Financial Literacy: Millennials Are a Wake-up Call to Build a Strong Foundation

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Highlights

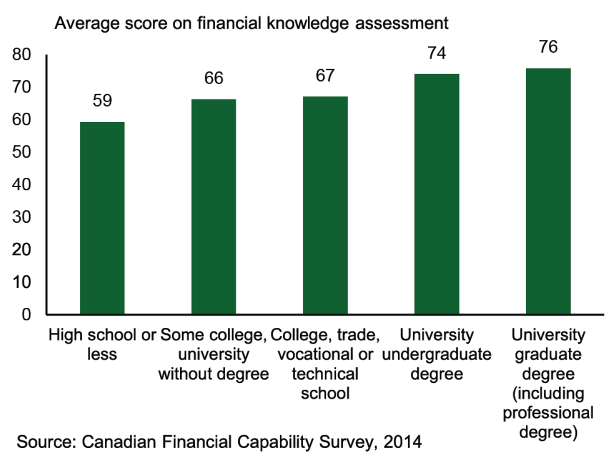
- The need for strong financial literacy skills has never been higher. With record-low interest rates, household debt levels have grown faster than income, taking household leverage ratios to record highs. This debt accumulation has been positive, allowing for an expansion in homeownership for young and old alike, but it also has raised the vulnerability to changes in financial conditions.
- Nowhere is the need more pressing than among millennials. Even before leaving secondary school, young people have bank accounts, debit cards and smart phones that give them access to financial products with the mere touch of a button. Despite higher levels of educational attainment, most young people do not know how much they need to save for retirement.
- Higher levels of post-secondary participation are not sufficient to ensure that young people have the financial capability necessary to navigate the brave new financial world. Building a foundation in financial literacy must begin even before adulthood. Skills learned at an early age should be reinforced so that by the time major financial decisions must be made, young people are ready for them.
- In order to prepare young people for financial decisions throughout their lives, financial education should be incorporated in the K-12 curriculum in elementary grades and competencies built up year after year, as they are with basic numeracy and literacy. In later grades, these can be expanded upon with applied courses that cover more specific financial and economic concepts..

Millennials (loosely defined as those born between 1981 and 2000) are the most educated generation in Canada. Levels of post-secondary enrollment are higher than any group that came before them.

The trend in educational attainment is certainly positive, but not sufficient to ensure that young people have the financial literacy skills they require. Research shows a link between educational attainment and financial capability (Chart 1), yet this well educated generation self-report and test lower on measures of financial literacy than older Canadians. By financial literacy, we take the definition of the Financial Consumer Agency of Canada (FCAC) to represent the knowledge, skills, and confidence to make responsible financial decisions.[1]

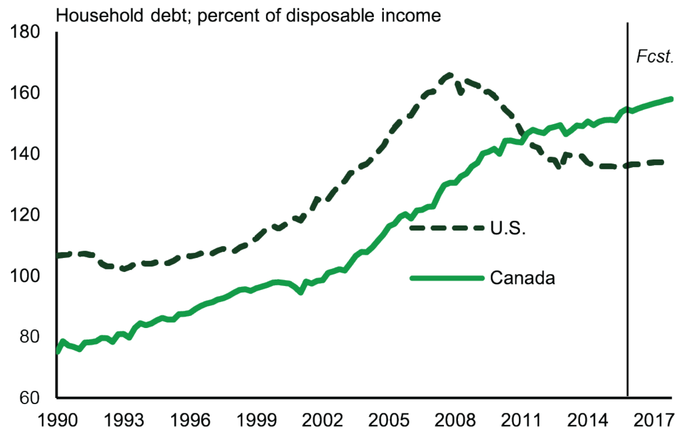
The call for improved financial literacy is not new, but its urgency has increased. The current economic environment of low interest rates has incented a rise in debt among all age groups (Chart 2, next

