Financial Counseling, Financial Literacy, and Household Decision Making

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Financial Education Programs

- Mounting evidence of inadequate financial literacy in the population
- Poor financial literacy leads to poor, and costly, financial decisions

- There is a spectrum of financial education programs
- The way to learn about what works and what does not is through examination of many individual programs

- Here we sample two programs from the opposite ends of the spectrum
  - Mandatory 2-hour counselor review of mortgage offers in Illinois
  - Voluntary 2-year counseling program in Indiana

Mandatory Counselor Review - Chicago

- The State of Illinois forced borrowers in 10 zip codes to submit mortgage offers to review by HUD-certified counselors
- Counseling is mandated for low-FICO borrowers and borrowers who choose risky products
- Counselors explained loan terms and <u>also</u> collected information on borrower income and recorded recommendations in a state database
- Program lasted 4.5 months (Sep 2006 – Jan 2007)
- Program discontinued due to political pressure of lenders and consumer groups
- Counseling in this context: education or oversight?

Mandatory Counselor Review - Chicago

- Outcomes:
  - Exit of lenders: smaller lenders, lender with looser lending criteria exit
  - Exit of borrowers: low FICO borrowers exit
  - Remaining lenders screen borrowers more effectively: better ex post loan performance of mandate-period (low-FICO) counseled borrowers
  - Education: minor changes in the behavior of counseled borrowers
  - Borrowers actively try to avoid counseling sessions: substitute to mortgage products that do not trigger counselor review
    → *Counseling program achieved its goals without providing counseling*
  - Low-doc mortgages disappear: little point if counselors collect and record info

Voluntary Financial Education - Indianapolis

- Prospective low-income borrowers enroll in long-term homebuyer program.
  - Develop a financial plan, learn about repairing credit history, budgeting, etc.
  - Monthly one-on-one sessions to track progress
  - If "demonstrably" successful, get loans from partner lenders
  - If observables still poor, but borrower deemed creditworthy, get funded internally
- Counseling in this context: education and screening on unobservables
- Outcomes:
  - Graduates' loans perform much better than those in control group
  - Internally funded loans perform better still
    - Immediate intervention at first sign of trouble (first late payment)
    - Tight screening motivated by continuous need to raise new funding

