The Collins Institute

Equipping Citizens to Deal with Financial Choice

A Paper from the Collins Institute

April 2018

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1. INTRODUCTION AND ANALOGY

Since the infamous free driving licences of 1979, we have travelled a significant journey in the way that we train people to handle a car. We have come from a point where you could simply apply for a provisional licence and then drive unaccompanied to the following situation:

- You must take a theory test to obtain your provisional licence.
- You must take 12 lessons before you can take your test.
- You must have your provisional driving licence for 6 months before you can sit your test.
- You must have an eye test.
- Once you have passed your test you can drive, but the L plate is replaced by the N plate for 2 years.

In effect, we have sought to ensure that people know what they are doing before we let them loose on the road to minimise the danger to themselves and everyone else. It is one of the many reasons why road fatalities have dropped over the past 30 years. In 1978 628 people were killed on Irish roads, in 2016 it was 188 up from 165 the year in 2015. At the same time, the number of cars on our roads has increased as our population has grown. In 2000 there were 1.3m private cars registered. In 2016 that number had risen to 2.0m. Crystallised in the establishment and great work done by the Road Safety Authority, we have successfully taken steps as a society to minimise the causes of and chances of injury on our roads. It is a battle that needs to be constantly fought. It has education and enforcement at its core.

2. OTHER CHANGES

There have been other changes in Irish society over the same period. As recently as the 1980s, the majority of those left school and got a job after school and only a minority went to third level education. In that era of relative prosperity, those who gained employment in the banks, civil service or insurance were regarded as set fair for a good, prosperous life. Many would have anticipated coming to retirement now. They typically would have anticipated a 40-hour week, for 48 weeks of the year, for 45 years of their lives. For those born in 1960, life expectancy was 68 for men and 72 for women.

There were other forces at play. While high inflation had many downsides through the seventies and eighties, it also reduced the real cost of personal debt. It meant that the pain of home ownership was reduced on a year by year basis as the value of debt decreased in real terms. People grew or gained 'wealth' by default and house purchase was a low risk activity for borrower and lender.

The presence of defined benefit pension schemes gave real certainty for post-retirement income – which was not necessarily into several decades. Pension liabilities were impacted by lower life expectancy, inflation in asset prices and the fact that it was generally anticipated that most women would not participate in the workforce for an extended period.

It was in the context of these predictable environments that our attitudes to personal financial literacy and planning were formed. While the world has changed, we are arguing that our knowledge has not. One of our aims at the Collins Institute is to argue for the concept of self-reliant and empowered citizens, who are equipped to make informed choices that suit their own lives.

3. WHAT HAPPENED FINANCIALLY

There have been cataclysmic and catastrophic changes in financial futures since then. On the individual level, the financial future that was anticipated in 1979 never really materialised. Those who entered the workforce then have reached or are contemplating retirement. The changes along the way have been significant.

- **The traditional model of one employer for life** has been largely eliminated.
- **The promise of pensions has in many cases not been delivered.** There are a handful of defined benefit pension schemes left in the private sector. Their presence in the public sector will be a source of social tension in years to come.
- **The era of high inflation and declining real values of debt was replaced by low inflation and unpredictable house prices** – which crashed as part of the economic collapse in 2008 and have left many in negative equity. The certainty of home ownership has been replaced by the certainty of renting right into one's thirties. The risks associated with borrowing and home ownership have risen exponentially.
- **The rise in participation in third level from less than 20% of Leaving Certificate students to two-thirds is obviously welcome**. It has however extended the cost of child rearing to include third level and beyond. It potentially has also shortened working lives and mortgage repayment periods.
- **The demise of the defined benefit pension scheme creates unpredictability and uncertainty.** There is demonstrable evidence that people do not yet understand that the promise of pensions is an aspiration and not a guarantee.
- **The role of technology has already eliminated a range of what would have been school leaver employments.**
- **Life expectancy has continued to rise. It is not fanciful to believe that as the working life has shortened (a consequence of longer time in College)**; the post retirement life has the potential to be longer than the working life.

In contrast to our efforts to upgrade our ability to drive safely and reduce fatalities and injuries as a result, we have silently transferred personal financial responsibility to the individual without any real or appropriate training. Realistically it is our view that the personal financial car crash caused by this change is akin to letting a learner driver out in a Porsche. The potential for long term injury and worse is huge. Since the crash, our courts are filled with people (banks, companies and individuals) who were driving too fast financially and were unaware of the risks that they were taking.