CHART 1: FINANCIAL KNOWLEDGE IS CORRELATED WITH EDUCATION LEVEL



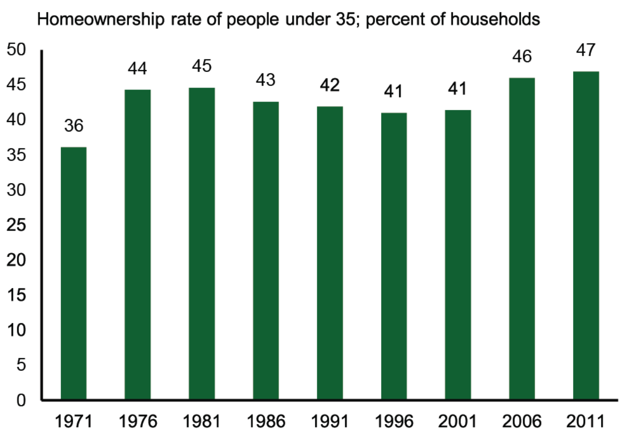
Source: Canadian Financial Capability Survey, 2014

CHART 2: CANADIAN HOUSEHOLD DEBT LEVELS HAVE NEVER BEEN HIGHER



Source: Statistics Canada, Federal Reserve, Bureau of Labor Statistics

CHART 3: MILLENNIALS ARE MORE LIKELY THAN THEIR PARENTS TO OWN THEIR HOME



Source: Statistics Canada

page). The Bank of Canada, along with international bodies like the International Monetary Fund, have expressed concern over Canada's growing debt burden, calling on households to exercise caution.

Millennials are carrying debt levels well in excess of those who went before them. Greater student debt levels are partly the source, but so too is a larger appetite to take on a mortgage earlier in life. Homeownership rates among people under the age of 35 are higher than their parents' generation (Chart 3). Young people also have more accessible tools to make financial decisions at an earlier age than their parents. Even before leaving secondary school, many have bank accounts, debit cards, and smart phones that provide access to their cash with the mere touch of a button or the flash of a screen. Ask a millennial when was the last time they spoke with a bank teller, and you may find the answer to be: "what is a teller"?

By its very nature, the greater degree of household leverage in combination with a persistently low interest rate environment requires developing sophisticated knowledge on retirement saving, which is at risk of being edged out by debt payments for mortgages and higher education. This is the flip side of the coin. Many Canadians have not saved enough for retirement and there is little reason to believe millennials will be any better at it, or face fewer challenges. Low interest rates are a symptom of slower trend economic growth, in which rates of return are likely to remain lower than they have been historically. This means that old rules of thumb in terms of how much to save and borrow are less relevant and financial knowledge and skills must be continually upgraded.

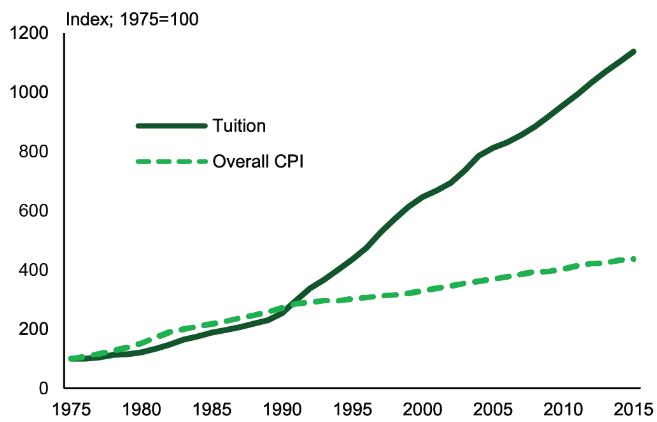
The mere presence of a university degree is not a catch-all safeguard. Even within the university educated population, there exists a dispersion of results in financial capability that may be perpetuating cycles of low-income

households. Younger individuals benefit from parents with strong financial literacy skills, but what about those who don't have mentors with that knowledge? And, what happens to those who do not pursue higher education? Learning-by-doing can be a risky proposition, where missteps can have long lasting effects on a household. The rise in educational attainment will likely serve to accentuate gaps in financial literacy skills within the population for those who follow a different path.

