Quaderni di finanza

Challenges in ensuring financial competencies

Essays on how to measure financial knowledge, target beneficiaries and deliver educational programmes

N. Linciano and P. Soccorso Editors

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Essays on how to measure financial knowledge, target beneficiaries and deliver educational programmes

N. Linciano and P. Soccorso Editors

The present collective work was occasioned by Consob participation in the World Investor Week (WIW) a week-long, global campaign promoted by the International Organization of Securities Commissions (IOSCO) from 2-8 October 2017 to raise awareness about the importance of investor education and protection.

Following a multidisciplinary perspective, the work gathers views on how behavioural finance, neuroscience, sociology, cognitive psychology and pedagogy may contribute to improve measurement of financial knowledge, elicitation of personal attitudes, targeting audiences and delivery of educational programmes.

The aim of the work is to give food for thought with regard to methods and tools that may foster effective initiatives and coordination among the academia and the stakeholders involved in the design and delivery of educational programmes.

JEL Classifications: D1, D14, D15, D81, D83, G41.

Keywords: behavioural finance, decision-making, financial advice, financial education, financial literacy, household behaviours, investment decisions, learning, overconfidence, personality, risk, uncertainty.

Contents

Trust and financial literacy

Substitutes or complements?

C. Cruciani(*) and U. Rigoni(**)

The global financial turmoil and the European sovereign debt crisis dramatically affected the way in which the general public understands the role of financial markets and the responsibilities of financial institutions. Despite the fact that some of the negative effects of the crisis have already started to fade away, it is important to acknowledge that the crisis showed that both investors and financial institutions need to scale up their game to effectively participate and prosper in modern financial markets. Understanding the reasons for the financial crisis requires addressing the limits of current financial education and awareness of key financial topics and the limits of formal regulation of financial institutions.

More importantly, the crisis contributed to foster a «*trust crisis*» (Guiso, 2010) that may undermine a key asset in financial markets - the unregulated, informal bond of trust linking investors and institutions. This short article argues that addressing the trust crisis is a way to deal with the limits of investors' knowledge and financial education and the complexity of the environment in which financial institutions operate.

Post-crisis financial markets need to be characterised by better rules and more efficient players. How can the relationship between investors and financial intermediaries be improved through policy interventions? Judging from the recent evolution in financial regulations (e.g., the upcoming entry into force of the European MiFID II package), transparency and information delivery have become key to investor protection and more effective financial planning. These keywords paint a novel landscape for financial intermediaries, whose strengths and weaknesses need to be fully understood and addressed in order for the plan to succeed.

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On one side, the focus on information transmission is grounded in the hypothesis that better information should lead to better decision making. Even setting aside the bulk of empirical evidence showing that individuals are able to process only a limited amount of information and are prone to several, well-documented biases even when offered objective information, the faith in the role of information delivery in improving financial decision has already been empirically challenged by a different but related strand of literature.

Indeed, the idea that skill transfer may affect financial market participation is not a new one and has been thoroughly explored in the financial literacy research. Financial literacy can be defined as the ability to understand and use key financial concepts regarding investment and saving in everyday life. Several authors have investigated how financial literacy can act as a facilitator for stock market participation (Lusardi and Mitchell, 2007; Lusardi and Mitchell, 2011; van Rooij, Lusardi, and Alessie, 2011). More literate individuals are more likely to invest in the stock market and to select riskier assets with higher expected returns, as well as voluntarily engage in retirement plans. Despite its crucial role, the level of financial literacy in the average western population tends to be rather low (Lusardi and Mitchell, 2014).

Given its importance in fostering stock market participation, retirement planning and the use of financial tools to hedge against future uncertainties, financial education programmes represent a viable policy intervention to improve financial literacy, especially among the lower-income fringes of the population.

Unfortunately, the effectiveness of these programmes is difficult to prove, as there may be self-selection issues amongst participants (when they are not compulsory, only the most motivated may decide to enrol), which are impossible to rule out in the absence of a control group. Collins et al. (2010) show that such concerns have characterized many financial education programmes. The authors also point out the timing of the evaluations: many programmes are evaluated too soon after their completion and tend to rely only on self-assessment. In their meta study Fernandes et al. (2014) show that financial education seems to decay already 20 months after the exposure to financial education programmes, with almost negligible effects on actual financial behaviour, especially among low-income groups. Miller et al. (2015) underlines the difficulties in the assessment of educational interventions, but provides preliminary support to their positive impact on at least some areas of financial concern, such as savings and record keeping.

Empirical evidence suggests that educational programmes may not target the population groups that would need it the most (as they may be unable to understand the importance to participate or are too busy to join in a voluntary initiative) or may only produce temporary effects.

