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## The democratisation of finance? Promises, outcomes and conditions

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## Abstract

This paper analyses the 'democratisation of finance' or the promise that all households can make money and/or manage risk by buying appropriate financial services products. It develops a distinctive cultural economy perspective by focusing first on the visions which encourage and rationalise broader and deeper relations between households and the capital market before then exploring the reasons for discrepancy between what is promised and what can be delivered. Our analysis starts from the economic promises and political pitches for the democratisation of finance since the early 1990s and the corollary emphasis on promoting mass financial literacy. The article then identifies three key social preconditions which must be satisfied before the promise is delivered and presents evidence and argument which suggests that these conditions are not met because the context is confusing, individuals lack calculative competence and products are opaque. Under these conditions felicitous outcomes are uncertain for existing middle class savers and very unlikely for lower income groups.

# The democratisation of finance?
# Promises, outcomes and conditions

> 'The world of capitalist civilization is a polarized and polarizing world. How then has it survived so long?… What has preserved the system thus far has been the hope of incremental reformism, the eventual bridging of the gap… Capitalist civilization has not only been a successful civilization. It has above all been a seductive one. It has seduced even its victims and opponents'
>
> (Wallerstein, Historical Capitalism and Capitalist Civilization, p.137)
>
> '(In) Austin's account of performative utterances…. the magical efficacy… is inseparable from the existence of an institution defining the conditions (regarding the agent, time and place, etc) which have to be fulfilled for the magic of words to operate. As is indicated, in the examples analysed by Austin, the conditions of felicity are social conditions'
>
> (Bourdieu, Language and Symbolic Power, p. 73)

## (1) Introduction

This is a paper about the consequences and conditions of the democratisation of finance, a term we use to signify the broadening and deepening of access to the capital market for ordinary, moderate income individuals and households. Households are increasingly encouraged (by the state as well as by financial services providers) to purchase appropriate securities (either directly or via policies and funds); their asset portfolios are then to be balanced by appropriate borrowings in the form of mortgages, credit cards and all the rest in ways which encourage households to manage a balance sheet as well as current income and expenditure. In this way, savings are routed through a 'coupon pool' to meet a wider range of financial needs, such as saving for retirement income or for the university education of children, as well as to avoid risk and personal mishap, such as unemployment, ill health or falling house prices. At the same time, the expansion of debt through securitisation and such like increases the supply of coupons. The capital market thereby can displace public or quasi public arrangements of taxation or compulsory contribution and risk pooling by the state or the large welfarist employer and can capture household savings that would previously have been held in bank deposits or under the mattress. The paper explores these issues by taking up the two themes raised by Wallerstein and Bourdieu in the preliminary quotes, though it will avoid appropriating their apparatus or positions in any orthodox way.

This paper takes up Wallerstein's theme about capitalism as a 'seductive civilization', which was intended to highlight the importance of collective reformist politics. It makes a kind of transposition to focus on the individualised promise of money making and risk control after financialisation which partly substitutes for the collective politics of social security. It observes that in the 1990s and 2000s there has been a marked discrepancy between promise and outcome with, first, the repeated discursive promises of financial democratisation (i.e. easy money making in the 1990s and better risk management for all through the capital market in the 2000s) and, second, the repeated distributive outcome of disappointment for the many from mass mis-selling, for example of endowment mortgages and personal pensions in the UK.

The paper then takes up Bourdieu's reflections on the social conditions of effective performance, which were originally intended to analyse the power and authority of the few over the many. We use this observation to consider what particular socio-economic conditions would be necessary if the middle class masses were to fulfil the promise and participate effectively in a financialised order which meets their needs. We identify three key preconditions which must be satisfied, in ascending order: first, predictability of income and wealth effects over the life cycle of individuals and/or households; second, a basic level of consumer financial literacy and competence to select appropriate financial products and services; and, third, financial services products where risk and return are calculable. The remaining sections of the paper then establish that these conditions are not met (indeed most probably cannot be met) so that outcomes often fall short of the various exuberant promises.

There are many ironies here, not least the fact that the many victims who believe the promise and then suffer from the gap between promise and outcome are not the abject poor but the ordinary middle classes who generally have a misplaced confidence in their own capacity to make judgements. Meanwhile, those in the bottom half of the income distribution in the UK and US are (for the purposes of this argument) currently economically and politically irrelevant but are still included in future plans and schemes for the extension of citizenship via the democratisation of finance. Our paper ends on a clear note of caution about extension, which will surely bring disappointing outcomes if substantial and practically insurmountable obstacles complicate and obstruct delivery. Thus, boosting financial literacy may be a worthy objective but it does not in its own right secure positive economic outcomes for individuals and households inside or outside the existing circle of investors.

Readers will note that our paper concentrates on this practical issue about how the promise of democratised finance disappoints but the paper does not tackle the fundamental question about why the promises of individual money making and security through the capital market are made and believed. In our view, individual households, government officials, politicians and policy wonks of the right and centre left all have different reasons for believing in the promise of democratised finance which is about something more than individual greed and gullibility. Standard risk households are attracted by the idea of taking out what you put in and not paying for somebody else's pension; treasury officials want to avoid the higher taxes necessary to fund the next generation of social security pensioners who will live longer; right wing commentators believe private provision liberates from dependence on the state while the centre left believe it may secure social inclusion.

The reasons why the promise of democratised finance is issued and believed could and should be analysed in other articles. In this article we concentrate on how the promise cannot be delivered and the paper which develops these themes is organised in a relatively straightforward way. The next three sections of this paper outline the promise and explain its context. Thus, the next section (section 2) considers political and cultural economy approaches to analysis of financialisation; while section three analyses the economic and political promises of democratisation about money making and risk management for all; before section four outlines the new official interest in programmes for promoting financial literacy. In the second half of the article, sections five, six and seven then analyse the three conditions necessary to the delivery of the promises of democratisation and present argument and evidence suggesting that these conditions cannot be met. Section five deals with the first contextual precondition of a life cycle with predictable income and wealth effects; section six examines the second precondition of financial literacy and considers evidence about the calculative competence of the middle classes; while section seven considers the final prerequisite of financial services products with calculable risk/return characteristics. A short final section then presents a conclusion.

## (2) Political and cultural economy approaches to financialization

The promise of democratized finance needs to be set in the context of *financialization* as a term which is used increasingly to identify a number of related and overlapping economic, social and political phenomena. At the simplest and broadest level, financialization generally denotes the growing influence of capital market on firm and households behaviours, including an interconnection between these two groups of actors as the routing of household savings through the stock market leads to the creation of a coupon pool (Froud *et al.,* 2002).

While there is general agreement that 'finance' and the 'financial' has become more important, within this broad definition there are differences in emphasis so that some researchers and commentators (e.g. Krippner, 2005 or Crotty, 2005) are concerned primarily with the corporation, while others focus on individuals and identity (e.g. Martin, 2002). An alternative way of classifying the literature is in terms of approach rather than focus, and here we would distinguish two different approaches: the more established political economy approach generally equates financialization with some behavioural shift or set of new relations while the cultural economy approach recognises a distinction between the rhetoric of shareholder value (or democratisation of finance) and the project of financialization. We will begin by outlining the two different approaches of political and cultural economy in relation to corporate behaviour before shifting to consider financialization and households.

The political economy approach is usually characterised by the search for a set of mechanical changes and new generalisable relations (such as increased distribution to shareholders) which would structurally and epochally distinguish a financialized economy from (earlier or other) forms of capitalism, according to one or two key measures. Thus, authors like Boyer (2000) and O'Sullivan (2000) in different ways try to find distinctive, durable and predictable consequences of financialisation, such as asset price bubbles or 'downsize and distribute' corporate policies which would then define and distinguish a new form or epoch of capitalism. This approach continues with the work of Krippner (2005), who uses an 'accumulation-centred' view of economic change and analyses the extent to which non-financial firms are increasingly dependent on financial sources of revenue as a key indicator of financialization (p.181). Following careful analysis, Krippner concludes that non-financial firms have become more financialized but that the process of financialization pre-dates the 1990s stock market boom (pp.184-5).

