

# Americans' Financial Capability

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# Questions

- 1. Are Americans financially *capable*?**
- 2. Do financial literacy and financial capability matter?**
- 3. Does financial illiteracy generate risks at the micro and macro level?**

# Background

## Before the financial crisis

- 1. Americans were saving very little, saving rate had been very low and reached zero**
- 2. Household debt had been growing steadily**
- 3. Opportunities to borrow became widely available**
  - 3a. Mortgages**
  - 3b. Credit cards**

# Main points

- 1. Most Americans are not financially capable**
- 2. Levels of financial literacy are strikingly low**
- 3. Lack of financial literacy and financial capability create instability at both the micro and macro level**

# Study Methodology

## National Financial Capability Study includes three linked surveys:

1. **National Survey**: Nationally-projectable telephone survey of 1,488 American adults
2. **State-by-State Survey**: Online survey of approximately 25,000 respondents (roughly 500 per state + DC)
3. **Military Survey**: Online survey of 800 military personnel and spouses

Some findings are from the TNS Global Economic Crisis Survey

# Objective

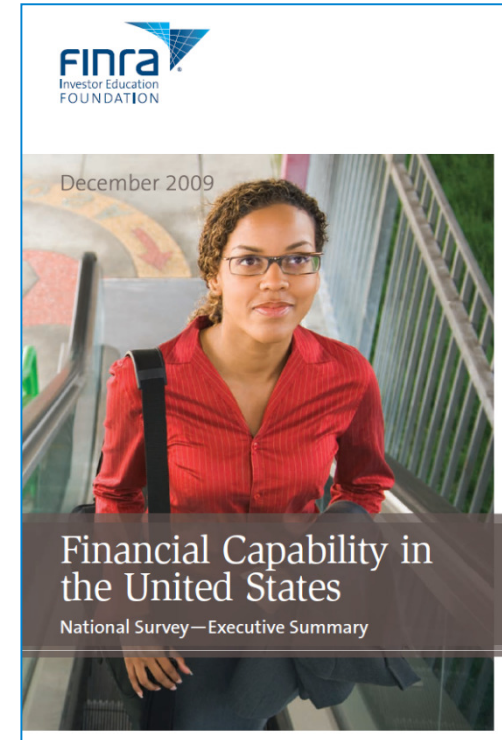
## Establish a baseline measure of the ability of Americans to manage their money.

### Multi-Disciplinary Team:

- Applied Research & Consulting LLC (ARC)
- FINRA Investor Education Foundation
- Office of Financial Education, U.S. Treasury Department
- Annamaria Lusardi (Dartmouth College)
- Additional input from:
  - Craig Copeland, Employee Benefit Research Institute (EBRI)
  - American Institute of Certified Public Accountants (AICPA)
  - Bob Willis, Univ. of Michigan, past PI of U.S. Health and Retirement Study

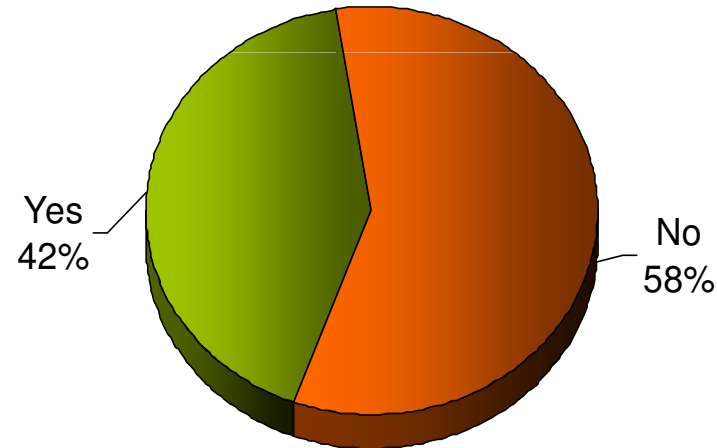
# Four Key Financial Capability Components

