Investing in Financial Literacy

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This is taken from my 17/4/17 response to the UK government's Green Paper on Industrial Strategy. The full response is at http://bit.ly/AlexIndStr.

1. Question 10: What more can we do to improve basic skills?

1.1 Pillar 2 of the Green Paper rightly prioritises investing in basic skills. p38 principally thinks of basic skills as being numeracy and literacy, with a reference also made to digital skills. However, financial literacy is a crucial basic skill which has substantial implications for people's financial wellbeing and employability, as well as wealth inequality and trust in business.

1.2 Financial literacy helps people preserve their long-term financial future. This is important not only for their own wellbeing, but also inequality and social cohesion. Disparities in wealth stem from not only disparities in income, but how people spend, borrow, and save. Examples are as follows:

1.2.i *Budgeting*. Two-thirds of Americans do not budget[1] (I was unable to find a similar figure in the UK but financial literacy is unlikely to be wildly different.) This leads to households running out of money before the next pay cheque, and having to borrow on credit cards or from payday lenders. This may contribute why one in four UK families have less than £95 in savings.[2]

1.2.ii *Basic financial mistakes*. Personal conversations with many people reveal to me basic financial mistakes. These mistakes will seem obvious to many, but are still being made:

- Some people keep their money at home to avoid paying tax on interest income. They do not realise that their after-tax interest rate is still positive.
- Some people believe that, if you have several loans (e.g. a payday loan, a credit card, and a personal loan from a bank), you should pay off the smallest loan balance first, to reduce the number of individual loans outstanding, rather than the highest interest rate loan first.
- Many people do not understand the difference between simple and compound interest.
- Many people are unaware of alternative sources of finance (e.g. to payday loans).

1.2.iii *Ignorance of tax-efficient savings*. Many households are unaware of tax-efficient ways to save, e.g. ISAs and the personal pension allowance.

1.2.iv *The stock market*. A large proportion of households do not participate in the stock market, far more than can be explained by market volatility or risk aversion. This is very costly since, over the long-term, equities typically substantially outperform cash. Out of those who do participate, many do not understand basic concepts such as the benefits of diversification.

1.3 Financial institutions can exploit households' financial illiteracy by charging high fees or rates, or selling unnecessary products. This harms customers and leads to a general mistrust of business.

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[1] Gallups 2013 Economy and Personal Finance survey.
[2] https://www.theguardian.com/society/2017/feb/20/one-in-four-uk-families-have-less-than-95-in-savings-report-finds, quoting a report by Aviva.

1.3.i Payday lenders often exploit households' ignorance of the effect of interest compounding, leading to them vastly underestimating the cost of borrowing. Bertrand and Morse (2011) show that more transparent information significantly reduces the uptake of payday loans.

1.3.ii Credit card companies offer low "teaser" rates which significantly jump afterwards. Financially illiterate consumers do not know to look beyond the teaser rate. Ru and Schoar (2016) find that US credit card issuers target less-educated customers with lower introductory APRs, but higher default APRs, late fees, and over-limit fees.

- This exploitation can be undertaken by companies other than financial institutions. Consumers buy printers without anticipating the cost of future cartridges, or razors without anticipating the cost of future blades (Gabaix and Laibson (2006)).

1.3.iii Banks mis-sold Payment Protection Insurance, in part due to households' ignorance of what the product entailed. 1.3 million mistakenly believed they would be approved for credit if they took PPI, and up to 2 million were sold a policy that they would never be able to claim on.[3]

1.3.iv During the housing crisis of 2008, many households took out mortgages that they could not afford, perhaps due to lack of knowledge of budgeting or not looking beyond the teaser rate, combined with financial illiteracy allowing unscrupulous lenders to push unaffordable loans.

1.3.v Lusardi and Mitchell (2007) find that consumers around the world are poorly informed about basic financial practices. In particular, consumers know very little of saving and investing for retirement. This financial illiteracy is detrimental to both personal and aggregate welfare.

1.3.vi Carlin and Robinson (2012) study Los Angeles students aged 13-19 who participated at the Junior Achievement Finance Park of Southern California. One group of students received a 19-hour financial literacy course prior to the park experience and the other group did not. In the subsequent simulation, <u>the group that received training relied less on credit financing, paid off debt faster, and were more frugal in their financial decisions</u>.

1.3.vii Odean (1999), Barber and Odean (2000) find that investors trade too much, and that the average trade loses money. Odean (1998) finds that investors exhibit the disposition effect, i.e. sell winners more readily than losers, even though the winners they sell *subsequently* outperform the losers they hold onto. Educating households on cognitive biases such as the disposition effect, confirmation bias, and recency bias, may substantially reduce such losses.

1.4 <u>Financial literacy is important not only for households' financial decisions, but also for their employability</u> – particularly in the digital age. For example, MIT Professor David Autor's TED talk points out that there were 250k bank tellers in the US in 1970, yet 500k today (with 100k added since 2000) – despite the launch of the ATM. This is because bank tellers' role changed from principally handling deposits and withdrawals to advising customers on financial products. A baseline level of financial literacy is important for such reorientation. In particular, while many tasks can be automated, financial advice may be more difficult to do so, given the importance of trust and personal contact.

1.5 The Money Advice Service, set up by the Government, is a positive step in encouraging financial literacy but is to be abolished and replaced by a smaller advice body. A March 2015 government review found that few members of the public had even heard of it. It is necessary to teach financial literacy

[3] http://www.telegraph.co.uk/finance/personalfinance/money-saving-tips/8431821/Timeline-the-perils-of-payment-protection-insurance.html. Note that lenders were also culpable for the uptake of PPI, by adding it to loan agreements without customers' consent, or lying that it was an obligatory component of a loan.

skills to everyone (not just those who hear about the Money Advice Service) and from a young age. Financial literacy is so crucial to people's well-being that it should be part of our education.

1.6 More generally, I encourage the Government to think broadly and "out-of-the-box" when deciding what skills to invest in. For example, superior time management could help address the problem that UK workers take five days to produce what a US, French, or German worker produces in four days.

1.6.i Time management may not be considered a "proper" academic subject, and I am sure some might see this proposal as wildly unorthodox. Yet, there is no reason why the Government's investment in education should be confined to "academic" subjects. Indeed, IT was historically not considered an academic subject, yet is now seen as crucial. We have a major productivity problem and so cannot afford to be elitist about what counts as a proper subject.

1.6.ii Companies and individuals invest substantially in time management, investing thousands of pounds in seminars (the cost is $2,500 for an executive education short course in the US[4]), suggesting it has major benefits. Time management skills should be accessible to all, not just the privileged few. Moreover, these are skills that can be understood by the young, not just executives. Through London Business School's partnership with local secondary schools, I frequently teach time management to schoolkids.

1.6.iii The need for effective time management is even more pressing in the digital age, when workers are constantly bombarded by demands and distractions from many angles.

1.6.iv Note that the benefits of effective time management may extend well beyond workplace productivity. For example, a major reason why people do not exercise is lack of time, which subsequently has major implications for national health. Lack of time is likely a major reason for not engaging in community activities such as volunteering.

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[4] Source: http://www8.gsb.columbia.edu/execed/program-pages/details/1485/MYSO.