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Financial Literacy, Education, and Advice

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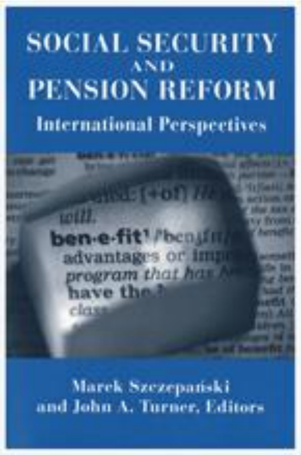

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International Perspectives

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Financial Literacy, Education, and Advice

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Social security privatization with individual accounts and employer-provided defined contribution systems shift responsibility for investment decisions to individual workers. With social security privatization, workers usually have some choice as to how the money in their individual accounts is invested. The choices workers make can have an important effect on their levels of retirement income. By comparison, in traditional social security and pension systems, fewer burdens for decision-making responsibility are placed on individual workers. Instead, decisions regarding financial management of investments are made by financial professionals. A further distinction is that in traditional defined benefit plans workers do not bear financial market risk, while in privatized defined contribution plans workers do bear this risk. This raises the issue of how to communicate to workers who are financially unsophisticated to the possible consequences of financial market risk.

Proponents of social security privatization and defined contribution systems argue that workers are capable of learning about financial markets and investments and making good financial decisions. Traditional economics, which assumes well-informed, rational decision makers, supports that position. Behavioral economics, however, focuses on the difficulties that many workers have making financial decisions. Many workers are not interested in, and some are not capable of, learning the financial information needed to adequately manage an individual account. In addition, the market for financial services is more complex and less transparent than most other markets for goods and services (Rajnes 2003).

In part because of problems clients have encountered when they seek financial advice, trust in financial services is at a low level. A recent survey in the EU finds that many people mistrust pension and investment services, ranking 50th among the services surveyed and ranking lower in trust than the market for used cars or for gambling (KPMG 2011).

In this chapter, we discuss financial literacy and financial advice as weak links in social security privatization and employer-provided defined contribution systems. They cause programs to take on added expenses to try to reduce the effects of worker investment errors and bad advice. Widespread financial education has become a necessary part of social security privatization.

We begin by discussing the lack of financial literacy and some of the types of errors that workers make in managing individual account pensions. We document that lack of financial literacy is widespread in a number of countries. We then discuss in turn financial education and financial advice as possible responses. Financial education is often seen to have limited success, in part because of a lack of interest by workers. This discussion is followed by commentary on problems that have arisen with financial advice, including legal issues that arise when advisers do not have a fiduciary duty to act in the best interest of their clients. We explain how the structure and level of advisory fees may result in conflicts of interest that may affect the quality of advice provided to individuals. Then we explain how laws and regulations are evolving in different countries in response to the conflicts of interest. We offer conclusions in a final section.

ERRORS INVESTORS MAKE

Making investment decisions is a complex process that requires an understanding of risk diversification as well as knowledge about different types of investments. A recent U.S. survey finds that 34 percent of investors were “overwhelmed” by the options facing them (Cornfield

2012). Another study finds that only 31 percent of U.S. workers are confident in their ability to manage their investments during retirement (Yakoboski 2005). A Canadian study finds that workers rated choosing the right investment for their individual account pension plan (RRSP plan in Canada) as more stressful than seeing the dentist (*Canadian Press* 2005).

While traditional economic theory assumes that investors do not make systematic errors, increasingly economic theory, using insights from behavioral economics, suggests otherwise (Turner 2003). Pension participants make at least three types of investment errors: 1) insufficient diversification of their investment portfolios, 2) inappropriate level of risk holdings in their investment portfolios, and 3) inappropriate portfolio adjustments, for example, in response to a market downturn.