- 1. Making Ends Meet**
- 2. Planning Ahead**
- 3. Managing Financial Products**
- 4. Financial Knowledge and Decision-Making**

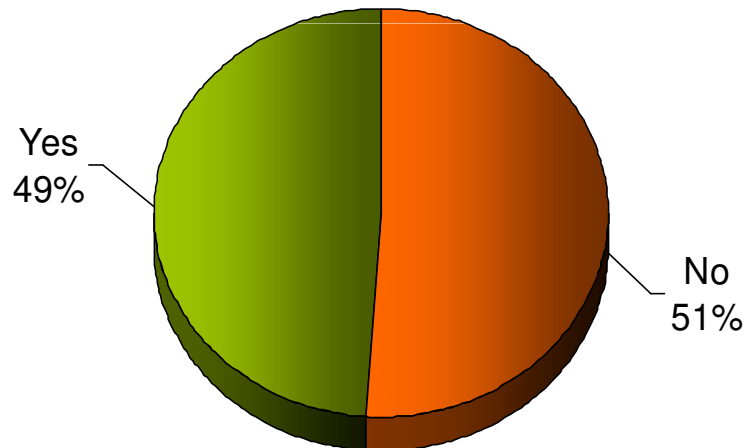


# Planning ahead: Most Americans don't

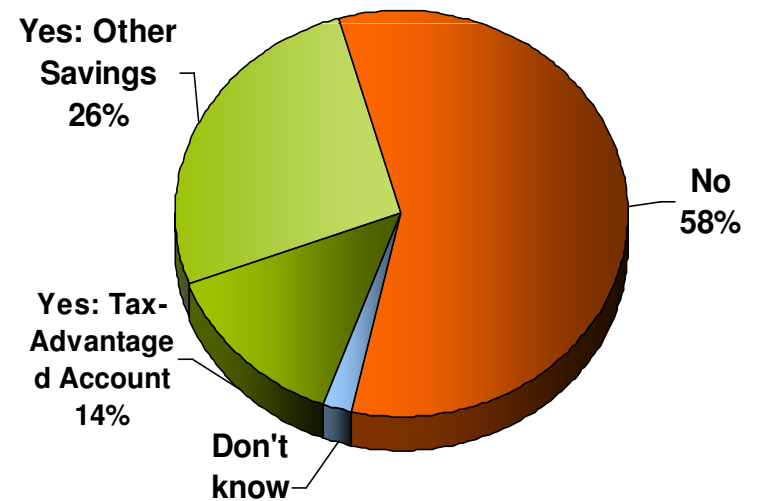
Have you ever tried to figure out how much you need to save for retirement?



Have you set aside an emergency or rainy day fund?

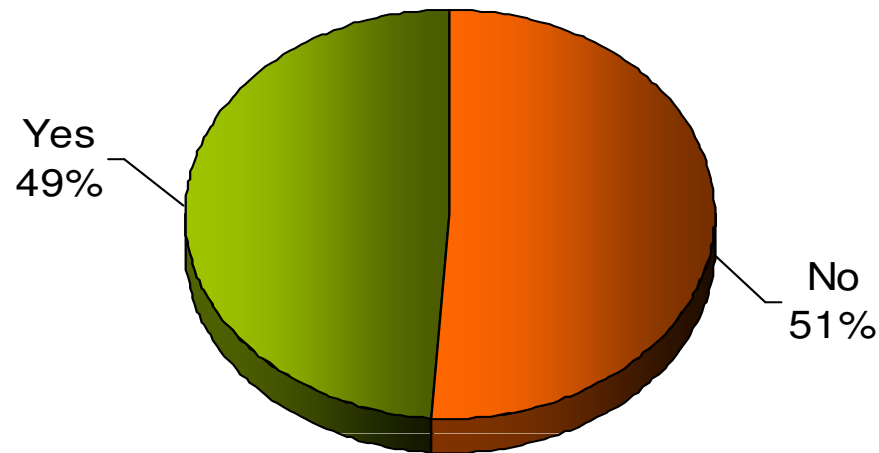


Are you setting aside any money for your children's college education?



