



**Consumer Federation of America**

**Testimony of**

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Consumer Federation of America**

**Before**

**The U.S. Senate  
Subcommittee on Oversight of Government Management, the Federal  
Workforce, and the District of Columbia**

**On**

**The Federal Government's Role in Empowering Americans to Make  
Informed Financial Decisions**

**July 15, 2010**

Chairman Akaka, Ranking Member Voinovich and Members of the Committee:

I am Barbara Roper, director of investor protection for the Consumer Federation of America. CFA is a nonprofit organization that was created in 1968 to advance the consumer interest through research, education and advocacy. For more than three decades, CFA has sought to promote effective financial education to increase financial literacy and improve financial decision-making. Indeed, CFA Executive Director Stephen Brobeck has testified on this topic on a number of occasions over the past decade before this and other congressional committees. In that testimony, he has emphasized both the importance of programs to promote financial literacy and the limits of financial education. He has called for development of a coherent national strategy to promote financial literacy, has credited the Financial Literacy and Education Commission (FLEC) with making progress toward that goal, and has detailed a variety of constraints that have limited its effectiveness. He has described what he views as the key components of effective financial education, and he has outlined one option for a federal financial literacy campaign to promote saving.

My own work at CFA has been primarily in the area of advocacy, working to promote policies that achieve the same goal of encouraging sound financial decision-making but through a different route. If financial literacy is aimed at educating consumers and investors to make sound financial decisions, my work as an investor advocate has tended to focus on ending the industry practices and market flaws that undermine that goal. Too often, these two areas of activity have proceeded independently of each other without adequate consideration for how they naturally interact. In my testimony today, I plan to discuss this interaction between financial education and consumer and investor protection policy in promoting sound financial decisions.

Although I have worked primarily as an advocate, I have also been involved in several research projects at CFA related to investor education which have shaped my views on this question. One project I was involved in consisted of a survey that was designed to explore the disconnect between expert recommendations and actual consumer practices with regard to saving and investing. The survey looked both at what consumers know – about setting up an emergency fund, for example, or saving for retirement – and what they did. Although the survey produced a lot of data, one finding jumped out from all the rest. We found that, across income levels, those who reported having some kind of savings plan, whether developed on their own or with the help of a professional, had dramatically higher savings rates than those without a plan. That finding provided one of the original kernels of research behind CFA's America Saves campaign, which promotes savings among lower and moderate income Americans.

I was also involved in a research project at CFA that looked at investors' mutual fund purchase practices. We began the project with a literature review to determine how experts recommend investors go about making an informed mutual fund purchase. What we found was nearly unanimous agreement about the factors that investors should consider and the information sources they should consult when selecting a mutual fund. Moreover, this message had been conveyed for many years, in every conceivable format, and by a wide variety of sources – regulators, industry groups, and investor advocates and educators, not to mention personal finance newspaper columns, magazines, books, and websites. And, finally, we found that the

information needed to follow those recommendations and make an informed choice was readily available to investors. In short, we appeared to have in place nearly all the characteristics required for an effective financial education campaign. And yet, when we then surveyed investors about their actual mutual fund purchase practices, they didn't remotely resemble those recommended by the experts. In this case, the primary outcome of that project was not a new financial education campaign, but a change in our advocacy positions and priorities to better reflect the reality revealed by that survey.

Based on these and other experiences, I have developed what I think are some common sense lessons regarding financial education and its interaction with consumer protection policy. These include lessons about what financial education can and cannot reasonably be expected to achieve, what it takes to develop an effective financial education campaign, and how what we know about Americans' financial literacy can and should be folded in to the larger policy debate regarding consumer and investor protection. Some of these lessons may seem old hat to those of you with greater experience in the field of financial education. But since it does not appear to me either that these simple lessons have been fully incorporated into our financial education programs or that an awareness of financial literacy constraints has been fully incorporated into our consumer and investor protection policies, perhaps they bear repeating.

**Lesson 1: Financial literacy should be viewed, not as an end in itself, but as a means to an end.** Our goal is not (or should not be) simply to empower consumers to make informed financial decisions. Our goal should be to empower consumers to make *sound* financial decisions. Thus, the measure of a successful financial education campaign should be its ability to produce substantial, positive behavioral change, especially in areas of critical importance to consumers' financial well-being. In measuring financial literacy programs' success, it is important to keep in mind that statistically significant changes in behavior are not necessarily socially significant. For example, increasing desirable behaviors from 20 percent of the population to 25 percent might be statistically significant, but for critically important financial decisions we need to aspire to spreading that behavior to a large majority of the population.