A cultural economy perspective is different in that it is concerned less with new changes, values and relations between hard 'economic' variables and more with soft discursive complication and paradox. For instance, while 'shareholder value' makes an appealing slogan, the first difficulty in delivering value is that various shareholders want different things by way of capital gains or income. Furthermore, the generic demand to safeguard shareholder interests or seek higher returns for shareholders implies different courses of action in different periods and sectors when, for example, stock prices are rising or falling. The shareholder demand for value is further complicated by the delegation of decisions to fund managers who together with corporate managers create narratives about good and bad company management within value creating or destroying sectors. These complications ensure that shareholder value is not so much a defined concept or agenda as a kind of pliable rhetoric which can be appropriated and inflected by social actors like consultancy firms or hedge funds.

Measurement remains important because it does help to identify the extent to which things have and have not changed. Cultural and political economy share an interest in issues such as whether there been an increase in dividends distributed to shareholders; or, whether the return on capital for giant firms increased since the adoption of a shareholder value orientation. However, cultural economy is much less preoccupied with changes in the values of key variables and relations as indicators of epochal change. In particular, if shareholder value is important in part because it is a powerful rhetoric, some of the corporate response to that rhetoric will be in terms of what firms say, as much as what they do and the level of performance they deliver. And the relation between saying and doing will be complicated if shareholder value is a pliable rhetoric where many seek to cover discrepancies between slogans and outcomes by focusing the attention of the financial community on the former.

From this point of view, financialization then becomes more a project with diverse consequences than a once and for all mechanical shift in relations or values. In terms of giant firm corporate strategy, Froud *et al.* (2006) argue that the rhetoric of shareholder value sets corporate management on a utopian quest for growth and higher returns for capital which has variable and uncertain consequences. This argument is supported by long run evidence on the FTSE 100 and S&P 500 groups of firms, which suggests that giant firm management is often ineffectual in creating value through strategic interventions to improve the numbers. Given this discrepancy between promise and outcome, the cultural economist would envisage a financialized economy as one that runs on different narratives of achievement and assertions of identity, and which has some trouble with the alignment of saying and doing.

This is not to imply that political economy analysis is unhelpful in understanding financialization (nor even that there is a single political economy approach) but only to argue that a cultural economy approach can add a sensitivity to the constitutive powers of discourse which is essential in understanding how finance affects corporate and household behaviours and outcomes. As with political economy, there are a range of approaches within cultural economy (see, for instance, duGay and Pryke, 2002 and Amin and Thrift, 2004) with different perspectives on the extent to which the economy exists independent of discourse. Many of the British cultural economists are influenced by the arguments of Callon about how the discourse of economics frames the economy (1998, p.2). So it is worth explaining how this kind of constructionism can and cannot help us to understand the problem of shareholder value and financialization.

If we consider corporations, the relevant point about management discourse and practice is that promising value is not at all the same as delivering value. So, academic analysis must consider not only how discourse frames what managers perform and the corporate narratives of purpose and achievement, but also consider the possibilities of discrepancy between promises and outcome in terms of financial results. In this respect our position draws on the cultural economy represented by MacKenzie's work on performativity in finance theory, which highlights the gap between saying and doing and the empirical possibilities of measuring verisimilitude. MacKenzie and Millo (2003) adopt an Austinian approach to performativity, which highlights infelicities as much as felicities in the study of the adoption of option pricing models on the behaviour of financial markets. MacKenzie also explores the interesting notion that theories can be 'counterperformative', so that 'widespread adoption can undermine the preconditions of its own empirical validity' (2004, p.306).

In a similar way, we can move from the idea of shareholder value as a discourse which reconstructs the world to exploring the discrepancy between promise and outcome which can include an empirical investigation of corporate performance and excuses in a world where outcomes depend on narrative as much as numbers. This approach to discrepancy between promise and outcome is developed in Froud *et al.* (2006), where it is used to analyse relations between the capital market and corporations. This paper transposes this approach and uses it to analyse relations between the capital market and households. Our analysis adds a distinctive cultural economy perspective by focusing first on the visions which encourage and rationalise broader and deeper household use of diverse financial services before shifting to explore the reasons for discrepancy between what is promised and what can be delivered. Our analysis starts by analysing the economic promises and political pitches for the democratisation of finance, accompanied by a new emphasis on promoting financial literacy; it then examines the social preconditions about calculability which must be satisfied before the promise is delivered. Evidence and argument suggests that the conditions around the democratisation of finance are such that felicitous outcomes are very unlikely for the middle class masses.

This broad perspective on the impossibilities of money making and risk management for all adds another strand to an already interesting body of culturally informed work on finance, especially on consumer credit. The observable phenomena here include the spread of financial services availability and the increasing emphasis on using financial products to manage risk, to bring forward consumption and to obtain speculative gains. The academic response includes interesting work on households and financial services, with attention often focused on particular kinds of financial products, such as debt (e.g. Leyshon *et al.,* 2004; Burton *et al.,* 2004) as well as on the marketing of such products and their (often damaging) impact on households in financial and social terms (e.g. Manning, 2000 and Schor, 1998). Leyshon *et al.* (2004) analyse how the spread of financial products variably link consumers into the financial system via credit scoring, though they are not concerned directly with the broader context of the capital market and how this is a part of the financial services offer and the associated levels and patterns of risks and returns. Similarly, Manning's (2000) dense and insightful analysis of consumer credit in the US does make the connection between the growth of corporate, federal and consumer debt but his primary object is not to develop an understanding of how the financial products that consumers buy are part of a wider financial system which we would argue includes inbuilt disappointment for many households.

## (3) The economic promises and political pitches of democratisation: money making and risk management in the ownership society

Wallerstein's 'hope of reformism' traditionally connects with a political process that works on the social democratic assumption that we are collectively responsible for delivering a socialised capitalism. Under coupon pool capitalism in the UK and US, things are rather different because economic promises about money making and risk management interpolate the individual and thereby help build consent for a transfer of risk onto individuals who hope to gain. In the US (but not so far in Europe), all this is intertwined with a political pitch summed up in George Bush's 2005 electoral slogan about the *ownership society*, which aimed to boost family 'choice and access' to healthcare, pensions and homeownership by encouraging individual saving, whilst reducing taxes for small businesses (Republican Party Fact Sheet, 9 August 2004).

Whether we focus on the promises about money making or the political slogans, we are here considering rhetoric which makes capitalism more appealing by indicating 'what it can do for you' and how this fits into a larger purpose to create a polity of independent citizens. But one of the most interesting aspects is that all this is rendered plausible and palatable by varying the promise in the light of current economic experience and changing the pitch so that it fits with national sensibilities. This is clearest in the way the promise has changed from the 1990s to the 2000s. The 1990s promise in the US media was the democratisation of finance as money making for all and that has been discredited by stock market events and cultural histories like those of Thomas Frank (2000). But, as Braudel said of capitalism itself, the promise of democratised finance is 'often ill but never dies'. Thus the promise is reasserted for the 2000s in academic work for the elites through behavioural finance texts like those of Robert Shiller which represent risk management through the capital market as the universal remedy for need and insecurity.

Frank's *One Market under God* (2000, p.98) is a book about, 'the faiths and beliefs of business' and presents the classic critique of the promise of financial democratization in the period of the New Economy bubble. The late 1990s, like the 1920s, was characterised by mass public enthusiasm for stocks and the notion of 'economic democracy through investing' (Frank, 2000, p.98) with Wall Street presented as the domain of the small investor and the common man. In a broad ranging chapter on the 'People's Market of the 1990s', Frank dissects the 'delusions' (p.116) and 'dotty' beliefs (p.127) that the elitism of the old financial industry was being displaced by a new generation of middle class investors, or their down home representatives like Warren Buffet, who took control of Wall Street and turned around the language of populism to defend, not criticise, the Street. By 1999, when 20-60 per cent of Americans were supposedly saving through the market:

> 'while the world of finance had once been a stronghold of WASP privilege, an engine of elite enrichment, journalist and PR man alike agreed that it had now been transformed utterly, being opened to all. This bull market was the Gotterdamerung of the ruling class, the final victory of the common people over their overlords'
>
> (Frank, 2000, p.92).

