Who's afraid of financial literacy?

Centre for Ethics and Corporate Responsibility
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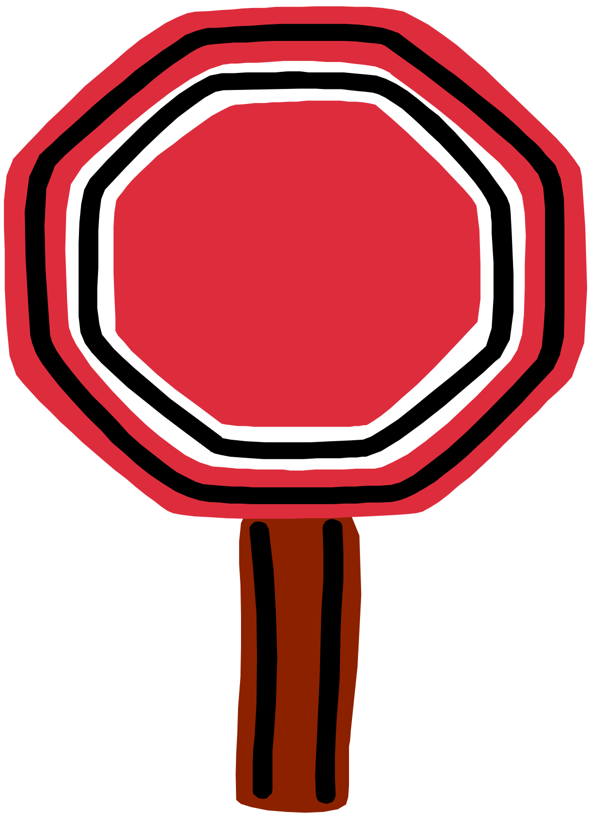
Who am I to speak about this?



My background

On the front lines of consumer literacy since 1974
Interesting irony in the binding problems of my first book, *Consumer, Beware!*
I cover the gap between what companies say and do in interacting with consumers
Also look at the government’s role in narrowing the gap

What I believe about literacy

Consumers must sharpen their defensive game

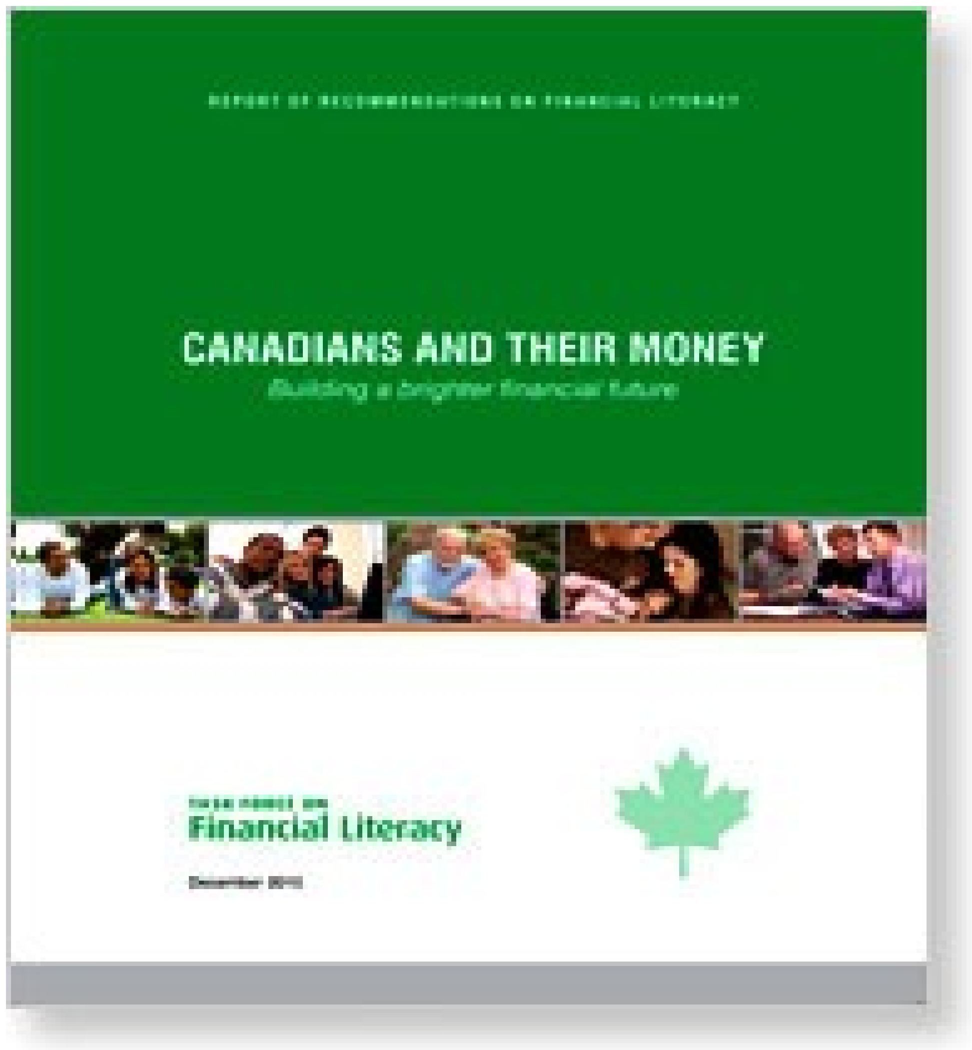
This means scrutinizing bills, spotting overcharges and demanding refunds

