Consumer Federation of America

TESTIMONY OF

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REGARDING

THE ROLE AND LIMITS OF FINANCIAL EDUCATION

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I am Stephen Brobeck, executive director of the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. For three decades, CFA, and I personally, have sought to promote effective financial education. We commend you, Mr. Chairman, Senator Sarbanes and members of your Committee for organizing these hearings and for providing us with the opportunity to explain our views on the role and limits of this education.

In this testimony, I will briefly discuss the need for financial literacy, the limits of financial education, essential characteristics of effective financial education, and the single most important initiative we could take to promote financial literacy.

Growing Need for Financial Literacy

Being financially literate means that one has the knowledge to effectively manage one's financial resources -- especially through budgeting, debt management, and asset accumulation -- to achieve lifetime financial security. Unfortunately, for several decades this financial management has grown more difficult, and in the future it is likely to become even more challenging. Two types of societal changes help account for this increasing difficulty.

Erosion of Economic and Social Security: Many Americans have experienced an erosion in their economic and social security. Advances in technology and economic globalization have accelerated the pace of change in our economy, increasing both job insecurity and the awareness of this insecurity. In the past two decades, this has been especially the case for relatively highly compensated blue collar workers forced to accept less lucrative positions or retire from the workforce. In the future, this will increasingly be true for large numbers of white collar employees who will be replaced by foreign workers with access to the latest communications technologies.

At the same time, globalization has spurred efforts by employers to reduce costly pension and health care benefits. As a result, over the past decade there has been a massive reduction in the availability of pension plans for employees. For younger workers, for all practical purposes these plans have ceased to exist. Employers have largely replaced these pension plans with contributory retirement programs that are voluntary and must be funded, entirely or in large part, out of wages. At present, most workers with access to these contributory programs are not participating sufficiently to allow them to retire in their sixties without suffering a great decrease in their level of living.

Employers have also sought, with some success, to reduce their medical care obligations to existing and retired workers. That often increases the need for these Americans to take a more active role in managing their health care. If Medicare and Medicaid programs must sharply cut back benefits in the future, as many experts predict, this need for greater skill in dealing with health care and health insurance providers will only increase.

<u>A More Complex and Risky Financial Services Marketplace:</u> Over the past two to three decades, as members of this Committee are well aware, the financial services marketplace has become much more complex and risky for consumers. In particular, the growing availability of credit, the way this credit is priced and sold, and the rising popularity of securities have increased financial literacy needs.

Massive increases in the availability and purchase of consumer and mortgage credit now require almost all consumers to understand and make sensible decisions about debt. A key factor in the rising number of personal bankruptcies over the past decade has been the growth in credit card marketing, which includes over five billion mail solicitations annually, and in available credit lines on these cards, which have nearly reached $5 trillion. There has also been a substantial increase in extremely high-cost loans with onerous or unsustainable terms, such as payday loans and some mortgage loans. Furthermore, a principal reason for the decline of discretionary income for many young and middle-aged consumers has been the rising availability of aggressively marketed first- and second-mortgage loans made attractive by lower down payments, relatively low interest rates, and the expectation of future increases in housing prices.

The more dynamic pricing of consumer and mortgage credit has also increased the need for financial literacy. As recently as ten years ago, for example, someone who made two late payments on a credit card was charged only two late fees of under $20. Today, the same person who makes two late payments on the same credit card will not only be charged late fees of about $35 but may also have their annual percentage rate hiked by more than ten percentage points, possibly have the interest rate on other credit cards increased, and experience a costly decline in their credit scores.

However, these risks are much lower for middle class consumers than those assumed by the less affluent who purchase nontraditional mortgages. Many experts, and lenders, worry about the ability of many purchasers of adjustable rate mortgages to afford rising interest obligations. And they cannot understand how many lower-income consumers would ever be able to afford interest-only mortgages once they are required to start repaying principal as well as interest.

As incomes and participation in contributory retirement programs have increased, more people, now nearly half of all households, have purchased stocks or bonds. But in the securities marketplace, as in the credit marketplace, consumers face complexity and risk. The latter include opportunities for casino-like day-trading, the temptation of highly risky, purportedly high-yield investments, increased availability of exotic financial products featuring derivatives, and solicitations by sellers more interested in their own compensation than investment risks and yields.

In brief, to effectively manage their financial resources, most consumers must be much more financially literate about financial products and about financial services professionals who sell and manage these products.

The Limits of Financial Education

Financial education, whose aim is to increase financial literacy, is limited by its current weaknesses and by its inherent character.

Fragmented Character: The most important weaknesses of this education today relate to its fragmented character which, some say, reflects our society's lack of commitment to effectively providing this education. There are many institutions and individuals who are working with dedication and effectiveness to increase financial literacy. Many of their programs, including several in which we participate or lead, are described in the recently released "National Strategy for Financial Literacy" report. But these worthy programs do not begin to meet the financial literacy needs of our nation.

