The Role, Limits of, and Alternatives to Financial Education in Support of Retirement Saving in the OECD, Eastern Europe and beyond

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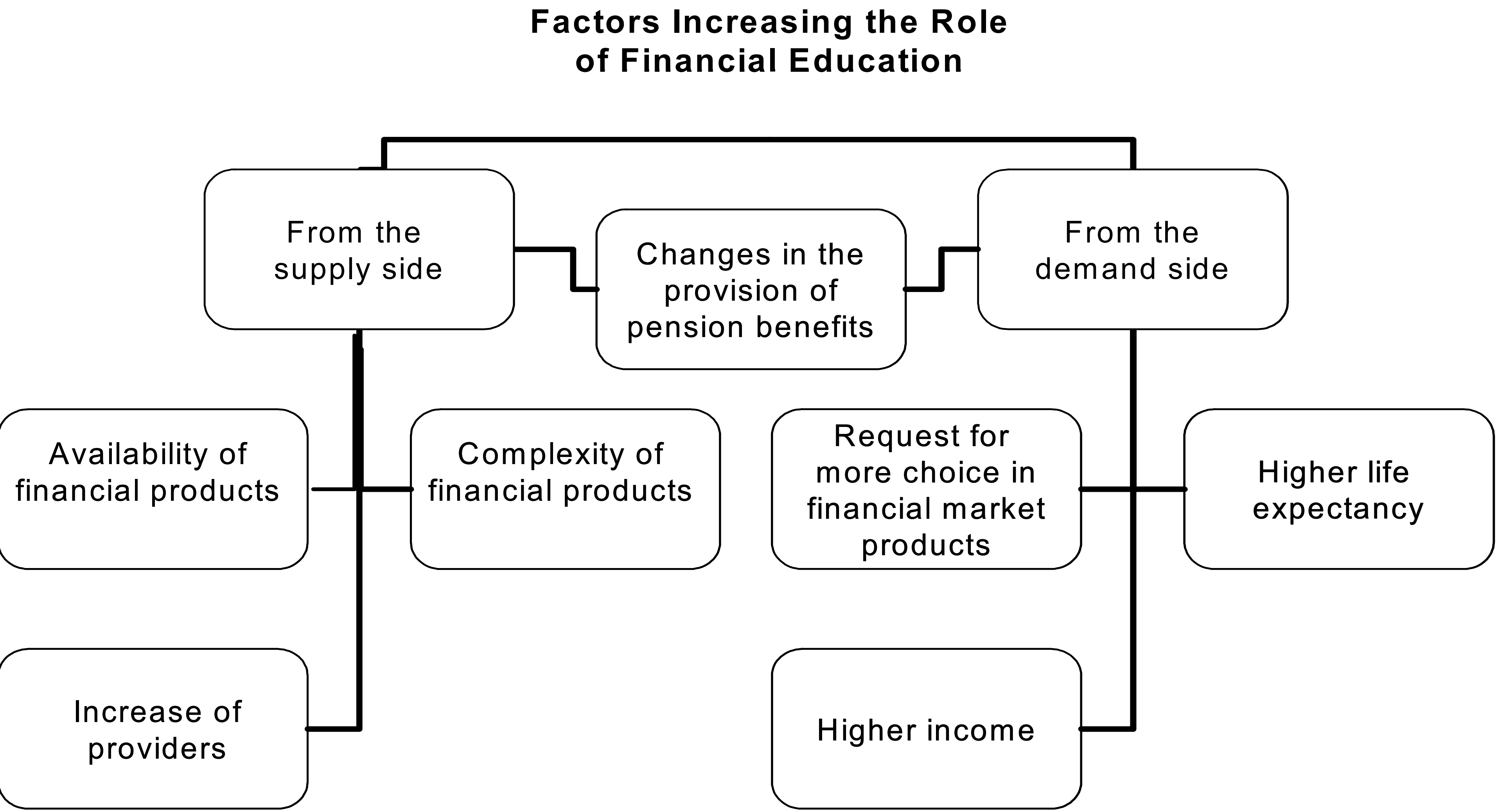
Road Map

- Motivation
- The status of financial literacy and education: What does the experience of OECD countries tell us?
- Financial education or framing the question: Lessons from Behavioral Finance
- Pension Reform, Financial Literacy, and the Use of Default Options in Transition Economies of Europe and Central Asia
- Preliminary Conclusions

The status of financial literacy and education: Lessons from OECD

- The changing needs for financial education
- How well educated is the population in financial matters?
- Who are the providers of financial education, what instruments do they have and what outcomes have been achieved?


