Consumer Financial Capability – A life cycle approach 04.11.2005

Johanna Leskinen

Ph.D.; Head of research, National Consumer Research Centre

johanna.leskinen@ncrc.fi

Anu Raijas

Ph.D.; Senior Lecturer in Consumer Economics, University of Helsinki

anu.raijas@helsinki.fi

Contents

Abstract

1. Introduction
2. Dynamics of consumer finances – constructing the context of consumer financial capability
3. Rationale of the life cycle approach
4. Conceptual approaches to consumer financial capability
5. Empirical evidence on consumer financial capability
6. Discussion and conclusions

Abstract

The paper discusses the concept of consumer financial capability and other related concepts. Additionally, we introduce a wider interpretative framework based on the microeconomics approach and discuss empirical findings in this area based on the life cycle approach. We argue that consumer financial capability is relative and evolving by nature. It is relative in relation to consumers' position in the life cycle and their education, income and living circumstances. Moreover, it is also culturally relative. Financial capability is closely connected to other concepts in the financial domain. Alongside other human capabilities, financial capability operationalised in financial management contributes to the well-being and consequent financial soundness. Empowerment of consumers in their financial capability requires tailored, targeted education and information to an increasingly diverse consumership in their 'own' language, consideration of various life cycle factors, and continuous research.

1 Introduction

One of the key concerns emerging in national and EU-level consumer policies is consumers' capability to manage their finances. Overextended credit use and debt difficulties continue to be a prominent problem in European economies despite a number of legislative and other preventive policy procedures introduced over the past decennium. The development of the credit market, including easy access to consumer credit and credit products, aggressive marketing, and positive attitudes toward credit based consumption, has stimulated the growth of credit use. New consumer groups such as young consumers form an easy target for credit problems. Consumption is further catalysed by the increasing amount of free time and the growing market of the leisure economy with its respective commodities and services (Pantzar, 2005).

In today's world where consumption is such an essential part of people's everyday life it is more important than ever before to manage one's personal finances, because one's financial resources tend to be scarcer than the needs and wants to be satisfied. Furthermore, changes in the overall economic environment challenge the financial capability of consumers. In many households there is uncertainty about permanent income due to temporary employment or no work at all. Money has become immaterial and non-concrete as everything can be paid with plastic. Agreements in which consumers have considerable financial responsibility have increased. Yet consumers – at least Finnish consumers – are accustomed to trust the authorities. They expect the authorities to be 'on their side' and, for instance, to remind them of the risks that they should take into account. The choices and decisions made in the financial domain have remarkable consequences for the future financial well-being of consumers and households. (See Financial … 2000, 4.)

The majority of households are able to live with their economic obligations and can manage their credit risks unless something unexpected happens in the national or the household economy. In Finland, the most dramatic incident at the national level in recent years was the recession of the 1990s. Dramatic changes in people's life situations – such as job loss, divorce, illness, death, bankruptcy, major debt or many simultaneous problems at once – can mess up the whole household economy. Apart from insolvency

due to ‘external factors’, new reasons for debt problems have been raised to the fore. A kind of carelessness or lack of skills in the management of personal finances or excessive consumption in relation to the available income causes growing problems. Payment defaults and debt problems from the use of consumer credits have emerged due to a lack of knowledge and ability to plan one’s financial matters or the inability to live according to one’s income (e.g. Valkama, 2004). The basic unmanageability of human life has also been proposed as one explanation for financial problems: anybody can run into illness, unemployment, death, etc., without warning. Nevertheless, the persistence of debt problems highlights the need for preventive tools to counter the threat of yielding to a certain, unavoidable level of such difficulties in national economies.

Technological development offers consumers access to and use of online services, which brings opportunities as well as challenges into their personal economy. Increased telebanking, on one hand, enables flexible time use and, on the other hand, forces people to use self-service and acquire computer skills. Finnish bank customers, for example, are expected to find out about loan issues on banks’ home pages on the Internet. Some banks encourage their customers to apply for a loan over the Internet in order to save in administrative costs. The home pages of banks provide a wide variety of information about loans and credits and offer tools such as calculators for loan application (Lehtinen and Leskinen, 2003).