With insufficient diversification, participants in some individual account systems purchase investment funds that are too narrowly focused on a particular segment of the investment market. For example, one study of U.S. defined contribution plan participants finds that most held either no equities (48 percent) or only equities (22 percent) in their portfolios, rather than diversifying (Agnew, Balduzzi, and Sundén 2003). Thus, with inappropriate levels of risk holdings, some investors hold investment portfolios that are either too conservative or too risky. With inappropriate portfolio adjustments, some investors tend to chase returns, purchasing the mutual funds that have risen and selling those that have fallen in value. A further error may be lack of sensitivity to fees, causing pension participants to spend too much in fees (Hastings, Mitchell, and Chyn 2011).

Sweden has attempted to provide investment information to the participants of its privatized social security system. Survey results concerning the mandatory individual account system in Sweden, where workers can choose from more than 600 mutual funds (Turner 2004), suggest that some participants may have been confused about their participation in the investment process. While 18 percent actually chose their investments (rather than taking the default), 34 percent thought they had (Betson 2001). Another Swedish survey indicated that of those Swedes who made a choice, 73 percent could not name all the funds they had invested in, and 41 percent could not name any of them (Jarvenpaa 2001).

A World Bank survey of the privatized social security systems in Latin America finds that workers and retirees encountered problems in making a number of decisions required of them by those systems (Devesa-Carpio and Vidal-Meliá 2002). These decisions extend beyond simply making investment decisions regarding the composition of their investment portfolios. They had difficulty choosing a pension fund management company, deciding whether to make additional contributions, whether to switch into the privatized system (when that choice was open to them), what form to receive benefits (phased withdrawal, annuity), and choosing a life insurance company to provide an annuity.

The errors participants make can be due to their lack of information when making investment decisions. Lack of information can include lack of knowledge about investing and lack of information about stock markets. Pension participants may lack information for financial decision making because of both the amount of information they have assimilated and the amount available to them. As a result of government or employer attempts to overcome the lack of information, some workers may suffer from the opposite problem—information overload (Agnew and Szykman 2004). They may have too much information, which also causes difficulties for workers when attempting to make investment decisions.

FINANCIAL LITERACY

A major reason why pension participants make investment errors may be a lack of financial literacy. Many do not have basic financial knowledge, lacking an understanding of financial terms and how financial markets work. For example, studies generally show that people do not know what happens to bond prices when interest rates rise (Lusardi 2006). In another survey in the United States, only a third of respondents correctly answered three questions about inflation, interest rates, and risk diversification (Lusardi and Mitchell 2006). Many people may not understand commonly used financial market jargon, such as "equity." A survey of pension participants finds that 10 percent did not know what the word *fund* meant (Russell 2012).

Causes of Financial Illiteracy

Numeracy is an aspect of financial literacy; it is the ability to apply simple mathematical concepts. One example of a lack of numeracy is exponential growth bias, which results in a lack of understanding of compound interest. Studies have shown that many people have a tendency to do linear (straight line) projections of growth of account balances, rather than exponential (upward curved) projections that are the result of compound interest. For this reason, they underestimate the benefits of saving because they underestimate its future value (Stango and Zinman 2009).

Literacy is a basic skill needed for financial literacy. A study in the United Kingdom finds that one-fifth of young persons aged 16–19 have low levels of literacy (17 percent) and numeracy (22 percent), making it difficult for them to function in the labor market (Shepherd 2010). These people would also have difficulty dealing with issues relating to investments. Data from the World Bank indicate that small minorities of people are illiterate in some countries that have privatized their social security systems. For example, the literacy rate in El Salvador is 84 percent, in Peru it is 90 percent, and in Mexico it is 93 percent. These rates are high compared to some poor African countries, such as Ethiopia (World Bank 2012). In the United States, the state of Alabama has an adult literacy rate of 85 percent (National Center for Educational Statistics 2012).

Prevalence of Financial Illiteracy

In some countries with generous traditional social security systems, financial literacy is not a major policy issue. Countries where the retirement system relies on defined contribution plans, either as part of privatized social security or as voluntary plans, place a greater burden of financial literacy on their workers. A study of financial literacy in 28 countries finds that, according to its measure, the leading countries for financial literacy are Brazil, Mexico, Australia, United States, and Canada (Ribeiro 2012). Nearly all of these countries place heavy reliance on defined contribution plans.

