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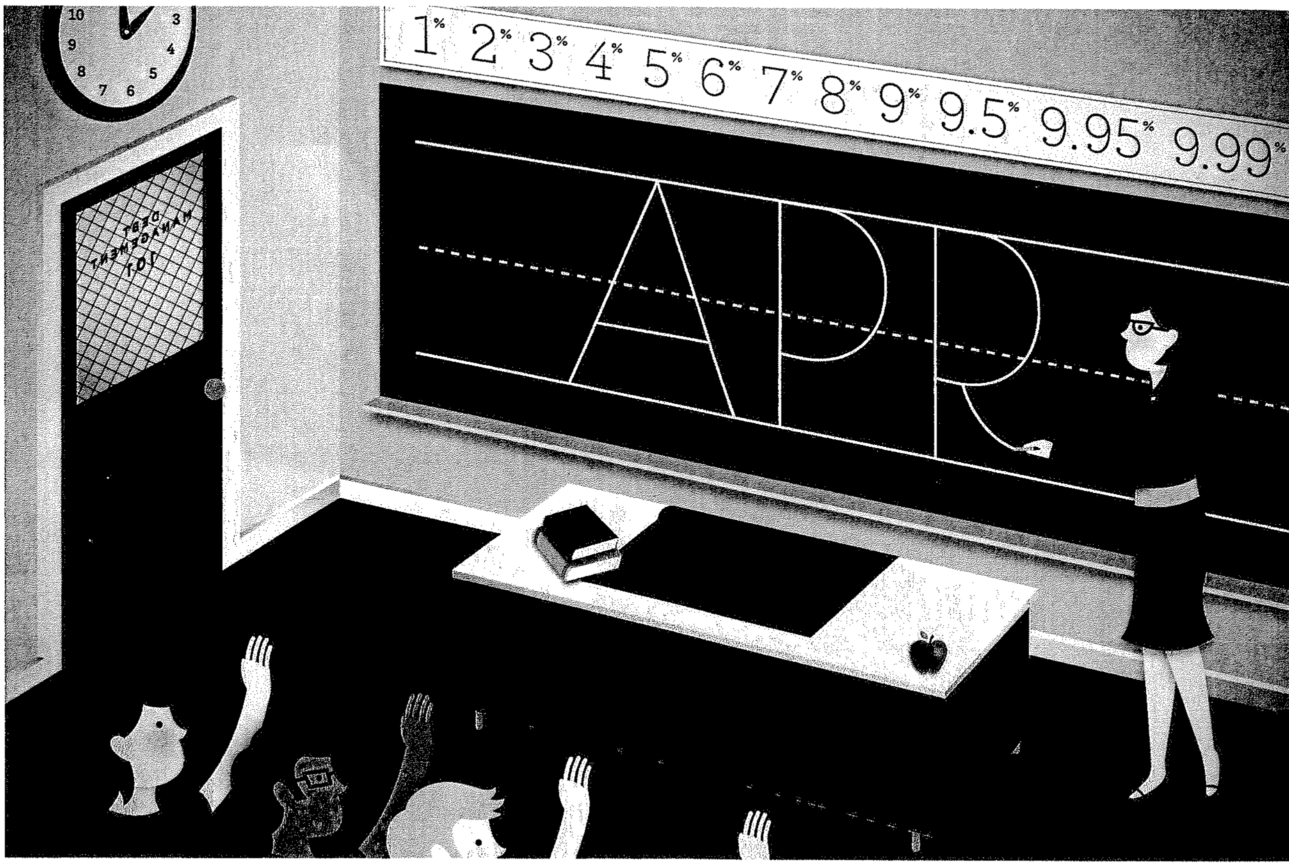

Jessica Hische

GRIST

Teach Workers About the Perils of Debt

by Annamaria Lusardi and Peter Tufano

IMAGINE THE DISASTERS that would befall your company if your chief financial officer didn't understand basic finance. That's the situation facing most of your employees, who are, in effect, the ill-prepared CFOs of their own lives, responsible for setting household financial policies and evaluating complex borrowing, investment, and insurance choices. One of the best benefits you can offer them, therefore, is financial education.

