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The importance of financial literacy

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As I finalize preparations for a presentation on the importance of financial literacy, I am struck by the sheer magnitude of the challenges ahead for the Task Force on Financial Literacy (TFFL).

This group is responsible for presenting recommendations for a national strategy on financial literacy to the Federal Minister of Finance by the end of 2010. This is an important and daunting task.

The TFFL defines financial literacy as “having the knowledge, skills and confidence to make responsible financial decisions”. However, the lessons from global best practices suggest that the reality is more complex. The term ‘financial literacy’ is often confused with or used interchangeably with ‘financial education’ or ‘financial capability’. Financial education is the methods used to develop financial literacy. Financial capability is built by participating in financial education and through responsible financial activity. As developed by the Government of Canada Policy Research Institute, Financial Consumer Agency of Canada, and Social and Enterprise Development Innovations, financial capability comes from:

- financial knowledge and understanding – making sense of everyday, self-interested financial matters;
- financial skills and knowledge – applying financial knowledge and understanding to predictable and unpredictable situations; and
- financial responsibility – appreciating the impact of financial decisions on both personal and wider circumstances, understanding rights and responsibilities, and knowing sources of advice or guidance.

Countries such as U.S., U.K., Australia and New Zealand as well as global agencies such as the OECD have already made significant efforts to develop national policies on financial literacy. Based on their experience, a more appropriate definition of financial literacy needs to account for the life cycle of the individual. Financial literacy will mean different things at different ages that roughly fall into three phases: youth, accumulation (working life), and post accumulation (retirement).

Phase I: Youth

During this phase; up to about 25 years of age, ‘financial literacy’ is a relative concept. Family and society are mainly responsible for financial literacy development, and safeguards to vulnerability are established and must be enforced. Financial literacy involves a hypothetical focus on financial education in earlier years, with real financial capability emerging in later years (university, part/full time work force). At the ‘graduation’ level, an individual’s financial literacy provides a key input to, and predictor of likelihood of success in, the next phase.

Phase II: Accumulation

This phase covers a person’s working life; approximately 25-65. Again, ‘financial literacy’ is relative. Development shifts from the social fabric to financial industry campaigns and/or employer pension and savings programs. Safeguards to vulnerability are reduced. Financial literacy at this stage is growth-oriented and individuals begin to develop real financial capability. The challenge is to reach an optimum level of financial literacy many years prior to the next phase such that individuals understand

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that the wealth accumulated during this phase and possibly in combination with other savings, will fund their retirement.

Phase III: Post-accumulation

From retirement on (generally about 20 years), the need for financial literacy is absolute – individuals need adequate assets to cover cost of living and other retirement expenses. Safeguards to vulnerability are questionable. The need is to protect principal, account for inflation, and understand how to mitigate the risks of longevity and capital draw-downs.

Nevertheless, academics and the pension and savings industry—both of which are heavily involved with the working and retirement components of the life cycle—appear to be against financial literacy. You have no doubt heard the arguments: Plan members are not engaged in the process. They are not qualified to make investment decisions. Modeling tools do not paint the right picture in terms of adequate sensitivity analysis (i.e. a range of outcomes). Sponsors do not engage actively in the process and refer members to independent advisors for help in creating an effective retirement plan. The industry has no incentive to empower members.

Look no further than the abundance of programs that offer pre-programmed fund options – members input answers to questions and presto! out pops the target date funds to go into. Add some auto-on features such as auto enrolment in the savings plan, default funds, etc. and members are not required to do much at all. This end of the spectrum of choice is often referred to as ‘paternalistic’ or ‘direct mapping’ as the members really do not have much choice.

The appeal of direct mapping programs is that limited financial literacy is required and less flexibility makes the plan easier to administrate and more cost-effective with a smaller set of potential risk-return outcomes. Of course, with little choice comes the greater responsibility on the sponsor for the outcomes. Sponsor liability increases if the investment program is mismanaged and underperforms. Under these scenarios, the sponsor can, and will be sued.

At the other end of the spectrum of choice is the program with a fully member-directed choice of assets, auto features turned off, multiple asset classes, and multiple fund managers. This results in the need for greater empowerment of members and an understanding of the wider range of potential risk-return outcomes. Some members will do much better or worse than others. At this end of the spectrum of choice, much greater financial literacy is needed to navigate the complexity of investment options and tools required to make investment decisions.

If greater choice is provided then members have greater responsibility for outcomes. This means that the sponsor has greater responsibility for financial education and communications to support member investment choices. The sponsor still has increased liability if members make poor investment choices and end up with inadequate retirement assets.

Regardless of more or less choice, ultimately, a plan member or an individual must have a reasonable expectation in terms of the level of retirement assets they are likely to achieve, and have a reasonable chance of fulfilling these expectations. Only an adequate level of financial literacy can optimize this process over a life cycle.

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