In some relatively rare cases, educating consumers may be an adequate means to achieve that goal. But in all too many cases, our regulatory policies either do not support that end or actively undermine it. To achieve our goal in such cases, we need to think not just about how to educate consumers to make sound decisions, but also about what policy changes are necessary to make consumer education both possible and effective or to produce the desired outcome through other means. An effective federal financial literacy campaign must, therefore, include an assessment on the front end not just of what consumers and investors need to know to make informed decisions about their finances, but also whether existing regulatory policies thwart that goal, and, if so, what regulatory changes are needed to support the desired outcome. As the campaign proceeds, it must also include an assessment of its effectiveness in achieving the goal of promoting socially significant behavior change.

**Lesson 2: For consumers and investors to make informed decisions, they need to get good information.** Consumers and investors can't make sound decisions if they don't get the information they need, at a time when it is useful to them, and in a form they can understand. However, most financial disclosures fail at least one of these three tests of effective disclosure.

Often, consumers receive the relevant information, but obscured in a mass of fine print, or conveyed in overly technical language that makes the information all but impenetrable, or delivered after the purchase (as is typical with mutual fund prospectus delivery). Even point-of-sale disclosures may come too late if the purchase decision has already effectively been made. Thus, for financial literacy efforts to succeed, we need sweeping revisions to our financial disclosures across product and industry lines. This should include testing disclosures with consumers and investors to determine how they can be designed and delivered to most effectively convey the desired information. Without those changes, financial literacy efforts will at best be fighting an uphill battle and will at worst be utterly futile.

**Lesson 3: For financial disclosures to be effective, and to support financial education goals, they need to be designed to motivate consumers to act.** In a system that relies heavily on disclosure to aid consumers to make informed decisions, too little thought has been given to the question of how to design financial disclosures so that they encourage consumers to make sound financial decisions. Or, more accurately, what we know about how to design such disclosures is rarely incorporated into our laws and regulations.

A perfect case in point is mutual fund cost disclosure. For years, financial educators have emphasized the importance of minimizing mutual fund costs. And yet, on CFA's survey regarding mutual fund purchase practices, just under half of respondents didn't even rate mutual fund costs as somewhat important to their purchase decision, and only a small minority rated them as very important. One problem may be the way that cost information is presented, in poorly understood percentages rather than dollar amounts and without adequate context for investors to understand where the fees they are paying fit within a scale from low to high among comparable funds. Conversely, allowing payday loan costs to be presented as dollar amount fees rather than as an annual percentage rate that could be compared to rates charged for other types of loans helps to hide the astronomical charges that are often imposed.

In short, if we want consumers and investors to make cost-conscious decisions, we need to present cost information in a way that is likely to get their attention and motivate them to act. And the same is true for other aspects of sound financial decision-making as well. In redesigning disclosures, we must look not only to ensure that they present the relevant information at the appropriate time and in an accessible format, we must also look to ensure that they present information in a way that is likely to motivate consumers to act on that information.

**Lesson 4: For education campaigns to be effective, they need to be based on messages that will motivate consumers to act.** Financial education campaigns often do a good job of providing people with useful information, but they may not be as effective in motivating people to change their behavior. Studies that look at consumer behavior as well as consumer knowledge, such as the *Financial Capability* study released last December, seem to indicate that, even in areas that have been the subject of significant efforts at financial education, we see frustratingly little evidence of changed behavior. That study found, for example, that altogether too many consumers don't have rainy day funds, don't plan for predictable events such as a child's college education or their own retirement, don't compare products or shop around, aren't knowledgeable about the financial products they own, and engage in numerous questionable or

risky financial practices. These are hardly areas where financial education efforts have been lacking.

While other factors may play a role (as discussed below) of undermining the effectiveness of financial education efforts in these areas, one problem may be that financial education campaigns, like financial disclosures, are designed with too little thought about how to motivate behavior change. As I noted above, the America Saves campaign was built around research that showed that, if you can get people to develop a saving plan, that relatively simple step will dramatically increase their saving level. While there is more to the program than that – including an emphasis on motivational messages, the availability of low-cost savings options, and group or one-on-one savings support – the requirement that participants identify an achievable savings goal and develop a plan to reach that goal is key component of the program. Time and again, we have found that individuals who experience success saving in one area go on to build on that success in other areas. The individual who saves successfully to eliminate credit card debts goes on to create an emergency fund. The individual who successfully saves for a down payment on a house goes on to establish a retirement fund. And, in the process, the opportunity is provided for additional financial education.