These knowledge gaps exacerbate the financial gaps felt across Irish society. Research by George Gloukoviezoff, then in the Geary Institute in UCD, for the Social Finance Foundation in 2014[1] found the following:

- 17% of people were going into debt for ordinary living expenses
- 54% would be unable to afford an unexpected expense
- 65% were unable to save

The CSO estimates that 650,000 adults live in credit constrained households.

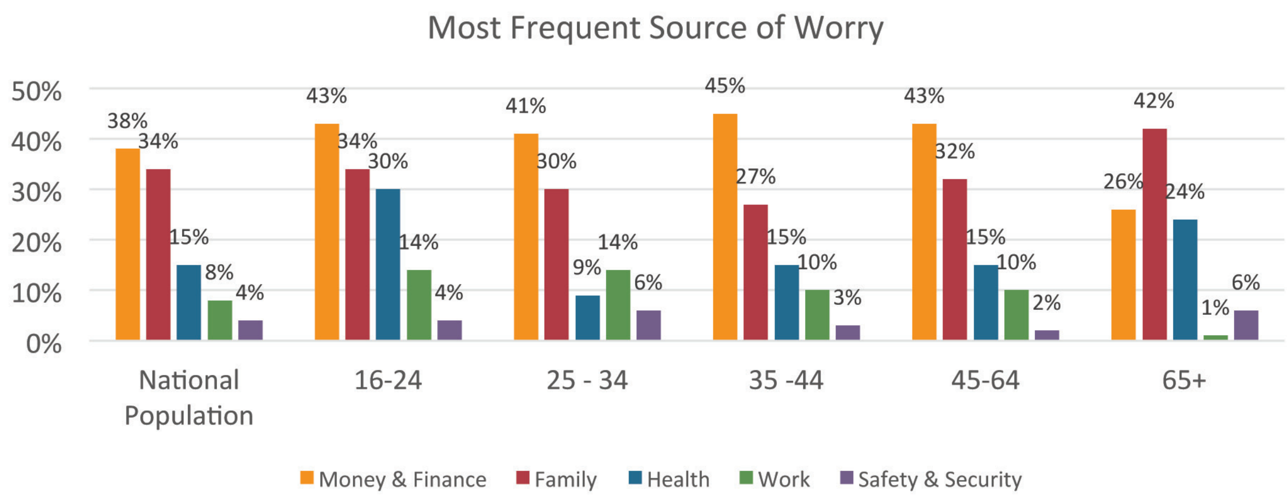
1 Creating Credit, not Debt, UCD Geary Institute for Public Policy, May 2014

4. SURVEY OF CURRENT ATTITUDES

Amárach Research undertook a survey of 1,000 adults in Ireland for the Collins Institute in Autumn 2017. The sample was representative of the national population by age, gender, social class and region. The survey was undertaken for the Collins Institute to ascertain current perspectives on financial understanding for individuals.

Money and Finance is the most frequent source of worry

Among the national population and among all age groups except the 65+ age band, money and finance are the most frequent source of worry in Ireland. The gap is particularly acute in the 25 to 44 age group. While some of this worry is down to an absence of money, the inability to understand contemporary products is also a contributory factor.



5. THE TRANSFER OF RESPONSIBILITY

Much of the change in the financial world is welcome. The cartel of the associated banks is long gone and there is competition in the mortgage market. The myriad of debt products available also is huge. Most financial products are appropriate for some element of the population, but not all products are suitable for all citizens. Many were too risky or too powerful to be handed to learner financial drivers.

Case Study 1

There are an estimated 300,000 people who borrow at very high rates from licenced lenders such as Provident Financial (source Central Bank of Ireland). The APR they pay is ten times the rate paid if they borrowed from a credit union. The excess interest gap is close to €100m per annum. The Personal Micro Credit Project supported by Government Agencies and Departments; An Post and the Credit Union Movement offers some way out for people, but much work remains to be done.

