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Rethinking Financial Literacy in the Aftermath of the Global Financial Crisis

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Abstract

Systemic risks and other factors that contributed to the global financial crisis have highlighted the need to reconsider the scope and nature of financial literacy initiatives and programs. In this article we argue the case to rethink financial literacy and the need for integrated solutions that explicitly incorporate solutions to behavioural shortcomings exhibited by individuals in their financial decision-making. While recognising the need to consider behavioural biases in individuals’ financial decisions, to date, regulatory responses have largely ignored those biases in their proposed education and other strategies designed to address poor financial literacy and improve financial disclosure that, in turn, will improve financial decision-making.

The ultimate protection against financial excess and crisis is a more sophisticated population of consumers and investors.¹

Introduction

The global financial crisis (GFC) has refocused attention on the vulnerability of global capital markets to large-scale, systemic risks and the urgent need for sustainable solutions that will minimise the impact of future shocks. While the causes of the crisis are numerous and complex, mispricing of financial risk is often at the heart of most explanations for the observed market failings. The mispricing of risk has been attributed to a number of factors. Guyatt² attributes the excessive risk-taking to three systematic problems: (1) behavioural biases of individual decision-makers; (2) short-termism that is built into the corporate and financial market system; and (3) an absence of acceptance of responsibility by individuals, financial institutions and corporations for their actions, and consequently, responsibility for the broader functioning of capital markets. To overcome these debilitating problems Guyatt calls for collaboration by universal owners³ and institutional investors with other industry players, regulators and policy makers in shaping the direction of future financial markets. This collaborative process should seek solutions that explicitly address behavioural flaws in financial decision-making of individuals and institutions, and introduce accountability and

¹ Lo (2009), p 5.
² Guyatt (2009).
³ Hawley and Williams (2000, 2007) refer to large fiduciary institutions, such as pension funds, mutual funds and bank trusts, as ‘universal owners’.
non-regulatory mechanisms that account for the behavioural biases of market participants. Guyatt summarises the challenge as follows:

The individuals that make up the capital market system are complex, driven by a variety of social, economic and psychological influences. Until we move closer to recognizing and accepting that, we will constantly fail to build systems around the realities of human nature and therefore suffer from the extreme outcomes when conventional thinking is left unquestioned.\(^4\)

The factors contributing to the global financial crisis highlight the need to rethink the scope and nature of financial literacy initiatives and programs from a number of perspectives. First, from the individual investor perspective, the identified behavioural biases need to be directly considered in the investment choices offered to investors, how information is presented to investors, and in education programs provided to investors. This is a particularly critical issue for superannuation fund members who are increasingly responsible for investment and other financial decisions related to their superannuation savings. Second, from the universal owner and institutional investor perspective, the increasing complexity of financial products and short-termist behaviour exhibited by these players suggests that financial literacy levels also need to be raised among these key market participants. Third, from a regulatory and policy-making perspective, high priority should be given to developing and encouraging universal owners to adopt financial literacy programs that enable individuals and intuitions to understand and effectively address the behavioural biases that inhibit effective financial decision-making. With the involvement of private sector organisations in delivering those programs, regulators also need to establish appropriate safeguards to ensure the programs are unbiased and are not just merely marketing exercises to sell product. Based on these perspectives, in this article we argue the case to rethink financial literacy and the need for integrated solutions that explicitly incorporate solutions to behavioural shortcomings exhibited by individuals in their financial decision-making.

The Financial Literacy Challenge

As in most countries, educating Australia’s population to adequate financial literacy levels is a major challenge, particularly given that a large proportion of Australians do not have basic literacy and numeracy skills. Recent Australian Bureau of Statistics (ABS) data show that only about half of Australians aged between 15 and 74 have sufficient levels of prose literacy,

\(^4\) Guyatt (2009), p 3.
document literacy and numeracy\textsuperscript{5} that are needed to deal with “the complex demands of everyday life and work”,\textsuperscript{6} and only 30 percent have adequate problem solving skills.\textsuperscript{7} When these poor levels of literacy and numeracy are considered in the context of investment decision-making, such as a superannuation fund member choosing an investment option, it is clear that only a small proportion of the population is likely have the requisite level of financial literacy.

In light of poor general literacy and numeracy across the Australian population, a germane question in a post-crisis world is: how much effort should be invested in providing universal financial literacy education to bring most Australians up to a level of financial literacy at which they are capable of making informed investment decisions? As highlighted in the superannuation choice framework developed by Brown Gallery and Gallery\textsuperscript{8} prior to the introduction of the “choice” regime, it is unrealistic (and perhaps undesirable) to expect all superannuation fund members to acquire the requisite knowledge and skills to become informed ‘investors’ for two key reasons: (1) not having the capacity to achieve an adequate level of financially literacy (cognitive capacity constraints); and (2) having the capacity, but unwilling to become financially literate (apathy constraints). It is important to recognise that like general literacy and numeracy, financial literacy is not an absolute (ie you are or are not financial literate), but rather, financial literacy can be measured on a continuum ranging from little or no understanding of financial matters to highly sophisticated financial literacy. Given this continuum, the impact of the behavioural constraints are likely to, at least partly, vary according to financial literacy levels. Recognition of the impact of the behavioural constraints is therefore essential in developing targeted education programs that aim to raise the level of financial literacy. This is particularly important with respect to changing attitudes towards long-term savings (eg superannuation).

