FINANCIAL LITERACY 101

Current strategies to improve financial literacy don't go far enough, argue **Ross Guest** and **Mark Brimble**

The Reserve Bank of Australia (RBA) sounded a warning in October last year about the high level of household debt in the face of a possible property downturn,[1] the signs of which may be evident in the fall of 1.4% in the September 2017 quarter in Sydney house prices[2]—the first decline in 17 months, and which has continued since then according to private sector data.[3] Household liabilities in Australia were 150% of income in 2016 according to the Australian Bureau of Statistics[4] which is one of the highest in the world. In early 2018 Australian property was rated 'severely unaffordable' with Sydney found to be the second least affordable market in the world after Hong Kong.[5]

The RBA is especially concerned about the high proportion of interest-only mortgages where borrowers do not understand that their repayments make no inroads into their debt. Interest-only loans make up around 30% of all housing loans and about half of all investor housing loans.[6] And the RBA worries that interest-only borrowers are more vulnerable to higher interest rates or lower income that might occur for any one of many reasons—forced reduction in work hours, a small business collapse, a tenancy problem in a rental property, and so on.

If household debt were a matter only for that household the case for government to do anything about it would perhaps be less—'buyer beware' and face the consequences. But it is not that simple. The Global Financial Crisis (GFC) of 2008-09 showed how dramatically and rapidly financial contagion can spread once households and some businesses default on their loans. One person's debt is another person's asset, so when the debt is written off so is the asset.

The costs of financial contagion justify government regulatory action, which has occurred to some extent since the GFC in terms of bank lending rules and limits. However little, if anything, has been done to improve financial literacy, the lack of which was one underlying cause of the GFC. According to a recent survey from investment bank UBS,[7] around one third of borrowers with interest-only loans did not understand that their repayments were not making inroads into their loan principal, and that their interest rates will jump considerably after the interest-only period of the loan has expired.

Evidence suggests that financial literacy has not improved since the GFC and may have worsened. An ANZ survey of adult financial literacy in Australia found that in 2014 compared with 2011, the number of people who could recognise an investment as 'too good to be true' fell to 50% from 53%, and people who recognised that good investments may fluctuate in value fell to 67% from 74%.[8]

Apart from saving people from financial hardship and even ruin, financial literacy is important for achieving a productive economy. Economic efficiency requires borrowers not only to

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have good information but also to understand it, so that they can weigh up the costs of borrowing with the benefits that they expect to receive. If the information is distorted, either deliberately by lenders or through misunderstanding of borrowers, they will miscalculate the benefits and therefore capital in the economy will be misallocated. Economists call this market failure, a lot of which occurred in the US housing market that was the precursor to the full-blown GFC.

Thus financial literacy is not just about the acquisition of some base level of competence or knowledge in relation to finance. Rather it is about equipping consumers with the ability to make more effective financial decisions. Furthermore, those who can equip themselves with relevant financial knowledge and skills can make more informed decisions, be less vulnerable to scams, and avoid accumulating unmanageable levels of debt. When it comes to more complex topics such as variation in investment returns (risk) and taxation,[9] many consumers have low levels of confidence and understanding and thus struggle to make effective decisions.

What is financial literacy?

This raises the issue of what is meant by the term 'financial literacy'. For some this is about being able to budget, for others it is about navigating the complex array of financial products and services, while for others it is about effective financial behaviours. The Australian Securities and Investments Commission (ASIC) defines it as 'a combination of financial knowledge, skills, attitudes and behaviours necessary to make sound financial decisions, based on personal circumstances, to improve financial wellbeing'.[10] Interestingly, ASIC in its consultation paper in 2017 on refining the National Financial Literacy Strategy acknowledges that they have moved beyond knowledge and skills by including attitudes and behaviours and thus propose changing to the term 'financial capability'.[11]

This suggests a more comprehensive and holistic approach to financial literacy and financial literacy education. This has been advocated by research in this area which argues that enabling factors (for example, numeracy and digital literacy) be included in education programs and a lifelong (and just-in-time) learning approach be adopted that develops with consumer engagement in, and use of, the financial system.[12]

This approach also recognises the role that professional financial advisers can play in supporting financial capability skills development of their clients (and the broader community) with a view to promoting and developing effective financial decision-making. For some consumers the complexity of their financial affairs dictates they will require professional advice, while for others they have neither the time nor the interest in managing their personal finances.