Alongside telebanking, the distance marketing of financial services further challenges consumer financial capability. Banking, credit, insurance, personal pension, investment or payment services are available to EU members by any means which, “without the simultaneous physical presence of the supplier and the consumer, may be used for the distance marketing of a service between those parties” (European Comission, 2002). This directive entered into force in Finland in January 2005 (Laki kuluttajansuojalain…, 2005). It remains to be seen how extensive the distance selling of financial services will be, what will characterise the customers, and what the individual, social and economic consequences of distance selling will be.

In today's 'quarterly economy' consumers are expected to be active, well-informed and reflective in their financial activities and responsible for the consequences of their choices. Directives and regulations easily hide the fact of the wide diversity of consumers, families and households as to their financial needs and resources in different phases of life. The increasing diversity and individualisation of consumers is posing a big challenge to all interest parties to promote their capability to manage their financial affairs. An example is the growing role of children as economic actors in the market and as targets of marketing. There are also great expectations for the impact of elderly people's increasing purchasing power and consumption capacity on economic growth.

Keeping these introductory remarks in mind, ECRI's definition of consumer financial capability as "the ability to understand borrowing choices and their implications, in order to make informed decisions regarding the use of credit products" offers an excellent starting point for further analysis and argumentation. Several questions arise. Who are these consumers with financial capability? What kind of an interpretative framework and context could be used to examine consumer financial capability? Is financial capability related to other consumer capabilities and related concepts? How does consumer financial capability materialise in different life stages? And finally, how could consumers be empowered in their financial capability?

This paper discusses the concept of consumer financial capability and neighbouring concepts. We also place the issue in a wider interpretative framework using the microeconomics approach and discuss also our empirical findings based on the life cycle concept. The final section presents our conclusions and recommendations.

2 Dynamics of consumer finances – constructing the context of consumer financial capability

Similar to all human activity, the primary goal of household activities is to provide well-being to the household members. Well-being, according to Allardt (1976), can be approached both objectively and subjectively. *Objective* well-being has material (standard of living) as well as non-material dimensions (quality of life). *Subjective* well-

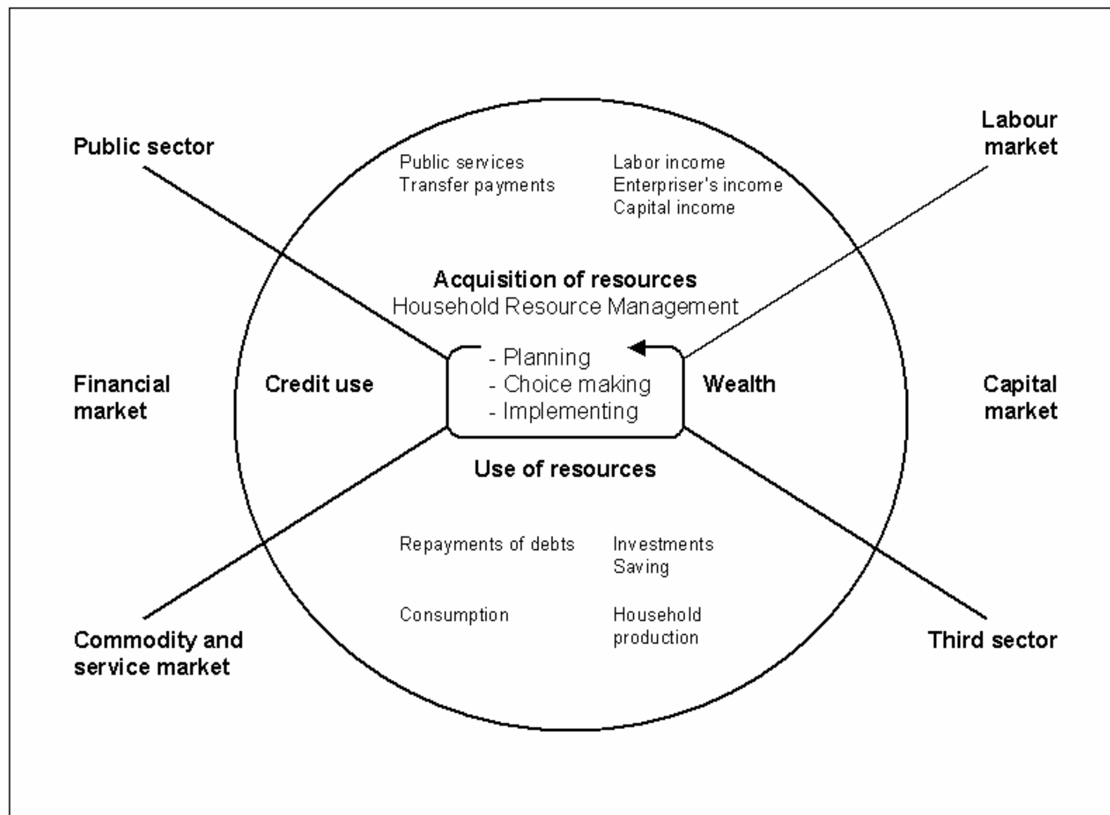
being refers to people's attitudes to and conceptions of satisfaction vs. dissatisfaction and happiness. In today's affluent societies, well-being is increasingly defined by features like a meaningful life, social relationships and avoidance of unfortunate economic and social circumstances (e.g. Kajanoja, 2005). However, consumer finances tend to tangle the economic activities of the household. It can be argued (Heinonen and Raijas, 2005) that well-being is largely based on services produced in dynamic interaction between the main sectors of society: the public sector, market sector, household sector and citizen sector (third sector). Participation and inclusion in societal and domestic functions – in other words, production and consumption, doing per se – provide well-being alongside other outcomes (Raijas, 2005).