In its report on agribusiness managed investment schemes, the Parliamentary Joint Committee on Corporations and Financial Services observed:

A potential problem with the disclosure-based regulatory approach occurs when the products being marketed are too complex for unsophisticated investors to be in a

\textsuperscript{5} ‘Prose literacy’ is the ability to understand various types of narrative text (e.g. able to read a newspaper), ‘document literacy’ is the ability to access and use information in various formats (e.g. read a bus timetable), and ‘numeracy’ is mathematical ability in diverse situations: ABS (2008), p 4.

\textsuperscript{6} ABS (2007).

\textsuperscript{7} ‘Problem solving’ is “goal-directed thinking and action in situations for which no routine solution is available”: ABS (2008), p 4.

\textsuperscript{8} Brown et al (2002).
position to make an informed decision about them, even where the relevant disclosure requirements are met. This raises the question of whether some products should be limited to institutional or sophisticated retail investors, with the consequential effect of reducing the efficiency of the market and potentially raising the cost of capital.\(^9\)

Emerging from the global financial crisis, questions have been raised not only about the financial literacy of retail investors, but also about the extent to which institutional investors understood the complex products they were investing in, and that of financial advisers who were providing retail investors with advice on complex financial products. Lo\(^10\) suggests that a contributing factor to the crisis was “corporate leaders and directors who did not fully understand the risks of the securities in which they were investing”. Similarly, Lo suggests that the rate of financial engineering and development of new financial products outpaced the development of expertise of senior management and board members, and operational staff in the financial institutions issuing the new financial instruments.\(^11\) He also suggests that the research underlying the product development was conducted by staff with sophisticated quantitative skills from PhD programs in mathematics, physics and computer science, but with no formal training in finance or economics.\(^12\)

**Financial Literacy and Superannuation Savings**

The Government’s introduction of compulsory superannuation in 1992 through the Superannuation Guarantee regime\(^13\) means almost all working Australians now have some level of retirement savings, and superannuation has become the second largest asset of most individuals, after their home. The policy decision to leave the management of those savings in the hands of the private sector also means that those workers are responsible for decisions about how their superannuation is invested and managed. This responsibility was further reinforced with the introduction in 2005 of legislation requiring employers to offer new employees a choice of superannuation fund on commencement of employment\(^14\) and with an ever-increasing number of funds offering their members within-fund investment choice.

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\(^9\) PJCCFS (2009a), para 4.55.
\(^10\) Lo (2009), p 4.
\(^12\) Lo (2009), p 32.
\(^13\) *Superannuation Guarantee (Administration) Act 1992* (SGAA) and its Regulations (SGAR) and the *Superannuation Guarantee Charge Act 1992*.
\(^14\) *Superannuation Guarantee (Administration) Act 1992* (SGAA) Part 3A.
While this responsibility is placed squarely on the shoulders of superannuation fund members, historically, few have actively engaged with their superannuation, as indicated by low levels of choice being exercised by members.\textsuperscript{15} When faced with choosing a fund to join when starting with a new employer, and/or choosing an investment option within the joined fund, the vast majority of superannuation members do not make a choice and consequently join the default fund nominated by employers, and/or the default investment option, nominated by superannuation fund trustees. This lack of engagement is also indicative of members generally paying little or no ongoing attention to the management of their superannuation.

This absence of engagement with superannuation can at least partly be attributed to poor understanding of superannuation and investments. Fear\textsuperscript{16} found that 44 percent of respondents in his survey agreed the superannuation is too complicated to understand properly and 46 percent considered investments are too complex to comprehend. Consequently, some people appear to avoid making difficult decisions about their superannuation or retirement lifestyle until they can avoid it no longer.\textsuperscript{17} This inertia has been recognised in the behavioural literature as a form of ‘bounded rationality’ where individuals faced with complex decisions requiring them to make a choice will procrastinate, which ultimately results in sub-optimal outcomes.\textsuperscript{18}

One of the effects of the GFC was to jolt many individuals out of such inertia as they saw large declines in their superannuation savings, learning, perhaps for the first time, that there is a connection between the world’s financial markets and their superannuation. Bowerman\textsuperscript{19} suggests that a positive outcome of the GFC may be that superannuation fund members will pay more attention to how their funds are managed and perform relative to other funds. However, for individuals to effectively monitor their superannuation and make informed decisions, requires considerable improvement in financial literacy levels, particularly understanding of investment products and concepts.

