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Conclusions

The apparently low levels of capability with regard to individual financial planning show that there is no room for complacency, and that at least half of the UK population needs reminding that it is dangerous to make no provision for changes in circumstance or unexpected expenditure. This is a more pressing concern in the face of the current 'credit crunch' and economic downturn.

In the long term, the best solution to financial capability may be to engender a profound cultural change, in terms of attitudes towards consumption, borrowing and debt. Dixon argues that UK society needs to move towards a 'sustainability ethic' [14] where both saving and borrowing are appropriate within the context of overall financial sustainability. If this is the case, what is required now is to think about which policies will achieve this goal in the long term.

So far, the *National Strategy for Financial Capability* has focused largely on education as the best way to change behaviour and improve the nation's financial acumen. It is widely acknowledged that financial education has a role to play in helping people take better informed financial decisions. However, more research is required to examine the link between financial education and behaviour change. The debate over financial education must evolve to ensure the current approach brings about the required change.

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References

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Financial Capability

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> "This briefing paper provides a description and overview of financial capability alongside recent policy responses and proposals."

Key Points:

- Financial capability covers a range and depth of skills, knowledge and behaviour: very few people are fully financially capable in all domains. This means that we cannot simply say that someone is financially capable or that they are not. People may be very capable in some respects but not in others.
- Concern about financial capability has increased as individuals now have more responsibility for ensuring they have adequate resources for their old age, and must provide financial security during times when they may be unable to work, (e.g. through unemployment, sickness or disability). At the same time, the increasing complexity of financial services has made it more difficult for consumers to be sure they have made appropriate provision.
- Low levels of financial capability cause harm: individuals are not protected against the risks they face, experience higher costs and miss out on opportunities to save and benefit from financial products. Lack of financial capability can have a considerable effect on people's well-being: financial concerns are a major cause of stress and even ill health.
- The benefits of improved consumer education will only be seen in the longer-term so cannot be the only response to this problem. Appropriate regulatory protection that takes account of consumers' behaviour patterns is also needed.
- Financial inclusion and financial capability are often linked in debates, however there has been little attempt to establish the extent to which they are actually associated in practice. Research shows that people living on a low income are at high risk of financial exclusion but are often excellent money managers.

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Financial Capability

The term 'financial capability' is relatively new. It has been defined by the Treasury as:

> '... a broad concept, encompassing people's knowledge and skills to understand their own financial circumstances, along with the motivation to take action. Financially capable consumers plan ahead, find and use information, know when to seek advice and can understand and act on this advice, leading to greater participation in the financial services market.' [1]

The concept is not only 'broad', but also multi-dimensional and requires considerable ability on the part of individuals. Financial capability covers a range and depth of skills, knowledge and behaviour - very few people are fully financially capable in all domains. This means that we cannot simply say that someone is financially capable or that they are not. The level of financial capability which an individual needs depends to some extent on individual circumstances. Measurement of such capability cannot be reduced to a simple pass or fail.

Financial capability has emerged as a policy issue in response to the growing complexity of the financial services market; the increasing emphasis placed on individual responsibility for managing personal finances; and the perceived emergence of a 'live for today, pay later' culture [2].

The concept of financial capability is most developed in the UK. Other countries tend to refer to the narrower concept of 'financial literacy' [3], including the US, where efforts to improve financial awareness are most prevalent. It has been argued that financial capability provides a more useful focus for policy efforts as it offers a more realistic encapsulation of the way people think about money in everyday life, and highlights the importance of helping people to change their behaviour.

1 HM Treasury, 2007
2 Resolution Foundation, 2007
3 Vitt et al, 2005
4 Atkinson et al, 2007
5 FSA, 2006
6 FSA, 2006
7 Atkinson et al, 2007
8 FSA 2008
9 Thomson et al, 2002
10 Resolution Foundation, 2006; Dixon, 2006
11 HM Treasury, 2007
12 www.62.164.176.164/d/thoresenreview_interimleaflet.pdf, see also HM Treasury, 2008
13 www.fsa.gov.uk/financial_capability/pdfs/money_pathfinder.pdf
14 Dixon, 2006

Personal Consequences & Social Effects

Lacking the skills to make informed choices about products that meet individual needs makes individuals vulnerable to mis-selling. Instances of serious and widespread mis-selling include endowment mortgages and private pensions [4], and there are other cases that are less known but which still have considerable impact.

Individuals who lack financial capability face a range of other negative consequences. For example, consumers who do not shop around for financial products are insensitive to price differences. They may also end up buying inappropriate products: either failing to understand the financial risks involved or unnecessarily insuring themselves against risks that they do not face [5].