If the ideological illusions about what moneymaking was in the 1990s were swept away by stock market crash and corporate scandals, they were then renewed as scientific promises of what risk management could be. In *The New Financial Order* (2003) Shiller, the doyen of behavioural finance, appropriates the old language and imagery of market democracy when he argues 'we need to democratize finance and bring the advantages enjoyed by the clients of Wall Street to the customers of Wal-Mart', because, 'finance must be for all of us in deep and fundamental ways' (Shiller, 2003, p.2). As a critic of the overvalued stock-market of the late 1990s, Shiller puts his faith not in equity investment but in the potential of digital technologies, contracts and the coupon pool to create a new 'risk management infrastructure' (2003, p.ix) for private individuals and governments who operate under a kind of remorseless neo-liberal logic where globalisation and financialization first create new risks which the market then manages. Thus, for individuals, the sphere of insurance would be extended to cover risks other than life, property and health. It would be possible to take out 'livelihood insurance' to cover against risks to US pay checks arising from, for example, Asian low wage competition, just as it would be possible to take out 'home equity insurance' which guarded against falls in the value of house property (Shiller, 2003, p.4). Meanwhile, banks would make income-linked loans where, if incomes fell below expectations, the loan balance would be reduced (Shiller, 2003, p.5).

Shiller sketches a kind of performative agenda which is already being enacted on web sites by firms like *hedge street.com* which allows 'most investors' to 'trade on economic events relevant to everyday life', such as mortgage interest rates or gas prices at the pump. However as yet, the revolution appears to be incomplete because very few households hedge on things like gas at $2 a gallon and only the middle classes in the broadest sense of that term have already been converted to stock market saving and home ownership for retirement. Households in the bottom half of the income distribution have no large stock market savings and much lower levels of home ownership. As we have demonstrated elsewhere (Froud *et al*., 2002, p.141) only those US or British households in the top half of the income distribution have significant stock market savings. Even in the US at the peak of the bull market, only 12% of families in the lowest 20% income group owned stocks directly or indirectly at a time when over half of all families had stock market related savings (Aizcorpe *et al.,* 2003). Likewise only two thirds of US households are 'home owners' because many poorer households cannot afford the initial down payment and so rent rather than buy.

Hence the continued relevance in the US of the political pitch, which justifies the broader franchise as a contribution to the freedom of an independent citizenry by promising an extension of the benefits of finance experienced by the middle classes to the lower echelons of society. This promise is then endorsed through specific programmes, like the privatisation of social security accounts or the setting up of retirement and lifetime savings accounts, which deliberately aim to broaden financial 'inclusion'. Here, for example, is a right wing think tank, the Cato Institute, announcing a February 2005 conference on the reform of social security which starts with political philosophy about 'the ownership society' before turning to the specifics. The claim is that 'individuals are empowered by freeing them from dependence on government handouts and making them owners' when 'patients control their own health care, parents control their own children's education, and workers control their own retirement funds'. But the problem is that 'half of Americans are not benefiting as owners' with those 'below the average income' excluded'. And the solution is to 'let workers put their Social Security taxes into private retirement accounts' liberating the 12.4 per cent of income which Americans earning below $88,000 send to the government. Cynics like UK economist John Kay allege that the US reform of social security is a ploy to extend the market for financial services conglomerates (*Financial Times,* 24 January 2005). But, from the Cato Institute's point of view, the reform of social security is the next step in a noble mission to spread freedom.

Interestingly all this works partly because the political pitch is adjusted to suit national political sensibilities in different high income countries; just as the economic promise is varied in line with current and recent experience. Thus President Bush has used the phrase 'ownership society' to frame his domestic policy agenda in speeches since 2002. This was explicit in his second inaugural address, which included the promise to,

> 'build an ownership society (to)… widen the ownership of homes and businesses, retirement savings and health insurance - preparing our people for the challenges of life in a free society. By making every citizen an agent of his or her own destiny, we will give our fellow Americans greater freedom from want and fear, and make our society more prosperous and just and equal'
>
> (Whitehouse, 2005).

Bush's campaign reform agenda included a simpler more investor-friendly tax code as well as private accounts in Social Security. By way of contrast, Tony Blair, in his 2005 re-election campaign offered a rather vaguer vision of 'personal prosperity' which fitted British sensibilities and highlighted widening home ownership and private pensions alongside strong public services: 'by prosperity I mean both the income and wealth of individuals and their families, and the opportunity and security available to them through radically improved public services and a reformed welfare state' (BBC, 13 January 2005).

## (4) Financial literacy and the role of literacy programmes

As the franchise broadens, so new questions about the benefits and social preconditions of democratized finance have also begun to intrude. The official answer in the USA and UK is that democratization has already brought significant benefits and can bring more provided it is supported by appropriate financial literacy programmes. Thus, all the high income Anglo Saxon countries (including the USA, UK and Australia) since the late 1990s have launched official initiatives to raise levels of financial literacy on the premise that only financially literate citizens can manage their own affairs. Financial literacy for the citizen is, like governance for the corporation, now being promoted as a key control technology whereby financialized capitalism obtains improved economic performance and socially responsible outcomes.

The conventional wisdom is that democratised finance can deliver private and social benefits provided citizens have increased financial literacy. The argument is not so much a deductive syllogism as a jump cut between two sets of assertions. This is nicely illustrated in two successive paragraphs of a recent speech by Alan Greenspan (2005) whose role in explaining the economy and polity to the financial community is almost as important as any Federal Reserve decision about interest rates. In the first paragraph below, Greenspan asserts the 'significant benefits' of financial deregulation which has made credit accessible to lower income groups and thereby enabled wider home ownership; the second paragraph then immediately insists on the new relevance of financial education.

> Improved access to credit for consumers…has had significant benefits. Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services…Credit cards and instalment loans are also available to the vast majority of households.
>
> The more credit availability expands, however, the more important financial education becomes. In this increasingly competitive and complex financial services market, it is essential that consumers acquire the knowledge that will enable them to evaluate products and services from competing providers and determine which best meet their long- and short- term needs.
>
> (Greenspan, 2005).

In this context, it is easy to understand why financial literacy programmes which target the mass of citizenry acquired a new importance in the late 1990s and early 2000s and are now being promoted by elite national and supra national organisations. In 1994, the American SEC was pioneering attempts to educate stock market investors through town meetings and school visits backed by publications like 'The Facts on Saving and Investing' and 'Financial Facts Tool Kit'. Martin (2002) claims that Arthur Levitt was a key promoter of financial literacy through also making US corporate filings publicly available via the EDGAR database to allow private investors to know more about their investments. By the early mid 2000s, such efforts were more structured and higher profile across all the high income countries where they involved key public and regulatory financial institutions who now defined the promotion of financial literacy as a core task.

By 2004, the OECD was co-ordinating an international Financial Education Project (OECD, 2004). In the USA the Federal Reserve System has taken the lead in developing and leading a national strategy on financial literacy (Federal Reserve Board, 2004), whilst national financial services regulators like the British Financial Services Authority (FSA) and Australian Securities and Investments Commission (ASIC) played the same role in the UK and Australia respectively (The Consumer and Literacy Taskforce, 2004; Financial Services Authority, 1998 and 2004a). The regulators justified their involvement by emphasising how new literacy programmes could reduce the need for regulation and make markets work better. According to Howard Davies, former Chairman of the FSA, improving the financial literacy of the population will reduce the cost of regulating the financial services sector and also remove the informational asymmetry that hinders the smooth working of financial markets (Davies, 2003). Both the OECD and the US Federal Reserve underline the same objective by relating higher financial literacy rates to market efficiency, general economic welfare and economic development (OECD, 2004, p. 224; Federal Reserve Board, 2004, p.447).

The language and promises of the new policy documents are particularly interesting. In the British FSA 2004 report *Building Financial Capability in the UK* (2004b), the 'people' and 'individuals' who are encouraged to change are characterised as 'consumers' only once, and that is in the forward to the report written by the head of the FSA (p.1). Throughout the main body of the report, the democratisation of finance is invoked by the characterisation of the financially literate as 'citizens', with the implication that the financially illiterate are excluded from market democracy: 'we share a vision of better informed, educated and more confident citizens, able to take greater responsibility for their financial affairs and play a more active role in the market for financial services' (FSA, 2004b, p.2). Just as in the 1990s versions of (stock) market democracy, the report includes a simplistic virtuous circle account of how the national strategy can make a difference as everybody wins:

> 'more people review their financial situation regularly; people are more discriminating when shopping for financial services; fewer people buy unsuitable

> financial services and products; the financial services industry designs products that more closely meet people's needs; products are promoted and sold in a fashion that is more suited to people's needs; the FSA is able to take a less interventionist approach to the regulation of the financial services industry'
>
> (FSA, 2004b, p.11).

