Financial Education

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An archetypical Indian peasant borrows small amounts from a moneylender for family functions against the mortgage of land. He does not understand the terrible power of compounding and ends up losing all his land. A shop assistant in the USA knows that whatever he gets deducted from his salary for his pension account an equal amount will be paid by the employer but never bothers to sign up for the pension scheme. A college educated Canadian couple living in a six-bed room house and earning over quarter a million dollars every year is financially distressed as it blows up much of its income on pizzas, starbucks coffee and parking tickets. A star footballer in UK earning tens of millions of dollars ends up in bankruptcy. All of these are actual live examples. There is one common thread in their tale of woe – they all lacked financial education. For our ancestors recognizing pugmarks of big cats must have been an indispensable life skill. For us, distinguishing between a benign and predatory financial product is an equally important life skill.

Why financial education has become so important?

There was never a time that financial education was not important. However, in the recent times several factors have contributed to increasing the importance of Financial Education. The first is the increasing complexity of financial products. Consumers are now face a variety of different types of financial instruments offering a range of options with respect to fees, interest rates, maturities, etc. The quality of some of these financial products, such as life insurance policies, is difficult to assess because they are purchased infrequently and there is often a significant lapse of time between purchase and use.

Second, there are just too many financial products. Deregulation of financial markets and the reduction in costs brought about by developments in information technology and telecommunications have resulted in a proliferation in the number of new products tailored to meet very specific market needs. It takes considerable sophistication to understand these products and profit from them.

Third, the break up of joint family system, increased life expectancy and fewer numbers of children have meant that people need to save considerably more to provide for their old age. Changes in pension arrangements have compounded the problem. A major trend in pension systems is the shift from defined benefit to defined contribution pension schemes. In the former, the pension provider guarantees a set retirement income, while in the latter it is the contribution levels that are set, with the retirement income depending upon the contribution rates and the investment decisions made during the individual's work life. As a result, more of the risk in pension provisioning is shifted from the provider to the worker. In the future, an increasing number of retirees will depend upon income from defined contribution pension plans as even the Central Government has shifted to defined contribution pension scheme.

Benefits of financial education to consumers and the economy

Financial education can benefit consumers of all ages and income levels. For young people just beginning their working lives, it can provide basic tools for budgeting and saving so that expenses and debt can be kept under control. Financial education can help families acquire the discipline to save for a home of their own and/or for their children's education. It can help older workers ensure that they have enough savings for a comfortable retirement by providing them with the information and skills to make wise investment choices with both their pension plans and any individual savings plans. Financial education can help those at low income levels make the most of what they are able to save and help them avoid the high cost charged for small borrowings through credit cards. For those with money to invest, financial education can provide increased understanding of both basic financial information, such as the trade-off between risk and return as check against greed. They can also understand how embedded derivatives, especially written options can lead to disastrous non-linear payments

Financially educated consumers can also benefit the economy. By demanding products more responsive to their needs, they also encourage providers to develop new products and services, thus increasing competition in financial markets, innovation and improvement in quality. Financially educated consumers are also more likely to save and to save more than their less literate counterparts are. The increase in savings associated with greater financial literacy has positive effects on both investment levels and economic growth. In emerging economies, providing both information and training to consumers on the operation of markets and on the roles of market participants can help these countries make the most of their developing markets. (There is an interesting case of a very successful Indian company, which traded almost at par in early nineties and was held 100% by retail domestic shareholders. Twenty years later, after several splits and bonuses and rights, the company sells at scores of times over par value. Interestingly, it is about three fourths held by foreign investors. Obviously, the domestic investors did not understand the company as well as the foreign investors did.)

In addition, financially educated consumers are in a better position to protect themselves on their own and to report possible misconducts by financial intermediaries to the authorities. Thus, they would facilitate supervisory activity and in-principle might allow for lower levels of regulatory intervention. As a result, there would be reduced regulatory burden on firms. The entire supervisory attempt at protecting the customer notwithstanding, the bottom line of all contractual transactions is *caveat emptor,* let buyer be beware. It forms the basis of free markets. Only a financially educated person can be beware. If we choose free markets, we cannot afford to downplay financial education.

Who should do what?

Over the past few years, financial education has become the flavour of the decade. Every financial sector player and its subsidiary take a shot at becoming champions of financial education. Supervisors vie with each other in reaching out to people conveying their message of financial education. However, in this entire din everyone appears to be doing the same thing. While doing it the self-interest somehow shows up. An unwritten subscript is that please do buy our kind of products. Conflict of interest in financial education must be identified forthwith and addressed. In the following paragraphs, I have tried to identify basic components of financial education and recommended the financial sector players who will be best suited for delivering that part.

Basic Financial Literacy:

This consists of fundamental tenets of financial well being such as importance of savings, necessity of staying out of unproductive loans that are beyond the capacity to repay, concept of interest and the power of compounding, time value of money, inflation, description of major financial sector institutions such as banks, stock exchanges and insurance companies and basic concept regarding relation between risks and rewards. An attempt has to be made to convey these basic concepts to everyone whether he or she is an actual or potential consumer of financial services or not. However, the modes of delivery can be different depending upon who is the recipient. School children can be reached best through school curricula, employees can be reached through employers, home makers through NGOs and so on. The content and method of presentation has also to be tailored according to the target groups.

However, it has to be kept in mind that the target audience is not to be treated as actual or potential consumer of financial services. The content has to be entirely sector neutral. In fact, financial education should not at all mean that it is to be limited to financial instruments alone. For example, while dealing with the diversification, examples should not be limited to financial sector products. Possibility and importance of diversification in non-financial modes of savings is also a part of financial education that could lead to financial well being of the recipient. *Basic financial literacy has to be totally sector neutral.* A very high level committee where government and various regulators are represented should be the focal point of spread of basic financial literacy.