\textsuperscript{15} Industry research shows that fund switching rates are only about 8% per year and much of this is due to employees changing jobs (Clare 2007). Similarly, 82 percent of superannuation fund members are in their funds’ default investment option (SuperRatings 2006); it is assumed that most of those in the default option did not make an active choice.

\textsuperscript{16} Fear (2008).

\textsuperscript{17} Fear (2008), 34.

\textsuperscript{18} Choi, Laibson, Madrian and Metrick (2003); Madrian and Shea (2001); Mitchell and Utkus (2004).

\textsuperscript{19} Bowerman (2009).
**Understanding investment concepts**

Understanding risks associated with investment products is central to investors’ investment decision-making. To properly evaluate their risk exposure, investors need to understand the financial risks associated with various investment types and asset allocation options. There is evidence showing that people generally lack an appreciation of financial risk and often view risk as loss\(^{20}\) rather than variability of return.

ASIC highlights the importance of individuals understanding the investment basics of diversification and risk, particularly as most individuals are responsible for decisions about how their superannuation savings are invested.\(^ {21}\) Results of general population surveys have shown that only about 50 percent of individuals understand the importance of diversification, and this level declines to about only one-third of people who have a low level of financial literacy skills.\(^ {22}\) Many consumers similarly do not understand the basic risk-return relationship\(^ {23}\) as demonstrated by two thirds of respondents to a Financial Literacy Foundation survey indicating that they “would not consider both risk and return when choosing an investment”.\(^ {24}\)

In their study of superannuation fund members’ financial literacy, Gallery et al\(^ {25}\) found fundamental misunderstanding of the nature of risk associated with the various investment options offered by the fund. While they found that survey participants generally had adequate basic financial literacy, they found significant shortcomings in participants’ understanding of the basic risk-return relationship. They question “whether large numbers of members have the requisite knowledge and skills to undertake even a most basic assessment of the relative risks of the investment options on offer.”\(^ {26}\) They recommend targeted programs that specifically address complex financial literacy for the more active and engaged fund members. The benefits of improving financial literacy can also extend beyond financial benefits. Taylor et al show that moving an individual from a low level to average level of financial capability improves that individual’s psychological wellbeing by about 6 percent.\(^ {27}\)

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\(^{20}\) See for example the Financial Literacy Foundation (2007) survey results.

\(^{21}\) ASIC (2009), p 78.

\(^{22}\) ANZ (2008).

\(^{23}\) OECD (2005).


\(^{25}\) Gallery et al (forthcoming).

\(^{26}\) Gallery et al (forthcoming).

\(^{27}\) Taylor et al (2005).
Risk of Overconfidence

As people become more financially literate and more actively engaged with their superannuation, there is the danger that they do not recognise the limitations to their financial knowledge and abilities. There is considerable evidence that people are generally overconfident in their judgments about the likelihood of events occurring and estimating the quantity of outcomes.\(^{28}\) Overconfidence is partly explained by ‘self-attribution bias’, where individuals attribute success to their own skills and blame failure on bad luck, rather than their poor judgement, and ‘hindsight bias’, where after an event has occurred, individuals believe they predicted the event, giving them confidence that they are able to predict the future better than they actually can.\(^{29}\)

This general overconfidence in judgement also manifests in overconfidence in financial capabilities that had been found in population surveys in Australia and overseas. Those surveys show that while individuals are confident in their own financial abilities, tests of their understanding of basic finance indicate their actual knowledge is limited.\(^{30}\) For example, a 2003 German study “found that although 80 per cent of respondents felt confident about their understanding of financial issues, only 42 per cent were able to answer correctly just half of the 35 survey questions.”\(^{31}\) Overconfidence may lead to individuals failing to realise that they need to become better educated in financial matters or seek professional advice.\(^{32}\)

In their survey of superannuation fund members, Gallery et al\(^{33}\) found that this overconfidence tends to be more pronounced among individuals with moderate levels of financial literacy. Figure 1 shows that 90 percent of respondents who self-rated their financial literacy as poor or very poor, achieved low to medium scores on tests of their understanding of investment risks and returns concepts. However, only half of those who self-rated rated their financial literacy skills as good or very good achieved an above-medium score on the objective tests. This finding of overconfidence among those who have some financial skills brings to mind the adage ‘a little knowledge is a dangerous thing’, particularly in the superannuation context where individuals may not seek timely advice or may not make

\(^{28}\) Barberis and Thaler (2003).
\(^{30}\) OECD (2005).
\(^{31}\) OECD (2005), p 46.
\(^{32}\) OECD (2005); Lusardi and Mitchell (2007).
appropriate investment decisions, with potentially dire consequences for their retirement savings.  