Even in countries that rank relatively high in financial literacy, many people lack basic financial knowledge. For example, a study in Canada finds that 16 percent participating in an employer-provided pension plan did not know whether the plan was an individual account (defined contribution) or traditional pension (defined benefit) plan (Schellenberg and Ostrovsky 2008). A study in the United States finds that fewer than one-third of young adults had basic knowledge about risk diversification, interest rates, and inflation (Lusardi, Mitchell, and Curto 2010). In the United States, studies document that many workers lack basic financial knowledge (e.g., Lusardi and Mitchell 2006; McCarthy and Turner 2000). For example, surveys have found that many people do not know that they are paying fees for the management of the investments in their defined contribution plans (Turner and Korczyk 2004). Studies have indicated that a lack of financial literacy is prevalent in many countries. International research demonstrates that many workers lack financial literacy in Germany, the Netherlands, Sweden, Japan, Italy, New Zealand, and the United States (Lusardi and Mitchell 2011).

Gender plays a role in the lack of financial literacy—women on average are less financially literate than men (Lusardi and Mitchell 2011). Reasons for this could include a division of labor in some households, where men take responsibility for financial decisions, or it could be that women are less confident in dealing with numbers. The groups who are the least financially literate also are those who are the most financially vulnerable—minorities, women, and people with low levels of education and income (Hastings, Mitchell, and Chyn 2011). Thus, those most in need of financial skills to deal with a privatized social security system are the least well-equipped, making them even more vulnerable.

Chile is a leader of the social security privatization movement, having privatized its social security system in 1981. In Chile, according to the 2009 Social Protection Survey, 94 percent of respondents indicated that they did not know anything about the pension options that existed (IOPS 2011). This lack of knowledge existed even though the pension system had been in existence for more than 25 years. A study in Chile finds that workers with lower levels of financial literacy and lower education and income tend to rely on their employers, coworkers, and friends more than on cost fundamentals in choosing a pension fund (Hastings, Mitchell, and Chyn 2011). As a result, they may make poor fund choices that adversely affect their retirement security.

One problem for people with low levels of financial literacy is that people tend to think they know more than they do. For example, in an

Australian survey, 67 percent indicated that they understood compound interest, but only 28 percent were able to determine the correct answer to a problem involving that concept (OECD 2006). Before governments can successfully provide financial education, they need to convince workers that they need it.

FINANCIAL EDUCATION

Growth

The growth in financial education provided by governments and employers in a number of countries is a direct result of the increasing importance of defined contribution plans as voluntary or mandatory parts of retirement income systems. Financial education can cover such topics as investment terminology, asset allocation, risk tolerance, and retirement goal setting (Olsen and Whitman 2007). The cost of financial education becomes one of the costs of social security privatization, though it often is not included in studies that compare the advantages of privatized to traditional social security programs and compute the rates of return in privatized systems. Using financial education to address the lack of financial literacy of pension participants is not a quick fix; it needs to be a long-term and sustained effort, which can be quite costly (Ashcroft and Stewart 2010).

Several international organizations, such as the OECD and the International Organisation of Pension Supervisors (IOPS 2011), have taken an interest in financial education for pension participants in individual account pension systems. In 2008, the OECD created the International Network on Financial Education.

A survey by IOPS (2011) found that 16 out of 19 financial supervisors of pension systems provided some type of financial education. The pension supervisors not providing financial education tend to be fairly young, with intentions of providing financial education in the future. In Chile, the pension supervisory authority has a specific budget set aside for financial education (Ashcroft and Stewart 2010). Chile has launched several initiatives to encourage financial literacy, and in Mexico, the pension supervisory authority has undertaken a comprehensive program of financial education (IOPS 2011). This program has provided financial education not only to workers and those nearing retirement, but also to school children. In the United States, 13 out of the 50 states require that children in secondary (high) school are required to take a class in personal finance (Malcolm 2012).

In 2009, more than 20 U.S. federal government agencies had programs aimed at improving financial literacy (U.S. Government Accountability Office 2011). One of the often overlooked aspects of these programs is their cost, as they are funded with general government tax revenues.