Data, Distribution & Trends

The overwhelming picture from UK financial capability surveys is a nation that is poorly informed about financial issues. A key policy concern is the number of people currently failing to save enough for retirement.

The Financial Services Agency (FSA) commissioned a large-scale survey to establish a baseline for measuring changes in financial capability in the UK [6]; the largest survey of its kind ever undertaken. Key findings from this survey published in 2006 included the following:

- **Planning Ahead:** A key component of financial capability is the ability to make adequate provision for the future, but those under the age of 40, and aged 18-30 in particular, are less financially capable in this respect than older age groups.

- **Keeping Track of Finances:** Low income households are better than average at keeping track of their finances. Lone parents, people without a current account and the unemployed are particularly capable in this area. Women are also better than men at keeping track of personal finances.

- **Making Ends Meet:** 31% of people say they sometimes run out of money at the end of the week or month, and 9% of people always run out. Difficulty in making ends meet was not restricted to people with low incomes. Similar proportions of people on higher and lower incomes said that they sometimes run out of money at the end of the week or month.

It is the intention of the FSA to repeat this survey every 4 to 5 years. It will be important to examine the impact of the changing economic environment on levels of capability.

Key Factors, Associations & Causes

Overall, economically disadvantaged groups are less likely to have high levels of financial capability. Furthermore, there is a strong, statistically significant correlation between people's financial stake - in terms of holding products, buying products or possessing savings - and their financial capability [7].

An FSA review of behavioural economics literature found that psychological rather than informational differences may explain much of the variation documented in the FSA's financial capability survey. People's financial behaviour may primarily depend on their intrinsic psychological attributes rather than information or skills, or how they choose to deploy them. The authors concluded that financial capability initiatives which are designed to inform and educate should be expected to have a positive but modest impact [8].

In an effort to isolate what really matters in determining an individual's behaviour over the longer term, some theorists have turned to the idea of critical moments . Here, life stage transitions (e.g. having a child) or changes in circumstances (e.g. employment status) are used to explain changes in behaviour rather than focusing on innate or environmental explanations, such as demographic or socio-economic status.

Policy Responses & Proposals

The Government set out its long-term approach to financial capability in January 2007. The FSA leads the *National Strategy for Financial Capability*. This National Strategy is based on a partnership between Government and the private sector, largely funded by a levy on the financial services industry, with the Government committed to funding delivery in schools.

The and other efforts to improve financial capability have tended to focus on the linked themes of financial education, access to information and advice.

The respective national curriculums for schools in England and the devolved administrations are all in the process of being revised to cover personal finance education. However, it will take many years for the benefits of this schooling to feed through. Arguably, poor levels of literacy and numeracy need to be improved before financial capability can be addressed. Shorter-term policies and initiatives are required to meet the needs of those who cannot benefit from these in-school initiatives.

Critics argue that the current National Strategy is too limited in scope to achieve its ambition of significant change. For example, the Resolution Foundation argued that a substantial increase in resources devoted to the Strategy is needed if it is to meet its objectives. Dixon has argued further, that the policy approach needs to be revised by making better use of emerging thinking from academia and experiences from other countries and policy areas. For Dixon behavioural economics and economic psychology could help policymakers anticipate better how people will react to policy and policy can better fulfil its aims [10].

A wide range of financial capability initiatives has been supported and funded by the financial services industry, usually through Corporate Social Responsibility budgets. Target audiences span ages, incomes and lifecycle points.

Financial capability initiatives are all designed to improve some aspect of financial capability. The FSA commissioned review found that the areas covered most often are money management (keeping track in particular), and planning ahead. Keeping track is particularly encouraged in schemes aimed at young people and those on low incomes (despite the fact that people living on a low income are often excellent money managers) whilst workplace schemes are most likely to aim to increase levels of planning ahead through retirement savings. General financial knowledge is most likely to be taught in schools.

A number of surveys and evaluations have reviewed the impact of initiatives delivered across the UK. A survey commissioned by the FSA revealed that although there is much good practice, often it takes a piecemeal approach and programmes tend to be short term. Furthermore, the amounts of funding are small, especially when compared with, for example, the £170 million spent on advertising by the financial services industry in the second quarter of 2006 [11].

Recent Policy Developments

The government and the FSA have been working together on the development of a new national Money Guidance Service that will provide generic financial advice. 'Generic financial advice' is:

> '...any advice about your personal finances that does not involve someone recommending that you buy a particular product. It may also include related topics like tax and benefits. The idea behind a generic advice service is to make sure that information and guidance on money matters is available to everybody' [12].

The financial advice provided will go beyond the provision of information, to consider individuals' circumstances and help them plan and manage their finances. To test the model recommended in the Thoresen Review, the Government and the FSA are each contributing up to £6m to fund pathfinder projects that will run for two years [13].