# Review of Financial Capability Studies

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## Abstract

*Financial capability  or the ability of people to manage their day-to-day finances is receiving an increasing interest among policy makers and researchers as more people find themselves in difficult financial situations especially during the economic downturn. Alarmed by this situation, the purpose of this paper is to tackle the problem of how to measure financial capability with a specific focus on general four domains; managing money, staying informed, choosing products and planning ahead. The study concludes with financial capability studies in ten countries which provide the similarities and differences in measuring financial capability. From the evidence reviews, it finds the lowest financial capability is among the young people who is under 45 years old, women, married or living with a partner, those on low income and low levels of education, literacy and numeracy. In contrast, older men and women who live with employed spouse have the most financial capability.*

**Keywords:** Financial capability, Financial literacy, Financial problems, Financial well-being.

## *Review of Financial Capability Studies*

In recent years, there are many international bodies, financial service regulators,educators and policy makers have called for action to be taken in order to help people to manage their personal finances better and to become more financially capable. Financial capability is becoming more crucial as people are faced with the complexity of financial decisions. Particularly, young people are lack of financial understanding and unable to develop adequate personal financial capability. Without basic financial skills and understanding, individuals become unknowledgeable and not confident enough to take full advantage of financial sector services and government benefits. According to Mind (2007), easy credit, low incomes and poor money management become among the factors that contribute to financial problem among low and moderate-income families. Surveys of young adults conducted by the Financial Services Authority (FSA) and other organizations have found that a basic understanding of personal finance has been often poor, especially among those with few formal qualifications and those who are not in education, employment or training. Poor financial capability is a major cause of adults do not access and benefiting from financial services, leading to financial exclusion.

Individuals lacking financial capability may at risk of serious consequences whereby they have limited basic budgeting skills, getting into unattainable debt, experiencing high levels of stress and anxiety and not be able to cope with unexpected changes due to the certain circumstances. Becoming financially capable is a critical step toward establishing financial security, especially for young workers who is financially worse off consumers. The ability to make a sound financial decision is an essential life skill whereby it enables the individual to manage their day-to-day expenditure, cope with unforeseen emergencies and plan for their retirement. It becomes even more important as the financial services market becomes more complex and the emphasis on individuals who started to take personal responsibility for their financial welfare.

By managing expenses, establishing long-term goals, and effectively choosing financial products and services provided, these consumers are putting themselves in a better position to face the economic downturns and the pursuit of financial prosperity (National Foundation for Credit Counselling, 2009). The terms financial capability and financial literacy often used interchangeably in the literature. The term financial capability has emerged recently after for many years policy makers referred to financial literacy to define the ability in making informed judgments and to take effective decisions regarding the use and management of money. However, there is a main conceptual debate between definitions of financial literacy and financial capability. The distinction between literacy and capability is refined but significant. Definitions of financial literacy tend to emphasize on knowledge of basic financial concepts such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification (Lusardi, 2008). By contrast, financial capability is generally understood to be a concept with three different components which are 1) financial knowledge and understanding, 2) financial skills and competence and 3) financial responsibility. These three components of capability used in practice when consumers make decisions and choices about how to allocate financial resources (Leskinen and Raijas, 2005). Apart from that, we can assume that there are various levels and expressions involve in financial capability. These are based on certain demographic consumer characteristics such as sex, age, education and as well as values, attitudes or habits. Phase of the consumer's life and the immediate environment they live in will shape their financial capability.

In addition, the macro environment such as community and society has both direct and indirect influences on consumers' financial capability. Scholars, policy makers and educators recently introduced the concept of financial capability to describe a person's ability to successfully manage the demands of personal finance (Remund, 2010). The National Financial Capability Study (FINRA Investor Education Foundation, 2009) defines it as various aspects of behavior which is related to how individuals manage resources and make financial decisions. It has also been defined as the knowledge, ability and opportunity to act in ways that maximize the chances of life and enable fulfilling lives (Johnson & Sherraden, 2007). Financial capability is a construct that goes beyond financial literacy, whereby it is not just refer to knowledge or understanding of financial concepts, but on how people manage their resources and make financial decisions (FINRA Investor Education Foundation, 2009). In the United Kingdom, it is conceptualized as behaviors and attitudes that fall within the four domains of behavior which are managing money, planning ahead, choosing products, and staying informed (Atkinson, McKay, Collard, & Kempson, 2007). Johnson and Sherraden (2007) and Sherraden (2010) extended this definition of financial capability by including access to financial services and asset building opportunities. The financial capability approach suggests that children and youth should learn about financial management as well as the financial world at the same time in order to truly enhance well-being.