It is a well-known fact that the institutional provision of welfare services is undergoing major changes, not only in the Nordic welfare states but all over Europe. The share of the public sector is decreasing, while the private sector, third sector and household sector are increasing their service production. Technological development, digitalisation, new service innovations and reconstruction of the service production system are considered as important solutions. Households and consumers have an interesting and challenging role in the ongoing development. Households generate a whole array of services for their own use and maintain economic growth through consumption. Furthermore, they are expected to be 'rational', reflective and responsible actors in the market, in their economic activities and in decision making (Varjonen et al., 2005).

With this in mind we may ask: how are consumer finances and consumer financial capability related to this tendency towards well-being? Household economic activities have to do with the acquisition and use of resources to satisfy human needs. Households operate in interaction with the public sector, the market sector and the third sector. Thus, their resources originate from a number of sources. Earned income, entrepreneurial income, capital income and transfer payments form their basic financial resources, extended when necessary by credits and loans. Households allocate these to consumption, repayments of debts and accumulation of wealth. They also have obligations to different parties of the economy and of society; one example is their

participation in the labour market. Balancing between needs and resources constitutes the core of household resource management. Figure 1 summarises the dynamics of household economic activities and consumer finances:

Figure 1. Dynamics of household economic activities and consumer finances



Source: Applied from different sources, e.g. Raijas (2005)

The figure indicates that household resource management constitutes planning, choices and decision making, implementation, and the mutual interaction of these activities. Consequently, with successful planning and choice making, it is possible to compensate for a shortage of income by credit use, increased household production, and/or liquidity of potential assets (wealth). The households have also to be conscious for risks possible in the future and be prepared for them. Excessive income can be used for consumption or for saving and accumulation of wealth. Financial capability in its broadest sense is needed for operating in different markets, especially for allocating resources to consumption, credit use and investments. The importance of human and social capital in

the formation of financial capability grows in an environment characterised by increasingly complex socio-economic development.

3 Rationale of the life cycle approach

The life cycle approach (e.g. Deacon and Firebaugh, 1988) offers several advantages for a conceptual clarification of ‘a consumer’ and ‘consumer financial capability’. It recognises the diversity of financial needs and resources, rights and responsibilities in different phases of a consumer’s life. This approach challenges the idea of equal financial capability among all consumers and recognises the wide array of capabilities in a consumer career. By combining an individual’s age and family context it also helps to avoid the problem introduced by Lea et al. (1981) of the assumption of consistent household decisions – as if they were composed of a single individual.

