Welcome to the new issue of Seeing Beyond Risk, the quarterly electronic publication from the Canadian Institute of Actuaries (CIA). Each issue presents the latest actuarial thinking from experts; below, Claudia Gagné—an experienced actuary and a professor—looks at the vital importance of financial literacy in Canada. We are sure you will find this article informative and thought-provoking, and we encourage you to distribute it among your friends and colleagues.

Financial Literacy – A Necessity with its Own Set of Challenges

AT A TIME WHEN DECISIONS relating to savings and retirement planning are increasingly left to individuals, readers may be surprised to learn that many Canadians lack the knowledge and competencies necessary to make these decisions. As in other countries, the low level of financial literacy among Canadians constitutes a major issue and is drawing the attention of government authorities; witness the federal government’s decision to set up a task force in 2009 charged with designing a national strategy aimed at improving Canadians’ financial literacy.

The challenges associated with this objective are enormous, but the social and economic effects of poor planning decisions by individuals are every bit as dire. We must not let the daunting nature of the task deter us.

In this article I will attempt to illuminate the very concept of financial literacy, the problems currently faced by individuals in this area, and potential solutions being considered. More specifically, and in order to quickly address the gaps in Canadians’ knowledge, I recommend that a national financial literacy campaign be set up in short order. It should be designed in such a way as to offer Canadians a source of information that they will perceive as credible and independent.

It should also be heavily promoted to create maximum awareness of the value and importance of financial literacy.

WHAT IS FINANCIAL LITERACY?

A complicated expression seemingly invented by the deep thinkers in a department of education, this notion—indeed, the very subject of financial planning—is almost fear-inducing.

Several definitions have been proposed by various researchers. The above-mentioned Task Force on Financial Literacy opted for a relatively straightforward definition of financial literacy: “having the knowledge, skills and confidence to make responsible financial decisions.” An interesting parallel can be drawn with educational literacy: does an individual have the required knowledge to read a text? Is that person able to read, summarize, and interpret the text? In the case of financial literacy, we are dealing instead with basic notions like the concept of compound interest, inflation, investment diversification, and critical analysis of various investment options.

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The effects of poor financial literacy in a society are well documented. First, it has been shown\(^2\) that people unable to make simple calculations of interest accumulation and who do not understand the effect of inflation and diversification are far less likely to correctly estimate their retirement savings needs. Similarly, we see a higher rate of savings among those more comfortable with these concepts (interest, inflation, and diversification).

Thus, the lack of basic financial knowledge seems to lead to less-than-optimal planning when it comes to savings and achieving retirement income replacement objectives. People with less financial “education” tend to either underestimate the savings they will need for retirement, or simply neglect savings.

Despite these observations, one could argue that Canadian retirees’ standard of living seems adequate, by and large. So why worry so much about financial literacy? And why more now than before? Here is a partial list of the trends and changes that have taken place in recent years, making financial knowledge increasingly important:

- **Population aging and stability of retirement age**: Upon retirement, financial needs are extended over an increasingly lengthy period without an increase in the amount of time needed to accumulate savings.

- **Lower yields on investments**: The expected return on a diverse portfolio (composed of stocks and bonds) is far lower than before, increasing the level of savings necessary to amass the same amount on retirement.

- **Responsibility for investment decisions is transferred to individuals**: The conversion of a number of defined benefit pension plans to defined contribution pension plans has the effect, in the vast majority of cases, of transferring responsibility for investment choices from the employer to plan members. Furthermore, this conversion increases the level of savings required outside the plan.

- **Increased complexity of investment vehicles**: Investment products, be they for retirement savings, educational savings, or insurance, are increasingly diverse and complex. What’s more, the people proposing these products to investors usually have an interest in the sale of these products. This makes it all the more important for individuals faced with investment choices to analyze these proposals with a critical eye.

### OBSERVATIONS

What is the current level of financial literacy and how is it assessed? In 2009 Statistics Canada published the *Canadian Financial Capability Survey*. In addition to certain foreseeable results, such as the level of financial literacy increasing with the level of education and level of earnings, this survey produced some interesting findings:\(^3\):

- Only 51 percent of Canadians have a budget;
- 52 percent of Canadians planning to purchase a home do not expect to have to pay any costs over and above the down payment;
- 70 percent of Canadians say they are “fairly confident” or “very confident” that their retirement income will give them the standard of living they want; however, only 40 percent of Canadians have a good idea of the amount of money they must save to maintain the standard of living they would like to have post-retirement; and
- The two leading sources of information on financial products are banks/credit unions (40 percent) and financial advisors (39 percent).

These results show us that little in the way of planning goes into people’s spending choices, and that they underestimate how much it costs to purchase a tangible asset such as a home. Moreover, much of the training and information available to people to guide them in their choice of investments comes from organizations with a business interest, which greatly reduces the independence of this information.

We also note a high degree of confidence among survey respondents in their retirement planning, without these people knowing how to measure their savings needs. This feeling of confidence was noted in an American study (Lusardi, Mitchell, 2009)\(^2\). In this study, the participants answered five very simple questions on compound interest, inflation, etc.

