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RETIREMENT SAVINGS AND FINANCIAL LITERACY

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Abstract

Saving for retirement is among the complex decisions that a household encounters inlifetime. The importance of planning and saving for old age is so essential that the government of various nations across the globe have introduced special employee financial planning programmes, social security benefits and have also provided various tax benefits for encouragingretirement savings. All of this is putting a great pressure on economic conditions of a country. Despite the measures undertaken, individuals have failed to save enough for their retirement. Since changes in economic conditions affect everyone in an economy. However individuals get affected differently depending upon the level of planning undertaken and the resources that have been earmarked for uncertain times. As government is bringing the onus of retirement planning to individuals by shifting from defined benefit to defined contribution plan of savings for retirement, the need for planning for the old age has intensified. The article throws light on how individuals get affected by factors which apparently are not related to savings decision. The article also documents how the retirement savings decision is affected by financial knowledge and identifies gaps for future research. The findings from this paper shall have implications for policy makers, financial institutions such as pension agencies, employers, and personal financial consultants for developing various mechanisms that will help in saving for old age.

Keywords: *Retirement Planning, Financial literacy*

Introduction

When individuals leave work force as they retire, they no longer receive generous income from their employers. The employers provide pension which is not adequate enough and needs to be supplemented by state pension or accumulated savings. The landscape of pension across the globe has changed and many countries are now moving from defined benefit plan to defined contribution plan for the obvious reasons of pressure on the exchequer of a country. As a result many individuals are at the risk of not having adequate resources left for their old age. At present individuals are faced with a lot of options for saving for their old age, but at the same time it has put tremendous pressure on individuals to plan for their retirement themselves. Therefore there is a pressing need to understand the factors affecting retirement savings behaviour which may help individuals to plan financially for the retirement and save adequately so that they may not run short of the resources in their old age.

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Saving for retirement

The rising pressure of demographic changes coupled with low performance of financial markets during times of crisis has casted doubts on pension system in various developed countries (Bodie&Prast, 2012). As a result many countries have decided to put reins on providing very lavish pension and social security.Therefore saving decision of an individual is now of utmost importance. Further the retirement age in various nations has been increased, forcing people to work more and delay their reliance on social security.

As people move towards retirement, they usually understand how important it is to plan financially for their old age and what are the consequences of not having planned for the retirement.Hershey et al. (2010) studied people from America and the Netherlands in their working age which ranged from 25 to 64 years. It was found that across the cultures, age turns out to be significant factor for explaining the financial planning for retirement. Clark et al. (2009) also found age to be an important factor in determining whether an individual has planned for his retirement.

Traditional economic analysis such as life-cycle Hypothesis suggests that an individual over the course of his lifespan will smooth the marginal utility of his consumption (Modigliani &Brumberg, 1954). The rationale behind saving is to amass wealth so as to fund the future consumption, more specifically during retirement period. It is therefore expected that people will save during their working period in life (Modigliani 1986). As per life-cycle hypothesis postulated by Ando and Modigliani(2005), in order to decide how much to save and what variety of assets to hold, individuals fine-tune such decisions in a way so that the marginal utility of consumption is maintained over the course of life(Browning &Crossley, 2001).

Studies on precautionary savings reveal that given the increased uncertainty of savings, the precautionary savings increase. In order to overcome the future uncertainty against unanticipated events people build up stock of wealth which acts as buffer (Carroll & Kimball, 2008; Hubbard et al., 1996). Retirement can be seen as such event in one's life where an individual experiences decline in income and an unpredictable health. Individuals therefore build up buffer of wealth to avoid the state of income decline in future and thus insure against variance of income (Lusardi, 1997).

As assumed by the economic theories, utility is the function of both current and future consumption of a person,individuals therefore try to increase their utility over the course of life, subject to the resource constraint (Modigliani &Brumberg, 1954). People, subject to the resource available, distribute time and other resources to variety of activities in life so that their utility is maximised (Becker, 1965). For maximising the utility individuals have been observed to work towards improving their financial health(Gerrans et al., 2014) and greater well-being has been reported bythe people who have planned for their retirement (Noone et al., 2009). Individuals who enter into retirement without having properly planned for the old age, generally report lower level of well-being (Schellenberg et al., 2005). Individuals in real world, however,do not appear to conformtothe expectations made by traditional economic models.

