Understanding financial capability
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Wellness and employee finances

- Many employers have employee wellness schemes
  - But very few focus on financial matters

- There is growing evidence of the links between financial stress and employee productivity
  - 20% of employees distracted at work
  - 22% of employees took at least one day off in the past year
  - Lost productivity estimated to hit the bottom line by up to 4%

- And evidence that staff are not equipped to make decisions about pension or medical insurance

- Many would welcome employer engagement
  - 38% would move to a firm that made financial well being a priority
Financial capability and financial literacy

- There is widespread concern about how people manage their personal finances
  - And many poorly-evidenced assertions that they do it badly
  - But also good examples of what to measure and how

- Many programs delivering financial education
  - And a small but growing evidence base of what works
  - Education is not always the best solution
So where do you start?

- Identify the needs your employees have
- And how these needs differ between different groups
- Identify what is driving the financially incapable behaviors
  - Lack of knowledge? Of skills?
  - Attitudes? Motivations? Behavioral biases?
  - Or factors such as income level? Complexity of financial products?
- Can then design programs to address them
Financial literacy

- Early discussions and measurement mainly in US
- Focussed on knowledge and understanding of key economic concepts eg inflation, compound interest
- Measured by a small number of questions that (usually) have a single correct answer
- Researchers seldom reported the questions they used, so not clear what they were measuring
- Where they did were often measuring different things
How does financial capability differ?

- Growing dissatisfaction with this narrow definition
- And a realisation that skills, attitudes and behaviour also need to be taken into account
- UK financial services regulator began developing a wider conceptual framework
- Coined the term ‘financial capability’
- Commissioned a large-scale research study to develop the conceptualisation and devise ways of measuring it
Developing the concept of financial capability and ways of measuring it: UK research

• Used a *vox populi* approach
  – Groups of people from different walks of life
  – Asked to describe a financially incapable person and then a capable one and to reflect on what most distinguishes them

• From this a set of capabilities was developed on which there was consensus

• And used cognitive testing to develop a questionnaire to measure them
The core capabilities in the UK

- Day-to-day money management:
  - making ends meet, living within one’s means,
  - planning expenditure, keeping track of spending and money left

- Planning for expected and unexpected future events:
  - known future expenses, retirement, unexpected expenses, job loss, ill health

- Choosing appropriate financial products:
  - shopping around, comparing products, knowing product features

- Being and remaining well-informed
Other key lessons learnt

• Proof of capability lies in action taken – not knowledge
  – so often not amenable to being taught

• Underlying financial capability is not related to income
  – although the ability to demonstrate it may be

• Underlying financial capability is not related to education level
  – but design of some questions required high level of education

• Need to be sensitive to cultural differences
Other research at that time grappling with the same issues

- Research for Dutch regulator developed the UK framework further
  - (appropriately) adding more questions relating to motivations
  - But (inappropriately) removed questions relating to choosing products
The World Bank Russian Trust Fund research

- Built on UK and Dutch work to develop a tool to measure financial capability in low- and middle-income countries

- Started with same *vox populi* approach
  - 70 focus groups each of 8-10 people across 8 countries
  - again focussing on describing financially incapable and financially capable people

- Followed by two waves of extensive cognitive interviews
The results were remarkable!

• Two key concepts identified across all 8 countries

• Day-to-day money management:
  – plans spending and sticks to plan; prioritises spending on essentials; doesn't spend money impulsively; lives within means and doesn't borrow for essentials

• Planning for the future:
  – saves money at end of budgeting cycle when possible; plans ahead and doesn't live for today; has provision for unexpected expenses or events; saves/plans for known expenditure in the future; enterprising and focuses on self-improvement
  – plans for children's future; makes plans for old age
Plus two further areas most applicable to people with higher incomes

- Selecting and using financial products:
  - seeks information before deciding which products to buy/use; checks product features before selecting/buying

- Information gathering:
  - seeks information before making decisions; learns from own mistakes and those of others, listens to others

- Also confirmed that behaviour and attitudes are more important than knowledge

- And the need for income and education neutrality
Second challenge: developing a way of reporting the findings

- Knowledge questions can count the number of correct replies

- But new surveys were measuring nuances of behaviour and attitudes
  - With no one correct reply
  - And no way of knowing how to add the replies together

- Used statistical tool widely used for building indexes: ‘Principal Component Analysis’
  - Identifies questions that are correlated and together measure an underlying component
  - Assesses how strongly each question correlates with the component so that can combine them into a score
The lessons learnt from UK and RTF

• Questions combined into the key components identified by the focus groups and were stable across countries

• The components can be combined into a smaller number of domains but not into a single score
  – So financial capability is a multi-faceted concept

• The domains were not identical across countries but two broad areas consistently emerged:
  – Day-to-day money management and planning for the future

• Comparative analysis across countries needs to be made using components not domains
Overview of the UK scores

• UK population did well on making ends meet

• A very flat distribution of scores for planning ahead
  – some people making considerable efforts
  – others very few

• UK population was particularly bad at choosing appropriate products for their needs

• Almost identical results were obtained from a survey conducted in Ireland using the same questionnaire
The large majority of people are capable at making ends meet.
Nearly half of the UK population appear to be making insufficient effort to plan ahead.
Distribution of scores: choosing products

Many people are not very capable at choosing products
Overview of component scores in low- and middle-income countries

• Scores were highest for the money management components:
  – living within ones means, not overspending and budgeting
  – but very low for monitoring spending

• Scores were much lower for the future planning components:
  – very low for future orientation and saving
  – not quite so low for covering unexpected expenses and planning for old age (under 60s)

• Scores for choosing appropriate products were consistently rather low
But there were also some important country differences

- The populations of Lebanon and Mexico were very poor budgeters
- Armenians and Russians were very much better than others at monitoring their spending
- The Turkish population was particularly bad at saving
Which personal characteristics are most associated with day-to-day money management?

- In most countries age has a big effect
  - Younger people (under 30) very prone to over-spending and not budgeting
- Income also has interesting effects
  - Poorer people are less likely to overspend and more likely to monitor spending
  - But are more likely not to be able to live within their means
- Men generally do much worse than women
- Having children reduces ability to live within means
- Education level has little effect
- Links with financial literacy only found in Turkey!
Which personal characteristics are most associated with not planning for the future?

- In a number of countries age has a big effect
  - UK and Ireland: the younger people are the less they plan
  - Colombia and Uruguay: the older people are the less they save and the less forward-looking they are

- Income also has an effect in most countries

- Education level has some effect, but not in all countries

- Men generally do slightly worse than women

- Single people less well than those living with a partner

- Links between financial literacy and saving (Lebanon, Mexico and Uruguay) and planning for the future (UK)
Which personal characteristics are most associated with being poor at choosing financial products?

- Age has the biggest effect
  - the youngest and oldest age groups are the least capable and those in their 40s are the most capable
- Income has a large effect in some middle-income countries but is less pronounced in higher-income ones
- Education level has some effect, but not in all countries
- Women generally do slightly less well than men
- Single people less well than those living with a partner
- Area effects (covered in UK only)
- Extent of engagement with product purchase
- Links with financial literacy in Mexico and UK only
How would a corporation implement this?

- Convene a group of interested companies
- Define objectives
- Adapt existing survey questionnaires to measure financial capability of a workforce
  - And explore the links between financial capability and wellness
- Conduct surveys in individual companies
- Analyse the survey data to identify
  - The main areas of low financial capability & the people affected
  - What is driving the incapable behaviors
  - And the links with financial wellness
- Can then design appropriate programs for the workplace
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