### *An Overview of Studies Conducted on Financial Capability of Young People*

In various countries, the concept of financial capability has been clarified through domains that help in explaining more about how people are supposed to be financially capable and those who are adversely impacted due to lack of financial capability. Financial capability can be linked to other achievable capabilities in order to ensure individuals are able to achieve what they want and become resilient toward changing circumstances. In general, there is no internationally accepted terminology of financial capability. However, the core definition of this term is about having the knowledge, understanding, skills, motivation and confidence in making financial decisions which are appropriate subject to the one's personal circumstances. The term "financial capability" is also used in the UK and Canada. However, while it represents the expanded of financial literacy it does not link the people to financial institutions. Practitioners and scholars especially in the UK and Canada were pioneered to use the term of financial capability in order to describe people's financial knowledge and their confidence as well as motivation to manage their personal finances. The UK government, for instance, has adopted the following definition:

> "Financial capability is 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 "(HM Treasury, 2007, p. 19).

Meanwhile the Scottish government's 'Financial Capability Discussion Paper' (2010) offers a definition of financial capability as a motivation to efficiently manage finances and effect change, day-to-day financial management such as effective budgeting and use of bank account, planning ahead for retirement and unexpected events by saving, efficient in selecting and understand about the financial products before taking any action and knowing where and how to seek for appropriate financial advice.

According to Nussbaum (2000), the idea of capability would not only require that person to have internal capabilities or the ability to act but also the benefit from external capabilities in order to allow them to exercise their abilities. People can develop their internal capability but unable to take it into the action if conditions do not permit it. Therefore, the external capabilities such as policies, laws, regulations and practices can help to provide opportunities for people to develop the full range of capabilities that lead to their well-being.

Based on the study of "*Review of Research on Financial Capability, Financial Inclusion and Financial Education"*, they take financial capability as their nearest outcome of interest and suggest that it may depend on another variable such as financial inclusion and financial education. In order to keep with current use of terminology they defined financial capability as a combination of one's ability and opportunity to act. The children and youth were advisable to learn about financial management and be familiar with the financial world and at the same time they were also having the opportunity to participate by providing them beneficial tools. They also refer the term of financial capability from the definition given by Sen (1987) whereby the financial capability has to do with real opportunity and involve individual ability, accompanied by assurance of access in order to enhance their well-being. The understanding of financial capability has gradually become accepted and today the standard definition of financial capability suggested by Lusardi (2010) includes financial knowledge and skills, attitudes, motivation, habits, self-efficacy, confidence as well as behavior.

The term financial capability and financial literacy can be distinguished according to its definition whereby in order to be financially capable, a person must be more than financially literate, confident and motivated. They also must have genuine access towards quality financial products and services in order to help them make a sound decision base on their financial interest.  Apart from that, according to the Financial Services Authority (2005), financial capability exists when a people are able to make informed financial decisions, numerate and able to budget and manage money effectively. It is believed that a financial capable person tends to understand on how to manage credit and debt and able to assess needs for insurance and protection. They also can assess the different risks and returns involved in different saving and investment options. In a meantime, having a great understanding of the wider ethical, social, political and environmental dimensions of finances could help a person to keep abreast of current issues especially related to financial matters.

Financial capability cannot be measured simply by looking at one indicator, such as demonstrated knowledge of specific terms or concepts. Instead, financial capability encompasses multiple aspects of behavior relating to how individuals manage their resources and how they make financial decisions, including the factors they consider and the skills they use. It is a multi-dimensional concept that requires looking at individual behavior from various angles. Basically, most of the studies on financial capability are focusing on four key components of financial capability which is making ends meet, staying informed, planning ahead and choosing products. However, different countries may use different components or domains in measuring financial capability. Therefore, the Table 1 below shows a summary of reference domains used by various countries:

Majority local studies only study general population of employees and mainly focus on financial knowledge and behavior. Relatively little is known about the financial capability of young adults. Based on the previous research, large proportions of the population particularly amongst the young and unemployed are lack of financial capability. Concern with the current high levels of indebtedness, complexity and rapidly changing of the financial landscape and the current financial crisis, indicate that there is a growing need in improving financial capability. The comprehensive empirical studies on the financial capability among the young and household which dated from 1991 to 2009 were found in the reviewed literature either in U.S or outside U.S. The first study is done by using the data from the British Household Panel Survey (BHPS) in order to examine the degrees of association between the various indicators of financial capability and to construct an indicator of people's financial capability covering years 1991 to 2006. In this study, they conducted a factor analysis which uses correlations between variables to determine the underlying factor on financial capability that represented by the variables.

