and Shea (2001) Choi, Laibson, Madrian, Metrick (2004)]

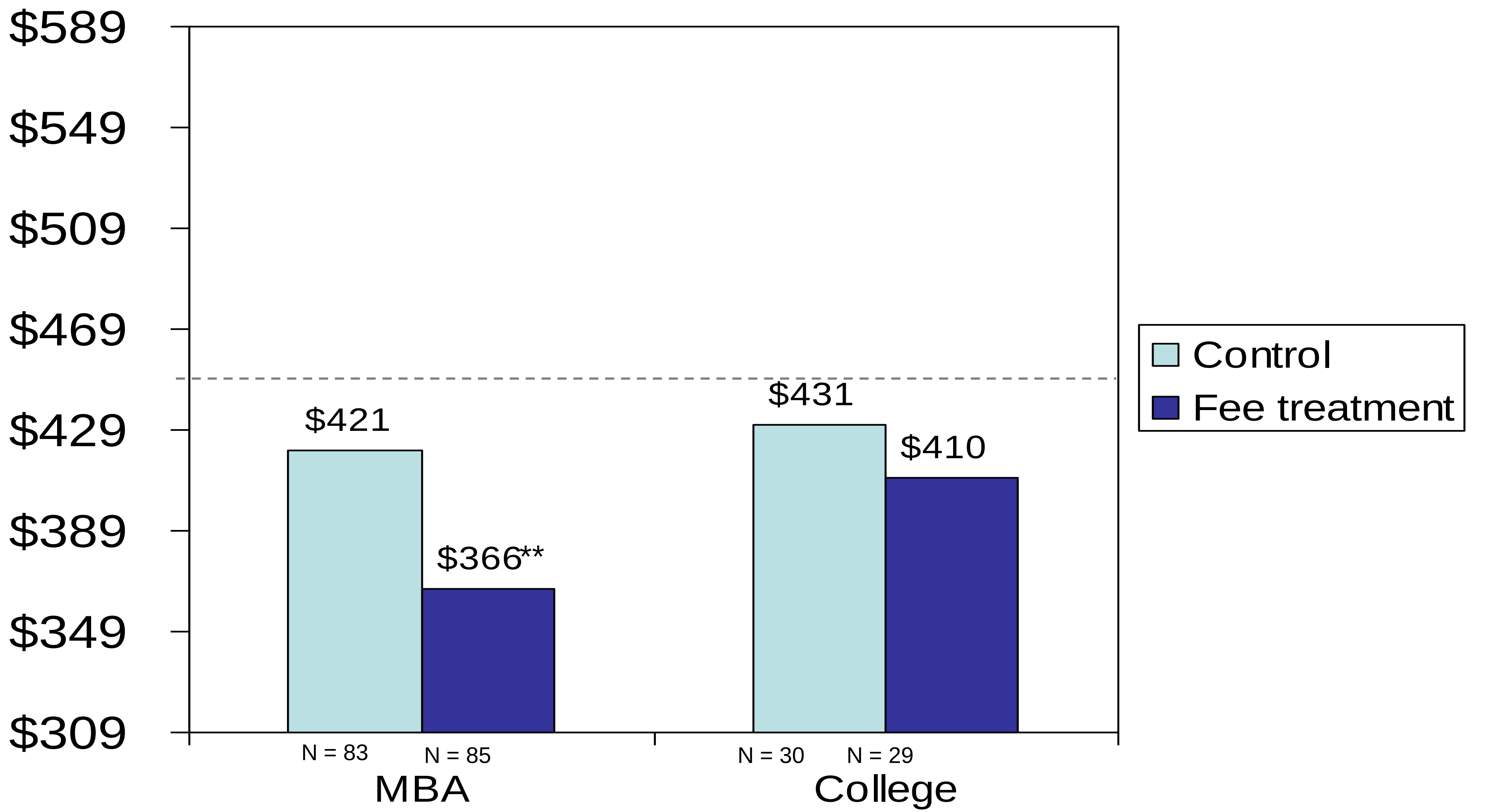


Financial illiteracy among Wharton MBA’s
Choi, Laibson, Madrian (2006)

- Experimental subjects allocate $10,000 among four funds
- Two subjects randomly chosen to receive any positive portfolio return during the subsequent year. Experimenters pay out portfolio returns.
- Design eliminates variation in pre-fee returns
  - Subjects choose among identical S&P 500 index funds
- Fees vary
- Treatments vary in extent to which fee information highlighted and irrelevant information presented (returns since inception)