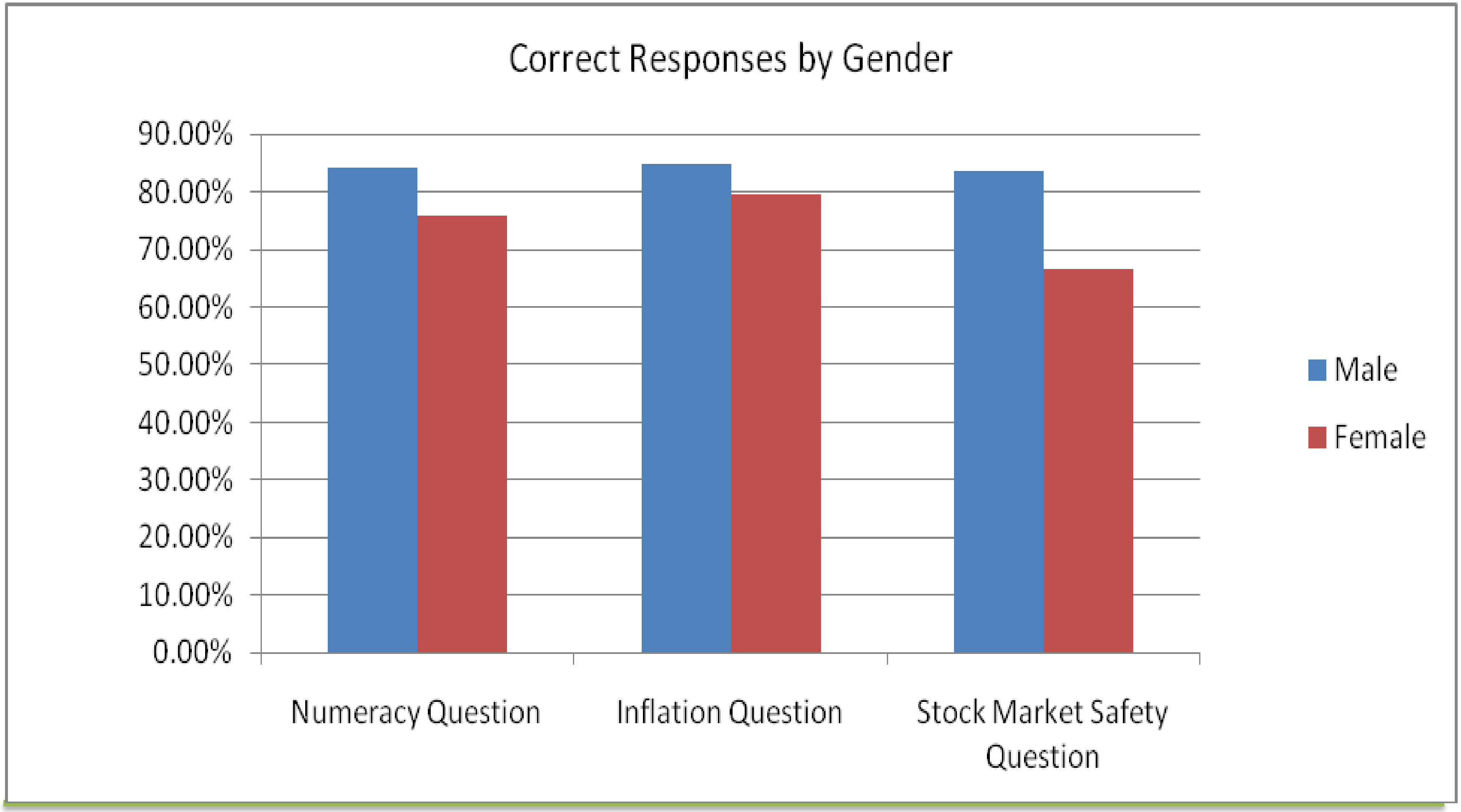
Are these findings contradictory?

- Not at all
- In Chicago, program labeled as “counseling” had a much stronger regulatory oversight component (by chance?)
- Hence, improvements in performance of remaining borrowers are easier to trace to actions of remaining lenders, and not more informed choices by the borrowers
- In Indianapolis, “counseling” was effective because it was
  - Long-term, thorough, and voluntary (education more than counseling)
  - The counselors had a long-term stake in graduates’ outcomes
  - Attracted private capital – offered borrower education and screening for banks seeking to satisfy CRA requirements