The family life cycle has a special status especially in the research tradition of Anglo-American consumer economists. People’s progress through life varies depending on their social-emotional and economic demands. The most frequently used definition of a family life cycle, according to Deacon and Firebaugh (1988), takes into account the ages of the children and their presence in the home. The authors emphasise the challenge that today’s complex family forms pose to the traditional model. Mainstream economic theories which focus on the effects of income, prices and interest level on consumption and consumption expenditure, introduced the life cycle hypothesis already in the 1950s, based on Ando, Brumberg and Modigliani (e.g. Hallman, 1991). Consumption does not depend merely on the present, available income, but also on the income expectations in later phases of the life cycle. The hypothesis draws on the idea of ‘typical income development’: minimum income at the beginning and end of the life cycle and maximum income in the middle. It also assumes that the consumption expenditure level remains quite stable, although increasing slightly. When young, consumers have to take credit because their consumption expenditure easily exceeds the available income. In the middle of the life cycle, people repay their loans and save and make investments for old age. Considering today’s complex economic and financial environment, the materialisation of such life cycle hypotheses remains idealistic.

Yet, a life cycle hypothesis makes it possible to look at income and expenditure paths within certain time frames. Apart from statistics, empirical applications also indicate the relevancy of a 'Gaussian type' of curve in the development of income and consumption expenditure in different phases of the life cycle. Those in the middle of their life cycle – households with two adults, that is, couples without children or two-parent families – seem to succeed best in increasing their consumption expenditure (Ahlqvist and Berg, 2003).

How does the life cycle approach help us to characterise and analyse consumer financial capability? Our suggestion is that different financial capabilities are related to different life stages: consumers of different ages are expected to have different financial capabilities to be able to make informed decisions. For example, children have become important economic actors starting from early childhood. They become aware at a very young age that money is an essential resource for acquiring the commodities they desire, and most children begin to exert their shopping power at the age of three. At the same time children have become a target of marketing and advertising. Many different, competing brands of clothing, food, hobbies, etc., penetrate into their consciousness. Consequently, already at the age of two, children are able to recognise different brands. There is evidence that the financial decisions made early in life affect one's ability to become a financially secure adult (Martin and Oliva, 2001). Additionally, children's influence on their parents' decision making increases their economic role in the family.

One of the paradoxes of child raising is that children are more influenced by examples and models than by instructions. We may ask what kind of models and experiences of economic behaviour children get from the home or from shopping centres, leisure activities or special occasions such as birthdays, etc. Attention has been also called to the role of gift giving and the potentially divergent educational models offered by grandparents and other relatives (Envall, 2005) – without forgetting the educational effects of the media.

To take another example, young consumers from their late teens through their mid-to-late 20s represent a new life phase called 'emerging adulthood'. Emerging adulthood refers to a rise in the ages of entry into marriage and parenthood, lengthening of higher education and prolonged job instability among young people, reflecting the development of a new period of life for them in wealthy industrialised societies (e.g. Arnett, 2000). However, this is also the phase in which young people are starting an independent life, also in economic terms, often involving credit use as well as possible credit problems (e.g. Lehtinen and Leskinen, 2005). The status of an adult, juridical person widens the scope of the financial capability of young adults into issues like the legal and other obligations of credit contracts.

And then, what about the elderly population? Competence in the financial domain is considered a critical component of effective living for older persons. There are numerous and substantial risks involved in making financial decisions. Additionally, there is an ongoing demand for capacity assessments by concerned individuals (e.g., family caregivers, legal representatives) in the financial domain. (Cramer et al., 2004) Even though elderly people are not 'heavy debtors' or typical clients of debt counselling services (Valkama, 2004), their increasing number makes them a prominent group to be included into discussions on consumer financial capability.

4 Conceptual approaches to consumer financial capability

According to the Oxford English Dictionary (2005), *capability* is "the quality of being capable in various senses" and offers the following additional definitions of capability:

1. The quality of having room for any thing; ability to receive or contain.
2. Physical or mental power or ability in general.
3. Legal or moral qualification or capacity.
4. The quality of being susceptible of, or admitting of treatment, in any specified manner.

5. An undeveloped faculty or property; a condition, physical or otherwise, capable of being converted or turned to use.

Amartya Sen (1993, 30) defines capability as a person's ability to include valuable functioning in her/his life. The capability of a person is based on various individual and environmental factors. Poverty, for example, is not necessarily a failure of the person's capabilities but can be due to an inadequacy of income caused by an unstable economic situation in society. (Sen, 1993, 33, 41.)