Factors Increasing the Role of Financial Education
From the supply side
Changes in the provision of pension benefits
From the demand side
Availability of financial products
Complexity of financial products
Request for more choice in financial market products
Higher life expectancy
Increase of providers
Higher income

How well educated is the population in financial matters?

- Financial literacy: Relative concept
- Useful to distinguish
  - General financial literacy
  - Financial literacy related to retirement saving
- Empirical results essentially not based on scientific evidence with experimental design
- Results in principal not comparable across countries – not even OECD 2005
- BUT results pretty consistent, and sobering

General Financial Literacy

- **Overall:** Most people are not well prepared to make basic decisions about their finances
- **Other main findings**
  - *Financial literacy is correlated with education, income*, and, to a lesser extent, with age
  - *Respondents often feel they know more about financial matters than is actually the case*
  - *Consumers feel financial information is difficult to find and understand*

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Retirement Savings Literacy (1/2)

- Has been reviewed to a lesser extend, and knowledge areas include:
- The saving/contribution rate needed to achieve targeted living standard in retirement
- Knowledge about the choice of savings products and providers taking into account service quality, fees and investment performance
- Knowledge about the choice of investment portfolio taking into account return-risk trade-off and risk diversification
- Knowledge about the form of disbursement: annuity (and how), or gradual drawdown of accumulated balance

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Retirement Savings Literacy (2/2)

- **Overall**: Knowledge towards retirement saving is generally worse than for other life events
- Other findings:
  - Too low planning for retirement saving
  - Limited know of alternative savings products
  - Inadequate risk diversification
  - Low understanding and selection of annuity products

Providers of Financial Education, applied Instruments, and Outcome

- Main providers are
  - Schools, and issues include
    - Discrete subject or life-time skill, integrated
    - Structured program for teachers needed
    - So far, few countries put it into curriculum
  - Workplace
  - Financial Institutions
  - Governments
  - Others, such as trade unions, NGOs, foundations, etc.

Main Instruments

- Presentations, lectures, conferences, symposia, training courses and seminars
- Publications in diverse form, including books, brochures, magazines, booklets, guidance papers, newsletters, annual reports, direct mail documents, letters and disclosure documents
- TV spots, and other types of channel, such as CD ROMs and videos
- An increasingly used method is the Internet, in the form of websites, web portals, and other online services
- Other methods used include advisory services from institutions, including telephone help lines

Effects and Outcomes?

- No systematic assessment of effectiveness of providers and instruments available
- Publication-type material seems little effective
- Workplace related and context-specific education seems to have most effect
- TV spots and similar media campaigns seem effective for marketing of pension reforms
- Some US studies suggest that if well done, FE can have major impact savings decision and execution

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Financial Literacy or Framing the Question: Lessons from Behavioral Finance

- Why system design matters for retirement savings?
- What is the role and what are the limits of default options?
- The New Zealand National Default Savings Program: KiwiSaver

Why system design matters for retirement savings?

- Actual saving by individuals not only dependent on economic and financial fundamentals (as predicted in life-cycle)
- Psychological and behavioral factors influence saving at level of both planning and execution
- This has implications for the design of retirement saving

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Reasons for inadequate savings plans and/or investment decisions

- **At planning stage:**
  - Uncertainty about many elements of optimal saving plan such as future earnings, rates of return and health status
  - Prevalence of many other and more short-term risks, such as sickness and unemployment
  - Lack of information needed, such benefits provided by public and corporate pension benefits
  - Too many choices and hence “choice overload”
- At **execution stage:**
  - Lack of will power, or non-exponential discounting (e.g. near discount rate much higher than long-term discount rate)
  - Time-inconsistent preferences leading to inertia in saving choices (individuals defer action if there are immediate costs even if long-term gains are substantial)

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Consequences of behavioral factors for saving planning and execution

- Individuals chose not to choose
  - (jam booth example: Iyengar and Lepper 2000)
- Individuals take mental short-cut
  - Simple rule of thump like 1/n rule in portfolio allocation
  - Supposedly save or familiar (such as investing in own enterprise)
- Stick to what you have got (inertia)
- Self-control through self-binding mechanism

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What is the Role and what are the Limits of Default Options?

