

Understanding financial capability

Elaine Kempson

Emeritus Professor, University of Bristol

www.pfrc.bris.ac.uk



PERSONAL • FINANCE • RESEARCH • CENTRE

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

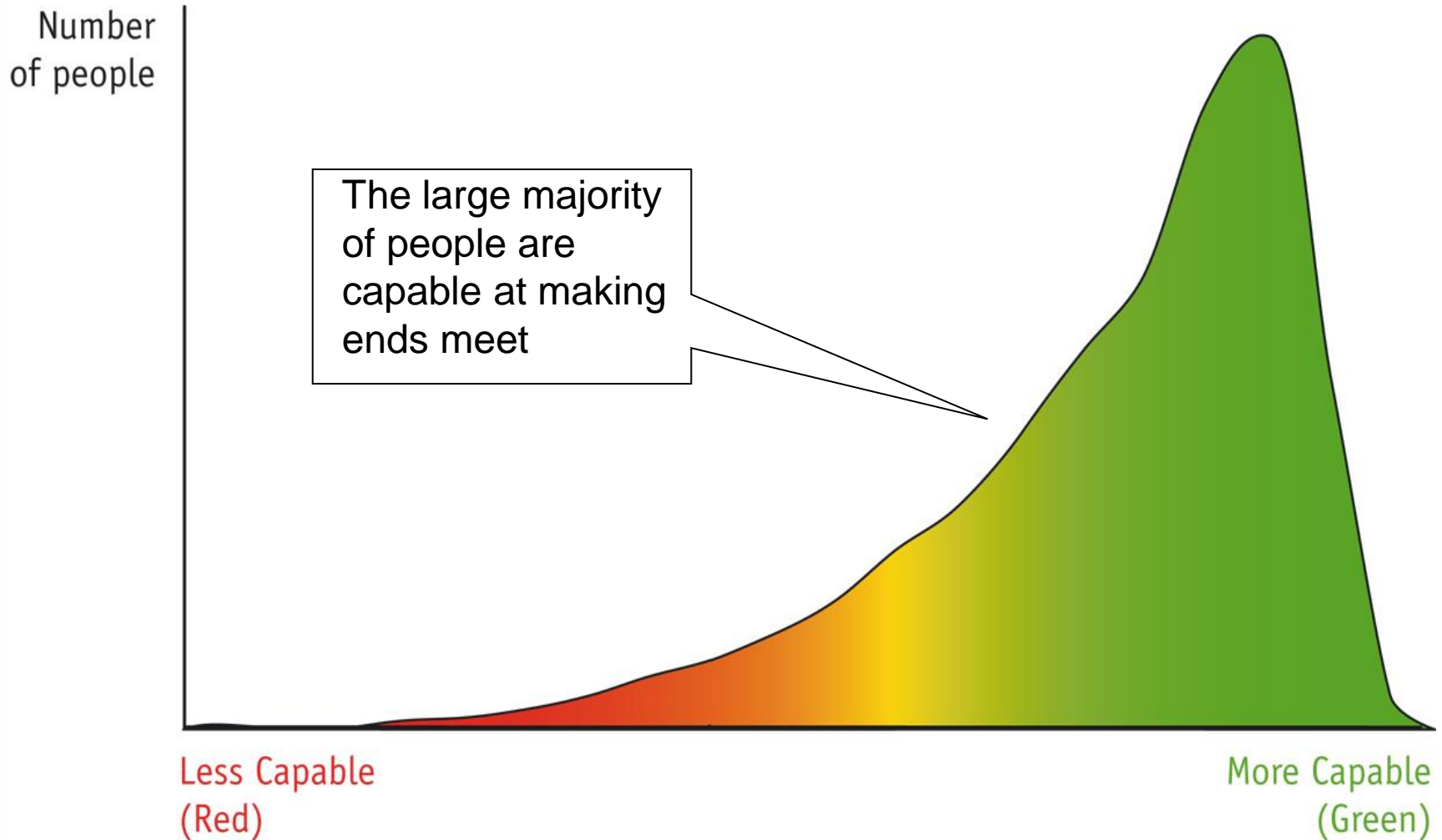


Overview of the UK scores

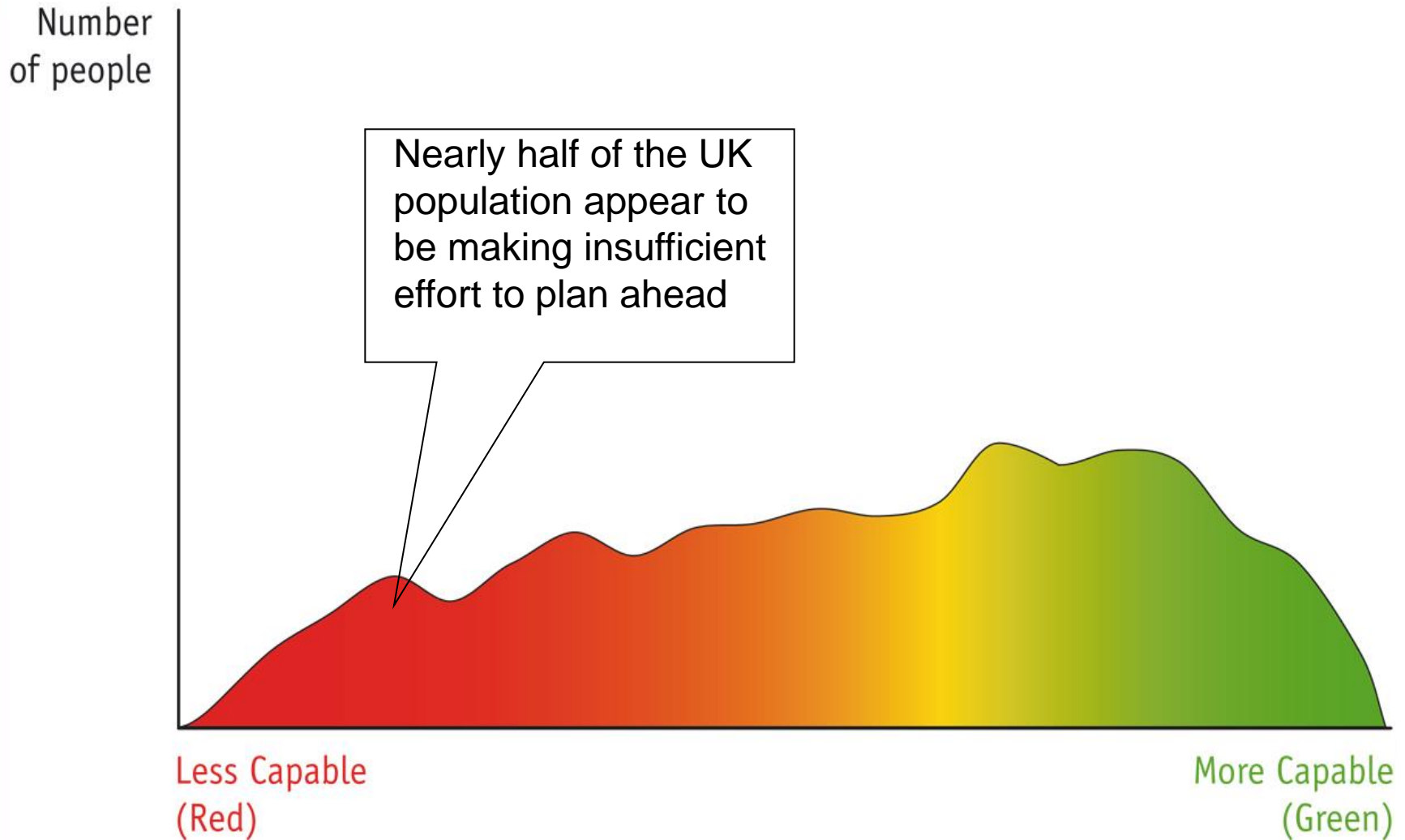
- UK population did well on making ends meet
- A very flat distribution of scores for planning ahead
 - some people making considerable efforts
 - others very few
- UK population was particularly bad at choosing appropriate products for their needs
- Almost identical results were obtained from a survey conducted in Ireland using the same questionnaire