Figuring out how much to save for the retirement is often considered to be a difficult task. People in the circumstances, which involve complex cognitive process usually get overwhelmed and avoid taking such decisions (Iyengar et al., 2004). This makes people not to engage themselves in taking such decisions and behave passively (Choi et al., 2002). Also people who fall into the trap ofpresent-bias generally make short-sighted investments which are not financially optimal since such people tend to value earlier payoffs as against later payoffs which are more profitable (Hasting & Mitchell, 2011). Around one out of two persons in the United States are not sure whether they have a comfortable living in the retirement phase of their life (Helman et al., 2010).

The qualitative research reveals that an individual finds the decision making process to be very confusing and complex in context of choosing a pension product (Harrison et al., 2006). According to the study, the authors find people are either partially informed or do not behave rationally when making a decision pertaining to pension. It has been observed that higher cognitive skills help in facilitating financial success by affecting the choices and preferences made by a person (Burks et al., 2009).Yet with the limited knowledge of how pension products work and the increasing number of pension products floated in financial markets, the task of choosing optimal pension solution becomes more demanding. An individual being a utility maximiser will try to choose a pension product that will maximise the total benefits to be reaped by it. Also in line with the decision theory, an individual assigns value to the options and is supposed to choose from various alternatives in a manner that will maximize the value of choice that is being made. However, choice can be very confusingwhich can derail the entire process of retirement savings behaviour. The choice brings conflicting situation to an individual that may prompt him to search for latest alternatives or make default option or defer the entire decision (Tversky&Shafir, 1992). The study conducted byIyengar et al. (2004) by examining around 800000 employees, found that when a worker is offered with a variety of options in saving plans pertaining to the pension, the participation in such plans drop. However, when offered fewer standard options in pension plans, the participation rate of employees turns significantly higher.Curbing the number of various variants of pension plans to few standard ones may help in increasing the number of participation in retirement savings.On the other hand, such practice may act as an obstacle to the individuals who have diverse preference and different risk appetite compared to the available default savings plan. By opting default plans people have lesser incentive to acquire financial knowledge and information of various alternatives available in the financial markets. This may lead people to save for their retirement in a sub-optimal way. Therefore, more focus needs to be given by policy makers on how to make people more knowledgeable on financial matters pertaining to the retirement.

Financial Literacy

There has been an increase in financial literacy programs in recent years in order to address the challenges posed in understanding the dynamic nature of financial products and services by common people. Hasting and Mitchell (2011) found that people who are financially illiterate i.e. not understanding basic economic concepts and not able to carry out compound interest and investment return related calculations, have lesser retirement savings. There is a strong correlation between retirement planningand financial literacy and also having planned for the retirement results in greater wealth accumulation for the post retirement period even after many socio-demographic variables are controlled (Lusardi& Mitchell, 2007). Research conducted in Germany by Bucher-Koenen and Lusardi (2011) found a positive association between financial planning and financial literacy, it was found that households who have planned for the retirement were significantly literate in financial matters in comparison to others. Lusardi and Mitchell (2009) explored various aspects of financial literacy which were not studied earlier. They established financial literacy to be a key factor in determining the magnitude of retirement planning undertaken. The authors also found that exposure to economics curriculum in school or any such program sponsored byemployers to be associated with higher financial literacy.

In contrast with earlier findings, research conducted by Almenberg and Save-Soderberg (2011) in Sweden and Crossan et al. (2011) in New Zealand find no relationship between retirement planning and financial literacy.Recent study by KalmiandRuuskanen (2018) in Finland also find little evidence to support the relationship between financial literacy and retirement planning.However the relationship turns significantly positive when the construct of financial literacy is extended to include specialised questions pertaining to investments.