But practically the virtuous circle scenario encounters difficulties about finding an object and point of intervention. The worthy objective is life-long education but in practice literacy programmes focus on schoolchildren and students. Programmes like 'Financial literacy in Schools' in Australia, or 'No Child Left Behind Act of 2001' and 'Jump$tart' in the USA, or the work of the Personal financial education group (Pfeg) or Institute for Citizenship in the UK, share a common preoccupation with developing formal methods to introduce financial education to school children through national curricula with the idea of 'economic citizenship' recurring as the motif (see, for instance, Institute for Citizenship, 2002). The ASIC report in Australia recommends that 'resources should include teachers' notes, lesson plans, case studies and topical content to stimulate teaching of financial literacy in the classroom' (ASIC, 2004, p.10). This emphasis is nearly inevitable, because the next generation of financial citizens is conveniently accessible behind school desks and survey evidence suggests that personal finance education is generally popular with older schoolchildren. A survey in the UK found that 41 per cent of 14-19 year olds think that their school should cover money management in more detail; the percentage wanting more curriculum time for issues like drugs, sex and politics is apparently lower (Davies, 2003, p.7). All this then opens onto debates about whether the teaching of financial literacy should be embedded in the existing curriculum or stand alone as envisaged in the British IFS (Institute of Financial Services) proposal for stand alone A level qualification in financial literacy.

But school children are also years away from big irreversible decisions about pensions or mortgages, so there is a lot of confusion about exactly which decisions these trainee consumers are being educated for, combined with some tendency to regress onto simple issues about responsible use of plastic cards and other personal credit issues which are most relevant to school leavers. The Australian financial literacy initiative is particularly concerned about mobile phone and credit card debts among the youth. The UK initiative in improving financial literacy at the school level includes a package called 'mega-money' for primary schools. The package for teenagers is called 'colossal cards' which covers the notion of debt and dangers of over-indebtedness; though 16-19 year olds are also educated about insurance products by a package called 'making the most of it'. But schools programmes cannot address the literacy problems of the current generation of consumers where recent scandals about the mis-selling of private pensions and endowment mortgages in the UK suggest a major problem about functional literacy. Nor can schools programmes easily prepare consumers to choose between as yet unknown products available within policy frameworks which do not yet exist. The point is admitted in the 2004 OECD document which argues that insurance companies no longer provide life insurance but individualised wealth management; and suggests the insurance industry will generally fill the gap by substituting for state-provided pensions and other benefits. After the new literacy programmes (just as before), we must ask what is the evidence on whether citizens are equipped with the requisite information to use their new found freedom, and whether it is ever possible to make accurate long term predictions using current information, when speculative investments can unexpectedly fail and lifecycle earnings change.

At this point in the argument, we shift from official attempts to encourage more financial literacy to consider three basic empirical questions whose answers will allow us to decide whether the basic preconditions for democratised finance are present and incidentally illustrate how a cultural economy approach to household decisions can help frame analysis of discrepancy and disappointment. First, can citizens make reasonable assumptions about life cycle earnings and wealth effects within which they can plan for a definite set of contingencies? Second, is the average level of financial literacy and capacity for decision making under conditions of uncertainty sufficient to allow processing of complex information? And, third, do the savings products available have predictable characteristics which allow them to be used in long term savings strategies? If the answer to any of these three questions is 'no', then the basic social preconditions for felicitous outcomes have not been met.

## (5) Precondition (a) predictable life cycle earnings and wealth effects versus a snakes and ladders society

One of the basic preconditions for any kind of rational financial planning of long term saving is the predictability of earnings and wealth effects over the life cycle for the group, if not the individual. The unpredictability of individual vicissitudes like premature death of course motivates the purchase of certain insurance products and Shiller's argument is that individuals can learn to cover a much wider range of individual hazards by writing contracts on house price falls or petrol price rises. But, when making major decisions about instiutionalised contingencies such as retirement from the workforce, individuals (just like the supplying industry when offering products like annuities) need predictability of group life expectancy, earnings and wealth effects. The problem now is that group predictability of everything except life expectancy is becoming more difficult as we move from a proto-Keynesian world of permanent income to a snakes and ladders society where the duration of earning power is uncertain and complicated by wealth effects.

The legacy of Keynesianism still influences much of our thinking about long term saving. It was Keynes and the Keynesians of the 1950s who introduced ideas about the appropriate level of savings. The original Keynesian view was that over-saving (or under consumption arising from a marginal propensity to consume of less than one) could cause inadequate demand which would lead to decreased output and employment. Modigliani (1992), however, argued that inadequate saving is a source of cyclical fluctuations and long-run stagnation, and was a primary cause of the Great Depression. This difference stimulated research on the determinants of saving where Keynes (1936) in the *General Theory* had presented current income as the sole determinant of saving. Against this, Modigliani and Brumberg (1954) and Friedman (1957) argued that saving is a function of permanent income or the present value of expected lifetime labour earnings and bequests. This congealed into the so called 'life cycle hypothesis of saving and wealth accumulation' which implies that households accumulate assets throughout the working years and use these assets to support consumption in old age. This life cycle theory about the appropriate quantum of saving now lingers on, as Keynes would have expected, in the form of alarmist political claims that we are all saving too little for our retirement and indeed, as Manning (2000) or Schor (1998) argue, consuming too much now, funded by availability of credit.

Such political claims have little intellectual usefulness when they do not engage with current uncertainties about the returns from complex savings products, the future age of retirement or the long-term macro trajectory of the economy. Keynes himself realised the importance of this trajectory question in his discussions with Beveridge about the affordability of expanded post war social insurance provision. Keynes' position in the early 1940s was that with much fuller employment and economic growth, the Beveridge reforms were affordable after the war had ended. The permanent income theory then became both an empirical hypothesis for testing and a priori assumption derived from the experience of full employment and sustained growth in the decades of the 1950s and 1960s, as part of a post war settlement where retirement at 65 was, for the first time, universalised in high-income countries. Since the 1970s, permanent income has not been refuted but has faded into irrelevance. The theoretical prediction was that net worth should increase until retirement and then fall sharply (Ando and

Modigliani, 1963). Empirical work seems to support the view that the elderly dis-save, but they do so at a rate that is not as high as theory predicts (Shorrocks, 1975). Meanwhile, some US studies also claim that sociological explanations of saving behaviour tend to be more relevant and accurate than the economic explanations (Frenzen *et al*., 1994). While economists recognise that the life cycle thesis is challenged by financialisation insofar as the underlying assumption about certainty of return from simple saving products no longer holds (Attonasio and Banks, 2001), the question now is not how much to save and at what age, but in which saving products or portfolio to invest and at what period?

The politically sponsored break up of the post war social settlements in the USA and UK after Reagan and Thatcher is itself one of the main complications. Neo-liberal reform, marketisation and free trade have encouraged the break up of national and intra-regional cycles of production and consumption. The main losers so far have been blue collar workers employed in and around the manufacturing sector, where the halving of British manufacturing employment from a level of more than seven million over the past thirty years since the mid 1970s sends a chill warning. What assumptions should white collar workers make for the *next* 30 years about the export of service sector and back office jobs to low wage economies or about the capacity of metropolitan capitalism to generate replacement jobs whose quantity and quality fits workforce skills and economic expectations?