If transfer of information contents by itself may be ineffective and cumbersome, financial intermediaries could play the role of financial educators and find ways to steer a correct information processing and a correct decision making process. Unfortunately, again empirical evidence suggests that seeking for professional financial advice is most frequent among financially literate individuals, i.e. advice and literacy are complements rather than substitutes (Calcagno and Monticone, 2015; Collins, 2012; Debbich, 2015). This article suggests that trust is another key feature in financial services provision and should be considered a powerful complement to information delivery and the general goal of increasing investors' competencies.

Trust can be defined as the lubricant of economic activities. Several studies have shown that generalized trust (i.e., trust towards others in general) is a significant determinant of economic growth (Knack and Keefer, 1997). Trust plays a significant role also in financial market participation (Guiso, Sapienza, and Zingales, 2008), while trust in financial advisors may increase the level of delegation and yield positive results to both clients and professionals (Gennaioli et al., 2015). In particular, the 'money doctors' model proposed by Gennaioli and colleagues shows that trust in a financial advisor translates into increased market participation by reducing clients' perceived risk aversion. Trust needs not necessarily be well-placed: as shown by empirical evidence, advisors pursue higher commissions and exploit trust by engaging their clients in riskier investments that investors would not have chosen on their own (Mullainathan et al., 2012). However, this behaviour not only generates higher commissions to advisors but also leads to higher expected outcomes and higher participation to clients, especially when they are so risk averse that they would not have entered financial markets on their own.

Recent empirical analysis shows that the 'money doctors' model bears significant empirical implications in times when trust is put most to the test. Dorn and Weber (2017) address how a sample of German investors reacted to the 2008 financial crisis, by distinguishing among fully managed, partially managed and individually managed accounts. Just as predicted in the money doctor model, trust is crucial for some investors to engage in the stock market, but it also carries a disastrous potential for backfiring when challenged. In fact, fully managed accounts are significantly much more likely to sell off all positions (suggesting trust was determinant in deciding to invest in the first place) and not reengage in the stock market after the crisis (showing that trust is difficult to rebuild once lost). In a way, trust in a financial expert is able to induce participation in the stock market, but delegation is vulnerable not only to observable financial results but also to shocks to trust. Provided that advisors act in the best interest of their clients, understanding the determinants of trust in advisors and detecting the types of clients more likely to trust them may contribute to increase market participation throughout alternative strategies based on increased delegation rather than on the mere transferring of skills from advisors to clients. The complementarity between financial education and trust develops its potential precisely in the figure of the financial intermediary – the financial advisor – who should act as a facilitator of information collection and processing as a way to build back trust. In other words, the delivery of information alone cannot effectively reduce the competence gap between the client and the advisor, but can foster a trusting environment where delegation can take place again. Financial intermediaries need to continue being the better informed part in the relationship with clients, but their willingness to disclose, explain and share information (regardless of the effectiveness of these actions) may be a viable avenue to testify of their trustworthiness and re-establish a climate of mutual trust.

The features of the relationship between clients and their advisors should be further investigated. Recent empirical research on a large sample of Italian professional financial advisors has shown that advisors' trustworthiness is linked to a series of non-material factors that characterize the relationship they have with their clients (Cruciani et al., forthcoming). Once the relationship with the client stabilizes over time, professional success and absolute results lose importance compared to relational features (such as the frequency of meetings) and the ability to provide emotional support to the client. Interestingly, the tendency of some advisors to publish short articles on personal websites significantly explains the trust they receive once the relationship is stabilized. This implies that unsolicited and publicly available testimonies of competence and willingness to disclose contribute to promote a climate of trust, where a client knows that potential queries will be addressed professionally, even if he never puts any forward. This evidence supports the idea that trust is a key element in financial market participation and that rebuilding it should be the main goal of financial institutions. In order to preserve the positive effects of trust on financial market participation, an increased focus on information delivery and transparency need not make more impersonal the advisor-client relationship, where individuals are only a passive receivers of the information flow.

By assuming that a complementarity may exist between information and trust, financial intermediaries may find a way to rebuild their perceived professionalism and a positive climate for delegation.

The trust crisis generated by the recent financial turmoil still lingers and scholars and practitioners have an important task ahead of them. The effects of new regulation, such as MiFID II in Europe, on financial market participation should be carefully monitored. Trust encompasses an element of risk, as if the risk of being exploited did not exist, trust would not be necessary in the first place. Reducing the riskiness of delegation to an intermediary is necessary to govern financial advisory markets. However, if implemented simply in the direction of making the client-advisor relationship more impersonal and codified, it may crowd out the very incentive to trust, which for some is even a crucial driver of participation in financial markets.

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