In relation to enabling factors, financial literacy education must go hand in hand with broader improvements in general literacy and numeracy. The Australian Productivity Commission found that in 2011-12 14% of the adult population had relatively low literacy skills defined as being able, at best, to locate basic information from simple texts but being unable to evaluate truth claims or arguments. And 22% of the population had low numeracy skills meaning that they can count, add and subtract and do other basic arithmetic, but they cannot understand statistical ideas, mathematical formula or analyse data.[13]

In other words, a significant proportion of the Australian adult population are ill-equipped to understand the effect of an interest rate increase on their loan repayments, or understand a loan document that has an interest uplift clause that kicks in after an initial period. These skills are best learned in an education setting (primary, secondary and tertiary) where teachers can guide and support learning in a structured way, and students can spend the necessary time on tasks to be able to really understand and apply concepts.

Education is key

Financial literacy education cannot wait, however, until people are in the throes of negotiating a housing loan, selecting a credit card, determining which insurance policy best suits their needs, or evaluating how to invest hard-earned and accumulated savings. Rather, it needs to start at school age before credit cards, personal loans such as the insidious payday lenders like Nimble Loans,[14] and home loans become a possibility.

This is the aim of the Australian government's National Financial Literacy Strategy 2014-17, updated in 2018, which proposes a number of worthy educational initiatives including embedding financial literacy in the school curriculum, a formal teacher training program, and development of educational resources and tools.[15] The strategy draws on similar steps that have been adopted by other countries and recommendations by the Organisation for Economic Cooperation and Development (OECD).[16] The OECD defines financial literacy as a combination of financial knowledge and skills, financially 'savvy' behaviours, and attitudes towards saving and spending.[17]

It must also be recognised that not all elements of financial literacy education are effectively delivered during schooling years as a lack of experience with the system (and life in general) of school students can undermine outcomes.[18] Rather, a highly financially literate person will tend to make decisions about money and finance that will improve their financial well-being, and these decisions (and thus the financial skills and knowledge required) change over the various stages of life and the circumstances encountered. This does not diminish the importance of financial education programs in schools, but rather suggests that it needs to continue throughout life.

The OECD's Program for International Student Assessment (PISA) 2015 Financial Literacy assessment was conducted in 15 countries including Australia where it was funded by ASIC.[19] A random sample of 14,500 Australian 15-year-old students participated in the assessment. The results showed that Australia's performance was significantly higher than nine of the 15 countries including the United States, but significantly lower than four countries including China. Females performed significantly higher than males; and socioeconomically-disadvantaged students performed worse in Australia relative to advantaged students, than in other countries. Worryingly, a significantly higher proportion of disadvantaged students reported that they would '*buy something they really wanted with money that really should be used for something else*', while a higher proportion of advantaged students reported that they would '*save up to buy it*'.[20]

Improving financial literacy requires an intergenerational approach. The 2015 PISA study found that for Australia the 15-year-olds who discussed money matters with parents at least some of the time performed better in financial literacy than students who never discussed money matters with parents, even after controlling for students' socioeconomic background. In fact the OECD conducted a parallel survey of adult financial literacy covering 30 countries, including 17 OECD countries, but not including Australia.[21] The report recommended that financial education should start early in school, focusing on numeracy skills and attitudes towards saving, spending and financial planning. Given the PISA finding, it would seem that a program encouraging parental involvement would also be worthwhile.

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Adult financial literacy

Universities, through their business schools, could also play an important role in improving financial literacy among young adults. All Australian business schools have curricula in relevant fields such as finance and investments, banking, digital literacy and numeracy/statistics. Universities also have significant human capital with expertise that delivers these curricula.

Furthermore, some business schools have programs in personal finance/financial planning (including retirement, estate planning, insurance taxation). Business law (contracts, business structure, negligence, and so on) is also covered in a typical business degree. When coupled with the learning technology and educational design/delivery expertise at the disposal of higher education institutions, all the ingredients for financial education program design exist for such institutions to engage in financial literacy education programs.

