

STATEMENT No. 7

22ND SEPTEMBER 2010, AUCKLAND

Retail finance:

A path forward for education, advice and disclosure

Summary

In this statement the Australia-New Zealand Shadow Financial Regulatory Committee (ANZSFRC)

- Emphasizes the importance of financial literacy for principles-based financial regulation that is based on disclosure and *caveat emptor*.
- Recommends that key financial concepts need to be fully integrated into, and emphasized by, the national mathematics curriculum.
- Recommends that the governments of Australia and New Zealand reconsider policies that allow school pupils to escape formal mathematics education at too early an age.
- Recommends that information about finance principles, products, markets, institutions and history be incorporated into national high school curricula within courses that are taken by all students, and, to the greatest extent possible, these topics be integrated with the tools and concepts taught in the mathematics curriculum, particularly through the use of case studies and experiential learning.
- Supports further development of public good services in the area of financial literacy, and encourages financial institutions to become more active in the promotion, development, and funding of financial literacy services and activities.
- Recommends the establishment of (i) a simple, minimalist and concise list of information designed specifically for retail investors be included in all disclosure documents for financial securities and products and (ii) an online forum designed to elicit information about a financial security or product offering during a pre-registration period.

Introduction

The August 2010 collapse of South Canterbury Finance is the latest in a string of financial industry failures affecting retail investors in New Zealand. Similarly in Australia, individuals have borrowed funds (margin lending), entered derivatives contracts, and invested in other complex products where, arguably, their understanding of the risks involved was inadequate. As well as losses to individuals and taxpayers, these episodes have important implications for confidence in the financial system.

The financial system allocates funds to risky activities, transforms those risks, and raises money from those investors willing to assume risk in exchange for the expected compensation offered. As many individuals are unable to properly assess the risks involved in financial contracts (and also

because of the wider consequences of failures of financial institutions), much of the financial sector is subjected to prudential regulation and other features of a government-provided “safety net”.

However, it is not necessary to apply these constraints to those who *are* able to assess the risks and are willing to take them on, unless this results in a threat to the stability of the financial system and hence the economy as a whole. Indeed the financial system is unlikely to be efficient if there is not an appropriate balance of prudentially regulated and non-prudentially regulated sectors. This raises the problem of how to deal with the inability of some individuals to assess the risks involved - both as end users and end suppliers of funds. Individuals borrow to make risky investments (housing, margin loans etc) and also allocate their savings to financial instruments issued by companies and financial institutions.

The standard approach to financial regulation outside the prudentially regulated sector has been based on *caveat emptor*, but this is only viable if the decisions made are well informed and based on “correct” information. Australia and New Zealand have placed a relatively strong reliance on disclosure and caveat emptor in retail finance, even in the prudentially regulated sector. Hence, there has been considerable emphasis on appropriate education, advice and disclosure as the three pillars of financial markets regulation. Also important, of course, have been the structure of property rights laws and the role of enforcement and compliance as a deterrent to violations of those laws and expropriation based on abuse of trust, inadequate knowledge and incorrect information. Public sector enforcement by regulatory agencies, financial ombudsman services, and private (class action) court actions are all relevant in this regard.

Even though the Australian and New Zealand banking sectors largely escaped the calamities of the Global Financial Crisis, there have been substantial losses (albeit not necessarily GFC related) for retail investors outside the prudentially regulated sector. In New Zealand, there have been around fifty finance company collapses, involving accumulated losses of over NZD 6 billion affecting over 100,000 investors, as well as other scandals involving the misrepresentation of risks to retail investors. In Australia, losses to investors from failures of financial advisors and financial product manufacturers led to the parliamentary Ripoll inquiry whose recommendations included ensuring greater disclosure and improved investor education as well as specific suggestions on financial advice and commissions. If there had also been a major effect from the GFC, the impact could have been much worse.

Changes are taking place. In both countries, there has been some recent movement towards a more rules-based approach in the retail finance area (which has costs in the form of inhibiting financial innovation), but the overall emphasis remains largely principles-based. While there is likely to be some optimal balance between rules and principles, we do not propose to enter that debate at this time. Rather, we see much merit in exploring how the principles-based approach can be enhanced. In this Statement the ANZSFRC explores what improvements in financial education, literacy, and disclosure arrangements should be considered to achieve that aim.

