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OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The Importance of Financial Education

Introduction

Financial education is increasingly important, and not just for investors. It is becoming essential for the average family trying to decide how to balance its budget, buy a home, fund the children's education and ensure an income when the parents retire.

Of course people have always been responsible for managing their own finances on a day to day basis – spend on a holiday or save for new furniture; how much to put aside for a child's education or to set them up in life – but recent developments have made financial education and awareness increasingly important for financial well-being.

For one thing, the growing sophistication of financial markets means consumers are not just choosing between interest rates on two different bank loans or savings plans, but are rather being offered a variety of complex financial instruments for borrowing and saving, with a large range of options. At the same time, the responsibility and risk for financial decisions that will have a major impact on an individual's future life, notably pensions, are being shifted increasingly to workers and away from government and employers. As life expectancy is increasing, the pension question is particularly important as individuals will be enjoying longer periods of retirement.

Individuals will not be able to choose the right savings or investments for themselves, and may be at risk of fraud, if they are not financially literate. But if individuals do become financially educated, they will be more likely to save and to challenge financial service providers to develop products that truly respond to their needs, and that should have positive effects on both investment levels and economic growth.

This *Policy Brief* looks at the importance of financial education, and how the OECD is helping governments achieve it. One key challenge is convincing people that they are not as financially literate as they think they are. ■

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Why is financial education important?

Individuals are increasingly being asked to take on sole responsibility – and assume the burden of risk – for complex savings tasks which were previously at least shared with governments or employers, such as investing for a pension or for higher education for their children.

But how can individual workers or parents be expected to weigh the risks and make responsible choices in an ever more sophisticated financial market? This is true even in countries where consumers generally are familiar with financial instruments such as credit cards, mortgage loans and perhaps private saving to "top up" company pension plans. It is all the more difficult in emerging economies whose rapid development has given access to financial services to a large number of consumers, many of whom have only a limited experience with formal financial systems.

For emerging economies, financially educated consumers can help ensure that the financial sector makes an effective contribution to real economic growth and poverty reduction. But financial literacy is also crucial for more developed economies, to help ensure consumers save enough to provide an adequate income in retirement while avoiding high levels of debt that might result in bankruptcy and foreclosures.

The information available on consumer financial literacy is worrying for two reasons – not only do individuals generally lack an adequate financial background or understanding to navigate today's complex market, but unfortunately they also generally believe that they are far more financially literate than is really the case.

This has become a cause for increasing concern for governments for a number of reasons. For one thing, increasing use of credit cards in OECD countries has led to an increase in personal bankruptcies – in 2003, almost one in 10 US households filed for bankruptcy and the number of private bankruptcies in Austria rose by 11%. And similar problems are arising in countries where credit is becoming more widespread – Korea has experienced large increases in consumer debt, while in Germany there has been an increase in private insolvencies, at least partly due to increased availability of credit.

And for some people in OECD countries, the question of financial literacy is far more basic and boils down to whether they have a bank account. Across the OECD, between 3% and 10% of the population are without a bank account, and are therefore financially isolated in a world where financial transactions – including payment of welfare benefits – are increasingly carried out electronically. ■

How can it be achieved?

To help governments respond to these concerns, the OECD has taken the lead in examining financial literacy across member countries and suggesting how to improve it.

It has released the first major international study on financial education (entitled *Improving Financial Literacy*) as well as the world's first practical guidelines on good practices in financial education and awareness. These are addressed to all countries, developed and developing, that are interested in financial education and are designed to help them design and implement effective financial education programmes. These guidelines, in the form of a non-binding recommendation, are drawn from the experience of OECD countries on best practice in this area. They promote the role of all the main stakeholders in financial education: governments, financial institutions, employers, trade unions and consumer groups. The Recommendation calls for a number of actions to improve financial education (see Box), from basic savings and private debt management to assessing whether your pension savings are adequate. They also draw a clear distinction between public information provided by government and regulatory authorities, and that provided by private sector investment advisors such as banks and brokers.

Box 1.

HOW TO IMPROVE FINANCIAL LITERACY

The OECD's "Recommendation on Principles and Good Practices for Financial Education and Awareness" includes the following advice to governments:

- Governments and all concerned stakeholders should promote unbiased, fair and coordinated financial education.
- Financial education should start at school, for people to be educated as early as possible.
- Financial education should be part of the good governance of financial institutions, whose accountability and responsibility should be encouraged.
- Financial education should be clearly distinguished from commercial advice; codes of conduct for the staff of financial institutions should be developed.
- Financial institutions should be encouraged to check that clients read and understand information, especially when related to long-term commitments or financial services with potentially significant financial consequences: small print and abstruse documentation should be discouraged.
- Financial education programmes should focus particularly on important life-planning aspects, such as basic savings, debt, insurance or pensions.
- Programmes should be oriented towards financial capacity building, where appropriate targeted on specific groups and made as personalised as possible.
- Future retirees should be made aware of the need to assess the financial adequacy of their current public and private pensions schemes.
- National campaigns, specific Web sites, free information services and warning systems on high-risk issues for financial consumers (such as fraud) should be promoted.