Along with financial education, there has been an increased focus on the content of periodic statements provided to pension participants, which is part of an effort to improve communication. These statements are being used to attempt to improve the financial literacy of participants and their understanding of their pension plans. However, there is little consensus as to what information, beyond basic account information, should be provided and how. In particular, there is no consensus as to whether projections of possible future account balances should be included and how they should be calculated so as to indicate the possible effects of financial market risk. Communicating to pension participants about risk is a difficult and unresolved aspect of financial education (Antolin and Harrison 2012).

Effectiveness

In the United States, financial education often occurs at the workplace. Evidence suggests that financial education programs have had some success in helping people who participate in them make better decisions concerning saving for retirement (Hathaway and Kahtiwada 2008). Studies of workplace financial education programs have shown improved financial literacy after taking the programs (Clark, Morrill, and Allen 2012). These results, however, may be affected to some extent by selection bias in that positive results are found for programs for people who voluntarily participate because of their interest in learning about the subject. Some studies show limited effects of financial education, which may be in part because the financial education provided was of limited duration, such as a one-time presentation. Also, some people have difficulty following through on their intentions for making changes following financial education (Lusardi 2006).

Studies indicate that many people are not interested in financial education. One U.S. survey finds that 56 percent of employees did not review the educational material provided by their pension plans. In that survey, 52 percent said that they do not have the time, interest, or knowledge to manage their 401(k) plan adequately (Gray 2012). These results indicate that provision of information alone is insufficient to deal with problems of financial literacy.

The effectiveness of financial education may depend in part on details as to how it is presented, with behavioral economics providing insights as to effective methods. A study of Chilean workers (Hastings, Mitchell, and Chyn 2011) finds that framing investment information relating to investment choices as gains rather than losses had a large effect on the way the information was perceived, particularly by people with lower levels of education.

TRANSPARENCY

An alternative to dealing with problems of financial literacy is to make financial products more transparent in their features and costs. Often, pension participants and other investors do not understand the fees they are paying (Turner and Korczyk 2004). A lack of understanding about fees may in part be the result of a lack of transparency. In addition, attempts can be made to standardize financial products, simplify them, and limit their possible features so as to facilitate comparability across financial products (Inderst and Ottaviani 2012). A further approach is to standardize disclosure, to make it easier for clients to compare costs and risks across financial products. In addition, attempts have been made to assure that disclosures are made in “plain English,” that is, that they are written in language that is comprehensible by people with low levels of education.

DEFAULTS

Transparency and financial education, however, rarely are sufficient to deal with the problems many participants face when given the responsibility for managing their investments (Ashcroft and Stewart 2010). One way of dealing with the lack of interest in and lack of knowledge of about financial market issues of some participants in privatized social security systems is to establish defaults that provide reasonable outcomes for workers opting out of the decision-making process. Studies have shown that defaults can have a major impact on pension participants in some circumstances (Choi et al. 2002; Madrian and Shea 2001). Sweden has a default investment in its mandatory individual account system for people not choosing an investment (Turner 2004). Australia has also established a system of investment defaults for its mandatory individual account system (Muir 2012).

Defaults are a form of implicit advice, incorporating decision-making outcomes that experts view as desirable. With defaults, individuals who lack interest or knowledge in making financial decisions rely on the default investments to be a reasonable option. In addition, others who are knowledgeable may accept the default as a form of advice.

FINANCIAL INCENTIVES

The traditional policy approach to affect people's behavior is through financial incentives. Individuals do have financial incentives to overcome financial illiteracy and make effective investment decisions, because doing so would presumably improve their investment decisions and ultimately the amount of money they had accumulated at retirement. However, it seems that the incentives are not sufficient to have much effect on behavior. This may be due in part to the lack of a clear connection between achieving financial literacy and the financial rewards from doing so.

BANNING SOME PRODUCTS OR PRACTICES

Another approach to protecting unsophisticated investors is to ban certain financial products or practices. For example, in the United States, financial advisers are not permitted to charge fees based on the performance of the clients' portfolios, except for wealthy clients who are presumably sophisticated investors. Similarly, in the United States participants in defined contribution plans and Individual Retirement Accounts are prohibited from making certain investments, such as using their pension funds to purchase a home, short selling, or investing in collectibles, such as art work.