An additional question, however, is how such programs could be delivered. It is not completely unrealistic to consider a core financial capability course (or at least a module) for all undergraduate programs. Other options include elective courses in personal finance, extra/co-curricular financial education modules for students, and free online courses (so-called Massive Open Online Courses or MOOCS) that are open to students and the public. The key is to produce engaging materials and to use modern learning strategies such as blended learning, service learning, digital enhanced learning and gamification to drive participation, engagement and learning outcomes.

Thus, there is significant opportunity for universities to participate in this economic and social challenge—and in a world where universities are looking to support the development of their communities, this seems like an obvious area of consideration.

A further strategy would be for higher education providers to partner with other stakeholders that deal with consumers at different life stages to develop timely financial literacy education that draws on the strengths of all stakeholders. Options here might include mortgage providers in relation to first home buyers, relationship councillors for pre-marriage support, superannuation funds in relation to retirees, NDIS providers in relation to supporting scheme recipients, or employers in relation to first time employees.

More needs to be done

Australia's National Financial Literacy Strategy 2014-17 recommends a number of useful strategic priorities and actions, in particular building capacity through teacher training, curriculum tools and resources, and targeting vulnerable groups.[22] However it probably does not go far enough.

One problem is that the curriculum is a crowded space. Financial literacy must compete with the latest fashions in school education as well as traditional curriculum content. Fighting for curriculum space for financial literacy is a political exercise which the government would need to play hard, for example by attaching serious funding to the achievement of financial literacy indicators at school and tertiary level. Indicators could be developed using the OECD's guide to creating financial literacy scores which selects topics, questions and assigns scores to the answers.[23] Schools could be invited to administer the tests, with appropriate moderation and with additional school funding attached to successful outcomes. The National Strategy is silent on this important question of incentives for schools and parents to buy into the strategy.

Similarly, the OECD adult literacy report perhaps does not go far enough.[24] It recommends policies in financial regulation and consumer protection with the aim of helping people to avoid debt traps through misinformed decision-making in relation to credit cards and other loans. This is all worthwhile, but it might also have considered requiring loan applications to include some financial literacy questions drawing on the OECD's assessment instrument. Then applicants who score poorly could be required to undertake a more detailed interview and financial counselling before the loan can be approved.

This is comparable to the requirement for people to undertake medical assessments, sometimes including physical tests, before being allowed to participate in potentially dangerous sport and recreation pursuits, such as skydiving, or occupations such as the police force. In financial services, this exists only in the context of a 'sophisticated investor'[25] (as defined in chapter 5D of the Corporations Act 2001) which provides consumers that meet the relevant criteria to access certain types of investment options that may not otherwise be accessible. It does, however do so at the cost of exemptions to some of the consumer protections built into financial services law. Thus, while this regime is not seen as necessarily appropriate,[26] it does highlight the need for policy development in this area.

The ASIC Consultation paper on the 2018 National Financial Literacy Strategy also highlights the need to broaden the efforts in financial capability. It suggests additional priority audiences including people with disabilities, recent migrants and sole parents. Furthermore, the breadth of the scope of the strategy is also proposed to be expanded to include financial inclusion, financial resilience, social isolation and financial abuse. This highlights the scale of the issue and the effort required to tackle the various dimensions of it.

What is clear is that more needs to be done as the downside risk of not improving the financial capability of Australian consumers is significant. Arguably neither the Australian Strategy nor the OECD recommendations are ambitious enough and neither provides the sort of sharp incentives and regulations that will really make a difference in improving financial literacy and capability.

Yet it's never been more important to tackle financial literacy, especially given other looming issues such as the impact of an ageing population, increasing longevity (savings must last longer) and deterioration in the ratio of retirees to workers. While the retirement savings system approached $2.5 trillion in accumulated assets in late 2017,[27] it is expected that many individuals will have insufficient retirement savings to support themselves in retirement.[28] Thus, the fiscal impact of a lack of financial independence among more older Australians will compound the downside risk posed by a lack of financial literacy among the younger generation, whose taxes will have to pay for the rising costs of an ageing population.

Endnotes

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