Financial Education and Financial Stability: A Case Study

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International Conference on
Financial Education and Financial Awareness:
Challenges, Opportunities and Strategies
Istanbul, Turkey
March 9, 2011

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 expected[1]

- 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 mortgage[2]

- Believed home values would continue to appreciate
- 28% of all homes sold during 2005 were for investment purposes only[3]

[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 emergency[4]
- Only 40% used monthly budgets[5]
- 34% spent all of what they made[6]
- 11% spent ***more*** than what they made[7]
- 47% of those with savings rarely or never rebalanced the investments in their retirement portfolios[8]

[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 crash[9]
  - Then they engaged in panic selling at the low point of the market, and kept their money out of stocks, missing the strong market recovery[10]

[9-10] The 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 month[11]
- 29% Make only the minimum payment[12]
- 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 cards[14]

[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 essentials[14]

[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

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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	Contractual
Edicts from on high	Negotiated among parties
Top down decisions	Broad-based consensus
Very general, sets out broad vision and aspirations for others to pursue	Specific objectives, organizations held accountable for identified tasks
Small group of government experts	Inclusive: government, NGOs, private sector
Exercise of power	Exercise of influence
Executed with a spirit of compliance	Executed with a spirit of cooperation

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