# Setting aside an emergency/rainy day fund

**Have you set aside an emergency or rainy day fund?**



**When asked if they could come up with \$2,000 in 30 days, 46% of Americans said no.**

**Source: TNS Global Economic Crisis Survey**

# Asset building & debt management

## Many Americans carry debt

- High cost methods of borrowing
- Credit card debt
- Mortgages
  - Low down payments
- Borrowing on “themselves”
  - 9% took out a loan on their retirement accounts
  - 5% took a hardship withdrawal on ret. accounts

# High-Cost Borrowing

**Many Americans use high-cost borrowing—23% have used one of these methods in the past 5 years:**

- Pay-day loans
- Pawn shops
- Tax refund advances
- Auto title loans
- Rent-to-own



# Credit Cards

In the past 12 months...	Total	18-29	30-44	45-59	60+
I always paid credit cards in full	54%	51%	45%	44%	75%
In some months, I carried over a balance and was charged interest	51%	46%	<b>62%</b>	<b>58%</b>	33%
In some months, I paid the minimum payment only	29%	<b>41%</b>	<b>35%</b>	<b>31%</b>	11%
In some months, I was charged a fee for late payment	23%	<b>24%</b>	<b>27%</b>	<b>29%</b>	11%
In some months, I was charged a fee for exceeding my credit line	8%	<b>14%</b>	8%	<b>9%</b>	2%
In some months, I used the cards for a cash advance	8%	<b>11%</b>	<b>10%</b>	8%	5%

***12% of respondents who do not pay in full each month do not know the interest rate on their credit card.***

# Managing Financial Products

**Risky mortgage-lending played a role in the financial crisis. The data show many homeowners are under-informed about what types of mortgages they were carrying.**

Homeowners that stated	Total	<\$25K	\$25-\$75K	>\$75K
Have a mortgage	61%	31%	61%	77%
Have line of credit	21%	11%	20%	27%

When asked whether they have a mortgage that is either an interest-only mortgage or has an interest-only option, **20%** responded they **did not know**.

Moreover, **10%** of mortgage borrowers **did not know the interest rate** they are paying on their mortgage.

# Focusing on choice architecture/financial regulation only

## Some limitations

- **Not ideal to automatically enroll workers into pensions if they carry debt**
- **One size does not fit all**
  - Individuals have different needs and economic circumstances
- **Individuals make many financial decisions**
  - Financial decisions are interrelated
  - Individuals need to know some basic principles of economics/finance to make decisions

# Measuring Financial Literacy

**To test numeracy and understanding of interest rates, we asked:**

“Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?”

- i) more than \$102
- ii) exactly \$102
- iii) less than \$102
- iv) don't know (DK)
- v) Refuse to answer

# Measuring Financial Literacy

## To test understanding of inflation, we asked:

“Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, with the money in this account, would you be able to buy...”

- i) more than today
- ii) exactly the same as today
- iii) less than today
- iv) DK
- v) refuse

# Measuring Financial Literacy

**Finally, to test understanding of risk diversification, we asked:**

“Do you think the following statement is true or false? Buying a single company stock usually provides a safer return than a stock mutual fund.”

- i) true
- ii) false
- iii) DK
- iv) refuse

# How much do Americans know?

**Distribution of Responses to Financial Literacy Questions (%)**

	<b>Responses</b>			
	<i>Correct</i>	<i>Incorrect</i>	<i>DK</i>	<i>Refuse</i>
Interest rate	65%	21%	13%	1%
Inflation	64%	20%	14%	2%
Risk diversif.	52%	13%	34%	1%

NB: Only 30% correctly answer all 3 questions correctly; less than half (46%) got the first two questions right.