FINANCIAL ADVICE

Because of a lack of interest and engagement among some workers, there has been limited success with financial education. Therefore, attention has also focused on providing financial advice. While financial education provides general information about investments and financial markets, financial advice provides specific suggestions as to what investments to make. The use of advisers allows for specialization and economies of scale in the acquisition of financial skills and knowledge. With advisers, not everyone needs to become an expert. Financial expertise can be a specialized skill rather than one that is generally held. However, workers with low financial literacy may be vulnerable to exploitation through bad advice when the adviser can profit by steering clients to more expensive options.

Financial advisers can assist clients in several ways. They can provide financial advice, financial education, decision support, and marketing information, and they can manage the individual's investments. Decision support is education targeted to help a client reach a decision. Marketing information may appear to the client to be unbiased advice but is designed to sell a product. Many advisers assist their clients in carrying out their advice. If they provide financial management, they make investment decisions and carry them out, generally without involving the individual investor in the decision (Turner and Muir 2012).

Problems with Financial Advice

Workers seeking financial advice concerning investment decisions may encounter problems relating to the advice they receive, including the use of jargon and confusing terminology relating to fees, lack of knowledge about the client's goals and risk tolerance, lack of disclosure about fees, conflicts of interest of financial advisers that affect the quality of advice, lack of fiduciary protection against conflicts of interest, and a problem called "hat switching." With hat switching, a financial adviser has different levels of responsibility to the client depending on the circumstances. For example, under some circumstances in the United States advisers are required to provide advice in the best interest of their clients, while in other circumstances they are only required to provide advice that is suitable for their clients. For a financial adviser to provide quality advice, he must have some knowledge of the goals and risk tolerance of the client. This issue is sometimes formalized in "know your client requirements" that establish minimum standards for advisers concerning information they obtain from their clients.

Financial advisers have conflicts of interest when they have a financial stake in the advice that they provide. For example, that occurs if the adviser receives greater compensation when he recommends investments with higher fees for the recipient of the advice. If the adviser is also a salesperson, he will probably advise purchasing the financial products he sells rather than other products.

Information that financial advisers provide to participants can be tainted by conflicts of interest that the advisers have. Mutual funds, for example, often provide information about investing, but rarely does that information include the advice to determine how much the person is paying in fees, and to look for low-cost providers and funds. Lack of knowledge about fees charged can lead to participants paying higher fees than if they were better informed.

Part of the problem arising from conflicts of interest is that financial advisers do not have a fiduciary duty to their clients in some countries. For example, in the United States stockbrokers generally do not have a fiduciary duty to their clients when they advise them. Financial advisers have a clear information advantage over their clients that they can exploit for their gain when they do not have a fiduciary duty to act in the best interest of their clients. This may result in agency costs, which clients incur when an agent does not act in the best interest of the client. Agency costs can include the client paying higher fees, taking on greater risk, and having too much trading of their portfolio (churning). A lack of both educational standards for advisers and uniform certification requirements, combined with insufficient regulation of conflicts of interest, prevent financial advisers from achieving the quality expected of an advice professional.

An audit study in the United States has documented a number of problems with the financial advice that clients receive (Mullainathan, Noeth, and Schoar 2012). The study finds that advisers push for actively managed portfolios with high fees, even if clients start with well-diversified portfolios with low fees, and that financial advisers tend to profit from investor errors. For example, some investors sell during downturns and buy during upturns, known as "chasing returns." Rather than "debiasing" their clients, some advisers support that strategy, presumably because it involves greater sales commissions for themselves, even though it results in worse outcomes for their clients.