(Taylor et al 2004; Cappellari and Jenkins 2007). Among the variables are people's perceived financial situation; whether their financial situation has worsened since the last year; whether they save from their current income; whether they have housing payment problems; whether the problems required borrowing; whether the problems required cutbacks; and whether or not they have been at least two months in housing payment arrears in the last 12 months. From the result obtained, it was found that young workers who aged less than 35 are over-represented at the extremes of the financial capability distribution. Those aged less than 25 are particularly concentrated in the lowest 20 percent of the financial capability distribution. Only 13 percent of those in the lowest quintile group of the distribution are aged 65 and above compared with 29 percent of those in the highest quintile group. From this we can conclude that older people manage their relatively low incomes well and they are more likely to have a relatively high financial capability compared to young people.

The second study (Thoresen, Annex 7, 2008) found that the most financially vulnerable adults were under 45. Only one in ten of those in this worst off group were beyond retirement age. They were likely to be married or living with a partner, and had experienced the life stage change of having children. They were also the least confident in financial matters and displayed a low inclination or lack of ability to make reasoned financial decisions, although they were the most vulnerable to the effects of poor financial decisions.

The third reported study is done by the Financial Services Authority. A Financial Capability Survey was conducted in order to establish a baseline measure of financial capability. The study compiled a dataset comprising of 5,328 individuals aged 18 years and above (Financial Services Authority, 2006; Atkinson et al., 2006; Atkinson et al., 2007). This baseline study conceived financial capability as comprising of 4 domains which are managing money, planning ahead, choosing products and staying informed. Each domain measured using 5 separate scores. These scores were used to identify the social and demographic characteristics of those who lack financial capability. The conclusions indicates that younger people, those on low incomes, those with children and those with poor levels of education, literacy and numeracy are most likely to have low levels of financial capability (Financial Services Authority, 2006; Atkinson et al., 2006; Atkinson et al., 2007). Increased age and experience contributes to greater financial capability scores in most of the domains. However, it should be noted that individuals may score more highly in some domains than in others (Financial Services Authority, 2006; Atkinson et al., 2006; Atkinson, 2007; Sinclair et al., 2009).

Similarly, Atkinson et al. (2007), using the Financial Capability Survey, found that the least financially capable were younger, with children who were struggling on low incomes and were disorganized. The next least capable groups were low-income, younger, single people, using few products, plus the early middle-aged, who used few products and did some planning. From the evidence in the Financial Capability Survey, the Thoresen Review and Atkinson et al. (2007), it can be summarized that younger people (under 45 years), women, married or living with a partner, have low income, live in a rented accommodation and have low levels of education, literacy and numeracy is the group that most likely to lack financial capability.

The fifth study is taken from the Scottish Household Survey (SHS). The authors conducted an analysis of the SHS in 2005 and 2006 in order to see how the Scottish household managing financially these days, differ by age, gender, ethnic group, employment and geography. From the results obtained, it was found that those aged 18 to 25 and 26 to 35 years old are generally worse off. Meanwhile the older people are likely to respond to the question of how well they are managing to increase the financial capability more positively than younger people due to their differ expectations and experiences. Apart from that, the respondents were also asked whether they have any savings or investments. 69.9 percent of the 26 to 35 years old have no savings compared to those over 60 which is only 34 percent. In summary, evidence from the Scottish Household Survey have highlighted that younger people, those on low incomes, those with children and those with poor levels of education, literacy and numeracy needs are most likely to have low levels of financial capability, and for each of these groups those living in the most deprived areas have relatively lower levels of financial capability. Greater age and experience contributes to having greater financial capability.

The sixth study is done in Ireland. Followed by the study of financial capability in the UK during 2006, it was the first major evidence of financial capability in Ireland. It was conducted with a purpose-designed, in-depth, and representative survey of over 1500 people with the commissioned by the Financial Regulator in late 2007 and early 2008. Questions which were specific to the UK were removed from the questionnaire and were replaced with the details that reflected to Irish circumstances such as Special Savings Incentive Account (SSIA) scheme.

The same four domains of financial capability are examined as in the UK study. These are managing money, planning ahead, choosing products and staying informed. Factor analysis was used in order to get the score for each domain independently. From the results, it was found that respondents had experienced financial difficulties to make ends meet were come from the group of 20 to 29 years which is 36 percent and high figure were also for those in 30 to 39 years which is 40 percent. Those younger than the group of age 40 to 49 scored lower in planning ahead. However, only score for the staying informed domain shows that there are highest scores were recorded for those in 30 to 59 years of age range.