**Challenges for Financial Education Programs**

Improving financial literacy through education programs has become a global issue. To address concerns about low levels of financial literacy, the OECD\(^{35}\) established the Financial Education Project in 2004 to assist regulators and policymakers in member countries to analyse and assess the effectiveness of existing financial literacy programs, and to develop new education programs. Various government-initiated programs have been established, such as the National Strategy for Financial Capability developed by the Financial Services Authority in the U.K, programs of the Financial Literacy Education Commission in the US, and the Understanding Money program developed by the Financial Literacy Foundation in Australia.\(^{36}\)

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35 OECD (2005).
36 The Australian Government established the Financial Literacy Foundation (FLF) in 2005; its aim is to “build the capacity of all Australians to better understand and manage financial risk, deal effectively with market complexity and take advantage of increased competition and choice in Australia’s finance sector” (FLF, 2007, p.96). Shortly after its election, the Labor Government transferred the functions of the FLF to the Australian Securities and Investments Commission (ASIC) from 1 July 2008 (see Wayne Swan, Federal Treasurer’s Media Release No. 55 “Treasurer announces ASIC to take on financial literacy”, 13 May 2008 at
The OECD\textsuperscript{37} defines financial education as

the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being.\textsuperscript{38}

In adopting this definition, the OECD\textsuperscript{39} distinguishes financial education from consumer protection, viewing them as “complements rather than substitutes”. While some consumers may choose to acquire the requisite financial knowledge to enable them to make informed decisions, “others may be unwilling or unable to do so and for those individuals consumer protection is important”.\textsuperscript{40}

Nevertheless, financial education is seen as a key consumer protection measure. Shifting investment decision-making to individuals gives rise to the need for them to take responsibility for managing the associated financial risks and become educated consumers.\textsuperscript{41}

With the worldwide trend of individuals having to take responsibility for investment decisions associated with their retirement savings, the OECD\textsuperscript{42} established a set of core rights and protection of superannuation/pension fund members, including the right for members to be provided with “sufficient opportunity to acquire the financial skills or education and other assistance that they need in order to make appropriate investment decisions in their pension plans”.

There are however many challenges in attempting to raise the financial literacy levels of the general population. The Financial Literacy Foundation\textsuperscript{43} highlights these challenges:


\textsuperscript{37} OECD (2005), p 13.
\textsuperscript{38} The elements in the OECD’s (2005, pp 13-14) definition of financial education are explained as follows:
- \textit{information} involves providing consumers with facts, data, and specific knowledge to make them aware of financial opportunities, choices, and consequences;
- \textit{instruction} involves ensuring that individuals acquire the skills and ability to understand financial terms and concepts, through the provision of training and guidance; and
- \textit{advice} involves providing consumers with counsel about generic financial issues and products so that they can make the best use of the financial information and instruction they have received.
\textsuperscript{39} OECD (2008), p 105.
\textsuperscript{40} OECD (2008), p 105.
\textsuperscript{41} de Rato (2007).
\textsuperscript{42} OECD (2003), p 13.
\textsuperscript{43} Financial Literacy Foundation (2007), p xii.
A key consideration [for providers of financial literacy services and resources] relates to the practicalities of building pathways to effective consumer engagement with money issues – of putting appropriate emphasis on motivation in design and delivery strategies by promoting the personal relevance of better money management, and the prospect of the greater choices and opportunities, security and other quality of life benefits that better money skills can provide.

Simply providing comprehensive and well intentioned education resources will not be adequate. There is no shortage of quality resources available already to consumers with an active interest in building their money skills. The challenge is to promote engagement and motivation to those who, for reasons of disinterest in the issue, lack of perceived relevance, stress or … other obstacles …, are not currently seeking to build their money skills.

It is evident that financial education programs need to be targeted to engage those who are in most need of them, particularly reaching those who may be overconfident in their knowledge and skills, and thus are unaware of the need for them to improve their financial literacy.44 Accordingly, the major challenge in developing and delivering financial education programs is addressing behavioural issues and biases that presently limit the effectiveness of those programs.

However, education programs alone are unlikely to lead to improved financial decision-making if the information available to investors is not understandable and does not meet their information needs.

Financial Literacy and Disclosure

Commentators have emphasised the need for greater attention to be given to the dual aspects of better disclosure to investors and improving the financial literacy of investors. The full disclosure principle is well established in corporate regulation as a means of addressing the information asymmetry problem between corporate decision-makers and external shareholders and other stakeholders who do not have access to internal corporate information. In the absence of regulation, it is assumed that companies will not disclose the optimum level of information to mitigate the asymmetry problem.45 Regulators have extended the full disclosure principle as a cornerstone of consumer protection measures that have been instituted under the various financial reforms over the past decade. Also, as observed by Battellino, “one of the most important challenges raised by a disclosure-based regime is that it places a significant premium on financial literacy.”46 While disclosure of relevant and

44 Smith and Stewart (2008).
reliable information is a key requirement of informed investor decision making, in the absence of sufficient levels of financial literacy, disclosure is unlikely to be effective.\textsuperscript{47} Thus, a key challenge for regulators is to develop and implement disclosure regulation and other initiatives that deliver the essential information to meet the decision-making needs of investors with different levels of financial literacy.