This impresses the need for a level playing field among Canadians in developing foundational skills in financial literacy earlier in the educational system and consistently across the population. Closing knowledge gaps at an earlier age can help to ensure that the financial system serves the needs of all Canadians. Creating a strong foundation is then followed by lifelong learning, with supports at key points when major financial decisions take place.

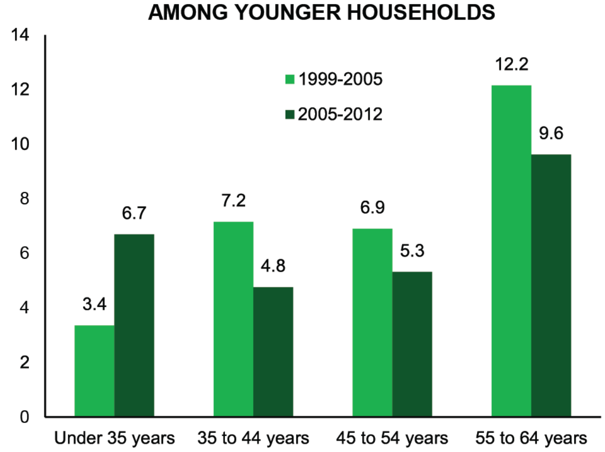
In order to prepare young people for these lifelong financial decisions, the educational system should put an emphasis on building a strong and consistent foundation in financial literacy within the K-to-12 curriculum. Financial education should be incorporated in elementary grades and competencies built up year after year, as they are with basic numeracy and literacy. In later grades, these can be expanded upon with applied courses that cover budgeting

CHART 4: TUITION PRICES HAVE GROWN TWICE AS FAST AS OVERALL INFLATION



Source: Statistics Canada

CHART 5: DEBT GROWTH HAS ACCELERATED AMONG YOUNGER HOUSEHOLDS



Source: Survey of Financial Security

and more specific financial and economic concepts. Just as important, these should be accompanied by regular assessments in order to measure how financial literacy is progressing among young people. Finally and critically, investments must be made in developing the financial capability of teachers, ensuring that they have the confidence and training to build these skills equally across a country of young learners.

The importance of influencing behaviour earlier in life

A number of the most important decisions individuals make over the course of their lives will involve their finances. The requirement for individuals to make responsible financial decisions begins before adulthood. Well before exiting high school, young people are confronted with the decision of whether to attend college or university and how to finance it. Even with recent legislation in Ontario to provide free post-secondary education to lower income families, there are other expenses to be considered, including, textbooks, commuting, living expenses and the opportunity cost of being out of the labour market.

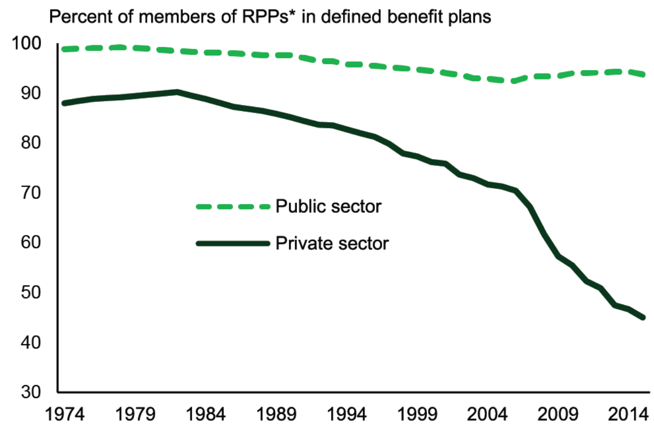
A post-secondary education contributes to greater job prospects and higher income growth later in life, but the burden of financing it has increasingly shifted onto individuals. Tuition costs have risen at more than double the rate of overall inflation over the past 20 years (Chart 4). As a result, there has been a steady increase in the share of young people taking on student debt, as well as in the average level of debt per student. The most vulnerable among these are young people who have taken on student debt, but not completed their post-secondary degrees, leaving them with the burden of debt repayment without the promise of a better job and income prospects. This highlights the importance of good financial management skills at an earlier age.