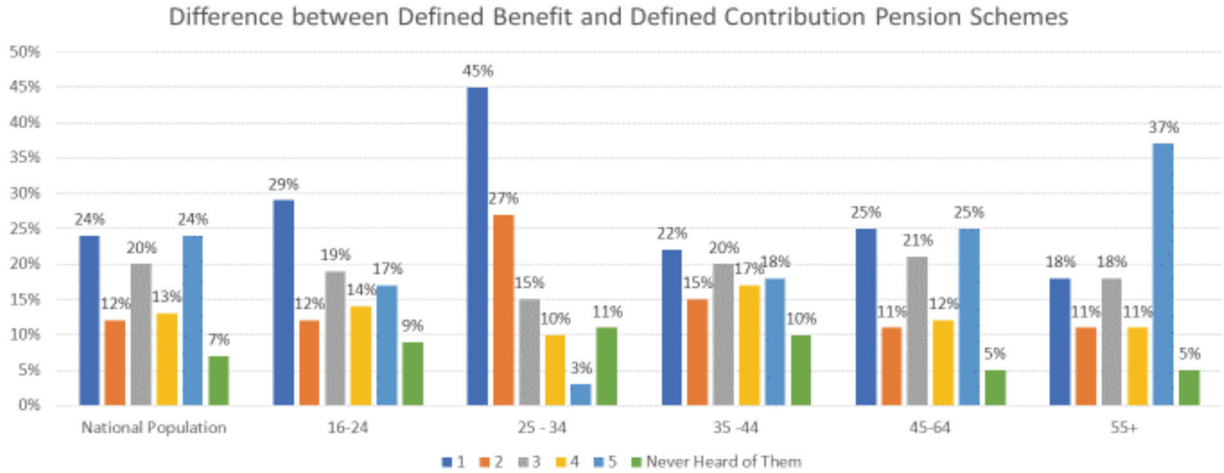
Case Study 2

Pre-boom, many banks and financial institutions offered their High Net Worth customers products such as Highly Leveraged Property Funds. These products were believed by many purchasers to be low risk investments in property markets. They were not – and in many cases, all of the money invested was lost. The loss of money was exacerbated in some cases by the fact that the investors borrowed the funds to invest (often from the same financial organisation that sold them the product) and were left with the residual debt.

Among the examples of concern are:

Many new cars are currently being bought on Personal Contract Plans (PCPs). These are an unregulated product – sold on a commission basis. No-one appears to know how many there are. There are people driving round in new cars that never believed that they could do so. In effect, they are a leasing product – where the car remains in the ownership of the finance house until the final bullet payment. Second hand car prices in Ireland are influenced by the Sterling/Euro exchange rate – with the rise in the number of cars imported from the UK reflecting this in the first half of 2017. The move to Euro/Sterling parity or beyond may have the unintended consequence of wiping out any equity that is perceived in the PCP'ed car in the three-year timeframe. Research published by the Competition and Consumer Protection Commission (CCPC) in 2017 indicates a high level of awareness of the different elements of the product, but there are still risks for the individual.

Pensions – just 52% of the adult population have pensions and they have limited knowledge of how they work. One of the huge changes for those who have pensions has been the switch for the pension holder from Defined Benefit (where they were promised a set predictable amount when they retire) to Defined Contribution (where they were promised only a set contribution to the pension scheme), in effect the risk was transferred from the pension fund to the pension holder. Despite the prevalence of the change just 1 in 4 of the population in our survey understood the difference very well.



Do you understand the difference between a defined benefit and defined contribution pension scheme. Use a scale of 1 to 5, where 1 is Don't Understand at all and 5 is Understand Very Well