# These questions have been asked in other countries

These questions have been added to national surveys in:

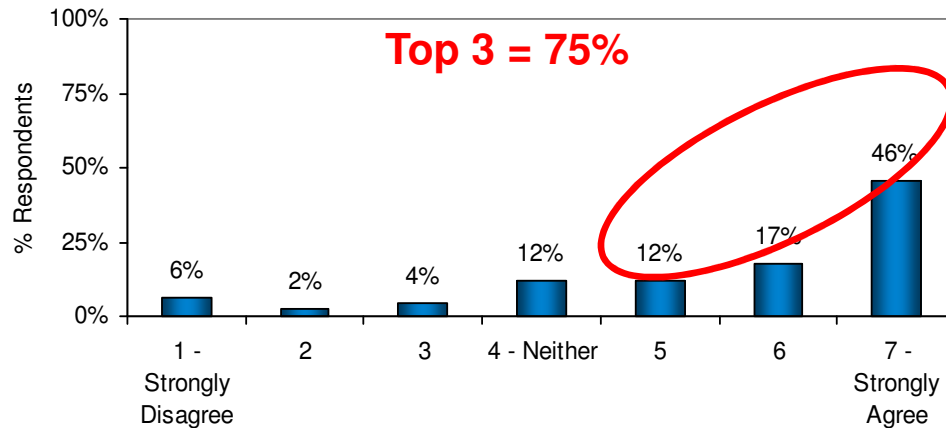
- ❖ The Netherlands
- ❖ Germany
- ❖ Italy
- ❖ New Zealand
- ❖ Russia
- ❖ Sweden
- ❖ Indonesia
- ❖ India
- ❖ Japan
- ❖ Survey of pension funds in Mexico
- ❖ Other Latin American countries



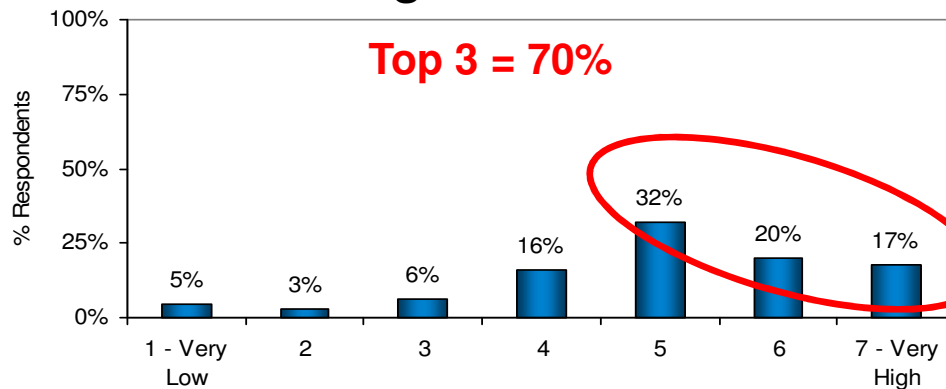
# Financial Knowledge and Decision-Making

## Positive Self-Perception

I am good at dealing with day-to-day financial matters.



How would you assess your overall financial knowledge?



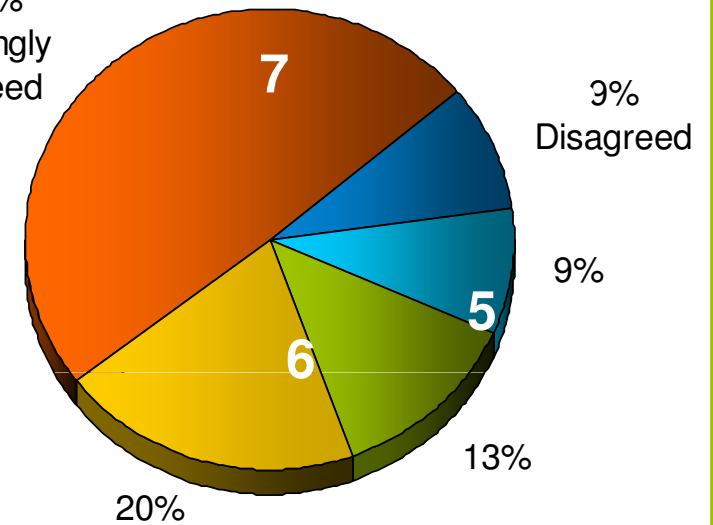
Vs.