The focus in the dictionary definition of 'capability' is clearly on the personal characteristics of an individual. A person has certain mental, social and material resources that s/he has to be aware of in order to utilise them to advantage. If the household has more than one member, part of the material resources will be used together with them. Sen's definition also includes environmental factors in addition to individual features. The influence of environmental factors on a person's capability is no doubt essential because every activity takes place in a community of some kind. The societal environment gives the framework for the functioning of households and also provides resources for them.

A widely used definition of financial capability contains the same idea as Sen's definition of capability. It defines *financial capability* as consisting of an individual's personal characteristics influenced by various factors in her/his micro and macro environment. This view allows us to examine the breadth and depth of financial capability. The breath of financial capability refers to the tasks from the actors in the national economy: financial services like banking or borrowing and institutions like taxation. The depth of financial capability covers actions and institutions related to an individual's personal features: 1) financial knowledge and understanding, 2) skills and competence, and 3) responsibility. (FSA, 2005a, 7.) These three dimensions of capability are utilised in practice whenever a consumers makes plans and decisions on how to allocate financial resources.

Financial knowledge and understanding means that the consumer knows and understands the forms, use and functions of money and financial services: cash, cheques, credit cards and loans. According to Hilgert and Hogarth (2003, 320-321), financial knowledge is associated with financial practices like cash-flow management, credit management, saving and investment. Firstly, financial knowledge and understanding involve an awareness of the household's amount of income: that is, how much money there is to be spent. Secondly, financial knowledge and understanding is needed when the household decides how much money to allocate to various forms of expenditure and what is the best way to conduct payments. This consciousness should be seen in people's behaviour: they should realise that they live in the real world, understand the restrictions set by their available income and, finally, be honest in their financial decision-making.

Financial skills and competence are needed in everyday financial management and, for example, in the use of basic banking services. These skills and competencies have to do with the practices and habits that form part of a consumer's everyday life. Financial skills and competence are based on financial knowledge and understanding, and are influenced by the consumer's attitudes towards the use of money: spending and saving. Financial skills and competence are needed to provide for potential economic, financial or personal risks in the future. A person can prepare for these risks by taking insurances. An excellent example of this is a payment protection insurances for loans that secures loan repayment even in unexpected situations of life (The Finnish Bankers' Association 2005, 11). Dealing with taxation questions also requires financial skills and competence.

A consumer who behaves in a *financially responsible* manner takes into account the other members in the household but also the broader community in making financial decisions (Financial …, 2000, 6; FSA and BSA, 2002; Roy Morgan Research, 2003, 73-76). The financially responsible consumer understands that the decisions s/he makes always have an influence on other persons as well.

Besides responsibilities, a consumer also has certain rights in making agreements with other financial actors in the market. These include the right to demand clear information about available financial products to make her/him aware of the commitments involved. If the consumer runs into disagreement with the service provider, s/he is entitled to independent dispute resolution. (Roy Morgan Research, 2003, 76)

Financial knowledge and understanding, skills and competence, and responsibility are of no use unless consumers can utilise them in practice. These capabilities are all essential elements of consumers' total financial capability; for instance, a consumer certainly cannot possess any financial skills without financial knowledge. On the other hand, how much knowledge does one need to reach a sufficient level of competence in financial issues?

Assuming that consumer financial capability involves the above three dimensions, we can also assume that there are various stages and expressions of financial capability. These are based on certain consumer characteristics of a demographic (sex, age, education, etc.) as well as a mental (values, attitudes, habits, etc.) nature. The consumer's phase of life and the immediate environment s/he lives in shape her/his financial capability. Finally, the macro environment – society and its social, economic and cultural arenas – has both a direct and an indirect influence on consumer financial capability. In addition to varying stages and expressions of financial capability there are also differences in its content among different consumers and different societies. Financial capability can be understood as a process that evolves over a person's life cycle and follows the current trends and circumstances in society.

