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The relationship between financial disputes and financial literacy

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ABSTRACT

This study examines financial literacy and its relationship with financial disputes. We devised two special modules from the Third National Financial Literacy Survey conducted by Taiwan's Financial Supervisory Commission (FSC) in 2011. With this unique database, we examine topics that have rarely been discussed in other studies. Our empirical evidence suggests that people with a higher financial literacy are less likely to experience financial disputes. When the purchase of financial products and services leads to a financial dispute, people with a higher financial literacy will aggressively handle the problem. In addition, personal characteristics, such as gender, work status, and household income, are key factors affecting the chances of a financial dispute. Finally, our results are robust to potential selection bias when we include the results of the National Financial Literacy Survey conducted by the FSC in 2007, 2009, and 2011.

1. Introduction

In practice, the providers of financial products and services show a more in-depth understanding of a given product and service in comparison to purchasers. As a result, information asymmetry leads such consumers to be in a less favorable position toward providers. Taking the structured notes default during the 2007 subprime crisis as an example, with the relevant financial supervisory body not properly regulating the market, the damage caused to investors could not be fairly identified in loss claims. This example revealed the conflict of interests between banks and consumers. After the financial crisis in 2008, financial consumer protection became a critical concern for financial supervision agencies around the world.[1] For example, the creation of the Consumer Financial Protection Bureau (CFPB) was authorized by the Dodd–Frank Wall Street Reform and Consumer Protection Act, whose passage in 2010 was a legislative response to the financial crisis of 2007–2008. The CFPB is an independent agency of the United States government, responsible for consumer protection in the financial sector.

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[1] In November 2009, the Technical Committee of the International Organization of Securities Commission (IOSCO) issued the Principles on Point of Sale Disclosure Consultation Report. This report was meant to protect so-called retail investors by requiring key information disclosures relating to collective investment schemes prior to the point of sale. The purpose of the report was to help retail investors make correct investment decisions by providing access to key information. The report stressed the importance of providing investors correct, understandable, and meaningful information under the background of the continuing financial crisis.

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In Taiwan, the Financial Supervisory Commission (FSC) implemented the Financial Consumer Protection Act on December 30, 2011 and founded a financial ombudsman institution to provide a mechanism other than legal litigation as an alternative solution to financial disputes.[2]

The International Organization of Securities Commission (IOSCO, 2009) qualifies the problem of information efficiency as the inability of investors to accurately understand financial information. Some financial products are complex and difficult to grasp, particularly for financially unsophisticated investors. Thus, low financial literacy gives rise to more financial disputes. Furthermore, a low financial literacy leads consumers to generally lack confidence in making financial decisions, be incapable of understanding financial concepts, and ultimately be unable to effectively deal with contingencies. Gerardi et al. (2010) argue that one of the reasons for the financial turmoil in 2008 was the lack of financial literacy. Klapper et al. (2013) also find that people with a higher financial literacy are more equipped to deal with negative macroeconomic effects. This state of affairs is described as an obstacle that needs to be overcome. The World Bank (2009), the Organization for Economic Co-operation and Development (OECD, 2005, 2006, 2008, 2009), and the European Commission (2007) have all concluded that financial literacy programs must be initiated. The reports are unequivocal in their conclusions: the level of financial knowledge must be raised so that nonprofessional investors can act in a financially responsible manner.

This study investigates the relationship between financial literacy and financial disputes by using a unique database of the Third National Financial Literacy Survey (hereafter, the Literacy Survey) conducted by the FSC of Taiwan in 2011. To measure financial literacy and assess its relationship with financial disputes, we follow Lusardi and Mitchell (2006) and van Rooij et al. (2011a) to design two modules to measure and evaluate financial literacy. We designed an extensive list of questions aimed at measuring and differentiating among different levels of financial literacy and sophistication. These questions are linked to a rich set of data on demographic characteristics and wealth holdings. We refer to a factor analysis to construct a financial literacy index and apply an ordered logit model to examine the relationship between financial disputes and financial literacy. The main findings are as follows. First, financial literacy shows a significantly negative effect on financial disputes. Thus, people with a higher level of financial literacy are less likely to have financial disputes. Second, an individual's work status and household income are key factors affecting the chance of a financial dispute. We find that housewives are more likely to have financial disputes, whereas groups with a medium annual household income (NTD 1.23–2.15 million) are less likely to have financial disputes. Third, we examine the relationship between financial literacy and the aggressive handling of financial disputes, and find that financial literacy has a significantly positive effect on pushing people to aggressively handle their financial disputes. Hence, people with a higher financial literacy are inclined to aggressively handle financial disputes, even if it is not the optimal method for arriving at a solution. In addition, women and individuals with an annual household income between NTD 0.66–1.23 million are more likely to aggressively handle financial disputes through appropriate ways. However, housewives are more passive in resolving financial disputes. Finally, our results are robust when we consider potential selection biases.

This paper contributes to existing research in several ways. Our primary contribution to the financial literacy literature is to show that financial literacy has a significantly negative effect on financial disputes. To our knowledge, this study is the first to investigate the relationship between financial literacy and financial disputes. Second, we conduct a relatively complete method for questionnaire design, sampling methodology, and interview procedures. Previous studies on financial literacy (such as Bucher-Koenen and Lusardi, 2011; Lusardi and Mitchell, 2011a, 2011b; van Rooij et al., 2011a) address only interest rate compounding, inflation, diversification, stocks and bonds, and online questionnaire surveys. We develop two indices of financial literacy, which allow us to differentiate among different levels of financial sophistication. Adding this information to existing data sets can substantially enhance the research on financial disputes. Finally, our study has implications for financial supervision agencies. By fostering financial education, people could have a greater understanding of financial-related knowledge and better distinguish and mitigate financial risks. As a result, misunderstandings about financial services could be diminished and consumer risk awareness and confidence in financial products and services could be increased. This could further improve the reputations of financial institutions and enhance financial resource efficiency. In the end, this positive cycle could reveal progressive and profound influences for a stable, healthy, and sustainable financial industry.

The rest of this paper is organized as follows. Section 2 reviews the relevant literature. Section 3 introduces the empirical analysis, describes the data set, and discusses the empirical strategy. Section 4 presents the results from the baseline analysis and robustness checks. Section 5 concludes the study.

2. Literature review

2.1. Financial literacy

Previous empirical studies related to financial literacy mainly focus on three aspects (Allmenberg and Widmark, 2011).[3] The first aspect is to measure the level of financial literacy in a country (Lusardi and Mitchell, 2014). Typically, studies suggest that even in advanced countries, the general public is still lacking in financial literacy. For example, few people across several countries could correctly

[2] The Taiwanese government has recently devoted much attention to handling failure in financial institutions and financial disputes, and has fully compensated the loss of individuals. Although the protection from government works to stabilize the financial industry and improve social perceptions, it also induces adverse selection and moral hazard.

[3] Financial literacy means "having the knowledge, skills and confidence to make responsible financial decisions" (Altman, 2012).