- Where are default options offered?
- How important are default options for savings outcomes?
- What are key policy issues – the less desirable effects?
- What is the role for government?

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Key Policy Issues of Default Option – the less desirable effects

- The default options may lead to low savings outcomes even if individuals are automatically enrolled. If the default option is a low contribution rate and applies to a very conservative portfolio, this will lead to a very low financial balance at retirement. A result the individual may not expect as he or she relied on the default option as, perhaps expected, "best" choice.
- What is the contingent liability of employers and government with regard to the default option? If such a liability (if only politically and notionally) for low outcomes is created which may also result from high-risk choice, it will impact the choice by the employer, and requests closer involvement of government.
- How to handle (socially, economically and politically) the inequality of outcomes between individuals across different pension plans which have all selected the default options in their individual plans?
- Will well designed default options undo the move toward the informed consumer and saver as individuals will see little possibility or usefulness to outdo the choice made by the employer (and regulated and hence agreed by the government?).

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Is there a role, and for what reasons, and is government able and willing to do so?

- As government "out-sources" social policy function to financial markets, it has to make sure that it delivers. DO have strong – positive or negative – effects on savings outcomes
- Does the government have the information to regulate the default options by the private sector? How should the regulatory objectives be defined?
- Default options may create avenues for misuse of government power or create perception of unnecessary government interferences

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Pension Reform, Financial Literacy, and Default Options in Transition Economies

- 14 countries have legislated, and 10 countries have introduced second pension pillar (Table 1)
- Only two follow Chile, others keep reduced and reformed first pillar
- Long-term contribution rate fore second pillar between 5 and 10 percent
- Different saving products and suppler stricture than Latin America, that is highly varied between countries
- Use of default options in reform design (Table 2)

Country and status of system	Starting date	First pillar	Size of second pillar as a percent of payroll	Projected pension fund assets in 2020 as a percent of GDP	Share of workforce in funded pillar in 2003	Switching strategy to new system
Bulgaria, operating	January 2002	Pay-as-you-go defined benefit	2, growing to 5	—	—	Mandatory for < 42
Croatia, operating	January 2002	Pay-as-you-go defined benefit	5	25–30	60–70	Mandatory for < 40; voluntary for 40–50
Estonia, operating	July 2002	Pay-as-you-go defined benefit	6	20	60	Voluntary (opt-out + 2 percent)
Hungary, operating	January 1998	Pay-as-you-go defined benefit	6	31	45	Mandatory for new entrants; voluntary for others
Kazakhstan, operating	January 1998	Guaranteed minimum	10	30	100	Mandatory
Kosovo, partially legislated and Operating	January 2002	Minimum	10	—	—	Mandatory
Latvia, operating	July 2001 (notional defined contribution, January 1996)	Notional defined contribution	2, growing to 9	20	72	Mandatory for < 30; voluntary for 30–50
Lithuania, operating	January 2004	Pay-as-you-go defined benefit	2.5	—	—	Voluntary
Macedonia, legislated	—	Pay-as-you-go defined benefit	7	26	—	Mandatory for new entrants
Poland, operating	January 1999	Notional defined contribution	7.2	33	70	Mandatory for < 30; voluntary for 30–50
Romania, partially legislated then questioned	January 2003	Pay-as-you-go defined benefit	8	30	—	Mandatory for > 20 years from retirement
Russia, partially legislated and operating	January 2002	Notional defined contribution	2 (< 35) to 6 (36–50)	—	—	Mandatory for < 50
Slovakia, operating	January 2005	Pay-as-you-go defined benefit	9	20	—	Mandatory for new entrants
Ukraine, partially legislated	January 2003	Pay-as-you-go defined benefit	2, growing to 7	—	—	Mandatory for new entrants

Financial Education in ECA

- Financial literacy started from very low level as financial market and instruments did essentially not exist 15 years ago
- Very quick reform and privatization of banking sector, with now mostly foreign dominance; capital market introduction, and pension reforms in all countries
- Countries are well aware of need of financial education and launched many programs (Table 3)