Sector Focused Financial Education:

This component is to be targeted to actual and potential consumers. To begin with, four sectors can be identified viz. banking, securities market, insurance and retirement planning. Education for the actual and potential securities market investor may consist of basics of stock exchange mechanism, clearing and settlement mechanism, dematerialisation and depositories, and role of various intermediaries such as brokers, merchant bankers registrars and transfer agents, underwriters etc. Potentially risky areas such as margin trading and derivatives need to be covered. Various instruments such as shares, mutual funds units, corporate bonds etc. need to be explained.

In the same way, bank related financial education should consist of details such as responsibilities under Negotiable Instruments Act, precautions while dealing with ATMs and net banking, fundamentals of payment system, lockers and safe custody, loans and guarantees etc. Insurance has to cover the basic concepts related to Insurance Sector; life and non-life. Retirement planning should be targeted to all employed persons. *Sector focused financial education has to be totally product neutral. For example, while explaining the Securities Markets we should not be telling that Mutual Funds are the best available investment option.* The Sectoral Regulators should be taking a lead in the process.

Product Education

Finally, when a financial sector consumer is buying a product or is being convinced to buy a product, it necessary that he may be educated about the particular he is being sold. For example, while selling a mutual fund product, he is to be explained as to what is meant by NAV, Exit Load, Total Expense Ratio, income and growth options, open and closed ended funds, performance bench marks etc. *Product education has to be neutral between the various available options within that product range.* In view of the above the best agency for delivery of product education would be the respective industry association. In the above example of Mutual Funds, Association of Mutual Funds of India (AMFI) would be the appropriate agency to launch product education.

The more important part of the product education lies with the manufacturer of the product himself. To borrow an example from the IT world, the best education on an IBM mainframe would be delivered by the tech support of the IBM itself. In the financial products, it will translate into the manufacturer taking the responsibility of educating the buyer about the appropriateness of the product, performance under various possible scenarios, charge structure through simple examples

Relation of Financial Education with Financial Inclusion

Government of India and the Reserve Bank of India have been striving for financial inclusion since a very long time. Financial inclusion is the delivery of financial services at affordable costs to sections of disadvantaged and low income segments of society. According to the United Nations the main goals of Inclusive Finance are as follows:

1. Access at a reasonable cost of all households and enterprises to the range of financial services for which they are "bankable," including savings, short and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers and international remittances
2. Sound institutions, guided by appropriate internal management systems, industry performance standards, and performance monitoring by the market, as well as by sound prudential regulation where required
3. Financial and institutional sustainability as a means of providing access to financial services over time
4. Multiple providers of financial services, wherever feasible, so as to bring cost-effective and a wide variety of alternatives to customers (which could include any number of combinations of sound private, non-profit and public providers).

It is well known that Indian farmer has been a victim of unscrupulous money lenders largely because he did not understand their methods of interest calculations and readily fell into a debt trap. (Munshi Prem Chand has described their plight in his great novel *Godaan*). Day in and day out people fall prey to ponzi schemes cleverly designed to escape legal consequences because they do not understand the relation between risks and rewards. Bringing the common man in the folds of regulated financial system is not only a supply side phenomenon by making available more modes of delivery, but also a demand side matter as he has to clearly understand where his interests lie. **In short, Financial Education will be tackling the demand side of Financial Inclusion process while leaving the supply side to other initiatives such as branch less banking and mobile banking.**

How inclusive should we be in Financial Education?

An important question that needs to be answered in a country of billion plus population is who would be the target audience. SEBI has made a good beginning by defining its target groups viz.; school students (middle and high School), college students, middle income groups, home makers, executives, retired people and self help groups. However, even a cursory look at the content of the financial education packages makes it very clear that literacy is seen as a pre-requisite for financial education. There is no reason why illiterate people should not receive financial education. A visit to a tribal bazaar will make it amply clear that the tribal women who set up stalls there are quick in calculation and use rather sophisticated approximations to while selling vegetables that cannot be weighed. They are capable of receiving financial education provided we use not only the local language but also use concepts that are understandable. These women don't understand the annual rate of interest but they do understand monthly rate. They have their own short cuts for doing calculations. They can perhaps even do discounted cash flow calculations provided it is taught to them in way they can understand, remember and apply. An example from an unrelated area might drive the point home. It is told that weaver women who weave intricate patterns in sarees remember the sequence of moves by way of songs that they sing as they weave. Sustained research efforts are needed in spreading financial education into the illiterate population.

Financial Education in Schools

There have been some attempts at convincing the education authorities in making financial education a subject in schools. They are reluctant to introduce financial education as a compulsory subject in the school curriculum. They have a point. The schoolchildren are already burdened with too many subjects and increasing one more subject would not be desirable. Traditionally, arithmetic worked as financial education vehicle in schools. Emphasis was on compound interest calculation, discounts, stock, debentures, and such other subjects. However, under the influence of scientists, the content of mathematics courses in school shifted to set theory and modern mathematics. Very few students actually need or are able to absorb this kind of training in mathematics at the school level. If school curriculum in mathematics is revised to have financial education topics while excluding the modern mathematics, it might be much more useful as life skill.

Way Forward

We need to build a national consensus on financial education policy and define a national strategy. Then the coordinated efforts need to be undertaken among various stakeholders such as government, regulators, financial sector firms, NGOs and microfinance entities. Given the level of sophistication of the financial sector players, funding should not a major problem as any enlightened business will see this an investment into the future markets.