Matters are further complicated politically by the way in which reform rolls forwards through breach of implicit social contract with stakeholder groups such as employees, suppliers and company retirees who draw a pension. Large corporations and the state increasingly retreat from social obligations with the excuse that they ‘can't pay, won't pay’. The giant British companies which topped up their pension funds from current profits after the 1970s stock market crash, responded briskly after the 2000 crash by closing final salary pension schemes. According to Norwich Union (a major financial services company, which is now part of Aviva plc, the UK's largest insurance group) in evidence to the House of Commons Work and Pensions Committee in 2002, 23 per cent of private sector employers had already closed defined benefit schemes to new members in the last two years and a further 23 per cent thought it was likely that they would close schemes in the following two years (Select Committee on Work and Pensions, 2002, para 67). Against this political background, long-term group calculation becomes extraordinarily difficult. For example, in the UK, what assumptions should public sector employees under 45 make about the future of their final salary (defined benefit) schemes? It is likely that they will be modified by technical changes, most probably by changing retirement ages and altering the weighting of different years of employment in the calculation, so that individuals and households with and without lifetime careers of rising salary will experience very different outcomes. Or, in the USA, what assumptions should blue collar workers make about the availability of public social security provision in 20 years time, which must depend on whether President Bush and his successors can enact social security reform more effectively than President Clinton could enact health care reform?

Against this neo liberal backdrop, some political economists like Dumenil and Levy (2004) have argued that US capitalism at least has a predictable 20/80 economic logic which sets a minority of winners in the upper income groups against a majority of losers. We do not accept Dumenil and Levy's Marxisant view of American politics and their argument that the top 20 per cent then has an incentive to vote with the super-rich and But their distinction between winners and losers does raise some interesting issues from our point of view about savings strategies. The implication is that higher income individuals or households should presumably do whatever is necessary in terms of savings and investment so as to consolidate their privilege. But, if this is the objective, it then turns out to be technically difficult or impossible to determine a household savings and investment strategy which specifies how much of income should be saved and how that should be invested.

If the objective is to consolidate income into wealth, the first problem is that the correlation between income and wealth is historically weak in all periods because saving from income is not a quick and efficient way of becoming rich. Thus, in the USA, the correlation between income and wealth gains is no higher than 0.49 according to Keister (2000) or 0.26 excluding asset income according to Lerman and Mikesell (1988). Saez (2004) notes that top income shares have increased substantially in English speaking countries like the USA, Canada and UK where top wage earners have replaced capital income earners at the top of the income distribution; Dumenil and Levy note the rise of the working rich in the USA in the 1990s as wages and partnership income replaced the capital income of the coupon clipping classes. But, the observation that a particular group like the top income or wealth quintile has done well or done relatively better in the last 20 years does not imply that they will do well in the next 20 years when the sources of income and wealth gains will almost certainly be different. This is particularly relevant at present when the 1990s was a decade of bull market optimism and high interest rates whereas the first half of the 2000s was a period of bear market pessimism and low interest rates. The pattern of wealth gains is very likely to vary between periods insofar as various asset classes like ordinary shares which perform well in one period then perform badly in the next and various income groups hold portfolios with different asset mixes.

Insofar as households acquire asset portfolios then fluctuations in asset prices certainly affect the wealth of all groups but not equally or according to any simple universal logic. According to Keister, between 1983 and 1995 all income groups in the USA experienced a decline in wealth but by different degrees: the bottom income group with incomes of less than $10,000 saw its wealth reduced by 18 per cent, the middle middle-income group ($25,000-49,999) by 25 per cent, the higher middle-income group ($50,000-$99,999) by 14 per cent and the high income group ($100,000+) by 45 per cent. Furthermore, decisions to save more have complex feedback effects for wealth, not least because of the interval required between the decision to save and the accumulation of wealth, even if different income groups invest in the same asset classes. So the problem cannot be simply solved by marginal members of higher income groups (or everybody in lower income groups) all saving a bit more because outcomes depend on whether and how asset prices go up or down over the next few decades.

This point has been demonstrated by Keister (2000) in an interesting simulation of the effects of higher middle class saving in the stock market after 1962. Keister first shows that there have been limited shifts in the distribution of wealth between 1962 and 1995. The columns headed ‘actual’ in Table 1 show that the top 80 per cent of households (ranked by wealth) increased their share from 81 to 84 per cent, with the second and third quintiles seeing no increase in their share of US household wealth. Up to 1995, equity was an insignificant component of middle class portfolios. In 1995, stock accounted for only 5 per cent of the wealth of the bottom 80 per cent in the US wealth distribution, but the equity bull market of the 1990s persuaded many middle class American’s to invest more in the stock market, by switching funds out of cash-based savings. Keister’s simulation asks, if the US middle classes had invested in the stock market earlier and slightly more heavily, what effect would this have had on the distribution of wealth several decades later? In the simulation there is an increase in both the probability of stock ownership and the value of stock holdings by 15 per cent in the second and third quintiles of wealth owners (by net worth).

***Table 1. The effects of Keister's simulation of middle class stock ownership on the distribution of wealth***

| | *Top 1%* | | *Top 20%* | | *2nd 20%* | | *3rd 20%* | | *Bottom 40%* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | Simulation | Actual | Simulation | Actual | Simulation | Actual | Simulation | Actual | Simulation |
| 1962 | 34 | 34 | 81 | 81 | 12 | 12 | 5 | 5 | 0.2 | 0.2 |
| 1983 | 34 | 31 | 80 | 77 | 11 | 14 | 4 | 7 | 2.0 | 2.0 |
| 1989 | 38 | 31 | 84 | 78 | 12 | 16 | 4 | 7 | -0.8 | -1 |
| 1992 | 39 | 33 | 85 | 79 | 10 | 12 | 4 | 8 | -0.3 | -1 |
| 1995 | 39 | 33 | 84 | 78 | 11 | 15 | 4 | 7 | -0.2 | 0 |

*Source: Keister, 2000, p.73 Table 3–5*

*Note:* The cells in the table indicate the percentage of net worth held by households in each segment of the distribution, where households are ranked by wealth. The 'actual' columns show the distribution of wealth between households, while the 'simulation' columns show the distribution of wealth after an adjustment of historical patterns of stock ownership among middle-class households so that middle class households were more likely to own stock in 1962 and to own more stock in subsequent years.

The results are shown in the columns headed 'simulation' in Table 1. As Keister notes, it takes 'some time' for the wealth effects of higher stock ownership to have an impact (p.72), partly because of a sluggish stock market in the 1970s but, if the 2nd and 3rd quintiles increased their participation in the stock market by 15 per cent, the wealth distribution effects between 1989 and 1992 would be more marked: between 1962 and 1989, the share in total wealth of the 2nd quintile would have increased from 12 to 16 per cent while that of the 3rd quintile would have increased from 5 to 7 per cent, with some reduction in the share of the wealthiest quintile. Interestingly, in the 1989-1992 bear market the second quintile sees its share of wealth fall quite significantly, while the third 20 per cent enjoy a small rise.

These simulation results are relevant for two reasons: first, they demonstrate the possibility of variable and unpredictable results from increased stock market investment by households and, second, they underline the significance of timing so that (whatever the promises about money-making imply) the outcomes for individual households depend not only on the amounts invested but also on when funds are invested and cashed out in relation to swings in asset prices and shifts in rates of interest. For example, the British middle classes retiring and buying an annuity in 1999 had a very different experience from those in 2002 when both stock prices and interest rates had fallen heavily. Such differences are crucially important for the middle classes who traditionally have little choice about when they retire or repay the mortgage and often have limited amounts in their savings fund so that an unexpected shortfall can have a major impact on their plans for comfort. Lower middle income groups have to get lucky with all their major job and savings decisions over a whole life cycle before they end up with enough retirement income for comfort. And they must in the intervening period live in a world where, as Rigg and Sefton (2004) have demonstrated for the UK, earned incomes and the discretionary surplus vary according to life cycle events such as marriage, birth of children, unemployment and moving house.

Overall, our verdict on the evidence would be that the middle classes live in a snakes and ladders world where earnings, wealth effects and final values are all unpredictable so that the context for rational calculation is extraordinarily difficult. One response might be that the revolution of democratised finance will fail if it is incomplete and the UK and USA should therefore both scrap state social security systems of risk pooling funded by compulsory deduction and develop more flexible financial products which can meet the variation in individual needs and wants over a working life. But that ‘solution’ will only work if households have the necessary calculative competence and can then apply that competence to choose amongst financial services products with definite risk and reward characteristics. The argument in the next two sections suggests that neither of these conditions is met.