The Objectives of Financial Literacy Programs

The broad objective of financial literacy is to ensure that individuals have adequate skills and understanding to make financial decisions suitable to their individual circumstances. It is not intended to eliminate risk-taking, but rather to ensure that individuals are aware of the risks

involved in financial products and services, whether the expected returns adequately compensate for the risk involved, and whether the level and type of risk is appropriate for their personal circumstances. Well-informed decision making of this sort has economy-wide benefits by contributing to the efficient operation of financial markets, as well as improving outcomes for individuals involved. It also, if effective, facilitates a more “hands-off” regulatory approach and avoidance of the distortions and impediments to innovation that regulation can bring.

As well as facilitating informed financial decisions, a crucial aspect of financial literacy programmes is to enable individuals to avoid personal tragedies arising from exposure to “scams” such as Ponzi schemes. This requires having not only an appropriate knowledge of the range and characteristics of financial products relevant to one’s needs, but also an awareness of how personal characteristics can create vulnerability to scams.

The Foundations of Financial Literacy

Whether one starts from a perspective of an individual as the “rational economic person” beloved of economics textbooks, but missing vital information needed for informed choice, or the more complex character of behavioural finance, making decisions affected by various behavioural biases, there are some fundamental skills required for operating in the modern world of finance and economics.

We are hardly the first to point out the importance of having a financially literate population, but we go beyond the general call for better education to suggest three specific methods of improvement.

1. *Numeracy.* Financial decision-making is inherently quantitative. While many of the needed numeracy skills are already taught in primary and secondary education, there is often a problem with context. The teaching of mathematics is typically science-focused, giving relatively short shrift to financial applications. As a result, the relevance of mathematics to financial decisions is frequently well concealed, discouraging the acquisition of necessary skills by potential future investors.

We believe that the following concepts, at a minimum, need to be fully integrated into, and emphasized by, the national mathematics curriculum: the mathematics of compounding and discounting, the measurement and meaning of risk and expected returns, the process and importance of diversification (not putting all one’s eggs in one basket), and the effects of fees.

However, no amount of emphasis on appropriate context can compensate for a lack of generic mathematics skills. Emerging research¹ suggests that a critical determinant of

¹ See, for example, Ann Morales Olazabal and Howard Marmorstein “Structured Products for the Retail Market: Regulatory Implications of Investor Innumeracy and Consumer Information Processing” *Arizona Law Review* (forthcoming), K Gerardi, L Goette and S Meier “Financial literacy and subprime mortgage delinquency: evidence from a survey matched to administrative data” *Atlanta Federal Reserve Working Paper* 2010-10. For a broader perspective on financial literacy

the quality of individual financial decisions is competence in mathematics, even after controlling for other factors such as financial literacy and IQ. Despite decades of effort and research into the teaching of mathematics, too many pupils leave school with only a cursory understanding of the subject, one that is often insufficient to cope with the complexities of modern financial decision-making.

We recommend that the governments of Australia and New Zealand reconsider policies that allow school pupils to escape formal mathematics education at too early an age.

2. *Knowledge.* For investors to operate effectively in the modern financial world, they need, at a minimum, to have some basic factual knowledge: differences between credit cards and debit cards, fixed and variable rate loans, what a ‘guarantee’ does and does not provide, and so on. They also need to understand some fundamental financial principles, be aware of what to consider when making decisions, appreciate the risks associated with different financial products and services, and be familiar with the recourse available should things go wrong – such as the protection afforded by regulators or ombudsman services. Ideally, investors should also be “savvy”: aware of the critical information to look for in disclosure documents, how to identify financial scams and scammers, the importance of the “no free lunch” principle (that if a financial proposition is “too good to be true” then it almost certainly is), and possess a healthy dose of skepticism about financial advertising (such as the use of high profile familiar faces to promote financial products).