While there is mixed response on the relationship between financial knowledge and financial retirement planning, yet governments across the globe try hard to impart such education. So far the literature on efficacy of financial education programs is concerned, it has been found that the programs designed to make individuals take optimal financial decisions yieldlimited results. Bruhn et al. (2014) examined financial literacy program which was conducted on a large-scale in Mexico City. It was noted that the training increased the financial knowledge, however, no lasting impact on financial behaviour was seen. Bruhn et al. (2016) conducted research examining the impact of financial curriculum on high school going students in Brazil. They found the curriculum increased the financial proficiency, improved savings and budgeting among the students and also it had spill-over effect on the financial knowledge of parents. Simultaneously the students also resorted to the increased use of costly financial products thereby showing mixed results of the curriculum on financial behaviour.Recent research conducted by Baruaet et al. (2018) on students in Singapore using quasi-experimental setting found that the financial education improves financial knowledge and planning among the students even after controlling the factor of motivation of getting enrolled in the financial educational course. However, they found that financial education is not significant enough for changing financial behaviour.

Despite not yielding positive results in individuals belonging to lower age group, financial knowledge affects various factors which may ultimately affect the retirement savings behaviour. Though the number of years spent in college education and the experience gained in business does not influence the confidence for making investment decisions, yet the exposure to finance and economics curriculum influences the confidence pertaining to investment decisions (Estes &Hosseini, 1988).It has been observed that financial literacy strongly affects how much sensitive the individual are in framing the investment information (Hasting & Mitchell 2011). Graham et al. (2002) contend that the information processing and susceptibility to lower levels of confidence in relation to investment decision varies across gender. In an experiment conducted by Estes and Hosseini (1988) on 1395 subjects, it was found that gender appears to be a significant factor in influencing the confidence while making the decision related to investments. They found women exhibit lower confidence in making investment decision when compared with men. Such results could be attributed to the fact that women possess lower level of financial knowledge,thus increasing the relevance of imparting adequate financial knowledge to women.

Impartinga general financial knowledge seems not to yield the desired results. The programs of financial literacy needs to designed in a way that will target a specific behavioural issue. Individuals fail to prepare financially for the retirement as they do not possess domain-specific knowledge (Mitchell & Moore, 1998). Lack of such knowledge has also been implicated in the difficulty faced by Australian superannuation fund members in deciding whether to choose a defined benefit plan or defined contribution plan (Clark-Murphy &Gerrans, 2001). Consistent with the previous research which showed employees possess limited knowledge of pension provisions (Benartzi&Thaler, 2002), the study conducted by Byrne (2007) finds individuals do not have requisite knowledge of pension products available in defined contribution system. In a research conducted on 633 Italian university students, it was found that financial literacy turns insignificant when an individual's pension knowledge is accounted for, suggesting that possessing specific knowledge of pension system operating in a country can be effective in deciding for investment in pension products (Doriana& Paola, 2019).

Improving financial literacy among adults is bit challenging, given the time constraint they do not attend school as compared to younger individuals and there is also lack of interest among older people in general financial literacy programs (Parrish &Servon, 2006). Therefore, financial knowledgewhich is being currently imparted ought to be seen with some level of scepticism and more research needs to be carried out in this regard. It needs to be figured out which method of imparting financial knowledge has highest efficacy in mending the behaviour of people. Researchers should also study effects of financial literacy on behavioural factors of individuals which may explain retirement savings behaviour in a better way. The policy makers need to design financial knowledge programs very domain-specific so that such endeavour may yield better result by targeting specific financial behaviour such as pension planning.

CONCLUSION

The shift to defined contribution pension plans in the world has brought increased responsibility on the individuals to make decisions for their retirement savings. The decrease in consumption after retirement suggests that individuals do not save adequately for their retirement. Individuals on the one hand fail to plan for retirement and on the other hand even if they plan, they find it difficult to implement such plan. It has been observed that, individuals do usually think about their financial position in retirement (Lusardi& Mitchell, 2007), however even if they plan, they are less willing to modify their plans or adjust their savings (Thaler&Benartzi, 2004). In order to sensitize individuals for saving for retirement, policy makers and market players in pension industry across the globe should take psychological and behavioural factors into consideration while bringing any reform or floating new pension products and should also impart domain-specific knowledge to people in the context of retirement. The behavioural factors affecting retirement savings has recently been investigated by the researchers. The task ahead is how well such factors are integrated by policy makers into retirement savings model to improve the savings behaviour. Moreover, most of the research has been conducted in developed nations; very few studies have been undertaken in emerging economies. So there exist enough research gaps to find whether there is consistency in retirement savings behaviour around the world.

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