**Regulatory Reforms: Disclosure as Consumer Protection**

A primary objective of the Australian *Financial Services Reform Act 2001* (Cth) (FSR) was to “promote confident and informed decision-making by consumers of financial products …”,\textsuperscript{48} and accordingly introduced more stringent licensing and disclosure rules. The intention was to make the understanding of financial products and advice easier for investors, promoting consumer confidence with improved disclosure quality and transparency through an enhanced disclosure regime. In addressing this need for improved disclosure quality and transparency to assist investors with understanding investment products, the *Corporations Act 2001* (Cth) now requires issuers or sellers of financial products to produce (and keep up to date) product disclosure statements (PDSs).

The broad objectives of PDSs are to help investors “compare and make informed choices about financial products”\textsuperscript{,49} to meet those objectives, information included in the PDS “must be worded and presented in a clear, concise and effective manner”.\textsuperscript{50} As the legislative requirements applying to PDSs were drafted to enhance flexibility, the legislation does not give specific guidance on preparation of PDSs.\textsuperscript{51} However, ASIC has issued a set of Good Disclosure Principles to assist issuers with compliance. The stated principles are: disclosure should be timely, relevant and complete, promote understanding and comparison, highlight important information, and have regard to consumers’ needs.\textsuperscript{52}

Despite these objectives for PDSs and guidance given by the Good Disclosure principles, PDSs have been widely criticised for being too long, complex and difficult to understand.\textsuperscript{53}

\begin{itemize}
\item \textsuperscript{47} ASIC (2009).
\item \textsuperscript{48} *Financial Services Reform Act 2001* (Cth) s 760A.
\item \textsuperscript{49} ASIC (2007) para 168.7.
\item \textsuperscript{50} *Corporations Act 2001* (Cth) s 1013C(4).
\item \textsuperscript{51} ASIC (2007), para 168.9.
\item \textsuperscript{52} ASIC (2007), para 168.10.
\item \textsuperscript{53} See Sherry and Tanner (2008a) and submissions to the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS, 2007) inquiry into the structure and operation of the superannuation industry.
\end{itemize}
As a consequence, it was claimed that many investors failed to read the PDSs. In response, Senator Nick Sherry suggested that PDSs should pass what he calls the ‘Burnie pub test’ in that they should be understandable to the average person. Whether such simplification is achievable needs to be considered in context of the drivers of PDS length and complexity. ASIC attributes possible drivers to (1) the regulatory requirements for high-level content, (2) complexity of products which inevitably results in complexity in explanations of those products, and (3) risk averse financial product issuers providing more, rather than less, information where there is uncertainty about legislative disclosure requirements. Thus these drivers would need to be addressed in any PDS simplification reforms.

In the first stage of reforms to simplify and reduce the length of PDSs, the Government introduced example PDSs for First Home Saver Accounts that are limited to four A4 pages. These PDSs are expected to “make it much easier for people who are interested in using First Home Saver Accounts to understand and compare the products on offer [with] key product information … provided … in concise, plain English [that] can be read and understood in just a few minutes”. Senator Sherry deems these example PDSs pass his ‘Burnie pub test’ as they are “simple” and “clear”. First Home Saver Accounts are relatively simple financial products and therefore have not presented much of a challenge to develop short, plain language disclosure documents. A greater challenge in addressing this ‘information overload’ issue will be to design simpler and shorter PDSs for more complex financial products, such as superannuation.

The Financial Service Working Group (FSWG) is devising short and simplified PDS disclosure requirements for superannuation and ‘simple’ managed investment scheme products, and these will be contained in PDSs with a maximum page limit of 10 to 12

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54 Research commissioned by ASIC found retail investors in failed Australian Capital Reserve Ltd were more influenced by advertisements than information in disclosure documents, and many did not seem to understand the riskiness of that investment (ASIC, 2009).
55 Senator Sherry (2008) considers a PDS is effective “if it can be easily understood by the average person, in the average pub, in an average community, like the city of Burnie” in Tasmania.
56 ASIC (2009), p 58.
57 The example PDSs were developed by the Financial Services Working Group (FSWG), which was established in February 2008 by the newly elected Labor Government. The FSWG comprises senior officials from the Department of Treasury, the Australian Securities and Investments Commission (ASIC) and the Department of Finance and Deregulation; its role is to address key issues associated with financial services advice and products.
58 Sherry and Tanner (2008b).
59 Sherry and Tanner (2008b).
Given that superannuation fund product disclosure statements generally range between 50 and 100 pages, restricting their length to 12 pages would mean that most of the information currently contained in PDSs would be excluded. ‘Incorporation by reference’ regulation introduced in August 2007, already allows fund trustees to reduce the content of PDSs. It is however unclear as to what type and extent of information that might be excluded from the PDS and made available elsewhere. To provide guidance, the FSWG’s proposed simplified example disclosures which will inter alia include “a new incorporation by reference regime identifying what information, when incorporated by reference, may be considered as part of the PDS.” While superannuation funds are permitted to incorporate certain information by reference in their PDSs, Corporations Regulations 2001 prescribe inclusion of specific core information. This ‘incorporate by reference’ approach is likely to simplify and reduce the size of PDSs but may in fact increase the complexity of superannuation fund disclosures if PDS users need to access multiple documents/sources to obtain all relevant and complete information they need for their decision-making.