Unfortunately, such financial literacy topics are largely absent from mainstream curricula in Australia and New Zealand schools, despite fitting naturally and easily into history and social studies courses. In our view, the continued absence of financial topics from mainstream school courses is a recipe for continued financial ignorance in most households.

We recommend that information about finance principles, products, markets, institutions and history be incorporated into national high school curricula within courses that are taken by all students. We also recommend that, to the greatest extent possible, these topics be integrated with the tools and concepts taught in the mathematics curriculum, particularly through the use of case studies and experiential learning.

3. *Lifelong learning.* Beyond school, investors will continue to require opportunities for updating and improving their financial knowledge, particularly given the ever-expanding diversity and complexity of choices. Financial innovation, while providing many valuable new financial products and services, also can reduce the value of extant consumer knowledge, experience, and prior research. The elderly, in particular, are easier to deceive. Tools for lifelong learning are thus critical, and use of modern technology such

issues, see the forthcoming Feature in *The Economic Journal* on Cognitive Function, Financial Literacy and Financial Outcomes at Older Ages.

as mobile phone applications and web based information resources is important (complemented by other delivery mechanisms for older, less technologically aware individuals). We see this as the third and crucial prong (complementing numeracy and knowledge) of a financial literacy strategy. We have noted the impressive range of resources available on the New Zealand “SORTED” web site (www.sorted.org.nz) and the August 2010 announcement of the Australian Government to develop ASIC’s consumer financial information web capacity (currently FIDO) further along similar lines as part of its financial literacy programs. We also note, however, that some of its tools - such as risk tolerance questionnaires - require further research to assess their ultimate value, appropriate content, and ability to capture behavioural biases. *For these reasons, we support further development of public good services in the area of financial literacy.*

Of course, initiatives to improve financial literacy are necessarily costly, which begs the question of who might pay. Inevitably, and not unreasonably given the public good nature of greater financial literacy, most will look to government. In these times of tightly constrained public finances, however, any potential contribution from this avenue is likely to be limited.

By enabling a principles- rather than rules-based approach to retail finance regulation, banks and other financial institutions should also benefit from a more financially informed population. *We therefore encourage financial institutions to become even more active in the promotion, development, and funding of financial literacy services and activities*

Disclosure

Disclosure requirements underpin principles-based regulation of financial products, practices and markets. In the absence of adequate financial literacy, disclosure will not work; but without adequate disclosure, no amount of financial literacy will help.

An enduring problem with disclosure is that, more or less by definition, only “legitimate” providers of financial services and products actually offer it - scams and other illegal financial activities, by their very nature, do not (hence our earlier recommendation for school education that can help investors recognise such activities). Another problem is the unavoidable tension between the desire of lawyers to protect their issuer clients in as many circumstances as possible and the needs of retail investors for concise and easily understood information.²

For these reasons, getting disclosure “right” is a difficult, if not impossible, task. However, we believe there may be merit in a two-pronged approach to providing retail investors with information. First, regardless of the detail contained in the rest of any disclosure statement, it should also provide a simple and short summary of answers to at least the following questions:

- What will my money be used for?
- How will my investment be managed?
- Is my investment guaranteed by the government?

² Both Australia and New Zealand are currently considering ways by which disclosure to retail investors can be simplified.

- How can I get my money back?
- What fees will I be charged?

We note that moves to introduce short-form disclosure statements address some such issues, but emphasize that developing simple informative “risk indicators” adequate for a diverse range of personal situations and understandings of risk is a challenging task needing attention.

Second, this would usefully be complemented by a “pre-registration” period (e.g., two weeks) where the prospectus is available for both viewing and comment/evaluation online. While the precise details of such a process are beyond the scope of this Statement, we envisage a system where both independent (e.g., financial journalists, academics) and other analysts (e.g., financial advisors) could post evaluations and raise questions online about any security offering, and are incentivised to do so by a revenue pool generated from retail investor viewing fees (which would be very low in order to encourage uptake). Underlying this innovation is a desire to harness the ‘wisdom of crowds’, rather than rely on the supposed expertise of individual advisors, as is typically the case currently.

We recommend

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(ii) the establishment of an online forum designed to elicit information about a financial security or product offering during a pre-registration period.