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Preliminary results of Selective Survey (Table 4)

- Financial and retirement saving literacy is considered low, but the latter may be relatively better …
- Financial education generally considered also moderate, but change over last 5-10 years assessed positive re pensions
- General financial education takes mostly place via financial institutions and workplace; pension education by government and workplace. Us of instruments is across the board (except seminars)
- Unanimity of view that education differs across socio-economic groups
- Default options are considered as important, the role of government in regulation and supervision of these default options even as very important

Questions	Results:	COUNTRY AVERAGE	CROATIA	HUNGARY	LITHUANIA	MACEDONIA	POLAND	SERBIA	SLOVAKIA
How would you assess general financial knowledge in your country?									
A. Do people know the interest rate on their credit card or bank account?		-0.28	0.00	-0.33	-0.50	0.67	0.00	-3.00	1.20
B. Do people know the difference between bonds and stocks?		-0.45	0.00	-0.67	0.00	-0.33	-0.33	-2.00	0.20
C. Do people know the difference between real and nominal interest rates?		-1.38	-1.00	-0.67	-2.00	-1.67	-2.33	-1.00	-1.00
	Average of financial knowledge	**-0.70**	**-0.33**	**-0.56**	**-0.83**	**-0.44**	**-0.89**	**-2.00**	**0.13**
How would you assess pension knowledge in your country?									
A. Do people understand how much income they would need to continue their way of life in retiremer		-0.52	0.50	0.00	-1.25	0.67	-1.33	-3.00	0.80
B. Do people understand the way public and private pensions are financed?		-0.08	1.00	0.00	-1.25	0.33	-0.67	1.00	-1.00
C. Do people understand the trade-off between risk and return?		-0.46	1.50	-1.33	-2.00	0.00	-1.00	0.00	-0.40
	Average of pensions knowledge	**-0.35**	**1.00**	**-0.44**	**-1.50**	**0.33**	**-1.00**	**-0.67**	**-0.20**
Difference - General and retirement literacy		**-0.35**	**-1.33**	**-0.11**	**0.67**	**-0.78**	**0.11**	**-1.33**	**0.33**
How do you see the change on financial knowledge during the next 5 or 10 years?									
General Finances knowledge		0.92	0.50	0.00	-0.25	1.67	1.33	2.00	1.20
Pension Knowledge		1.06	1.50	0.00	-1.00	2.00	1.33	2.00	1.60
Difference - Change General and retirement literacy		**-0.14**	**-1.00**	**0.00**	**0.75**	**-0.33**	**0.00**	**0.00**	**-0.40**
How do you assess the scope and quality of financial education in your country? (Such as the efforts made and the outcome achieved)									
General Finances knowledge		-0.77	0.00	-2.50	-1.50	0.33	-0.33	0.00	-1.40
Pension Knowledge		-0.25	1.00	-2.00	-1.75	1.00	1.00	0.00	-1.00
Difference - General and retirement knowledge		**-0.52**	**-1.00**	**-0.50**	**0.25**	**-0.67**	**-1.33**	**0.00**	**-0.40**
How do you assess the change in scope and quality of financial education over the last 5 to 10 years in your country?									
General Finances knowledge		-0.45	0.00	-2.00	-0.25	0.67	1.00	-3.00	0.40
Pension Knowledge		0.21	2.00	-0.50	-0.50	1.00	1.67	-3.00	0.80
Difference - General and retirement knowledge		**-0.66**	**-2.00**	**-1.50**	**0.25**	**-0.33**	**-0.67**	**0.00**	**-0.40**

Concluding Remarks

- Sobering assessment with optimistic outlook:
  - Modest levels of financial literacy
  - Unknown effectiveness of financial education
  - BUT: Some education seems to produce savings outcomes
- Many other constraints on planning and executing retirement saving
  - Need to adjust savings design to findings of behavioral finance
  - Crucial role of default options/ public policy dimension
- Preliminary findings for transition economies seem confirm studies for (older) OECD countries
  - Knowledge gap for retirement perhaps lower?
  - Default options considered importance
  - Role of public regulation and supervision in determination of default options considered very important