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\(^3\) Statistics Canada, Special Surveys Division, 2010, “Initial Findings from the 2009 Canadian Financial Capability Survey”.

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**Further Reading**

- Actuaries and the Actuarial Foundation of Canada worked with the Financial Consumer Agency of Canada (FCAC) on its Financial Goal Calculator. The online tool shows people how to get out of debt, or save for retirement or some other goal, by calculating their current position and needs and providing straightforward advice and answers to financial questions.
- A CIA task force has produced a in-depth discussion paper, *The Role of Individual Savings and Financial Literacy*.
- The Institute’s many submissions to governments include one to the House of Commons Standing Committee on Finance calling for action to encourage Canadians to save more for retirement.
- The study *Retirement Risk: defining retirement horizons* features data on Canadians’ understanding of their financial situation.
- The CIA has numerous reports, studies, and other publications on financial topics.

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They also had to assess their own level of financial literacy (from 1 to 7). Among those giving themselves the highest mark (7), only 71 percent were among those who best answered the five questions (among the strongest 50 percent of the participants). In addition, among these same respondents who gave themselves a 7, 25 percent scored in the weakest quartile of respondents (among the weakest 25 percent of participants). These outcomes demonstrate a level of confidence that is at times too high in relation to actual knowledge.

The task force set up by the Canadian government established self-confidence as an element defining financial literacy. The results of the American study show that attention must be paid to this notion of confidence. People demonstrating a high level of confidence do not necessarily possess knowledge and skills necessary to make responsible financial decisions.

The importance of this message was recently driven home by federal representatives during Talk With Our Kids About Money Day, and by the appointment of Canada’s first financial literacy leader. The Financial Consumer Agency of Canada (FCAC) has also established online programs, although they must be promoted widely in order to reach the largest possible audience.

REQUIRED ACTION: INTERVENING QUICKLY

The Canadian task force provided the government with a number of recommendations aimed at increasing Canadians’ level of financial literacy. The objectives are ambitious, and the means and programs put in place must be sufficiently diverse to reach a varied population—varied in terms of age, current level of knowledge, place of residence, etc.

It would seem that in order to reach as broad a population base as possible and target future generations, action must be taken on three fronts, mainly schools, the workplace, and more online tools:

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| **Schools**     | • Educational programs in pre-university establishments (primary, secondary, college). | • Instills healthy financial management habits (comparable to healthy living habits when it comes to sports and nutrition).  
                  |                                                                             | • Mandatory training taken by all students.                             | • Complex to put in place.                                             |
|                 |                                                                             | • The time required for lessons in financial topics could be incorporated into other subjects (e.g., mathematics).    | • Requires that teachers be trained in financial concepts.             |
|                 |                                                                             | • Programs could have long-lasting effects.                           |                                                                      |
| **Workplaces**  | • Training program sponsored by employers.                                   | • Easily accessible to employees.                                     | • Difficult to make mandatory.                                        |
|                 |                                                                             | • The right tax incentives would encourage employer buy-in.            |                                                                      |
| **More online tools** | • Further develop the FCAC’s online programs, or develop new websites. | • Provides unique, reliable, credible, and independent information.   | • Must be maintained and updated.                                      |
|                 |                                                                             | • Promoted well, it can reach segments of the population outside the education system and outside the workplace (the jobless, the elderly). |                                                                      |

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As we observed earlier, Canadians are seriously deficient in terms of their financial literacy. In view of this observation, it is essential to prioritize a short-term response and promote the FCAC programs and their recently-implemented website much more heavily. High-profile websites—supported by a telephone helpline for those who are less comfortable with computers, unable to access the internet, or need to speak to someone about a question—allow rapid access to information necessary for sound financial planning (core concepts like compound interest, inflation, forecasting tools, and so forth). As the primary aim of this website is to provide information, it is just as important, over the medium and long terms, to round out this information with a more detailed educational component. For example, this would enable individuals to better quantify their risk appetite based on their retirement income replacement objective (and not only their personal feelings towards risk, as covered by the FCAC’s website). In addition, this education would aim to help individuals hone their critical judgment of the products available to them (charges linked to these products, added value derived from active management by managers, etc.). This objective could be fulfilled by additional online tools and educational programs in schools and in the workplace.

**IN CONCLUSION**

The changes that have taken place in recent years in the population and in the retirement and financial products environment make it essential to take measures aimed at improving Canadians’ financial literacy. Ottawa’s decision to set up a Task Force on Financial Literacy, and its more recent work in this area, constitutes a first step toward this objective. I recommend that government authorities increase their promotion of the recently-implemented website developed by the FCAC. As well, in order to send a clear signal of the desire to increase the level of financial literacy, wider-ranging educational programs should be set up in schools and in the workplace. It is important for all actors able to contribute to this effort (financial institutions, educational institutions, employers, federal and provincial governments, etc.) to work together so as to maximize the effects of the various measures that will be put in place.

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