For a start, there is no coherent national strategy, or effective leadership of the implementation of this strategy, to meet these needs. Such a strategy must define as precisely as possible the needs themselves and how they vary for different population groups, effective programs needed to meet these needs, and a rigorous method for assessing the success of these programs.

In the schools, Jump$tart and its partners have made progress persuading state legislatures to pass financial education mandates. And, these mandates are in large measure responsible for the fact that hundreds of thousands of students now receive at least some financial education. Yet, many states still have not approved mandates, and in those which have, the education varies widely in intensity and effectiveness. The magnitude of the remaining challenge is reflected by Jump$tart's annual surveys of the literacy of students who have had financial education instruction that reveal little or no progress in knowledge levels. Moreover, it is not at all clear that even statistically significant increases in this knowledge adequately prepare students for the financial challenges of adulthood.

In communities, financial education efforts are even more fragmented. Just in the past decade, hundreds of public, corporate, and nonprofit organizations, including CFA, have initiated their own financial education efforts. They have produced information on a wide variety of topics that they attempt to communicate to consumers through publications, audio-visual materials, the Internet, and workshops.

The quality of this information varies considerably. Some of it, for example, ignores the most important messages consumers should receive. There are many materials on the use of credit cards, for example, that fail to emphasize the importance of trying to pay off all balances on time each month and the risks of being unable to do so. These and other materials also often tend to communicate more information than consumers are prepared to read and digest. Unfortunately, the lower-income and least-educated consumers, who have the greatest need for this financial education, also tend to be those who have the most difficulty understanding complex materials.

There is little adequate evaluation of the effectiveness of all this community financial education. Most initiatives contain no assessment of consumer impact. Those that do tend to limit their evaluation to onetime surveys of the experience of participants. Very, very few attempt to study the long-term effect of the initiative on participant behavior and whether any behavioral changes are sufficient to meet financial services needs.

<u>Importance of Motivation and Opportunity as well as Knowledge:</u> As noted above, financially literate persons must have adequate knowledge to effectively manage their financial resources, and the goal of financial education is to provide this literacy. However, since this literacy is only one condition necessary for effective management of resources, financial education

alone cannot assure this skillful management. Two other conditions must also obtain: consumers must value this skillful management enough to learn and practice it, and there must be accessible opportunities in the marketplace for utilizing these skills.

The following examples illustrate the importance of all three conditions -- knowledge, motivation, and opportunity:

- Only employees with access to retirement plans at work can easily save for retirement. But they must want to participate in these voluntary plans, and they must know how to do so in ways that serve their long-term financial interests. That usually entails keeping most funds in equities, not "safer" money market funds.
- The knowledge necessary to maintain an emergency savings fund is not complicated. But one must value this savings highly enough to keep a separate savings account with balances sufficient to meet normal financial emergencies. For lower-income individuals, it is easier to open such accounts if financial institutions set low opening and minimum balance requirements. And it becomes much easier to maintain adequate balances if employers and financial institutions permit, even encourage, split direct payroll deposits into saving as well as checking.
- Aggressive credit marketing and its "deceptive" pricing make it difficult for many consumers, especially the inexperienced, to use and manage debt wisely. They assume that, if a financial institution offers them credit, they can afford it and that, if they are able to make minimum credit card payments and initial payments on ARMs or interest-only mortgages, this credit is sustainable. So, many think they have little need to manage their debts carefully, for instance, until their credit card balances are so large that 2 to 3 percent monthly payments are burdensome or until ARM rates rise or until principal must be repaid on an interest-only mortgage. In our opinion, the only effective way to address

these problems is for lenders to be more responsible about extending credit ("limiting credit opportunities") and intervening at the first sign of payment difficulties, perhaps by urging consultation with reputable credit counseling agencies.

Characteristics of Effective Financial Education Programs

Truly effective financial education programs share two general characteristics: They work -- that is, they produce desired behavior change -- and they have the capacity to "go to scale" -- that is, they can reach large numbers of consumers.

Unfortunately, we have no idea whether the vast majority of financial education initiatives really work because their impacts have never been carefully studied. That is not to say these unexamined programs have no value. For the past 12 years, for instance, CFA has led a Consumer Literacy Consortium of national governmental, nonprofit, and corporate groups that carefully developed key consumer money-saving tips and then distributed, on request, nearly two million copies of its "66 Ways to Save Money" brochure through the Federal Citizen Information Center, where it remains the most popular publication, and through other national networks. Frankly, we have no idea exactly what consumer impact this brochure, and related website, have had, but continuing strong consumer demand for this information, coupled with the program's low cost, strongly suggest it is cost-effective. That said, no one in the Consortium believes that this initiative should serve as the cornerstone of a national financial education program -- it is much too limited in scope and ambition.

Accordingly, for financial education programs to be seriously considered as model programs they must give evidence, through rigorous evaluation, of significant behavioral change resulting in satisfactory ability to manage financial resources. There are some initiatives, described in the "National Strategy for Financial Literacy," that offer much promise for meeting these criteria. We are most familiar with the America Saves program, which in local and regional areas (often with Cooperative Extension leadership) has recruited public and private organizations to undertake campaigns to enroll thousands of nonsaving individuals as Savers. These participants are required to make written commitments to implement a specific plan that they have developed to meet a savings goal. To date, more than 50,000 Americans, about half of them African-American or Hispanic-America, have enrolled as Savers. Assessments funded by The Ford Foundation have revealed that, in the aggregate, these Savers are saving $.50 on each pledged dollar.