A key issue in the challenge to reduce the size and complexity of PDSs issued by superannuation funds and issuers/sellers of other more complex financial products is that a single PDS document is expected to provide information to large numbers of diverse investors. For example, a large accumulation-style superannuation fund may offer members choice from a set of pre-mixed investment options and/or specific asset classes. As the number of investment options increases, so does the length of the PDS because it is required

ASIC (2009), p 62. In response to criticisms of the effectiveness of the FSR disclosure regime and to complement the work of the FSWG, ASIC intends to commence a project to explore whether more effective disclosure can be achieved. (ASIC, 2009, p 57)

See Pearce (2007).

ASIC (2009), p 62.

Regulation 7.9.15DA(4).

The ‘core’ information includes (CCH 2009, para 4-150):

- a summary description of the purpose and key features of the product, if certain prescribed information was incorporated by reference
- a summary description of the key risks of the product, if certain prescribed information was incorporated by reference
- a statement setting out the name and contact details of the issuer of the financial product and, if the statement is a sale statement, the seller
- most of the fees and costs template as prescribed in Pt 2 of Sch 10 of the Corporations Regulations (known as the enhanced dollar disclosure requirements)
- the Consumer Advisory Warning prescribed in Pt 2 of Sch 10 of the Corporations Regulations
- information about the dispute resolution system that covers complaints by holders of the product and about how that system can be accessed, and
- information about any cooling-off regime that applies in respect of acquisitions of the product.
(and expected) that information is disclosed about the asset allocation, performance, risks, etc., for each of the investment options.

An alternative to producing a static and long printed document, or a shorter PDS that refers to other documents/sources, might be an interactive web-delivered PDS where the information is personalised to the specific needs of the person accessing the information. For example, a superannuation fund member might seek information only about high growth investment options and would not need the information about other options. Similarly, other information, such as fees, could be tailored to the specific circumstances of the fund member (ie account balance and contribution rate), rather than the standardised fee disclosure currently required.

Customising disclosures to the specific needs and circumstances of individuals through a web-based interactive tool would significantly reduce the quantity and increase the relevance of the information presented. However, while such an approach may be technologically possible, it presents major challenges in the context of the existing legal framework in that it would be difficult for regulators to monitor and enforce compliance with disclosures prescribed by legislation. This customised approach is only likely to work well for individuals who have a clear idea of what information they are looking for; unsophisticated and less financially literate investors may have difficulty defining the parameters of the information they are seeking.

**Financial Literacy and the Role of the Regulator**

The role of government is to regulate capital markets without stifling the “creativity of capitalism”, while at the same time constraining “excesses that occur because of … animal spirits”. The question of how to achieve the balance between giving markets free rein and regulation has been debated with renewed vigour following the global financial crisis. As the dust settles from the crisis, the debate has turned from more regulation to how to devise

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65 Vanguard Investments (2008).
66 In accordance with Schedule 10 of Corporations Regulations 2001, superannuation funds are required to provide in their PDSs a standardised example of fees based on an account balance of $50,000 and contribution rate of $5000 per annum.
68 Akerlof and Shiller (2009), p ix. Akerlof and Shiller draw on Keynes’ view that “much economic activity is governed by animal spirits”, in that individuals have non-economic motives and “are not always rational in pursuit of their economic interests” (emphasis in original): Akerlof and Shiller (2009), p ix.
smarter and more effective regulation to deal with the consequences of future crises. Lo observes that:

... financial manias and panics cannot be legislated away, and may be an unavoidable aspect of modern capitalism - a consequence of the interactions between hardwired human behavior and the unfettered ability to innovate, compete, and evolve. Accepting these interactions leads to a need to focus regulatory responses on addressing the unpreparedness of investors for financial losses arising from bubbles and crashes and not on financial loss per se. Accordingly, in Lo’s framework the primary role of regulation should be “to facilitate access to information and education, and to address market failures and human behavior”. Flowing from these two main regulatory justifications are numerous implications for regulatory reform. From a financial literacy perspective, facilitating access to appropriate information and education is a particularly relevant objective, but regulatory interventions aimed at achieving this objective need to implicitly recognise market failures and behavioural shortcomings of individuals. We next consider in the Australian context regulatory reforms directed at improving the financial literacy in the wake of the global financial crisis.