Australia has recognized the importance of pension participants receiving quality financial advice in its system of mandatory individual accounts. It recently commissioned a study where it rated the quality of financial advice that people received. Out of 64 cases reviewed, only two people received what was considered to be high-quality financial advice. The majority (37 people) received adequate advice, while a significant minority (25 people) received poor quality advice. People receiving poor advice received advice that was inappropriate for their situation. Forty-two percent of people do not trust financial advisers and would not follow their recommendations (Kell 2012). Most people are not capable of judging whether the advice they are receiving is good. In the Australian study, most people who received poor advice thought that they had received good advice (Kell 2012). People may have difficulty assessing the quality of advice they receive. Nonetheless, according to a survey by the Investor Protection Trust, about 20 percent of adults aged 65 or older in the United States report having "been taken advantage of financially in terms of an inappropriate investment, unreasonably high fees for financial services, or outright fraud" (Infogroup/ORC 2010).

A study conducted in Singapore concerning the quality of financial advice received by "mystery shoppers," people who took part in the study, finds that frequently financial advisers did not obtain enough information from their clients to make suitable recommendations (Monetary Authority of Singapore 2012). For example, less than half asked about the clients' risk preferences. The study also finds that fees were not disclosed or discussed in nearly half of the cases. In 28 percent of the cases, the advice was judged to be suitable by independent financial experts, in 40 percent the advice might be suitable, and in 28 percent the advice was not suitable for the clients' needs.

Financial advice can provide a valuable service to clients. However, a U.S. survey finds that 83 percent of those surveyed indicated that they would be interested in receiving professional assistance in managing their 401(k) plans, but only 10 percent took advantage of that option when it was offered (Gray 2012).

Effects of Financial Advice

Several studies have examined the effects of advice. Hung and Yoong (2012) examine survey data relating to defined contribution plan participants to study whether advice resulted in improved results. They find little evidence of improved results. In an experiment, they find some evidence that unsolicited advice was ineffective, but when participants actively solicited advice the advice resulted in improved outcomes. Employees with low levels of financial literacy were more likely to solicit advice and to benefit from the advice.

Because of conflicts of interest, recipients of advice may actually have worse outcomes than those not receiving advice. A study in Germany of bank customers who used a financial adviser compensated through commissions finds that the portfolios of those customers who used a financial adviser had lower rates of return net of costs (Hackenthal, Haliassos, and Japelli 2011). Similarly, a U.S. study finds that mutual funds recommended by financial advisers underperformed other mutual funds on a risk-adjusted basis, taking into account fees (Bergstresser, Chalmers, and Tufano 2009).

Financial Advice Reforms

A number of countries are considering the issues of the quality of financial advice and its cost, and are considering reforms that would increase consumer protection.

United States. The U.S. Department of Labor is working on proposed regulations to improve the quality of advice to pension plan participants. Proposals have been made to extend fiduciary standards that apply to investment advisers and brokers.

United Kingdom. In order to improve the quality of advice, the UK has made it illegal for advisers to receive commissions for selling products to clients. Advisers who sell products tend to recommend the products they sell, which may not be the best products for particular clients. Instead, advisers will be required to charge their clients fees for their services, which will reduce conflicts of interest. It will have the further advantage that the compensation advisers receive will be more transparent. This reform is being made because the receipt of commissions has been viewed as a root cause of the pension misselling scandal in the UK. Previously, financial advisers receiving commissions for making recommendations concerning pensions to clients had an obligation to make recommendations in the best interest of the client, but it had become clear that because of commissions that approach was not working.

One criticism of banning commissions is that a single fee paid at the time of the advice may be too expensive for some clients, effectively preventing them from receiving advice. If the upfront fees are too expensive for a client to pay at one time, advisers in the UK are permitted to spread the fee charged over a period of time (BBC 2010).

An additional new requirement in the UK is that advisers will be required to tell their clients if their advice is independent, meaning that they provide advice over a full range of investment options, or if it is restricted, meaning that the advice they provide is only over a limited range of investments options, such as the options provided by the company they work for (Osborne 2010).

In addition, as of the end of 2012, a new agency in the UK, the Financial Conduct Authority, will be responsible for protecting consumers in financial markets. A regulatory issue this agency will face is the trade-off between protecting some consumers from detriment by not permitting certain risky investment products, while limiting the choice of others.