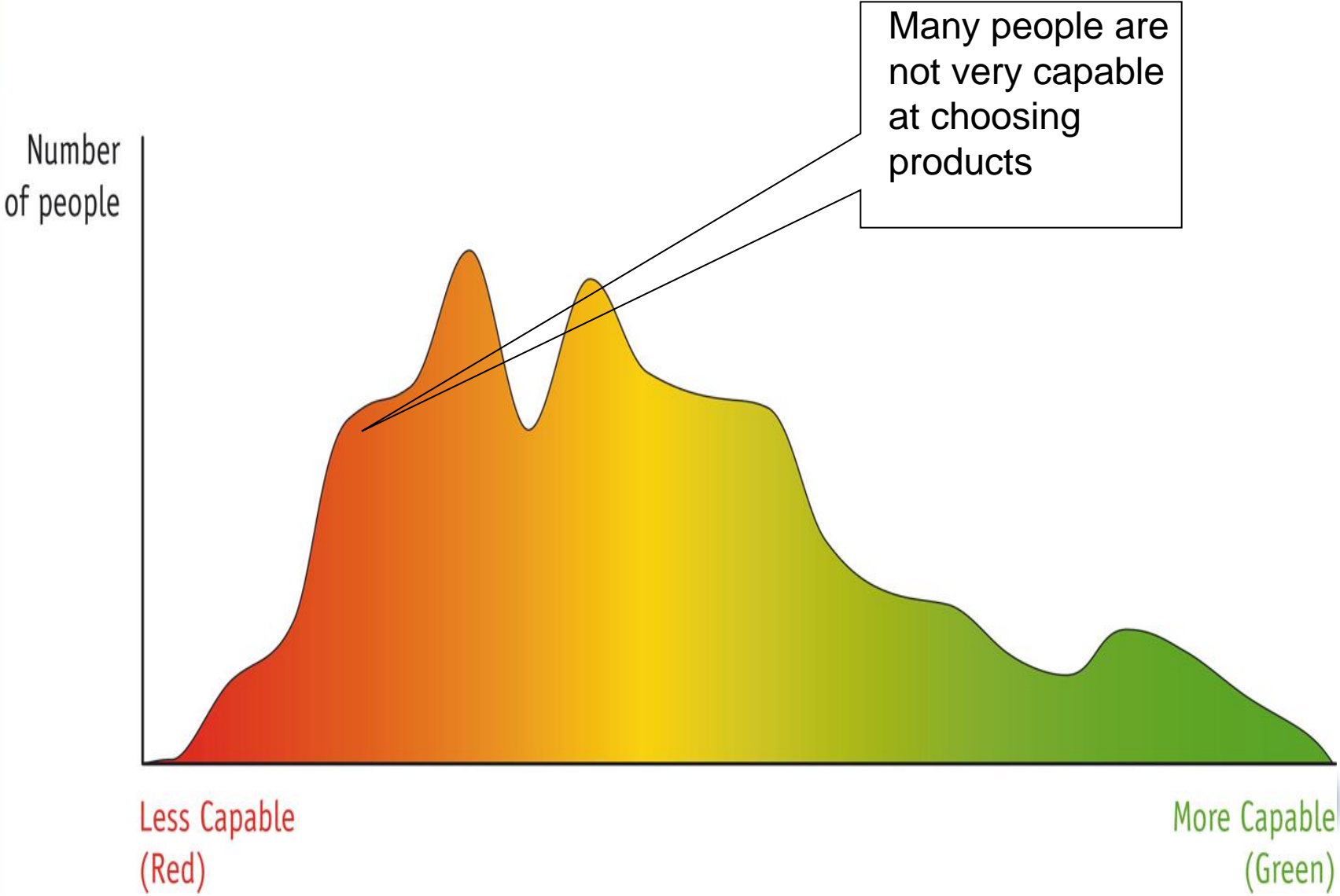
Distribution of scores: making ends meet



Distribution of scores: planning ahead



Distribution of scores: 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



Understanding financial capability

Elaine Kempson

Emeritus Professor, University of Bristol

www.pfrc.bris.ac.uk



PERSONAL • FINANCE • RESEARCH • CENTRE