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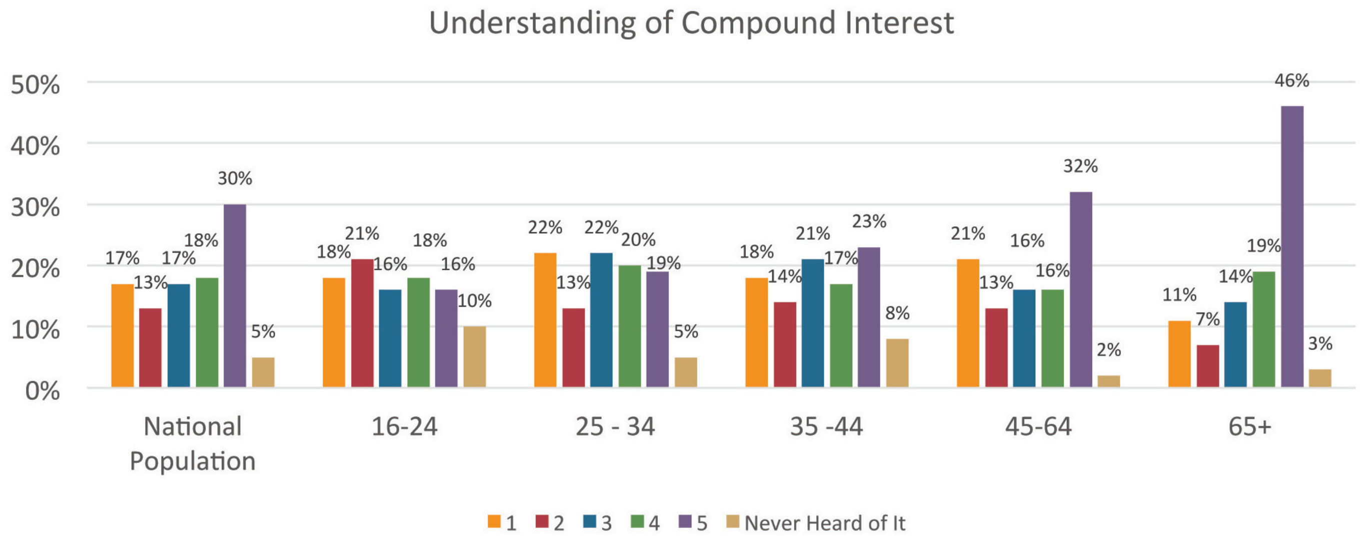
Most contemporary personal financial products be they deposit, or lending based are built on some element of compound interest. Yet even that is not understood enough for the general public to make an informed decision on product choice. Less than half of the population (48%) give themselves an understanding rating of 4 or 5 out of 5 for the most fundamental building blocks of financial products. In core purchasing age bands of 25 to 64, a majority give their understanding a rating of 3 or less out of 5 and in the 35 to 44 age group 8% have never heard of it.



Mortgages – we have the highest rates of variable rate mortgages in the Eurozone. The banks despicable behaviour over tracker mortgages is beyond the scope of this paper, but it is possible to argue that at least some of the reason why the banks could get away with what they did for so long was that at least some of the borrowers were not in a position to argue back. That is no way intended to absolve the banks of their responsibilities. Even more alarming is the reported number of staff working in financial institutions who overborrowed, did not understand the products that they were buying and in some in cases sold them on to their customers.

There are other indicators of concern. The caseload of Money Advice and Budgeting Service (MABS), the litany of cases of mortgage repossession in the High Court and the continuing purchase of high interest-bearing debt (when there are clear and easy alternatives) underline the following concerns:

- We have transferred responsibility for financial management without equipping people to manage.
- We have allowed debt to become credit, with a focus on the product to be purchased rather than the underlying financial product.
- There is no understanding of the issue of compound interest.
- There is no understanding of the role of banks and other vendors of finance.
- We appear to have defaulted as State agencies to acting more proactively on behalf of the financial services industry rather than the Citizen. Many of the improvements in regulation and accountability have come about as a consequence of court decisions taken as a result of cases by citizens against banks.
- We appear, despite the evidence of the past decade, to continue to adopt as individuals an approach that believes that "it will be all right on the night" demeanour to future financial planning.

Government in its various guises has been ineffective in this area. We have not insisted on 12 driving lessons in finance. We have trusted the financial services industry to act in the best interest of the consumer when the evidence regrettably shows that they were neither equipped nor willing to do so.

6. CURRENT APPROACHES

We need to have an honest conversation with ourselves about aspiration and reality. That includes the role of the individual and the state about respective responsibilities and realities on a range of areas including retirement income, home ownership and simple concepts of planning, saving and borrowing.

6.1 The Role of Regulation

We have regulated the sales process across many areas of financial purchase. We have insisted that there is a basic standard of financial competence in financial advisor functions through qualifications such as the Qualified Financial Advisor run by the Life Insurance Association (LIA) and the Institute of Bankers. We insist that a fact find is completed by those seeking to invest money or take out a pension. This fact find provides a financial profile and measures attitudes to risk and reward.

We have also regulated mortgage debt sales and through the new Central Bank rules sought to minimise the exposure of the individual to market shock and price collapse.

Yet the role of regulation appears to have been dominated by the demands of the financial services industry, rather than the needs of the consumer. The role of the consumer protection has sat in various government agencies at various times and is now split between the CCPC and the Central Bank of Ireland. The Central Bank in particular has struggled to convince that it is acting in the interests of the consumer with the tracker mortgage debacle being the latest area of concern and the pricing of some licenced lending being clear examples.

6.2 The Role of the Individual

The only progress that has been made has been about providing product information to the individual. To go back to the car analogy, there is understanding of what mortgages (tyres) are for; there is a limited understanding of what pensions (petrol) are for.