Australia. Australia is implementing legislation to improve the quality of advice (Kell 2012). To address problems associated with financial advice, Australia has instituted the Future of Financial Advice (FoFA) reform, which takes effect in July 2013. By eliminating commissions for advisers, the reform eliminates the problem of "hat switching," which occurs when an adviser receives fees for advice but also receives commissions depending on what he advises that the client purchases. In addition, advisers have a statutory requirement to act in the best interest of their clients, which is commonly considered to be a fiduciary duty. Thus, when they recommend a financial product, they will have the duty to recommend the product that is in the best interest of their client, not the one that is merely suitable. Also, the reform attempts to improve the transparency of fees. When advisers provide ongoing advice, they will be required to renew their fee agreements with clients every two years. In addition, the reforms attempt to facilitate the provision of "scaled" advice, which would be advice on a limited set of issues, rather than a full-scale review of their financial situation.

The Netherlands. The Netherlands Minister of Finance is considering legislation to improve the quality of advice, including requiring that every adviser have a college degree, that there be more emphasis on continuing education for financial advisers, and that examination questions for advisers' certification correspond more to the actual situations for which they provide advice (Schlingmann, Schutte, and Somsen 2012).

Singapore. Singapore is considering reforms of the way financial advice is provided. The Singapore regulator has already introduced limits on fees (KPMG 2011).

India. India has banned load fees charged on purchases of investment products (KPMG 2011).

While a number of countries are taking steps to increase the availability of unbiased financial advice to pension participants, the question remains whether implementing costly reforms will help participants in terms of improving pension outcomes.

LEGAL ISSUES

As the foregoing discussion indicates, countries around the world face similar issues when structuring a legal framework intended to increase access to financial advice while also ensuring that advice is not degraded by conflicts of interest, fraud, or misrepresentation of the adviser's qualifications. Examples also exist to illustrate the potential legal issues that result when a population is not financially literate.

Misselling in the United Kingdom

In the late 1980s, UK citizens were permitted to choose more individualized pensions, known as personal pensions, where they could select the pension provider rather than participate in the public pension scheme or a scheme offered by their employers. Insurance companies and financial advisers aggressively sold personal pensions without complying with the regulations that required them to understand the risk preferences and financial positions of their customers. A study commissioned after the misselling came to the attention of regulators, who concluded that the lack of regulatory compliance was widespread (Muir 2009).

The misselling caused many employees who bought personal pensions to be worse off than if they would have stayed in their employers' occupational scheme. At least at the time, the benefits formulas of occupational schemes tended to result in higher benefits than the investment returns on the personal pensions. Also, only employees (not employers) contributed to personal pensions. In comparison, employers typically did contribute to occupational schemes. So, the employees who were sold personal pensions forfeited their employers' contributions and received lower returns on the money they personally contributed (Muir 2009).

Some experts held both the financial services industry and the regulatory system to blame for the misselling scandal. The financial services industry provided compensation incentives for their sales forces to market personal pensions. This illustrates the potential effects of conflicts of interest, particularly when a new market opens up because of a rapid shift in a country's retirement funding paradigm. At the same time, regulators had little experience with the products being sold and the marketing techniques being used because of the shift in the paradigm to increase employee choice (Muir 2009).

Australia's Attention to Defaults

Australia does not have any history of shifting its government-run social insurance scheme to a privatization model. However, there is a sense in which there is a shadow privatization scheme in existence. Australia's government-run system, known as the Age Pension, is a pay-as-you-go pension program that is both means and asset tested. Australia also has a mandatory employment-based system, known as the Superannuation Guarantee (SG System), which requires employers to contribute 9 percent of most income for most employees to an individual account (Muir 2011). Because the Age Pension is means and asset tested, retirees with higher SG System account balances are less likely to qualify for the Age Pension. Thus, there is a sense in which the SG System is a privatized Age Pension for those fortunate enough to accumulate substantial account balances.

In 2010, a panel constituted by the Australian government to study the SG System released its report, which has come to be known as the *Cooper Report*. The two-part report addresses many perceived deficiencies in the SG System and made recommendations for improvement. The panel's findings on the importance of defaults are of particular interest here. The panel determined that having a financially literate population as a long-term goal would be useful. But, critical to the *Cooper Report*'s recommendation is its finding that shorter-term issues could not be resolved through education and financial literacy. Instead, it based its recommendation for a low-cost, more heavily regulated default system on the principle that not all members of the SG System are able or want to be involved in investment selection. Australia is currently in the process of moving toward the "MySuper" default product recommended in the *Cooper Report* (Muir 2011).

