

Financial Education and Financial Stability: A Case Study

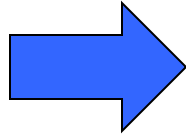


**Dan Iannicola, Jr.
President & CEO**

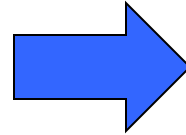
***International Conference on
Financial Education and Financial Awareness:
Challenges, Opportunities and Strategies
Istanbul, Turkey
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Operating Theory

**Consumer
Financial
Knowledge**



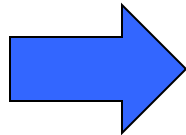
**Good
Individual
Behaviors**



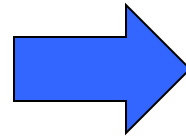
**Positive
National
Consequences**

If this is true, then it follows that:

**Lack of
Consumer
Financial
Knowledge**



**Bad
Individual
Behaviors**



**Negative
National
Consequences**



Three Objectives

- Case Study: the American consumer and the recent financial crisis
- What we can learn
- What we can do

Case Study: Caveats

- There were a number of converging factors that gave rise to the financial crisis that **do not** directly involve US consumer conduct, such as:
 - Easy Credit Policy of US Federal Reserve
 - Shortfalls in Regulatory Oversight by US regulators
 - Financial Innovation & Complexity
 - Incorrect Pricing of Risk
 - Weak/Fraudulent Underwriting Practices
 - General Overleveraging among Financial Institutions



Case Study: Three Phases of Crisis

- Phase #1: Bubble Formation (approx. 2003 – 2006)
- Phase #2: Crisis (2007 – 2008)
- Phase #3: Economic Aftermath (2009 – Present)



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Case Study:

Phase #1 Bubble Formation ('03 – '06)

■ Knowledge:

- Didn't understand basic terms of new exotic mortgages including adjustable rate and interest-only loans
- 28% of borrowers said payments were different than expected¹

- Presumed their lenders or mortgage brokers were acting in their best interest and failed to question or negotiate
- 44% did not comparison shop for a mortgage²

- Believed home values would continue to appreciate
- 28% of all homes sold during 2005 were for investment purposes only³

¹ Harris Interactive, Nat'l Found. For Credit Counseling, The 2009 Consumer Financial Literacy Survey Final Report (2009)

² FINRA. National Financial Capability Study (2009)

³ Homes: Big drop in speculation. Les Christie, CNNMoney.com. April 30, 2007



Case Study:

Phase #1 Bubble Formation ('03 – '06)

■ Behavior:

- Home buyers financed homes too expensive for their incomes under terms they grossly misunderstood



Case Study:

Phase #1 Bubble Formation ('03 – '06)

■ **Consequence :**

- Home buying accelerated
- Demand outstripped supply
- Prices quickly appreciated, which in turn fueled the urgency to buy
- This required buyers to finance a very high percentage of the purchase price to successfully bid up the home...& the cycle continued



Case Study: Three Phases of Crisis

- Phase #1: Bubble Formation (approx. 2003 – 2006)
- **Phase #2: Crisis (2007 – 2008)**
- Phase #3: Economic Aftermath (2009 – Present)

Case Study:

Phase #2 Crisis ('07 – '08)

■ Knowledge:

- Over 50% of Americans did not have enough emergency savings set aside to cover expenses for 3 months in case of sickness, job loss or other emergency⁴
- Only 40% used monthly budgets⁵
- 34% spent all of what they made⁶
- 11% spent **more** than what they made⁷
- 47% of those with savings rarely or never rebalanced the investments in their retirement portfolios⁸

^{4,6-8} FINRA National Financial Capability Study (2009)

⁵ NFCC Consumer Financial Literacy Survey (2007)

Case Study:

Phase #2 Crisis ('07 – '08)

■ Behavior:

- A number of Americans defaulted on their mortgages because they did not have savings for a financial emergency
- Many older Americans over-weighted their retirement portfolios toward equities and suffered from the market crash⁹
- Then they engaged in panic selling at the low point of the market, and kept their money out of stocks, missing the strong market recovery¹⁰

⁹⁻¹⁰The 12 Dumbest 401(k) Mistakes, CBS Marketwatch, Kate Ashford October 26, 2009



Case Study:

Phase #2 Crisis ('07 – '08)

■ **Consequence:**

- Nationwide defaults increased dramatically, straining financial institutions and further depressing the housing market
- Many Americans lost a great deal of personal wealth in the stock market during the sharp decline
- Some needed to change their retirement plans or rely more heavily on the public pension system



Case Study: Three Phases of Crisis

- Phase #1: Bubble Formation (approx. 2003 – 2006)
- Phase #2: Crisis (2007 – 2008)
- **Phase #3: Economic Aftermath (2009 – Present)**



Case Study:

Phase #3 Economic Aftermath ('09 – Present)

■ Knowledge:

- 46% Fail to pay credit card bills in full every month¹¹
- 29% Make only the minimum payment¹²
- The average amount of credit card debt per US household is \$14,750 ¹³
- 75% of US consumers believe they are **good** with financial matters including management of credit cards¹⁴

^{11-12, 14}FINRA National Financial Capability Study (2009)

¹³ Federal Reserve Report on Consumer Credit February 2011



Case Study:

Phase #3 Economic Aftermath ('09 – Present)

■ Behavior:

- During difficult economic times
Americans use credit cards to meet
monthly expenses for essentials¹⁴

¹⁴ Borrowing to Make Ends Meet, Demos, 2007



Case Study:

Phase #3 Economic Aftermath ('09 – Present)

■ **Consequence:**

- The US economy is now recovering more slowly than from past recessions because American households are too burdened by debt to fuel strong consumption



Three Objectives

Case Study: the American consumer and the recent financial crisis

What we can learn

What we can do



What We Can Learn...

- There are a number of approaches which will help a nation's consumers and its broader economy:
 - Strong regulation of financial institutions and markets along with increased consumer protection efforts
 - Simplification of some products
 - Accurate and timely disclosures
 - Carefully designed defaults
 - While necessary, these are not sufficient

Key Learning: Consumer financial education is a valuable policy tool to promote economic stability



What We Can Learn...

■ Why is financial education unavoidable:

- A free marketplace for financial products/services will always have **choice** and **risk** for consumers
- Both of these elements call for an informed consumer decision
- Every potentially harmful financial product/service cannot be regulated out of existence
- Even good products can be misused by the uninformed:
 - Checking accounts can be overdrawn
 - Credit cards can be abused
 - Stock portfolios can lose value
- The difference is an individual empowered by education



Three Objectives

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What We Can Do...

- Government is uniquely suited to help its citizens become more financially literate:
 - It can assess the national need, convene those who might help and lead them toward objectives
 - While individual programs can make an impact, a national strategy can elevate the topic and begin the progress towards widespread change
 - Drafting and implementing a strategy is a challenging task
 - Government is accustomed to implementing policy and enforcing regulations
 - Since strategies won't typically have the force of law, a different approach is worth considering

What We Can Do...

Two Models for Strategy Development

Mountain Top

- Edicts from on high
- Top down decisions
- Very general, sets out broad vision and aspirations for others to pursue
- Small group of government experts
- Exercise of power
- Executed with a spirit of compliance

Contractual

- Negotiated among parties
- Broad-based consensus
- Specific objectives, organizations held accountable for identified tasks
- Inclusive: government, NGOs, private sector
- Exercise of influence
- Executed with a spirit of cooperation



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(202) 747-9490

dan.iannicola@FinancialLiteracyGroup.com

FinancialLiteracyGroup.com