## (6) Precondition (b) financial literacy and calculative competence in and by the middle classes

The goal of financial literacy programmes to promote understanding of financial matters is reasonably uncontroversial. But from our point of view, the key question is not whether more literacy is desirable but, what is the average level of literacy and how does this vary with characteristics like income or socio-economic grouping? The promise of democratised finance can only be realised if enough citizens in the relevant socio-economic groups have the calculative competence to appraise different financial services and products. Indeed, the requirements are more onerous than this because the services and products on offer will often not consist of propositions with fixed, easily comparable characteristics as with, say, two savings accounts which differ only in interest rates offered and rules about access to funds. In many cases, there will be risk and uncertainty attached to different products, as well as rules about the timing and conditions of entry and exit, and therefore consumers must have some capacity for decision making under conditions of uncertainty in addition to basic financial literacy. The problem here is that the evidence on these points is alarming: the general level of financial literacy is very low; the middle classes in the UK have delusions about their competence to choose financial services products; and, under conditions of uncertainty, consumers are likely to focus on reward and ignore risk.

The fragments of survey evidence in the public domain suggest the level of financial illiteracy is high in all the Anglo Saxon countries where such competence is relevant for middle class consumers. In the USA, 55 per cent of adults and 66 per cent of high school students do not understand inflation and interest rates, while in Australia 37 per cent of those with investments do not understand that their investments can fluctuate in value (OECD, 2004, p.224). The problems with such fragments of evidence are twofold: first, the generalities about misunderstanding do not engage with the specifics about what consumers can or cannot do by way of calculation; second, the percentages about illiteracy in whole populations do not discriminate between the middle classes and the rest of the population whose literacy levels and requirements are likely to be much more basic. Hence, the importance of a recent MORI survey in the UK which was commissioned by the Institute of Financial Services and carried out from 30th September to 6th October 2004 (MORI, 2004). The limit of this poll is that it covers only the UK and we can only speculate about whether the position is much the same in other Anglo Saxon countries. But we are grateful to the IFS for giving us access to the raw data where responses are classified by socio economic group, savings level and region. The results are devastating because the MORI survey evidence demonstrates the inability of most British consumers to perform elementary calculations and highlights a distinct problem about the misplaced confidence of the higher socio economic groups in their own ability to make choices.

The general level of calculative competence was explored in the MORI survey by asking respondents two questions: first, they were asked to choose the one right answer from several alternatives about the sum of interest which would be earned on £2,000 over two years at 4 per cent; second, they were asked to define APR (annual percentage rate) which is universally used in adverts and information to provide bench mark comparisons of the cost of credit. Two thirds failed the most elementary test of calculative competence because they did not choose the correct answer of around £160 in interest earned. As for APR, 79 per cent of all respondents could not explain the term, which implies that this is a regulator's concept rather than a meaningful consumer one. Interestingly, the middle classes in the AB socio-economic groups got more answers right but arguably did not do all that much better overall. Nearly half of respondents in the AB groups got the interest answer right compared with just over a quarter of skilled workers in the C2s. But, as Table 2 shows significantly, the pretension element is much stronger in the middle classes with ABs much less likely to return an honest 'don't know': on the interest rate question, only 11 per cent of ABs admitted they did not know the answer, compared with 28 per cent of C2s. We would define functional literacy broadly as knowing the answer and knowing when one does not know the answer, with the ultimate aim being to avoid making bad decisions. From this point of view, it is interesting to note that, if we add up the correct answers and the don't knows, then the ABs and C2s are the worst performers with 44 per cent failing to produce the correct answer, whilst the DEs are the socio-economic group least likely to make the wrong decision. It should also be added that these high error rates were for a relatively straightforward question.

***Table 2 Responses by socio-economic group to the question 'If you were to put £2000 on deposit at 4% for two years, what interest would you expect to receive at the end of the two years? Would it be around ....'***

| | *AB* | *C1* | *C2* | *DE* |
|---|---|---|---|---|
| Unweighted base (number of respondents) | 410 | 463 | 418 | 629 |
| A: £80 | 35% | 31% | 32% | 22% |
| B: £40 | 9% | 12% | 12% | 14% |
| C: £160 | 46% | 39% | 28% | 21% |
| D: Don't Know | 11% | 19% | 28% | 43% |

*Source: Market & Opinion Research International (MORI), table 62.*

Note: Fieldwork dates 30th September - 6th October 2004.

Other MORI questions explored attitudes to financial decision-making and the extent of self-confidence and self-knowledge in these different socio-economic groups. The results reveal a marvellous picture of a bourgeoisie at ease with itself and adrift in the world in ways which require a satirist not an academic commentator. The responses to the MORI questions bring out the extent to which the middle classes are always significantly more confident about financial decision making than lower socio-economic groups who nevertheless share a quietly misplaced confidence in their own general understanding. Thus, 89 per cent of MORI's AB respondents are 'confident they understand their finances' as against 76 per cent of C2s; and 65 per cent of ABs think, 'they make good choices in financial matters' as against 59 per cent of C2s. The really interesting difference between the socioeconomic groups concerns their views of whether they are competent to judge specific financial products. Here, 60 per cent of MORI's AB respondents think, 'they understand the financial products available' as distinct from just 35 per cent of C2 respondents. Considered against the background of demonstrated calculative competence in response to earlier questions, these AB respondents, who could be expected to purchase complex products, have a delusional belief in their own calculative and decision making ability.

The differences between consumers are often understood through the categories of market research. Thus a recent FSA report *Consumer understanding of financial risk* distinguished between three groups of consumers in terms of their relation to advisers and product knowledge, without any guess as to the proportions in each category:

> '**Trusters-** low sophistication, less involvement in the decision process and more reliance on others, especially the adviser….
>
> **Partners-** medium sophistication, moderate involvement in the decision process, and with fairly good understanding of the characteristics of products
>
> **Controllers-** high sophistication, interested in the financial sector and had a good knowledge of products and markets'
>
> **(**FSA, 2004, p.2).

On the basis of the MORI evidence, it might be more sensible to draw the primary distinction between honest idiots and arrogant fools while recognising that the majority of middle class are in the latter group. The extent of their subsequent confusion is considerable when, for example, the FSA (2004, p.1) noted that consumers 'of low and medium sophistication' believed ISAs (individual savings accounts, which involve investment of some or all of the funds in equities) were safe because 'they were provided by the government'.

This evidence is all the more worrying if we make the connection sideways to the classic behavioural literature on probability judgements and decision making under conditions of uncertainty. In classic experiments Daniel Kahneman and Amos Tversky showed that subjects make different choices if the same probabilities are expressed in terms of reward and success or in terms of risk and failure (Kahneman *et al.,* 1982). Consider, for example, subjects asked to choose between a menu of outcomes for a garrison of 600 troops which is surrounded by an overwhelming enemy force and will be wiped out unless it breaks out. Three out of four experimental subjects choose an outcome where 200 lives can definitely be saved whereas only one out of five chooses the outcome where 400 lives will definitely be lost. The options are of course identical and the difference in response arises from how the choice is framed - in terms of lives saved or lives lost. While marketing managers of financial services conglomerates may not have read Kahneman and Tversky, they do appreciate the advantages of accentuating the positive and emphasising rewards especially through their advertisements which contain endless exemplars of families, couples and individuals whose diversity is unified by the motif of current and future happiness dependent on the earlier wise purchase of the suitable product. While it is easy to mock such advertisements, they do connect powerfully with the general tendency of less sophisticated financial services consumers who in the FSA study already cited tend to 'focus on the potential benefits and push downside of the risk to the back of their minds' (FSA, 2004, p.3).

Many consumers are 'sold to' on this basis. Significantly, respondents in the FSA study recalled that financial advisers had emphasised product performance rather than product risk (FSA, 2004, p.30). Advisers tend to talk about risk directly towards the end of the consultation when consumer has already been overwhelmed by complex information. One financial adviser in the survey said that, 'if it (the issue of risk) comes too early it might scare them (consumers)' (FSA, 2004, p.31). One of the stabilising forces in this situation is that, faced with a choice, many honest idiots become scared consumers who respond by becoming, as far as possible, non-investors with savings accounts. Based on her research in the USA, Bertaut (1998) argues that the perceived high cost of information about riskier investments causes households to persistently over invest in low risk or riskless assets. In this context, the reckless overconfidence of the MORI survey respondents is compatible with dawning realisation that it is all too much and the savings account is at least intelligible. According to one survey, two thirds of UK consumers think that financial matters are 'too complicated' for them and that they do not know enough to be confident that they can choose suitable financial products for their needs (Davies, 2003, p.2). Just as worryingly, many individuals do not understand the basic parameters on which calculations about product suitability should be made. A report by the UK think tank, the IPPR, reports the results of fieldwork on individuals' expectations about life expectancy as part of research into attitudes about pensions reform. The data showed that men and women on average underestimated their life expectancy by 4.62 and 5.95 years respectively (Robinson *et al.,* 2005, p.40). Even if financial products were simpler, many individuals lack the factual knowledge as well as the calculative competence to make good decisions about their financial affairs.