These financial institutions clearly have a role in providing financial education, but it needs to be more clearly defined. One OECD recommendation that could help make choosing a savings plan less of a nightmare is that they should provide clear information and stop adding abstruse small print to their documents.

The G8 Finance Ministers' meeting in St. Petersburg in June 2006 recognised the importance of financial education, welcomed "the ongoing work in the OECD on the Financial Education Project and call(ed) for further development of financial literacy guidelines based on best practices." ■

How financially literate are we?

Research conducted for the OECD's study on financial education indicates that the level of financial literacy is low in most countries, including in developed countries. In Japan, for instance, 71% of adults surveyed knew nothing about investment in equities and bonds, while surveys in the US and Korea found that high school students failed a test designed to measure students' ability to choose and manage a credit card or save for retirement.

Perhaps more worryingly, consumers often overestimate how much they know. In an Australian survey, 67% of those taking part claimed to understand the concept of compound interest but only 28% could find the correct answer to a problem using the concept. So before they can even start work on providing financial education to their citizens, governments need to persuade them it is needed.

The level of financial literacy tends to vary according to education and income levels, but the evidence shows that highly educated consumers with high incomes can be just as ignorant about financial issues as less educated, lower income consumers.

Countries are increasingly aware of the importance of financial education and are already providing a variety of financial education programmes, ranging from Web sites and pamphlets or brochures to training courses and media campaigns. They cover issues such as credit, insurance, investment and retirement saving.

But interesting consumers in financial education is no easy task. People taking part in a survey in Canada said they thought choosing the right investment for a retirement savings plan was more stressful than a visit to the dentist. ■

Is financial education effective?

Finding ways to measure whether financial education has achieved its aims, such as increased consumer awareness or changed behaviour, is not easy and is costly for governments, so not all programmes have been evaluated. But when programmes have been evaluated, they have been found to be effective.

Research in the United States shows that workers increase their participation in 401(k) retirement savings plans funded by employee and employer contributions when employers offer financial education programmes, whether in the form of brochures or seminars. Mortgage counselling before people take on their loan has been found to be effective in reducing the risk of mortgage delinquency. Consumers who attend one-on-one counselling sessions on their personal finances have lower debt and fewer delinquencies.

But while financial education is important, it is only one pillar of an adequate financial policy to improve financial literacy and access to financial services. Financial education can complement, but can never replace, other aspects of successful financial policy such as consumer protection and the regulation of financial institutions. Financial education should also go hand-in-hand with improving access to financial markets and services. Access to financial services is a significant issue in many emerging economies – as well as for significant groups in OECD countries, such as minorities or low income consumers who do not have bank accounts.

Finally, financial education might also need to be complemented by other approaches to ensure an improvement in consumer financial well-being. For example, some experts recommend that workers, when they become eligible, be automatically enrolled in defined contribution pension plans that include pre-determined contribution rates and investment allocations. ■

What more should be done?

Governments are clearly aware of the need to improve financial literacy, but the OECD recommendations are only a first step. One key element for the future is persuading consumers that they need financial education and enabling them to access it. Also important is better financial education in schools. Today's school-leavers need to be a lot more financially literate than even their parents were if they are to manage their personal finances successfully through life.

The role of financial institutions in providing financial education, not only to clients but also to their own staff, needs to be better defined and further promoted. More information is needed at both international and national levels on good programmes and practices and on ways to promote access to financial services. Sharing information on successful experiences can be helpful to all.

If governments are to win consumers over to financial education, more needs to be learned about what their financial education needs are at various stages in their lives. How to deliver this education is also important – governments need to know how to attract the attention of people busy with jobs and families.

More work is clearly needed to develop ways of measuring the success of financial education programmes, and governments need to invest time and money in evaluating them.

The OECD is deepening its work on financial education, particularly in the area of insurance and retirement saving. It will examine in more detail the important role of financial education in increasing consumers' awareness and understanding of insurance issues, including the benefits of insurance coverage. It will also focus on the role of financial education in both defined benefit and defined contribution pension schemes and the development of appropriate guidelines on financial education for retirement savings. ■

For more information

For more information on the OECD's work on financial education, please contact: André Laboul, Head of Financial Affairs Division, Directorate for Financial and Enterprise Affairs; tel.: +33 1 45 24 91 27; e-mail: Andre.Laboul@oecd.org.

The OECD Policy Briefs are available on the OECD's Internet site: *www.oecd.org/publications/Policybriefs*

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For further reading

OECD (2005), **Improving Financial Literacy: Analysis of Issues and Policies,** ISBN 92-64-01256-7, 178 pages, € 30.

OECD (2005), **Improving Financial Literacy: Analysis of Issues and Policies** (e-book, pdf format), ISBN 92-64-01257-5, 178 pages, € 21.

OECD (2005), **Recommendation on Principles and Good Practices for Financial Education and Awareness,** available free on the OECD Web site: *www.oecd.org/dataoecd/7/17/35108560.pdf*.

Where to contact us?

OECD HEADQUARTERS
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: *www.oecd.org*

GERMANY
OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN
OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: *www.oecdtokyo.org*

MEXICO
OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.ocdemexico.org.mx

UNITED STATES
OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: *www.oecdwash.org*
Toll free: (1-800) 456 6323

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