It's widely known that many consumers have poor numeracy – they can't figure out percentages or do other elementary calculations – and have barely a rudimentary grasp of economics. In our research, we looked deeper, studying consumers' "debt literacy," the ability to understand how interest rates work and make simple decisions about borrowing. We found it to be strikingly low. Working in partnership with the market-research firm TNS, we polled a nationally representative sample of 1,000 U.S. consumers about their financial knowledge. We had expected that a sizable percentage wouldn't be able to understand the workings of credit cards or apply the concept of compound interest to everyday situations; what surprised us was that the vast majority couldn't.

For example, we asked respondents: Suppose you owe $1,000 on your credit

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card, and the interest rate you are charged is 20% per year compounded annually. If you didn't pay anything off, how many years would it take for the amount you owe to double? Respondents had to choose one of six answers: (1) two years, (2) less than five years, (3) five to 10 years, (4) more than 10 years (5) do not know, (6) prefer not to answer. Just over a third of respondents selected the correct answer, less than five years. About 18% acknowledged their ignorance, but more than 30% overestimated the amount of time it would take for the debt to double, an alarming finding given the current amounts of credit card debt most U.S. consumers carry.

The penalty for lack of financial savvy is severe. We found that the credit card finance charges and fees of the least knowledgeable respondents were about 50% higher than those of the average cardholder. People with lower debt literacy were also more likely to say they were overindebted. It's troubling that the people with the biggest problems are the most ill-equipped to deal with them.

In light of the money consumers are pouring into credit card fees and interest payments, wouldn't it be wise for companies to put some effort into improving debt literacy, rather than focusing workplace programs exclusively on retirement savings? Piling up credit card debt at rates of 18% or higher while investing a small fraction of weekly pay into a 401(k) may not be the best way for an employee to achieve financial well-being.

Companies could easily add a debt-literacy component to employee assistance programs, focusing either on all workers or on demographic segments that are the most financially vulnerable and, according to our research, also have the lowest debt literacy, such as women. For example, during employee orientation, companies might show new hires videos illustrating how women succeeded in reducing interest payments on their credit card debt, an effective communication method that Dartmouth College uses.

One new approach to improving employees' financial literacy is through "financial entertainment," such as video games that focus on specific skills. Recently, the nonprofit Doorways to Dreams Fund created a video game called Celebrity Calamity, which allows players to learn about managing credit and debit cards by playing the role of a celebrity's financial manager. Companies might also consider providing more direct assistance for workers' credit problems. The firm E-Duction offers a 0% APR workplace-distributed credit card that permits employees to borrow against their future paychecks, so they don't have to pay high rates on payday loans or on more traditional credit cards. It sets up a standard payment plan, exploiting the same logic as the defaults used successfully in retirement plans.

Millions of family "CFOs" are overseeing households with too much debt and too thin a buffer for emergencies. Overall, U.S. households have more than twice as much debt, by virtually any metric, as they did a generation ago. In a new survey, also conducted with TNS in June 2009, almost half of Americans reported that they probably couldn't come up with $2,000 in 30 days – whether from savings, borrowing, friends, or family – to meet an unexpected financial need. All of that spells continued trouble for the economy. Unless people are better equipped to make sound financial decisions, the United States may face recurring episodes of financial weakness – a grim prospect for American companies' sales.

Who Got It Right?

Most respondents did poorly on our debt literacy test, but certain demographic groups fared worse than others. Here's a look at how groups fared when asked, **How long does it take a debt to double at a 20% compound annual interest rate, with no payments?**

% of respondents that chose the correct answer (less than five years)

36% All Adults

46% Men

26% Women

43% Age 18 to 30

29% Over age 65

48% Household income over $75K

26% Household income under $30K

Note: The demographic findings are similar for responses to other questions on the survey.

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