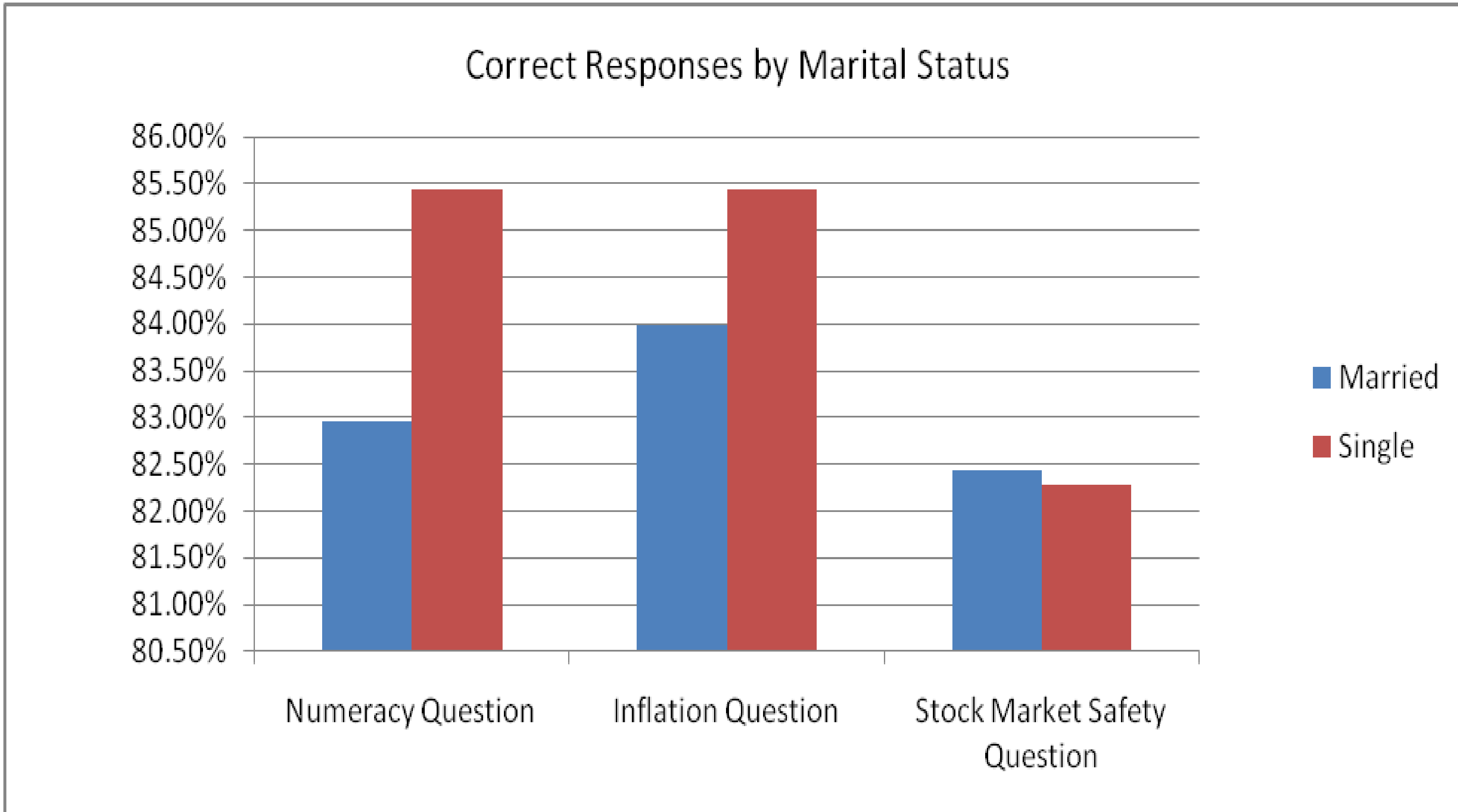
New Evidence from India

- Collected with InvestmentYogi Financial Advisory Services
- Consumers who seek financial planning fill out a questionnaire that includes:
  - Demographics
  - Financials: Assets, liabilities, income
  - Lusardi and Mitchell (2007) questions:
    - Numeracy (83.5% Correct)
    - Inflation (84.5% Correct)
    - Risk diversification (82.4% Correct)
- Overall 887 observations