## Reality

“I am good at dealing with day-to-day financial matters”

*Respondents with credit cards and checking accounts*

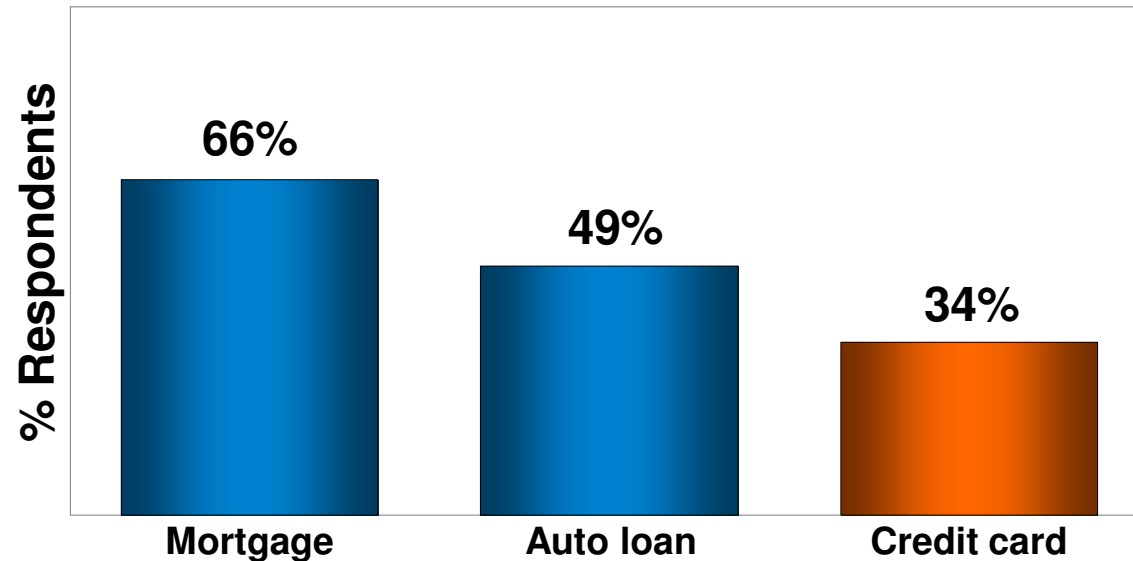
50% Strongly agreed



However, **24%** who strongly agreed and **40%** who agreed engaged in behaviors that generated fees or high costs.

# Taking control of financial decisions

## Few respondents shop around for...



## Or check their credit scores:

Respondents who, in the past 12 months,...	Total	<\$25K	\$25-\$75K	>\$75K	Less than HS	HS	Some College	College
Obtained copy of credit report	38%	18%	43%	56%	25%	30%	39%	53%
Checked credit score	36%	15%	42%	55%	22%	29%	35%	53%

# Linking Financial Literacy to Behavior

Debt and debt management



Investments



Planning and wealth accumulation

# Summary

## **People are not well-equipped to make financial decisions**

- **People are not well-informed about the terms of their financial contracts**
- **Many incur in behaviors that generate fees, interest payments, and other costs**
- **More than one in five Americans have used high-cost borrowing**
- **Lack of emergency savings makes Americans exposed to shocks**
- **Pervasive lack of financial knowledge and lack of awareness of financial illiteracy pose risk to both the individuals and the economy**

# Concluding comments

**Financial *literacy* is a necessary skill, like reading and writing**

- **Financial education and automatic enrollment into pensions are a complement not a substitute**
- **Need to equip workers with tools to make decisions**
  - Workers make many financial decisions and these decisions are interrelated
- **Cost of financial illiteracy at both the individual and macro level**