In addition to student loans, millennials are increasingly taking on other forms of debt, including mortgages and lines of credit. Debt levels among people under 35 years old have grown at an annual average rate of 6.7% since 2005 (Chart 5). The only age group to see faster debt growth were people over the age of 55. In both cases the increase in debt was faster than the rate of income growth. While low interest rates have made debt cheaper to carry, the rise in debt levels relative to income increases the vulnerability of individuals to the prospect of higher interest rates.

The need for strong financial literacy is just as pressing with respect to saving decisions. In earlier generations, the need to make choices around how much to save and where to place those savings was mitigated by the wide availability of employer-provided defined benefit pension programs. This is less and less true today. From a peak of 94% in the early 1980s, the share of registered retirement plan members that were enrolled in defined benefit plans has fallen to just 70% (Chart 6, next page). Within the private sector, where most young people will find jobs, the ratio has been cut in half from 90% to just 45%. The long-term decline in defined benefit plans has put more of the responsibility for managing savings and investments onto individuals.

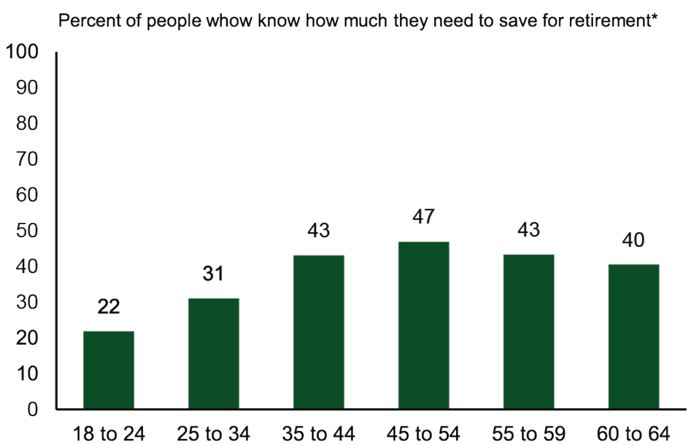
The federal government's registered retirement saving (RRSP) program provides a strong incentive for people of

CHART 6: DEFINED BENEFIT PENSION PLANS NO LONGER THE DEFAULT



*Registered pension plans. Source: Statistics Canada.

CHART 7: MOST PEOPLE DON'T KNOW HOW MUCH THEY NEED TO SAVE FOR RETIREMENT



*Percent that answered yes to the question "do you have a good idea of how much money you will need to save to maintain your desired standard of living when you retire." Source: Canadian Financial Capability Survey, 2014

all ages to increase their saving and defer taxes by contributing to RRSPs. But, over the past 15 years, contributions to the programs have fallen as a share of tax filers from 30% in 2000 to just 23% in 2014. For people in their prime saving years – 25 to 45 year olds – the share of tax filers that contribute to RRSPs has fallen from close to 40% to 30%. This trend is particularly worrying for young people, given the reality of slower economic growth and lower rates of return that will require higher savings in order to achieve the same living standards as previous generations.

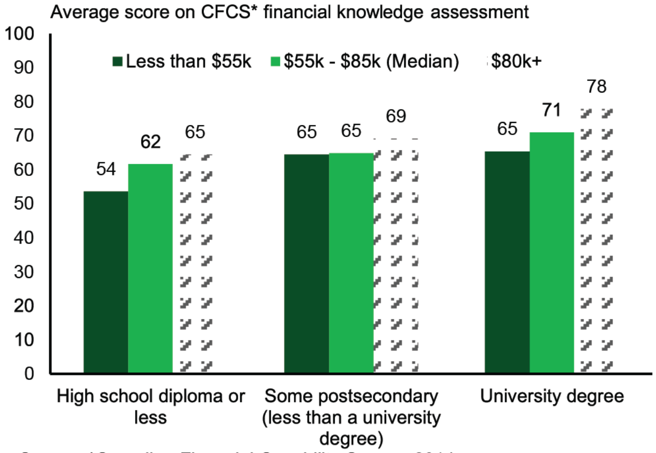
The Federal Government's recent expansion of the Canadian Pension Plan will go some of the way in addressing this vulnerability, but don't count on it to save the day, particularly among those with weaker foundations in financial capability. In fact, the enhanced CPP may lend a false sense of security to some individuals and incent behavioural changes that mitigate some of the benefit on retirement savings. A recent Statistics Canada study suggests that while the changes to CPP are likely to increase overall savings, this change occurs at the partial expense of private saving instruments, with private savings declining by about 50 cents for every dollar increase in CPP contributions.[2] A back-of-the-envelope calculation suggests that by 2025, the CPP changes will result in reduced private savings of around $5 billion to $5.5 billion per year (about 2% of overall household savings) relative to a 'business as usual' scenario. Although there is considerable uncertainty around these estimates, the broad point is that in the absence of a solid foundation for understanding and assessing one's financial needs, it's possible that thirty years down the road, we will find ourselves little better off than today. And, it's also possible that employers will shrink their workplace pensions over the range where CPP is expanded, requiring individuals to remain just as adept as ever towards saving for retirement.