This suggests that one way to improve financial education efforts is to focus not just on the information that consumers need, but on what one or two factors are most likely to motivate them to act. In other words, more study on the front end of the factors or messages that are likely to promote the desired behavior (whether increased savings, less reliance on high-cost debt, avoidance of unnecessarily high fees, or some other desirable financial conduct) could significantly improve the outcome of financial education efforts, with or without significant increases in financial knowledge or sophistication.

**Lesson 5: To be effective, financial education must be realistic about what consumers can and will do.** When, as part of CFA's study of mutual fund purchase practices, we looked at the reasons why investors failed to follow the practices recommended by experts, we concluded that one reason was that the expert recommendations were unrealistic. Even if investors were financially sophisticated enough to compare the relative investment strategies, costs, and risks of various mutual funds, conscientiously following the expert advice for researching and comparing mutual funds would consume huge amounts of their time. Far more time than busy people with jobs, and families, and lives were likely to devote to the task. That is, of course, precisely why so many investors choose to invest through a broker, financial planner, or investment adviser. And to turn around and suggest, as the experts do, that investors should carefully review the recommendations they receive from those financial professionals may be sound advice, but it ignores the simple reality that the reason they hired them in the first place was precisely because they either did not want to spend the time or effort, or did not feel capable of, making those assessments.

**Lesson 6: Complexity is the enemy of effective financial education.** One reason it is so difficult to design effective financial education programs is that the decisions we are educating consumers and investors to make can be extraordinarily, and in some cases unnecessarily, complex. For example, a financial education campaign targeted at purchasers of annuities might suggest that, before purchasing an annuity, the consumer ensure that they fully

understand any penalties they might pay for withdrawing money from the account early. The following excerpt from a prospectus for an equity-indexed annuity demonstrates, however, the futility of that advice:

A market value adjustment is applied to withdrawals or surrenders prior to the end of the surrender charge schedule elected ... The market value adjustment equals the contract value withdrawn or surrendered in excess of the free withdrawal amount multiplied by the following:

$$\left[ \frac{1 + i}{1 + j + 0.0050} \right]^{(n/12)} - 1$$

where:

$i$  - is the Treasury Constant Maturity yield as published by the Federal Reserve on the business day prior to the contract date for the maturity matching the duration of the surrender charge period;

$j$  - is the Treasury Constant Maturity yield as published by the Federal Reserve on the business day prior to the date of withdrawal or surrender for the maturity matching the remaining years in the surrender charge period (fractional years rounded up to the next full year);

$n$  - is the number of complete months from the time of withdrawal or surrender to the end of the surrender charge period.

If a Treasury Constant Maturity yield for a particular maturity is not published, the yield will be interpolated between the yields for maturities that are published. If the Treasury Constant Maturity yields are no longer published, we will choose a suitable replacement, subject to any regulatory approvals and provide you with notice accordingly.

A positive market value adjustment will increase the amount withdrawn or surrendered. There is no limit on a positive market value adjustment. A negative market value adjustment will decrease the amount withdrawn or surrendered. A negative market value adjustment will not decrease the amount withdrawn or surrendered by more than the interest or index credit earnings proportionately attributable to the withdrawal or surrender amount.

The market value adjustment is waived on the free withdrawal amount, on death, and on annuitization if annuitization occurs after five contract years. The market value adjustment is not waived on the nursing home and terminal illness waivers.

This is model disclosure language in many ways. It presents the relevant information thoroughly and in relatively straightforward language. And yet, few if any consumers who took the time to read the prospectus would walk away with a clear understanding of the market adjustment penalty they might pay for early withdrawal of their funds, and I doubt you could design a financial education campaign that would enable a significant percentage of consumers to do so. You simply cannot educate consumers to understand concepts that are so complex that they require the knowledge and sophistication of a highly trained financial professional to understand them.

**Lesson 7: You can't educate consumers to understand things that don't make sense.** Complexity is just one of the things that stand in the way of sound financial decision-making. Too often, our regulatory policies themselves are the problem. You cannot, for example, educate investors to understand that a financial advisor is not an investment adviser, but a financial planner is. Or that a financial advisor is not required to act in their best interest while an investment adviser is. But that is currently the case. Fortunately, the financial regulatory reform legislation pending before the Senate as this testimony is being drafted would fix at least part of that problem, by authorizing the SEC to adopt rules imposing a fiduciary duty on brokers when they give investment advice.