Effect of fee treatment

(prospectus plus 1-page sheet highlighting fees Minimum fee choice costs $309)

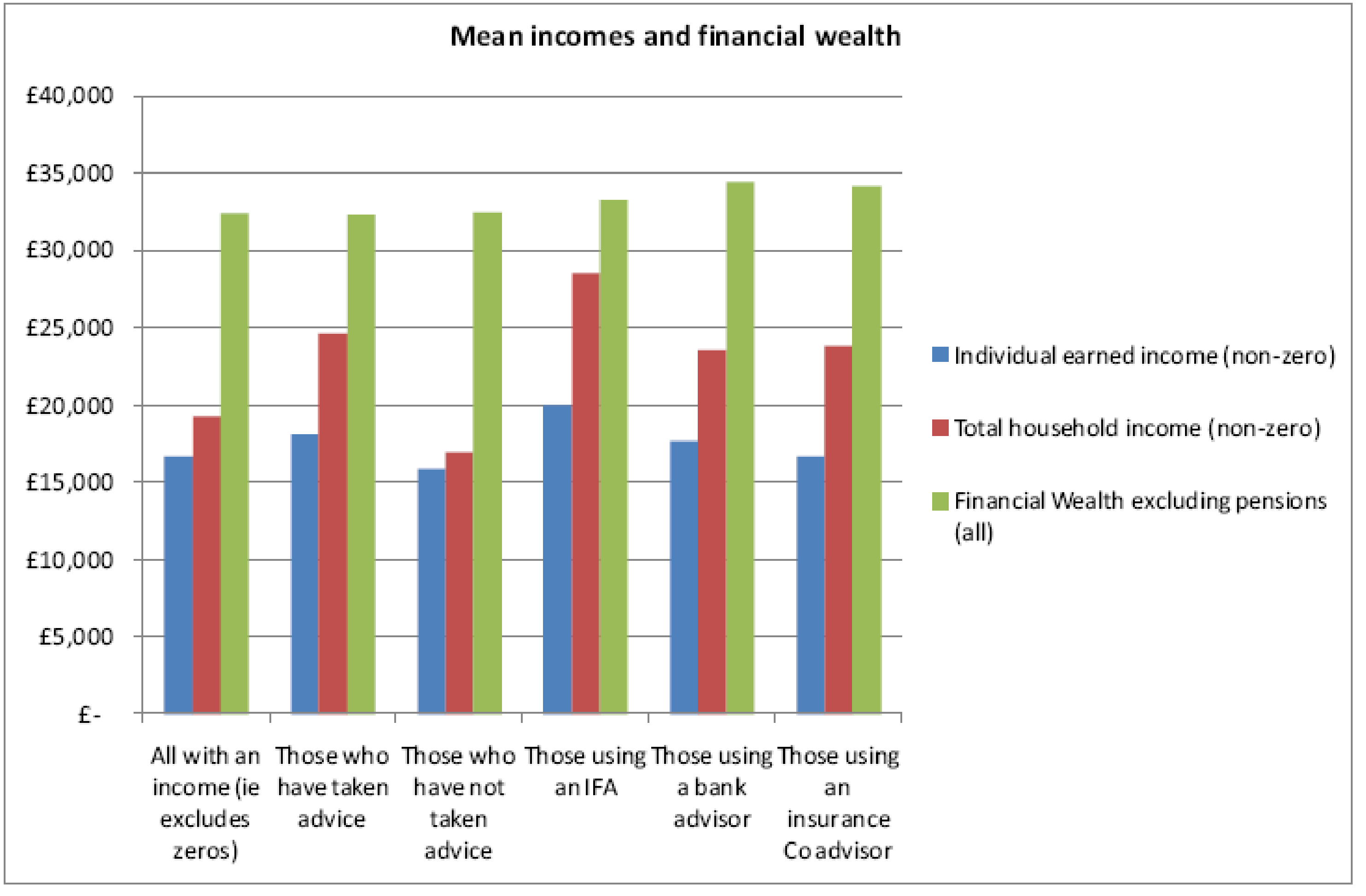


t-tests:
MBA: p=0.0000
College: p=0.1451

19% of MBA treatment put all funds in minimum-fee fund

10% of College treatment put all funds in minimum-fee fund

Returns to Advice



- Even if people know and understand the facts, they may still take poor decisions due to lack of self-control and other personality traits.

- What do these financially literate institutions have in common?
- HSBC, UBS, J.P. Morgan Chase, Bank of America, BNP Paribas, Citigroup, Royal Bank of Scotland.