

# **Financial Education for Pensions and Insurance: Importance, Limits and Default Options**

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## **IMPROVING FINANCIAL LITERACY**

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# Three Considerations

- **Going beyond basic standards of financial literacy for retirement savings: Is there a role for financial driving license?**
- **Financial education or framing the question: Lessons from behavioral finance**
- **Role and limits of default options in pension systems designs and implementation**



# Is there a role for financial driving license?

## ● **Financial literacy: Relative concept**

- Changes on supply (products, providers, complexity) and demand side (higher income, more choice)
- Increased outsourcing of risk management from government to individuals with financial sector instruments
- Increased need to be an informed consumer/get second opinion in all areas: with doctors, with professionals, with financial sector providers

## ● **Useful to distinguish**

- General financial literacy
- Financial literacy related to retirement saving

## ● **Role of a license, say for driving a car**

- Reducing damage to yourself, and other traffic participants (value of car and life)
- Well enforced in countries, and often expensive to get (some 2000+ Euros)

## ● **Role of a financial driving license**

- Allowing individuals to make better informed decisions, including about risks they are taking
- Licenses can be graduated as for types of vehicles (motorbike, car, truck. ...)
- Who should provide the education (financial institutions, NGOs, trade unions, employer, government), what kind of financial literacy instruments (brochures, e-learning, seminars at work place, etc), and who provides the license?



# Lessons from Behavioral Finance

## ● System design matters for retirement savings

- Saving by individuals not only dependent on economic and financial fundamentals (as predicted in life-cycle)
- Psychological and behavioral factors influence saving planning and execution (leading to inadequate decisions)

## ● Implications for system design, e.g.

- Avoid decision overload (5 not 500 investment options)
- Use decision inertia -- default options – you're in unless you opt out

## ● Issues of using default options in system design

- Empirical evidence: they are very powerful
- Promising national pilots underway (KiwiSaver in NZ, National Pension Savings Scheme in UK)
- But less desirable effects questioning the role of government in default option selection



# Default Option – the less desirable effects and the role of government

- **Default options may lead to low savings**
  - Even if individuals are automatically enrolled.
  - Default option with a low contribution rate and conservative portfolio => very low financial balance at retirement => individual may realize to late that default option was not the “best” choice.
- **Govt. and employer contingent liability with default option?**
  - What is the contingent liability of employers and government (if any) with regard to the default option?
  - If such a liability is created, how will this affect employer investment choice?
  - How does the default option impact required prudential standards?
- **How to handle inequality of outcomes between individuals across different pension plans (selecting default options)?**
- **Do well designed default options reduce the incentives for informed consumer choice?**
- **Does government have sufficient information and foresight to regulate the default options? How should the regulatory objectives be defined?**
- **Default options may create avenues for misuse of government power or perception of unnecessary government interference**