A significant minority of Canadians lack adequate financial literacy

Although most Canadians appear to be managing their finances responsibly, a significant minority are being held back from achieving their economic potential. Financial decision-making requires a highly specified knowledge set that covers economic and financial concepts as well as behaviors and attitudes toward borrowing, saving, and investing. Financial literacy assessments typically rely on a few different methods: 1) asking questions about specific financial behaviors (such as keeping a budget or paying off credit cards on a monthly basis), 2) asking for subjective self-assessments of financial capability, and 3) asking objective questions about specific financial concepts or problems.

Recent surveys of financial capability suggest that young Canadians have room for improvement across both subjective and objective measures. Some might draw comfort that Canada performed well in the OECD's recent international assessment of adult financial literacy – tied for third with Norway out of 31 countries that took the survey. But, gaps were evident across categories, marked by a wide dispersion in financial capability. Canada's scores were highest for behavior and attitude, while somewhat lower for financial knowledge. Roughly 60% of Canadian survey respondents

CHART 8: FINANCIAL KNOWLEDGE IS CORRELATED WITH INCOME



Source: *Canadian Financial Capability Survey, 2014

achieved what the OECD considered a minimum acceptable threshold of 70% or better on the financial knowledge section. This was below the OECD average of 62%.

This echoes the results of Canadian financial literacy assessments. The most recent Financial Capability Survey conducted by Statistics Canada in 2014 indicated that a full one-third of all Canadians were not preparing for retirement at all, either through an employer-provided plan or on their own. Furthermore, nearly 60% of Canadians did not know how much they need to save in order to maintain their standing of living in retirement (Chart 7). People's own evaluation of their level of financial literacy also indicates room for improvement, with more than 60% of adult Canadians rating their knowledge as "fair" or "poor."

The OECD's key recommendation to all policymakers was that better outcomes across countries can be best accomplished through greater investments in school-age financial education.[4] The importance of this cannot be dismissed. Studies show that young Canadians are more likely to be behind in paying their bills, less likely to have a budget, and less likely to be financially preparing for retirement than older Canadians. Among Canadians aged 18 to 24, close to 80% said they did not know how much they needed to save for retirement.

Counting on greater levels of post-secondary education to fill the gap may also not be sufficient. Even among university graduates, levels of financial knowledge remain lower for individuals at lower income levels (Chart 8). This is disconcerting because if the emphasis on teaching financial literacy skills remains skewed to life experiences or knowledge transfer from the old to young, the cycle will not be broken by maintaining the status quo. This places even more onus on the primary education system to improve foundational skills and, importantly, influence behaviors earlier in life.

Lessons from other countries

While we know something of the financial literacy skills of adult Canadians, we know less about the skills of school-age children. Canada did not participate in the OECD's inaugural financial literacy assessment of 15 year olds conducted in 2012 as part of its Programme for International Student Assessment (PISA).[4] Several provinces participated in the 2015 assessment, but these results will not be available until 2017.