What appears to be lacking for large parts of the population is an understanding of how it all works together. Differentiating between the price of petrol or diesel in different garages is easy and intuitive. People are less confident about the differences in prices of mortgages – or in switching provider[2]. Despite volatility in the marketplace, consumers are less inclined to switch motor insurance provider now than 2 years ago.

In arguing for greater financial literacy, we are in no way saying that this is a panacea for all financial challenges facing citizens. But we are saying that people's financial situation can be improved or strengthened by giving them the tools to make an informed decision.

2 CCPC Report on Irish Mortgage Market 2017.

7. PICTURE THE IDEAL SCENARIO

What we simply want is for people to be able to make informed decisions so that they can help themselves scope their financial future and avoid the financial pitfalls and trauma that are consequent of bad choices. They should also be in a position to identify where mis-selling might be occurring. They need to know which state and other agencies are available to act, advise and protect on their behalf. None of the following proposals reduces the requirement or responsibility at an industry and government level for full, proper and enforced regulation.

In an ideal scenario, the citizen should be able:

- To recognise the cost and consequences of financial decisions.
- Identify what their overall financial framework should be and know how feasible it is to improve this framework.
- Know in an era of personal scarcity how to avoid pitfalls and financial crisis.
- Understand the motives of the various players in the market.
- Understand risk and compound interest.
- Can think in short, medium and long term.
- Know rights and responsibilities.
- Know where to go and guidance.
- Understand financial advertising.

None of this creates money or wealth but at worst it avoids making bad situations worse and at best it empowers people to do more. It will absolutely improve quality of life. It should also improve the woeful standards that pertain in many aspects of our financial services industry by equipping people to hold them to account.

8. HOW DO WE EFFECT CHANGE?

There are various state agencies who have remit and regulatory responsibility in this area. They include the CCPC; The Pensions Authority; the Central Bank of Ireland; The Department of Finance and the Citizens' Information Board (via MABS). They all have an educative remit. The representative organisations including the LIA and the Irish Banking Federation also have some responsibility. There is also the Financial Services Ombudsman.

One of the key points of education is to introduce the concept at the time of need. There is little point in teaching a 14-year-old the theory of driving or a graduate how best to approach the Leaving Certificate. Neither are timely or relevant.

There needs to be a constantly accessible, continually renewed source of neutral financial information and education. It should be under the remit of the Competition and Consumer Protection Commission or a comparable agency. This must have the following attributes:

- Accessible language and communication.
- A series of product guides and explanations.
- It should highlight the positives and negatives of each product suite.
- It should highlight the typical commission and margin that a financial service company should make on each product sale.

In addition, there should be a course available online or delivered through partners which focuses on things people need to think about. It could include financial questionnaires and profiling.

This must be done by an independent government agency, distinct from the Central Bank. Its effectiveness should be measured on a yearly basis using a straightforward nationally representative survey of adults. It has to be properly resourced and we argue that this resource should come from a levy on the financial services industry. Success and impact will be measured:

- By consumer understanding of core concepts.
- A sense that people know what actions to take or where to turn to, if things go wrong.
- Evidence that people understand what financial needs that they or their family may face in the future.

This is a different form of literacy. But it is fundamental to our well-being as a society into the future.

9. CONCLUSIONS

There will be recessions and recoveries. We cannot protect people from every risk of the macro economy. The challenge for government in this context is to educate citizens as to the risks and benefits of the choices that they make. Changing behaviour requires a long-term commitment, dedicated resources and a broad societal agreement on the goals that are to be achieved. We have improved the quality of people's lives through a societal commitment to safer roads, better enforcement and driver education. We should now do the same with financial education and literacy.

ABOUT THE COLLINS INSTITUTE

The Collins Institute is a policy think tank which examines the long-term challenges facing Ireland and suggests possible policy responses. In particular, it will look at the way in which a Just Republic might be established in Ireland as we approach 2022, the centenary of both the founding of the Irish State and the death of Michael Collins.

By Just Republic, we mean a republic which empowers its citizens so that they have both the supports and capabilities they require to reach their full potential.

The Collins Institute is a Fine Gael initiative. It is supported by, but operates independently of, the Party. The goal over the longer term is to establish it as a stand-alone organisation.

A key objective of the Institute is to work closely with like-minded institutes and think tanks in other countries, particularly those which are associated with the Martens Centre – the think tank of the European People's Party. All papers published by the Institute are intended for discussion purposes only and do not represent Fine Gael policy.

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