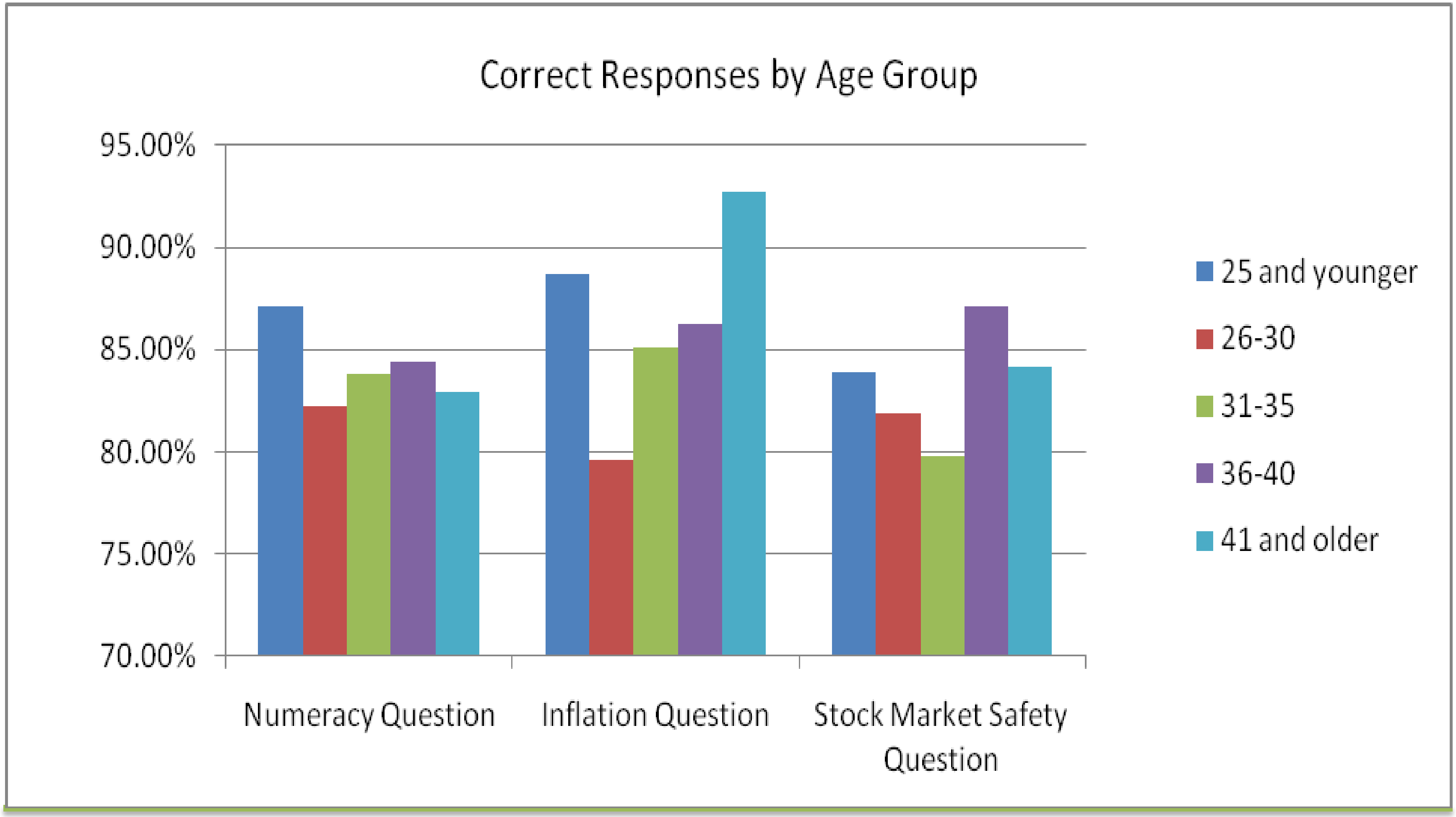
Correct responses by gender



Correct responses by martial status



Correct responses by age group



Additional Results

- Compare results with:
  - High fraction of correct answers
    - 60% answered correctly in the US (Lusardi and Mitchell, 2007)
    - 80% answered correctly in the Netherlands (van Rooij, Lusardi, and Alessie, 2007)

Multivariate analysis:

- Dependent variable: answering all three questions correctly
- After controlling for demographics:
  - Males (+14%)
  - “Aggressive risk taking” (+16%)
  - Educated people (+5% to +20%)
  - High number of financial goals (up to +26%)
  - No particular patterns for investments and liabilities

Conclusion

- A wide range of financial education programs
- Voluntary programs seem to increase literacy better, however, there are severe selection issues
- Mandated programs can achieve some financial literacy goals through incentives

- New evidence from India suggesting that financial literacy is correlated with gender, risk taking, and financial goals