Recent Financial Literacy Regulatory Initiatives in Australia

A key response to various financial failures brought about by the global financial crisis has been the establishment by the Australian Government of an inquiry into financial products and services. In its submission to this inquiry, ASIC acknowledges that financial literacy levels in Australia are low (low levels of understanding about financial products and investing) and that there are significant consequential costs to individuals and the economy. As part of its responsibility in addressing financial literacy, ASIC lists four streams of initiatives that it intends to continue to pursue to foster a more financially literate Australia:

(a) delivering financial literacy programs;

(b) ensuring access to information and tools;

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69 Lo (2009)
70 Lo (2009), p2.
71 Lo (2009), p3. While Lo concedes that economists usually attribute the need for regulation to market failures arising from “externalities, public goods, and incomplete markets”, he argues that there is an additional motivation for regulation: “human behavior that is driven not by logic and rationality, but by emotion”. These primary emotions include fear and greed. (Lo, 2009, p2).
72 Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services in Australia (2009).
73 ASIC (2009), p79.
(c) looking beyond education to solutions that promote financial well-being; and

(d) developing partnerships with industry and the community.

The regulator’s strategy for the delivery of financial literacy programs is to use existing educational pathways, including through schools (to year 10) and the higher education institutions, and through employer and union-sponsored and community-based programs. Access to information and tools is intended to be achieved through ASIC website tools, publications and public seminars. A consumer/investor website is being developed to promote financial well-being. The objective of this website it to provide guidance to assist individuals meet their personalised goals in the absence of formal financial plans. Finally, ASIC intends to harness the resources of the community, education and financial service providers through developing networks that promote best practice and knowledge sharing about financial literacy.74

A key part of its work on ensuring access to information and tools is ASIC’s “Investing between the flags” project. This project is aimed at increasing consumer understanding such investment basics as diversification, asset allocation, and risk versus returns.75 In using this recognisable between-the-flags image, ASIC is seeking to cut through investment jargon to enable retail investors to understand when they are inside the flags and therefore in ‘patrolled waters’, and when they are taking on more risk in territory outside the flags.76 ‘Inside the flags’ is investing in financial products with known risks, such as bank deposits and diversified blue chip share portfolios, whereas ‘outside the flags’ is investing in riskier, more complex, leveraged, illiquid, and undiversified investments.77 ASIC uses the analogy of getting a stronger swimmer, in the form of an independent adviser, to go with investors who wish to swim outside the flags.78 As Cooper notes, investing between the flags always involves some risk; like swimming at the beach, it can never be risk-free.79

While the simplicity of the between-the-flags approach to educating retail investors about investment risk is attractive and may alert and prevent some investors from taking on excessive investment risk, it is yet to be seen how this proposal will work in practice.

74 ASIC (2009).
75 ASIC (2009).
76 Cooper (2009b).
77 Cooper (2009a).
78 Cooper (2009a, 2009b).
79 Cooper (2009b).
Moreover, this initiative, like the others proposed by ASIC, do not directly address differences in individual financial literacy levels and behavioural impediments to improving financial literacy. Although ASIC recognises the limitations of financial literacy and the need to “look beyond” its current and proposed initiatives to other regulatory responses, it nevertheless intends to pursue a universal education objective\(^{80}\): “it is important to continue to better educate people about financial issues … despite the inherent limitations of consumer education”.\(^{81}\)

Disappointingly, ASIC offers no specific regulatory responses to address the behavioural impediments to financial literacy. As a consequence, the regulator appears to have ignored the calls of Lo\(^ {82}\) and others for initiatives that embed behavioural cross-checks in decision-making by investors and agents that protect against behavioural shortcomings (inertia, loss aversion, overconfidence and excessive risk taking, etc). A more appropriate response would have been to embed tools in education programs and other initiatives that enable investors to identify their own behaviour biases and alert them when their investment decisions are likely to be adversely influenced by those biases. Additionally, in developing education programs and consumer protection policies, ASIC should make greater use of such techniques as ‘nudging’ to steer investors in the right direction in their investment decisions.\(^ {83}\) Nudging is likely to be particularly beneficial in addressing problems encountered in superannuation funds where many members are incapable or unwilling to make informed choices.

**Role of Industry in Improving Financial Literacy**

The OECD\(^ {84}\) identifies that it is not just governments and regulators that have a responsibility to develop policies and implement programs to improve financial literacy levels among the general population, but rather, employers, unions, industry bodies, professional associations, and other organisations have an important role in educating consumers in financial matters. Accordingly, the Australian Government and regulator have adopted a partnership approach

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\(^{80}\) ASIC concedes that it will take decades to improve financial literacy levels. Additionally, programs will need to be well resourced and require the cooperation of Government and industry to succeed (ASIC 2009, p 81).

