Economic consequences of financial (il)literacy

Summary

Pension reforms are placing increasing responsibility on individuals for their financial security in old age. Likewise, the growing complexity of products requires an increasing degree of financial sophistication. Moreover, the fact that elderly households' wealth consists mainly of their own home casts doubts about the appropriateness of their choice. This has led scholars to investigate the level and the role of financial literacy (FL) and its role in households' financial decision making. Our proposal is within this field of research and follows two paths.

1) The first is more general and will focus on whether, and how much, financial literacy is necessary to achieve superior investment decisions in terms of risk and return trade-offs. Given that households could rely on experts' advice, we will investigate how financial literacy and "trust" in advisors are related to the choice of delegation. Aims are:

- to analyze the role of awareness of agency conflict in the decision to delegate portfolio management to financial advisors and its consequences on the portfolio performance
- to sort out the FL vs. trust dilemma in explaining the individual's amount of delegation of financial decision
- to define the optimal level of FL necessary to overcome market imperfections such as advisors' distorted incentives and non competitive fees
- to test and quantify the impact of FL on portfolio performance and investigate the main channels through which financial literacy operates.

We expect to derive policy conclusions about the role of FL and to find this to be important specifically in helping investors to recognize the advisors' conflicts of interests and in taking corrective action.

2) The second part is more specific and will investigate whether FL affects decisions related to the optimal allocation of life cycle resources, such as the gradual running down of housing wealth by the elderly and the decision to retire. Aims are:

- to investigate the impact of FL on the choice of (Italian) households, particularly at older ages, to own a very illiquid asset such as housing
- to study specific financial products, such as "reverse mortgage", which might help liquidating households' asset thus bringing a potential welfare gain
- to test whether the choice to save for physical capital (housing) displaces savings for children's education and whether this (possibly inefficient) displacement is related to the degree of households' FL
- to enquire how far FL heterogeneity can affect the degree to which workers respond rationally to retirement incentives.

As for policy conclusions, if it can be shown that poor FL causes inefficient behavior, such as over-exposure in housing wealth and lack of responsiveness to retirement incentives, the promotion of financial education can have far reaching positive social welfare effects especially for some target groups.