Regulation of Investment Advice in the United States

The United States has not moved to privatize Social Security, although as noted earlier such privatization has been considered. The issues of financial literacy and financial advice, however, have become more important as the population ages, as the United States becomes increasingly reliant on a defined contribution paradigm, and as the twin problems of high unemployment and a volatile stock market challenge retirement wealth creation.

A detailed discussion of the U.S. regulatory structure that applies to mutual funds, investment advice, brokers, and related financial services industry entities is beyond the scope of this chapter. At its essence, the complexities derive from two sources. The first is the state government and federal government dichotomy. Each state has some regulatory power over financial services industry entities that are active in the state. The federal government effectively has regulatory authority over all financial services entities. In some instances a state or multiple states may impose higher standards than imposed by the federal regulators. In others, the federal regulations may be more strict than those of the states. The second set of complexities results from the way regulatory power is allocated within a state and particularly at the federal level. The primary division of power at the federal level is between the Securities and Exchange Commission (SEC) and Employee Benefits Security Administration (EBSA). The SEC's mandate is to focus on investor protection. EBSA is charged with overseeing the regulation of private-sector employer-based retirement plans, including defined contribution plans (Turner and Muir 2012).

Over the past two years, the most controversial regulatory issue of import for this chapter has been whether the SEC or EBSA will apply fiduciary obligations to a larger set of financial services entities and individuals. EBSA proposed regulations to accomplish that in 2010 and—after congressional hearings, widespread publicity, and significant industry concern—withdrew the proposed regulations in 2011. Reportedly efforts continue to revise the proposed regulations for reissue. In response to a legislative requirement, the SEC staff studied the differing levels of client obligation discussed above, from fiduciary to suitability, as well as the hat-switching problem. In a report issued in 2011, the SEC staff recommended adoption of a single federal fiduciary standard that would apply to brokers as well as investment advisers. The costs and benefits of such an approach remain under study (Turner and Muir 2012).

CONCLUSION

An aspect of social security privatization and employer-provided defined contribution systems that raises their costs is that they place greater responsibility on workers for making financial decisions. They shift financial decision-making from professionals to individual workers. Proponents of privatization and defined contribution systems argue that workers should be capable of making these decisions, while opponents argue that many workers lack interest in acquiring the necessary knowledge. Studies have documented widespread financial illiteracy in many countries, with this issue being more important in countries with privatized social security systems. While lack of literacy and numeracy are causes of lack of financial literacy, financial literacy rates are considerably lower than literacy rates. Furthermore, financial illiteracy is most prevalent among people who are already economically vulnerable—women, minorities, and those with less education and income. The requirements for financial literacy placed on them by privatized social security systems only increase their economic vulnerability.

Financial education has been the focus of efforts to deal with financial illiteracy, but studies have documented that it often has limited success, perhaps because many workers are not interested. Some programs of financial education may have been ineffective because they have been of limited duration. In addition, some workers have had difficulty following through on changes that they intended to implement following financial education. Thus, while some programs have succeeded in improving financial knowledge, they have done less well in changing financial behavior.

The limited effectiveness of financial education shifts the focus in some countries to issues of financial advice. Workers seeking financial advice, however, have encountered a number of problems, the most significant of which perhaps is conflicts of interest that financial advisers may have, combined with not having a fiduciary duty to act in the best interest of their clients. Conflicts of interest arise because of the ways that the compensation of advisers is determined. For example, a financial adviser may receive higher compensation when he recommends a financial product that charges higher fees to the recipient of the advice. Studies in several countries have documented that many clients are receiving financial advice that is not appropriate for their needs. The level of fees charged is another issue. Frequently, fees are not disclosed or are not disclosed in a manner that is salient to the client. Because of the problems with the quality and cost of financial advice, a number of countries are considering reforms of the ways that financial advice is provided.

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