\(^{81}\) ASIC (2009), p78.

\(^{82}\) Lo (2009).

\(^{83}\) Thaler and Sunstein (2008) demonstrate how thoughtful “choice architecture” can be established by policy-makers to nudge people in beneficial directions in their choices without restricting freedom of choice. They refer to this nudging intervention as “libertarian paternalism”.

\(^{84}\) OECD (2005).
in promoting and supporting financial education programs delivered through schools, vocational and higher education, employer and union sponsored programs, and other community-based programs.\textsuperscript{85} Consistent with this approach, the Financial Literacy Foundation (FLF), established in 2005 by the Federal Government, was governed by a board comprising representatives from various business and community groups.\textsuperscript{86} Prior to its functions being transferred to ASIC in 2008, the FLF developed the Understanding Money website that provides financial literacy resources for individuals and education providers.\textsuperscript{87} Those resources were developed in conjunction with industry partners, including professional accounting bodies (CPA Australia and the Institute of Chartered Accountants in Australia) and industry bodies, such as the Investment and Financial Services Association and the Financial Planning Association. A major focus of the FLF was to also work with State and Territory education authorities to incorporate financial literacy into school curricula. Since taking on the FLF functions, ASIC formed a “national, cross-sectoral community of practice”, which brings together up to 90 individuals who work in financial literacy in Australia and New Zealand (via video-link each month) “to build networks and promote best practice and knowledge sharing about financial literacy.”\textsuperscript{88}

In the superannuation context, at the time that superannuation choice was being debated, the Government considered the superannuation industry was primarily responsible for educating members about choice.\textsuperscript{89} Many superannuation funds accept their role in educating their members with most large funds, to varying degrees, offering members services and education programs to assist them to understand their superannuation. However, there are two potential limitations of funds providing such education. First, the issue of whether the financial education they provide is objective and independent, rather than a marketing exercise biased towards superannuation and/or particular investment products offered by the fund.\textsuperscript{90} Second, superannuation funds are constrained by the ‘sole purpose test’\textsuperscript{91} in that a nexus must exist between education programs paid for out of members’ superannuation and providing benefits for their retirement (or in the event of death). Thus superannuation funds cannot provide

\textsuperscript{85} ASIC (2009), p 79.
\textsuperscript{86} Following the transfer of the FLF functions to ASIC, the Government established the Financial Literacy Board, comprising representatives from industry and the community, to provide advice to the Government and ASIC on financial literacy issues (see http://www.flb.gov.au/).
\textsuperscript{87} See http://www.understandingmoney.gov.au/.
\textsuperscript{88} ASIC (2009), p 81.
\textsuperscript{89} See SSCS (1998), paragraph 14.2.
\textsuperscript{90} Brown et al (2002).
\textsuperscript{91} Section 62, Superannuation Industry (Supervision) Act 1993.
members with broader financial education and advice on financial matters beyond their superannuation.

Such limited education programs are unlikely to be sufficiently customised and comprehensive to adequately address the behavioural biases evident in individual investment decision making, unless the member pays for appropriate education or advice from sources other than their superannuation savings. These external sources are also not without their limitations. Similar to the recent debate about problems that consumers might encounter with distinguishing between whether a financial adviser is providing independent financial advice or selling product, consumers of financial education programs that are delivered by the private sector are likely to also have difficulty in identifying whether the programs are free of bias towards particular types of investment or products.

A major challenge for policy-makers who are relying on industry and professional bodies to promote and deliver financial literacy programs to the wider community, is ensuring those programs are free from marketing products and other such activities that may lead to suboptimal financial outcomes for recipients of the programs. A second challenge is to ensure that educational programs and advice incorporate strategies that address the behavioural biases in investment decision by individuals. While there is evidence of action to address the first challenge, there is no evidence to date to suggest that the industry has attempted to alter its education programs, advice and products in ways that would specifically address those biases.

Conclusion

The global finance crisis has highlighted the vulnerability of retail investors to exposure to financial risks. Complex financial products originating from financial engineering combined with individuals’ poor financial literacy has opened gaps in consumer protection that need to be addressed through better market regulation and renewed focus on consumer education. In this context, “financial education should be regarded as a key element of national and global stability. ... Looking ahead there is a need to develop a coherent and coordinated financial education strategy as a pillar of sound financial regulatory and supervisory framework.” For financial education and consumer protection to successfully enable individuals to better deal

92 See PJCCFS (2009b).
93 See Guyatt (2009).
94 Wehinger (2009), p 27.
with financial risks and responsibilities,\textsuperscript{95} requires those measures to take account of behavioural biases in their design and implementation. By recognising the pervasive effects of human nature, or animal spirits, in individuals’ responses when faced with the need to make financial decisions, such programs will go a long way towards building populations that are more resilient in the event of future financial downturns and economic shocks.

\textsuperscript{95} Wehinger (2009).
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