Still, the results of the 2012 assessment across countries similar to Canada provide some important lessons. Test scores show a high correlation between basic literacy and numeracy and financial literacy. They also show a correlation between financial literacy and socio-economic status, with students from lower-income and immigrant backgrounds scoring lower on average than higher income and native-born students.

More encouragingly, the OECD study appears to show that there are things that countries can do to raise the level of financial literacy of young people. Students in Belgium, New Zealand, and Australia perform better in financial literacy than students in other countries with similar performance in mathematics and reading. These countries embed financial literacy education into the primary curriculum from an early age and offer support to teachers to improve their own financial capability. This suggests that the school system is equipping them with additional skills unique to financial literacy. As more assessments are completed, countries can be tracked over time and best practices identified.

Even without these assessments, we can look to the evidence for basic literacy and numeracy for some lessons. One of the clearest lessons is that top performing countries in terms of literacy and numeracy invest more in teacher training and skills. This is particularly important with respect to financial literacy where surveys consistently show that teachers' comfort and confidence with financial literacy concepts are generally lacking. A recent survey of educators in Canada conducted for TD Bank Group by the Canadian Foundation for Economic Education (CFEE) found that most teachers lack sufficient confidence in teaching financial education.[5] The top recommendation of that report was to invest in teacher's professional development.

A second lesson is that focusing resources on lower performing schools and students have shown positive results in closing gaps between high and low performers and limiting the impact of socio-economic status on literacy results. Canada is identified as a country that has had considerable success in this regard.

Finally, and perhaps most relevant, assessments that test both young people and adults show that stronger literacy and numeracy results in younger people are correlated with stronger results in adults. This is a particularly important point. If financial literacy skills among the most educated generation of people remains insufficient, then why would we presume their children will demonstrate stronger results? This is a strong argument for ensuring the primary educational system is providing all Canadians an equal learning platform on financial literacy.

Conclusion: Lifelong financial learning must begin early

Financial literacy, like literacy more broadly, is a foundational lifelong skill. The goal of improving financial literacy is giving individuals the knowledge, skills and information to avoid mistakes and pitfalls in financial decision-making.

There are three primary paths through which financial literacy skills may be attained: formal education, learningby-doing, and education by parents or mentors. Parents play an important role in passing on financial knowledge and behaviors to children, but given gaps in financial capability among adult Canadians, the school system is critically important to providing foundational skills to help close societal gaps. Young people born to parents that have weak foundational knowledge may be immediately disadvantaged, which can lead to errors in learning-by-doing that can compound through life. This places the impetus on formal education to level the playing field.

While financial education is nominally included in provincial curriculum, it is by no means universal. As noted in the TD Bank/CFEE report: "Currently financial education is inconsistent and sporadic in terms of its inclusion in provincial curriculum. Some components of financial education are integrated into a variety of courses in different subject areas at a range of grade levels. There is no commonality in terms of the financial education a student will receive in Canada."

Moreover, at present, financial education efforts are mainly at the high school level, with much less emphasis at early grade levels. This is a missed opportunity. The complementarity between financial literacy and basic literacy and numeracy is well established. Just as literacy and numeracy skills are built up year after year, financial literacy competencies can and should be too.

Indeed, at an early age, educators have the ability to develop positive financial behaviours, rather than leave it to individuals to try to modify them after the fact. This goes hand in hand with other interventions the federal government has made to improve financial outcomes, including recent changes to mortgage insurance rules and CPP enhancement. This is analogous to the government giving Canadians a fish, rather than putting the focus on teaching them to fish. With greater personal financial empowerment, the need for repeated and drastic government interventions may be lessened. Knowledge is one part of this, but just as important is building up young people's confidence around financial concepts. This should further convince young people of the benefits of financial capability and motivate them to continue learning throughout their adult lives.

While provincial/territorial governments are responsible for delivering education, the goal of more in-depth knowledge and regional consistency in financial literacy is a national imperative. Among educators surveyed by the TD Bank/CFEE study, there is a strong desire for collaboration across provinces in developing a national financial education program. Simultaneous with this, investments must be made in teacher development, insuring instructors have the confidence and knowledge they need to instill it in their students.

Endnotes

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