This means being more informed and demanding in seeking financial advice

Companies must communicate more clearly about possible pitfalls

Government must crack down on deceptive and misleading sales practices

Why create a Canadian task force?
www.financialliteracyincanada.com



Policy priority by OECD since 2003

People living longer
Pensions growing weaker
Private savings diminishing
Credit readily available
Societal emphasis on instant gratification, “live for today”
Financial products more complex
Governments reluctant to regulate

Consumer protection orphaned

Canada’s department of consumer and corporate affairs, created in 1965, was absorbed into Industry Canada in 1993
Canadian consumer groups are barely alive, with little capacity to lobby or do research
Issues that catch fire, such as usage-based billing for Internet, result in ad hoc fixes
Government prefers to rely on market forces and voluntary industry codes

Impact of the 2008 financial crash

Showed the failure of the deregulated world sold to us by neoclassical economists
Created pressure for consumer protection from hazardous financial products (U.S.)
Led Britain and Australia to ban commissions on investment product sales
Made the Harper government decide to appoint a task force on financial literacy

What the task force did right

Spent 18 months researching best practices, consulting experts and crossing the country

Came up with a working definition that most people liked:

> “Financial literacy means having the knowledge, skills and confidence to make responsible financial decisions”

Looked at behavioural research on saving (e.g. *Nudge*, by Thaler and Sunstein)

Best of 30 recommendations

Appoint a financial literacy leader (#1)
Create a single source website (#18)
Improve take-up of government benefits (#16)
Require counselling on student loans (#10)
Build capacity of the voluntary sector (#14)
Force companies to simplify information and disclosure documents (#23)

Information asymmetry hurts people

“Much of what exists is too complex for the average consumer to understand, and is not expressed in clear, plain language”

Design of documents needs rethinking

- Content should focus on **what’s truly important**
- Font size should be **large and legible**
- Layout should present **key information first**

Recent changes to credit card statements can also apply to mortgages, insurance policies, payday loans, tax-sheltered products

How far can we reduce complexity?

Many financial literacy tasks fall at level 4 or 5, beyond the capability of most Canadians

Engineering these tasks down to level 2, where most Canadians are, is next to impossible

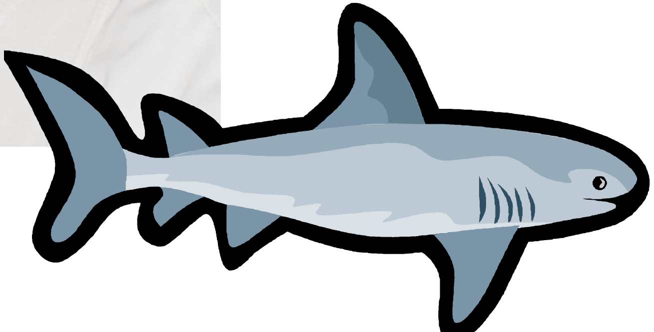
“This implies the ongoing need for professional advisers in the financial industry and thus, by extension, relatively high transaction costs”

Research report for the task force by T. Scott Murray

The role of financial advice

The task force recommended promoting financial advice as a planning tool
It urged more rigorous standards for advice, especially on **professional qualifications** and **transparency of remuneration**
It urged consumers to look online to confirm registration and check background
But it didn't deal with **conflicts of interest** and **fiduciary duty**

Financial advisers under the spotlight



Investors susceptible to fraud

Elderly people, immigrants, low-income, high-debt Canadians at particular risk
Task force urges intensified efforts to raise fraud awareness among the most vulnerable
FAIR report on financial scandals (Feb. 2011) shows few victims get compensation
People can’t expect consistent gains in good and bad markets or “safe” 10% returns

What do critics say?