## (7) Precondition (c) calculability of risk and reward

The third and final precondition for happy outcomes is a limited but real choice of different financial products whose risk and reward characteristics are ascertainable by the financially literate 'sophisticated consumer'. The regulators of the financial services admit these conditions are problematic given the bewildering proliferation of different products and the widespread use of confusion pricing. In 2003, the then chairman of the FSA observed that there were some four thousand different mortgages on offer in the UK including slow start, fast start, bubble payments, interest only, equity backed and denominated in foreign currency (Davies, 2003, p.2); while in 2002 a member of the Treasury Select Committee, Nick Palmer (with a PhD in mathematics) admitted he did not understand the APR calculations behind credit card offers (House of Commons Treasury Select Committee, 2002, question 52). In this section, we use case material on recent British scandals to analyse three underlying problems about financial services products: first, problems arising from the conventional wisdom of the epoch; second problems caused by active mis-selling especially by advisers on commission; and third, the practical difficulty of appraising technically complex financial products.

*i) The huge, market-dominating popularity of endowment mortgages in the 1990s illustrates the first problem about the power of conventional wisdom or the illusions of the epoch which we cannot reasonably expect individual consumers to appraise and reject*

According to the UK Consumers Association, by 2004 there were some 10 million outstanding endowment policies linked to mortgages. Under such schemes, borrowers pay only the interest on the loan and then, rather than repaying the principle directly, invest in equities with the intention that the gains achieved when the policy is cashed out is more than sufficient to repay the principle in a lump sum. Indeed, endowment policies were often sold with the implicit promise that they would provide a windfall investment gain which could be spent at the consumer's discretion. In the Consumer Association's view, up to half of these policies were technically mis-sold in that homebuyers were, 'not informed of the risks associated with using an investment product to repay (your) mortgage' (Which Consumer Fact Sheet 'endowment action'). And there is a much larger problem about shortfalls where the endowment will not be sufficient to pay off the mortgage, because the stock market has failed to perform at the projected level. The estimated collective shortfall is £40 billion and around 80 per cent of endowment policies are unlikely to generate enough funds to pay off the mortgage (let alone produce a surplus on top) with an estimated average shortfall of £5,500 per mortgage in February 2004 (House of Commons Treasury Select Committee, 2004, p.5).

The really interesting point is that the endowment mortgage was in its heyday a default choice, completely market dominating product. At least one million endowment mortgages per year were sold between 1986-91, and at their peak in 1988 the 1.7 million endowment mortgages accounted for 83 per cent of all mortgages issued according to Cazalet Consulting. With hindsight, the Treasury committee of 2004 discerned an elementary error:

> whether they were aware of it or not, anyone taking out an endowment mortgage was essentially gambling that when it matured their endowment policy - invested in

> relatively volatile assets such as equities – would generate the funds to pay off the fixed liability represented by the mortgage (p.19).

At the time this was almost universally seen to be an opportunity because in the late 1980s and early 1990s everybody expected the stock market to go up and generate useable capital gains. How and why should an individual consumer disagree? The choice of most long-term savings or credit products rests on macro assumptions about rates of return, inflation and interest rates where there is often a consensus in one historical period which is (unexpectedly) proved wrong in the next.

*ii) The personal pensions debacle illustrates another problem about mis–selling which in this case took the form of salespersons failing to explain the balance of risks and rewards associated with the alternatives of staying in a state or occupational pension scheme, so that many less sophisticated consumers were actively misled.*

Personal pensions were introduced by the Conservative Government in 1988 as a way of allowing higher income workers to opt out of the state earnings related pension scheme and to make portable provision for a pension outside any occupational scheme without any employer contributions. Around 11 million people have personal pension plans (Pickering, 2002, p.69) which were designed to extend pension provision by covering the needs of the self-employed and those, like journalists, who typically switched employers several times in mid career. By the late 1990s it was clear that in at least two million cases the projected returns on a personal scheme would be less than in the state or private schemes which individuals had switched out of. Many private pensions had been mis-sold because the commission based sales person had failed to make adequate comparison between the customer's existing plan and a personal one. A KPMG Peat Marwick report for the regulator in 1993 found that 91 per cent of 735 personal pension policy files reviewed were unsatisfactory or suspect in terms of giving clients appropriate advice. In 35 per cent of the cases, sales people apparently did not ask at what age the client planned to retire.

A series of official reports picked over the problems of pensions (Pickering, 2002; Sandler, 2002 and Turner, 2004) while insurance companies like Pearl and high street banks like Lloyds TSB accepted responsibility for mis-selling and made provisions of about £400 million in 1998. This cleaned up the selling of pensions but did not end the mis-selling of other financial products by staff in the same companies who were being incentivised by bonuses and commission sales. In Spring 2005 the Banking Codes Standards Board announced a new investigation into mis-selling after a BBC programme documented how staff at Lloyds TSB had sold large loans to customers who, in 1 in 6 cases, would struggle to meet repayments (*Financial Times,* 17 May 2005). Mis-selling for bonus or commission is arguably not so much a problem as the long established *modus operandi* in many sections of the retail financial services industry. Even where mis-selling is prevented, customers do not necessarily get best value out of technical products. This is a point which emerges from Blake et al.'s very interesting work on the more recently introduced stakeholder pensions where 80 per cent of stakeholder pension holders passively accept the default fund offered by the insurance company, thus rendering such pensions 'a lottery for the members' (Blake *et al.,* 2005, p.4).

*iii) The Equitable Life crisis about guaranteed annuities and the split capital trusts scandals directly illustrate another problem about how the individual consumer requires unfeasibly large amounts of technical information and expertise before the risk on complex products can be understood.*

The Equitable Life crisis was driven by the offer of guaranteed annuities, which were used as a marketing device by Equitable and by other insurance companies in a period of high inflation when no insurer expected to pay out on its guarantee. As inflation and interest rates dropped in the 1990s, the obligation became an onerous one: by 1998 the aggregate GAR (guaranteed annuity rate) on products sold since 1957 was around 30 per cent higher than current rates (Baird, 2001, p.1). Equitable Life's reserves were clearly inadequate and after it had, in late 2000, failed in a legal attempt to cap its obligations by reducing the terminal bonus paid to 90,000 guaranteed annuity holders, there was a shortfall of £3 billion on policy values. The insolvent Equitable Life could not meet its contractual obligations to annuity holders, which in turn meant it could not meet the expectations of other policy holders who held life with-profits policies. The debacle was picked over in two major reports by Baird (2001) for the FSA and by Penrose (2004) in 750 pages for the Treasury.

The Penrose report makes fascinating reading because its evidence suggests the conclusion that the problem was not the guaranteed annuities (which other insurance companies offered), the problem was the embeddedness of these annuities in the Equitable business model and in undisclosed policy decisions which even a financially sophisticated consumer could not reasonably have been expected to analyse or detect. Other companies offered GARs in the 1970s and 1980s but at Equitable they accounted for a larger proportion of the business than in other life companies. Attractive bonuses for policy holders were offered as a way of getting new business (Penrose, 2004, p. 689). In the 1980s bonuses were paid out of reserves, even though a mutual like Equitable had no shareholders to draw from. The frightening potential liability was covered by an undisclosed policy: in about 1983, Equitable set a, 'differential terminal bonus policy' which effectively meant that, in the event of sustained low interest rates, Equitable Life would recover the cost of the annuity guarantees by reducing the annuity holders' terminal bonus (Penrose, 2004, p.686-7). However, this policy was not disclosed to the Board until ten years later in 1993, nor to policy holders until 1995 (p.726). As Penrose concluded,

> 'Overall, the Society developed an impressive range of products that appealed to the relatively sophisticated market sector that it targeted. The changes in underlying assumptions within the developing forms of business would not, however, have been apparent except to financial analysts familiar with actuarial methods'
>
> (Penrose, 2004, p.687).