Just as importantly, as a related assessment reveals, the local campaigns have persuaded important local institutions, particularly financial institutions and employers, to more effectively promote saving. For example, in several dozen areas where campaigns exist, most banks and credit unions have lowered opening and monthly savings minimums considerably so that less affluent families can afford to begin building savings.

The America Saves program is relatively successful in large part because it seeks not only to communicate important financial information, but also to motivate individuals to apply this information in their financial lives and to create opportunities for the application of this knowledge. And, the program is expanding, both conceptually and physically, so that it can now realistically aspire to positively influence hundreds of thousands of Americans.

This program cannot solve all financial problems or fully prepare participants to effectively manage their financial resources. Its principal goals have been to jumpstart personal saving and wealth-building and to create an institutional environment that supports this wealth-building. So, no one with the some 1000 participating organizations believes that the program in and of itself is sufficient. But the experience of America Saves does suggest that there are great benefits to organizing a broad array of influential institutions to work together to develop and implement programs -- which combine knowledge with motivation and opportunity -- to change consumer behaviors in ways that are measured and evaluated.

In our view, many of the most successful future efforts will be closely linked to "products" that are sold by institutions which can reach millions of Americans. These organizations include employers, tax preparers, banks and credit unions, other mortgage lenders, mutual funds, credit counseling agencies, the military, and schools. There is increasing study and experimentation in this area, which should be encouraged. One especially promising initiative, for example, involves "financial education" by employers and financial institutions to persuade employees to split directly deposited paychecks into saving as well as checking. Nearly three-quarters of employees now directly deposit these paychecks, the ACH technology allows such splitting, and once employees have agreed to the split, saving is automatic. Of course, the risks of linking financial education to sale of products must be effectively minimized.

Linking Existing Financial Education Programs Through a New Initiative

As noted earlier, an important reason financial education programs are relatively weak is that they are so fragmented. Can they somehow be linked, not institutionally but programmatically, to provide greater program coherence, mutual support, public identity and visibility, and attractiveness to the tens of millions of Americans with financial literacy needs? Unfortunately, general messages, even the tested, relatively effective ones of programs such as America Saves -- "Build Wealth Not Debt" and "You Can Build Wealth" -- are too diffuse to meaningfully link diverse financial education programs. A more effective linkage would involve a call to a specific action that is personally relevant to consumers. We believe the most effective call would urge consumers to estimate, and then periodically monitor, their net personal wealth.

As financial educators as diverse as columnist Michelle Singletary, the Financial Planning Association, and my own organization have concluded, awareness of net personal wealth is an important motivator for better money management, debt management, and savings accumulation. People who have a pretty accurate idea of their wealth -- real and financial assets minus debts -- are more likely to spend money carefully, monitor their finances, live within their financial means, and patiently accumulate wealth through 401k contributions, amortizing mortgage payments, and other savings strategies. In other words, if Americans were more aware of their net personal wealth, they would be receptive to a broad array of financial education programs that helped them monitor, conserve, and accumulate financial resources. In a recent column, Singletary noted the parallels between keeping track of your physical weight and your net personal wealth. While weight-watching does not always result in weight-restraint, for many it is a precondition and motivator for such restraint.

In such an initiative, there would be a great benefit to having one or two wealth estimators that financial educators would recommend and even help consumers use. The America Saves wealth-estimator fairly easily helps one estimate their current net assets and their future wealth-building potential. But there are other useful asset estimators. Perhaps the most valuable would be one developed and promoted by a credible federal agency, such as the Federal Reserve Board, which all other financial education organizations also promoted and linked to.

Would using such an estimator be too discouraging for the tens of millions of Americans with few assets, including nearly one-tenth of households with negative net wealth? In our view, that might be the case for some but not for most of these individuals and families. There is a simple reason. People tend to grossly underestimate their capability to build substantial personal wealth over time through the combined working of regular deposits and interest compounding. In a new America Saves pilot financial education program with National City Bank, in which a series of case study scenarios show how less affluent households can build six or even seven-figure assets, hundreds of participants with modest incomes have gained hope that they too can build personal wealth. In doing so, they have become more hopeful about their financial futures. When we begin to carefully study any related behavioral changes, we are confident we will learn that this "How to Save $1 Million" program has also persuaded many participants to manage their money and debts more carefully.

What could the role of the federal government be in such an initiative? For it to collectively mobilize its resources behind a public/private initiative to encourage and assist all Americans to estimate and monitor their net personal wealth would give such an initiative a big boost. That boost could involve not only making available and promoting wealth estimators, but also encouraging and assisting a wide array of non-governmental organizations, especially financial institutions who service virtually all American households, to join the initiative.