But the legislation solves only part of the problem. Assuming it passes, as we hope it will, and the SEC proceeds with rulemaking, the fiduciary duty for brokers will still apply only to advice about securities. Advice about insurance products will be exempt. And, in one regard, the legislation actually makes the problem worse, by exempting equity-indexed annuities from regulation as securities, and regulating them exclusively under state insurance laws. So equity-indexed annuities, which sound like securities and are sold as investments, won't be subject to a fiduciary duty (or other investor protections such as limits on excessive commissions). But a whole host of other products that compete with equity-indexed annuities, including mutual funds and variable annuities, will be regulated as securities and thus subject to these enhanced investor protections. How on earth are you supposed to design a financial education campaign to explain that? For financial education efforts to be successful, our regulations must make sense.

**Lesson 8: Consumer and investor protection policies must be based on a realistic understanding of consumer and investor financial literacy as well as consumer and investor behavior.** Too often, our consumer and investor protection laws are based on an ideal or theory rather than reality. For example, a basic underpinning of securities regulation is that, if you give investors adequate information, they can make informed decisions and thus protect their own interests. In some cases, however, it is simply not realistic to expect that investors will be able to make informed choices about products, such as the equity-indexed annuity cited above, whose complexity defies comprehension. Similarly, our experience suggests that it is unrealistic to expect that you can educate consumers and investors into adopting certain appropriate practices – such as carefully comparing the costs, risks, and investment strategies of different mutual funds and double-checking the recommendations they get from investment professionals – however strongly we believe that would be in their best interests. While securities laws reflect these limitations to a degree (with the suitability obligation it imposes on securities sales, for example), more thought needs to be given to the gap between theory and reality in the assumptions that underlie our financial regulations.

When CFA concluded its study of mutual fund purchase practices, we conducted just such an assessment. As a result, we adopted two changes in long-held policy positions. For years, we had opposed sale of mutual funds from an abbreviated disclosure document, arguing that it encouraged uninformed decision-making. The results of our research, however, helped to convince us that it would be misguided to continue to insist on delivery of a long-form prospectus that a large majority of investors refused to read. We felt it would be more beneficial to focus our efforts on ensuring that any abbreviated disclosure document relied on was effective in conveying the most important information mutual fund investors need to make a sound purchase decision.

Second, having warned for years that investors should carefully assess the recommendations they receive from investment professionals, we recognized that this was advice that relatively few investors were likely to heed. The implication, in our view, was that regulatory policies to protect investors from those they rely on for recommendations needed to be strengthened in several ways: 1) they need to get better information up-front to make a more informed decision of who to rely on; 2) the standard of conduct for brokers offering advice needs to be raised; and 3) regulations restricting conflicts of interest that encourage those who sell investment products to recommend products that are not in the clients' best interest need to be strengthened. While these had always been priorities for CFA, our research conveyed a renewed sense of urgency to those efforts. Moreover, we concluded that, if the vast majority of investors will rely on others for recommendations of investments, educating investors to make an informed choice of who to rely on for recommendations was a higher priority than trying to educate them about how to select appropriate investment products. Unfortunately, this is an area where, so far at least, both disclosure requirements and investment education efforts are sorely lacking.

**Lesson 9: One way to reduce complexity, and improve financial education in the process, is to adopt consistent policies across industry and product lines.** It would be far easier to design effective financial education campaigns if one didn't have to adopt a different approach and a different set of messages for each industry and each product line. Regulatory policy that applies common principles across industries and product lines would simplify that process considerably. If, for example, all financial advice – whether about mortgages, or insurance, or securities – were subject to a fiduciary duty to act in the best interest of the customer, it would be far easier to educate around that policy. The same could be said if all financial product sales outside an advisory relationship were subject to a suitability obligation. And a huge financial education benefit would be gained from providing some degree of uniformity in the way we approach the timing, content and format of financial disclosures both for service providers and for products that are sold for essentially the same financial purposes. While there are limits to that approach, this is an area that deserves far greater attention than it has received to date.

## **Conclusion**

If our goal is to help consumers and investors make sound financial decisions, the first responsibility of the federal government is to ensure that the financial marketplace supports that goal. Are good choices available? Do consumers, for example, have access to reasonably priced

short-term loans from reputable lenders so they won't be dependent on payday lenders charging exorbitant fees? Even where good choices are available, is the market overwhelmed by bad choices? Do the incentives in the system encourage the intermediaries that consumers and investors rely on for financial products and services to act for or against their customers' interests? Are the disclosures consumers and investors rely on presented in a way and at a point in the process that encourages informed decision-making? Until you resolve those public policy questions, financial literacy efforts will be swimming against too strong a current to be effective. Only when the regulatory policies themselves support sound financial decision-making can financial education be truly effective in promoting that goal.