'Financial capability' and 'financial literacy' can be used as synonyms. According to SEDI (Social and Enterprise Development Innovations) (2004, 5) *financial literacy* is the concept used in North America while financial capability is the British term. The literature contains various references to financial literacy. If 'literacy' – "the quality or state of being literate" - is defined as "knowledge of letters", "condition in respect to education" and "ability to read and write" (Oxford English Dictionary, 2005), what is

financial literacy? Is it the ability to read information concerning financial issues? The above definition of literacy says nothing about reading comprehension and sounds more like a technical skill. A survey conducted for the ANZ Bank in Australia suggested that basic literacy and mathematical literacy are both elements of financial literacy (Roy Morgan Research, 2003, 3). This sounds reasonable: without the ability to read and comprehend the language of a given community or without the ability to make basic calculations it is impossible to understand financial agreements, make financial decisions or use money. Because it is by nature an advanced and applied skill, financial literacy can be argued to demand more knowledge and skills than basic literacy and mathematical literacy. Researchers like Adkins and Ozanne (2005, 94) introduced the concept of *consumer literacy*, which covers the ability to process written texts and numbers in consumption-related tasks in the market. Financial literacy can be thought of as an essential subset of consumer literacy.

In the literature, financial literacy refers to an understanding, competence and responsibility regarding financial affairs (see e.g. ASIC, 2003, 10) – in other words, the same elements as financial capability above. The American literature favours the model of a rational consumer. According to this view, financial understanding means a person's ability to gather, evaluate and understand information that is needed in decisions concerning one's economy. A person who can process and utilise financial information is able to compare various alternatives concerning her/his economy and evaluate the consequences of her/his actions. Financial competence has to do with practical activities – like managing a household budget, investing money for future use, or purchasing an apartment. It is part of an overall strategy to increase economic security especially in low-income households.

The literature in the area of financial capability contains other concepts similar to financial capability. We now turn to examine some of those terms. SEDI (2004, 5) suggests that *financial knowledge, literacy and education*; *economic literacy and education*; and *financial and money management* are all used almost as synonyms in the real world but also in research. Nevertheless, it should be noted that both in practice and

in research there are some differences in the content of these terms. We will take a brief look at two concepts which we consider central in this area: financial management and financial well-being.

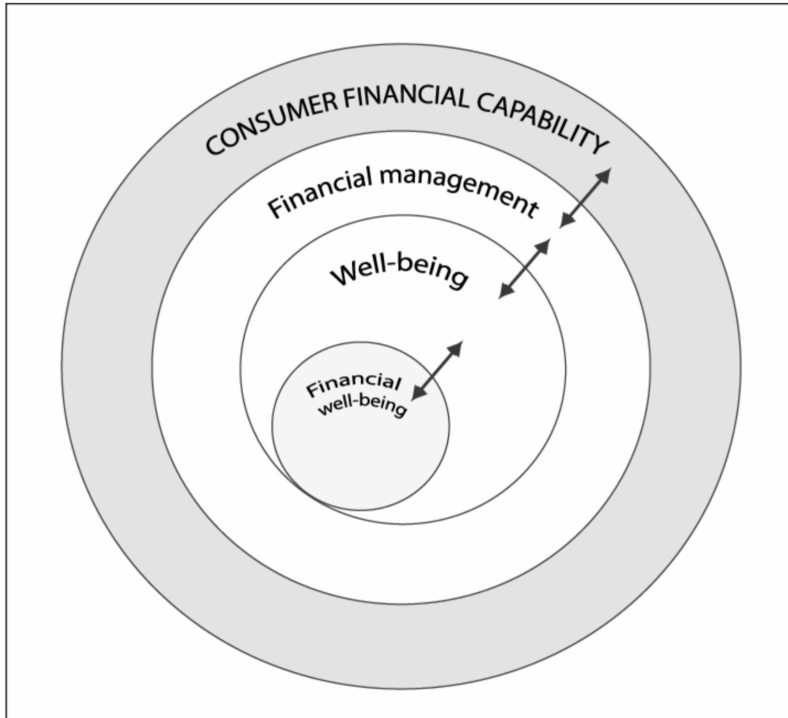
Financial management in the household includes day-to-day money management but some long-term activities as well, like saving and investment. Financial management refers to the practices of financial capability and further includes provision for future risks. To be successful, financial management requires communication and interaction between the household members. The term often has a normative connotation, implying that there is only one 'ideal' way to manage financial issues. In her study on financial management, Prochaska-Cue (1993, 129) found that households used various ways to manage their financial resources. The demand for rational behaviour assumes perfect availability of information and is an ideal situation which obviously cannot be realised for a number of reasons. An alternative solution is the notion of 'bounded rationality' (e.g. Simon, 1990; see also Timonen, 2005), which takes an individual's personal ability and the limits of the operational environment into consideration. Simon (1978) suggests that consumers are satisfied with options that are 'good enough' for them, because they realise that it is impossible to find the absolutely 'best' solution (ref. Timonen, 2002, 48). Furthermore, regardless of a person's financial knowledge and competence, her/his decision making is sometimes non-rational and based on intuitions, or irrational and motivated by compulsions and urges (see Gross, Grandall and Knoll, 1980, 236-237).