Big business is part of the problem and shouldn’t be part of the solution
Many financial service providers profit from the **illiteracy** of their customers
Why not attack advisers’ vested interest in selling their own (high-cost) products?
Governments should protect consumers, not blame them for high debt or low savings

A vocal critic of financial education

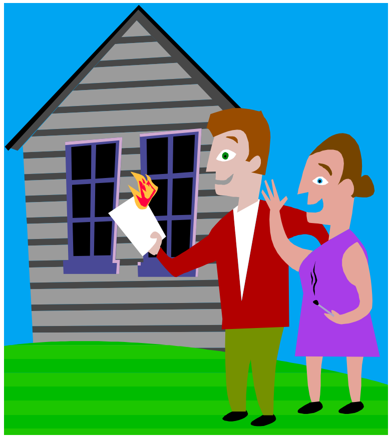
Saul Schwartz, public policy professor, Carleton University, paper for the Institute for Research in Public Policy (December 2010)

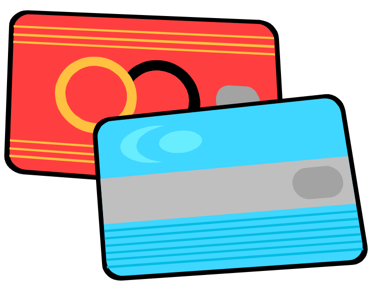
- **Governments should protect consumers against risky products and hard to understand financial services**
- **Should ensure access to expert, impartial, third-party advice about retirement planning**
- **Financial education programs are preaching to the converted and don't change outcomes**

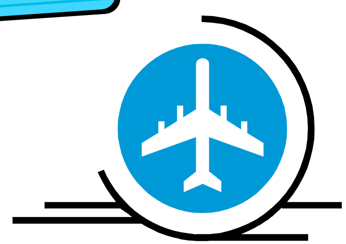
Potential pitfalls of providing consumer protection

Regulation can impede the development of promising new products
Calls for regulation can lead to fierce lobbying by financial providers (as in U.S.)
New tools used by behavioural economists may not work in the ways we expect
As usual in Canada, federal-provincial jurisdictional disputes could threaten to derail any serious reform

Some case studies from my files







Case #1: The tax-free savings account

Launched in January 2009, this tax shelter complements the RRSP
A little-known rule says that withdrawals from a TFSA can’t be added back until the following year
The Canada Revenue Agency waited until June 2010 to notify 70,000 people they owed extra tax (ranging from $100 to $1,500)
Media uproar caused the CRA to back down

Lessons from the TFSA troubles

Don’t oversell a complex tax shelter
Don’t underplay potential pitfalls
Don’t worry about over-communication

- Use large print
- **<u>Use bold type and underlining</u>**
- Use examples
- Show the worst case scenario
- www.ellenroseman.com, Lisa’s story: Charged $1,240 for TFSA over-contribution, June 14/10

Case #2: Mortgage penalties

Borrowers pay 3 months' interest or an interest rate differential (IRD), whatever is greater, to break a closed, fixed-rate mortgage
Lenders often fail to say:

> "We calculate the IRD based on the posted rate, not the rate you actually paid"
>
> "The IRD we quote before you list your property can grow and grow and grow by the time it's sold"
>
> "We can let you use your prepayment privileges to reduce the IRD substantially "

Lessons from the mortgage mess

IRD penalties can be lethal when rates fall
Mortgage documents must warn that:

- Penalties can change every day
- Penalties can eat up equity
- Prepayments can help cut penalties
- Borrowers can seek other options

Warning: Government can rewrite laws if disclosure isn't strong enough

Case #3: Group scholarship plans

This type of registered education savings plan (RESP) pays up-front commissions to sellers

The charges are disclosed in a prospectus, since group RESPs are regulated as a security

Sellers often ask parents to initial a clause describing the up-front charges

Parents who drop out before maturity find that sales charges deplete their principal

Lessons from the scholarship snafu

This is a long-term commitment for parents, who may drop out for financial reasons (divorce, disability, job loss)

They rarely read the prospectus

They don’t understand what they sign up for and what they lose by leaving early

Securities regulators want to see a mandatory plain language summary document (3 pages), highlighting potential benefits, risks and costs

Proposed wording for group RESP

If you change your mind

You have up to 60 days after signing to cancel your plan and get back all your money

If you cancel after 60 days, you'll get back your contributions, less sales charges and fees

Since you pay sales charges up front, you could end up with much less than what you put in

More financial literacy abuses

Gift cards issued by federally regulated financial institutions that have expiry dates and monthly fees that erode principal
Loyalty plans that take away members' reward points for inactivity
Credit reports that people don't know how to obtain for free under the law or correct

Who’s afraid of financial literacy?

Not you, I hope

An educated customer is a better customer

- Understands options and makes better choices
- Avoids costly mistakes
- Less likely to complain
- More likely to recommend you

Something that can be sold only by concealing information is not worth selling in the first place

For further reading

“Against Financial Literacy Education,” article by Lauren Willis, Loyola Law School
“Abandoned in the market: The sad state of Canadian consumer protection,” article by Michael Janigan, head of Public Interest Advocacy Centre, www.piac.ca
My Toronto Star articles and blog, www.moneyville.ca