This verdict is perhaps overly optimistic because the Government Actuary's Department, charged with monitoring life insurance companies, also failed to understand Equitable's position, which would of course have been completely unintelligible to a sophisticated policy-holder with a set of company financial accounts.

In our second example of highly complex financial products, split capital investment trusts, the dividend (income) and growth elements of their performance are divided. Companies offering 'splits' then issue at least two types of shares so that some shareholders receive income and others capital growth. Specific kinds of trusts are known as 'zeroes' where investors buy zero interest preference shares; these were viewed as almost risk free because they had first claim on the assets of the trust. The trusts run for a specified number of years then close and distribute the investment gains. Split trusts were marketed as low risk and high return investments which could be tailored to a variety of middle class savings objectives, such as increased income for the retired or lump sums for parents to pay school fees. Split trusts were nothing new, but boomed in the late 1990s when many promised 10 per cent returns, so that from 1998 to 2001, 86 splits and 73 zeroes were launched (FSA report cited in *The Guardian,* 19 February 2003). After 2001, it all went wrong so that the Association of Investment Trust Companies at the end of 2002 estimated that 39 out of 140 trusts had their shares suspended or lost 70 per cent of the initial capital raised (*Financial Times,* 27 December 2004). In mid-July 2003, it was estimated that around 50,000 people had lost money in what were supposed to be 'low risk' funds, 20 of which had collapsed completely by this time (*The Guardian,* 18 July 2003).

The split capital trusts debacle illustrates further aspects of opacity because the characteristics of the investment products investors originally bought were not the same as those of the products at the point of trust failure. When the stock market was booming, split managers leveraged their advantage by taking out bank loans which later had to be repaid when equity values fell. This meant that the zeroes became inherently more risky for those who were already investors because bank debt would have a prior claim on the assets of the trust. Further, share prices of the trusts were boosted by the way in which some trusts invested in others so that failure (when it happened) became contagious. The FSA estimated that, overall, splits had 17 per cent of their assets invested in other split capital funds; though 1 in 5 had more than 40 per cent and 1 in 10 had a staggering 68 per cent of their assets in the form of rivals' shares (*Observer,* 10 March 2002). The *Financial Times* then described a:

> 'magic circle' of brokers and managers… (who) created a network of highly-geared trusts investing in each other in order to boost assets on which they could charge high fees at the expense of private investors. Many of these trusts have since collapsed
>
> (2 November 2002).

Where 'management reserves the right …' and regulation is weak or non-existent, almost anything can happen to averagely sophisticated investors. This is of especial concern in a low inflation, post-bull market society which produces slim returns on most investments, so investors are easily attracted into risky products. In the UK, the buy-to-let boom and the selling of hedge funds to modest investors are both current causes for concern.

The UK buy-to-let market has boomed since the late 1990s, as evidenced by the growth in the value of outstanding loans to finance such properties which obviously captures only a part of this asset class. In 1998 the value of loans stood at £2 billion and covered 28,700 transactions. By 2003, £39 billion of loans were outstanding on some 408,300 properties (Council of Mortgage Lenders, 2004). In 2001 the average number of properties owned by landlords had fallen to four, compared with nine in 1994, again suggesting the entrance of a new group of investors, encouraged by the pull of rising property values and the push of a depressed stock market. Meanwhile, private buyers have also been moving rapidly into the commercial property market in the UK: in 2000, private owners accounted for only 2 per cent of the market but this had risen to more than 10 per cent by 2004 (RICS, 2004). Property is a traditional portfolio investment, but the spread of exposure to this market has now spread down the income scale as new groups have sought to replace equity based investments with other assets, with the risk of new price bubbles in the process.

Hedge funds can (in theory) make money out of declining markets via short selling and more complex derivative transactions so that they offer the lure of 'absolute returns' and can defy a falling market. Table 3 shows that the value of hedge funds managed more than doubled to $950 billion between 1999 and 2004. In the 1990s hedge funds catered only to high net worth individuals: this was part of a pact with regulators which protected the unregulated status of these investments, provided they were not openly marketed and were available only to high net worth individuals who were considered to have a degree of financial sophistication that made regulation unnecessary (SEC, 2003). Table 4 shows that in 1993 high net worth investors directly accounted for 90 per cent of investor funds, but by 2003 only 36 per cent of all finance in 2003 coming directly from high net worth individuals with funds and ordinary investors accounting for the rest. In the world of personal finance, the money making narrative of the new economy has been replaced with the money making narrative of the hedge fund and private equity, where once again the inflow of funds initially validates the story and then undermines the conditions for steady realisation of profit.

***Table 3: The growth of hedge funds***

| | *1999* | *2000* | *2001* | *2002* | *2003* | *2004* |
|---|---|---|---|---|---|---|
| Global hedge funds | | | | | | |
| Under management (US$ bn) | 480 | 520 | 600 | 650 | 820 | 950 |
| No. of funds | 6,200 | 6,500 | 7,000 | 7,500 | 8,100 | 8,700 |
| US hedge funds | | | | | | |
| Under management (US$ bn) | 255 | 280 | 315 | 340 | 420 | 480 |
| No. of funds | 4,150 | 4,250 | 4,400 | 4,600 | 4,875 | 5,000 |

*Source: Van Hedge Fund Advisors International (estimates)*
*(http://www.hedgefund.com/abouthfs/universe/universe.htm, accessed 25th July 2005)*

***Table 4: Investor base of hedge funds***

| | *1993* | *2003* |
|---|---|---|
| High net worth investors (direct) | 90% | 36% |
| Fund of funds | 10% | 50% |
| Institutional investors (direct) | 0% | 14% |

*Source: Deutsche Bank (2004)*

## (8) Policy implications

Shiller offers an optimistic prospectus about the democratisation of finance, whereby a 'new risk management infrastructure' (Shiller, 2003 p.ix) can deliver social as well as private benefits. While the promise of spreading security and prosperity down the income scale is sincere and democratisation of finance must appeal, the clear conclusion from the analysis in this paper is that the basic preconditions for felicitous outcomes are not in place because the established middle class consumers of financial services cannot predict their own futures and lack calculative competence in a marketplace where the risk and reward characteristics of many products are opaque. In this conclusion we draw out the implications for financial literacy programmes and regulation as well as for the (re)design of financial products.

Financial literacy programmes are a recent and worthwhile public service innovation which helps to counter the pressure selling techniques of financial services conglomerates which, one way or another, make lots of money by selling consumer debt and other financial products, with little regard for individual circumstance or household consequences. But given the problems about blurred context, calculative incompetence and opaque products, it is important not to expect too much of financial literacy programmes of the kind recently introduced for schoolchildren and students. Financial literacy programmes of the present kind may discourage but are just as unlikely to prevent irresponsible behaviour as those other worthy campaigns to encourage responsible drinking and protected sex amongst adolescents.

Substantially increased effort and expenditure is probably justified (just as reductions in gross illiteracy are highly desirable), it is not at all clear that literacy can be raised far and fast enough to justify a lighter regulatory touch. Likewise, many choices that consumers must make are opaque in ways that require consumer protection, particularly given the complexity of many existing products and the rate at which new and variant products are introduced.

The second implication is that, instead of trying to create increasingly sophisticated consumers who can appraise complex products, it might be more sensible to promote the opposite kind of adjustment and promote simpler, less risky financial services products which existing consumers could hope to understand. It is impossible to put the genie back into the bottle when so many middle class households now have asset portfolios including houses and shares. But it might be sensible for households to construct their savings strategies around the norm of 5% returns on bonds and bank deposits where capital values are secure; with investments like ordinary shares offering the sweetener of modest extra sales and earnings growth in line with national income subject to the risk of asset price falls. Any programme of renormalizing expectations around 5% with security of the principal would of course have revolutionary implications for the financial services conglomerates which would have to become more like old fashioned savings banks whose key products offered predictable (but low) returns. This would undermine the vision of the democratisation of finance and would require a far more active state role in provision of security in old age than many governments are now prepared to countenance.

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