### *Summary*

Based on the review of these findings, there can be no doubt that poor in financial capability become a concern problem especially among the young people. From the evidence review, it indicates that younger people who is under 45 years old, women, married or living with a partner, those on low income and low levels of education, literacy and numeracy were identified as lack financial capability. Most of the countries such as in the UK, Canada, Ireland and Austria proposed that financial capability comprises of four domains or components which is managing money, planning ahead, choosing products and staying informed. However in some other countries especially in the developing countries such as Malaysia and Kenya, the measurement of financial capability is slightly different. In order to establish the baseline of financial capability, development work was undertaken through literature reviews, focus groups and interviews to identify the components of financial capability. It is suggested that financial capability can be thought of as encompassing four interlinked domains which is managing money, planning ahead, choosing products and staying informed. It is hoped that a range of these measures can be used to determine consumers' financial capability. The term of financial capability may vary across time and cultures and sometimes this term may used interchangeably with financial literacy. However, the basis of financial capability is about having a knowledge and understanding, skills and responsibility. Thus, consumers need to update their knowledge and skills continuously. The ability to learn about new issues is a key requirement for financial capability. However, due to this flexibility, it is difficult to define the adequate level to assume that someone is capable enough. Therefore, in order to attain financial well-being, the financial capability must be put into the practice. Even if the consumers have the knowledge and skills to manage their finances, they must have a clear understanding and responsibility to adapt to certain circumstances.

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**Table 1: Summary of Financial Capability Studies**

| Country | Components in Financial Capability | Sample | Methods/ Sampling Technique | Reference |
|---|---|---|---|---|
| UK | • Making ends meet<br>• Keeping track<br>• Planning ahead<br>• Choosing products<br>• Staying informed | • 2 groups from low income neighborhood aged 18-39, 40 and above.<br>• 3 groups from middle-income neighborhood aged 18-24, 25-39, 40 and above.<br>• 3 groups from high-income neighborhood aged 18-24, 25-39, 40 and above. | • Cluster<br>• Questionnaire<br>• Face-to-face interviews | Financial capability amongst adults with literacy and numeracy needs (PFRC)<br><br>Financial Services Authority Levels of Financial Capability in the UK: Results of a baseline survey<br><br>British Financial Services Authority (FSA) |
| Canada | • Making ends meet<br>• Keeping track<br>• Planning ahead<br>• Choosing products<br>• Staying informed | • 20,000 respondents | • Questionnaire<br>• Telephone interviews | Understanding Financial Capability in Canada: Analysis of the Canadian Financial Capability Survey |
| US | • Making ends meet<br>• Planning ahead<br>• Managing financial products<br>• Financial knowledge and decision making/ Financial literacy and self-assessed skills | • 1,488 American adults | • Telephone survey | Financial Capability in the United States<br><br>Americans' Financial Capability |
| Kenya | • Day-to-day money management<br>• Appropriate use of financial services<br>• Planning for security and risk | • Kenyans from urban and rural areas, mix by gender and education levels. | • Cluster<br>• Questionnaire | Measuring and improving financial capability: Designing an approach for Kenya |

| Country | Components in Financial Capability | Sample | Methods/ Sampling Technique | Reference |
|---|---|---|---|---|
| Britain | • Making ends meet<br>• Managing money<br>• Planning ahead<br>• Choosing products<br>• Staying informed | • 5,328 adults aged 18 years and over | • Questionnaire | Financial capability, income and psychological well-being |
| Malaysia | • Financial products and services<br>• Planning<br>• Spending<br>• Risk management<br>• General issues | • Various target groups; university and college students, Malaysian household | • Online survey | Youth Financial Literacy: Development, Delivery and Execution of Programs (BNM) |
| Ireland | • Making ends meet<br>• Planning ahead<br>• Choosing products<br>• Staying informed | • 1,529 people aged between 18 and 75 | • Cluster | Financial Capability: New Evidence for Ireland |
| Austria | • Managing money<br>• Planning ahead<br>• Choosing products<br>• Staying informed | • Austrian households | • Cluster | Financial Capability of Austrian Households |
| Scotland | • Making ends meet<br>• Keeping track of finances<br>• Planning ahead<br>• Choosing financial products<br>• Staying informed | • 3,900 households | • Interviews | Financial Capability: The Scottish Household Survey Data |
| Singapore | • Understanding money<br>• Understanding yourself, rights and responsibilities<br>• Managing everyday money<br>• Planning ahead<br>• Selecting financial products | • Adults aged 18 to 60 years old | • Questionnaire | The MoneySENSE Core Financial Capabilities Framework |