If the goal of all household activities is the well-being of the household members, what then is the household's *financial well-being*? It can be examined objectively with certain measurable variables like the household's available income and real property. Yet, this approach measures only one dimension of financial well-being. Another approach is to ask a household member to evaluate the financial situation of the household. A third approach, proposed by Davis and Helmick (1985), is to investigate financial well-being by asking consumers to tell how their financial status has changed over time and what their desires are concerning their future economy.

Assessing the level of a household's financial well-being demands the capability to evaluate its financial situation. This is a subjective assessment that depends on the characteristics of the household as well as on various environmental factors. Consumer financial capability certainly has an influence on the financial well-being of the household. Porter and Garman (1992; 1993, 137) see financial well-being is a function of personal characteristics and attributes of a household's financial issues. This is a broad view to financial well-being with objective, perceived and evaluated attributes. *Objective attributes* are defined as quantitative indicators of the financial situation of the household: marital status, number of children, income, home ownership, responsibility for the financial support, receiving or paying alimony or child support, and responsibility for financial tasks and decision making. We could, of course, ask how well factors like marital status characterise the financial domain of the household. Furthermore, questions concerning responsibility are always based on the respondent's own evaluation and are therefore not objective. *Perceived attributes* are operationalised as perceived surplus (money left over from consumption, loan amount) and perceived adequacy of income (Porter and Garman 1993, 140, 145-146). To define the *evaluated attributes* of financial issues, Porter and Garman (1993, 148) asked respondents to compare their own economy with their reference groups and tell about their past financial experiences and future financial expectations. Reference groups no doubt have a strong influence on perceived financial well-being. Consumers are eager to compare their economy with the groups they belong to or want to belong to. Their comparison is based on their own perception about the others' well-being and does not necessarily say anything about the real financial situation: people may, for instance, use more money than they can actually afford.

This section concludes with a figure characterising the relationships between various concepts in the area of financial capability (Figure 2, p. 16).

Figure 2. The relationships between concepts in the area of financial capability



Along with other consumer capabilities, financial capability, as operationalised in financial management and through financial well-being, contributes to the well-being of the household members. Firstly, financial capability is influenced by factors in the macro and micro environments of consumers. The former – the economic situation and economic climate in society and the financial system used – creates the basis for consumer financial capability: how consumers react to economic changes in society and what kind of competencies the financial system demands from them. The latter factors, although based on the former, are more tangible in that they affect households and consumers in their immediate environment. The environmental factors can be regarded as given. Secondly, household factors and individual factors both have an influence on consumer financial capability. Household factors include the phase of life, place of residence and income of the household. Individual factors are both demographic – like sex and age – and psychological – like values, attitudes, opinions, habits, experiences. These variables are in constant interaction with each other. The whole phenomenon of financial capability grows more complicated because the relative importance of these

variables is dependent on situational factors that are difficult to observe or forecast. The next section gives some examples derived from empirical studies on financial capability.

5 Empirical evidence on consumer financial capability

Consumer financial capability has been investigated in empirical studies from an objective and a subjective viewpoint. In the *objective* approach, financial capability is defined based on the assets, debt, savings and investments of the household. *Subjective* financial capability is the consumer's own perception about how well s/he manages the household economy. A person may sometimes be unconscious of her/his subjective capability and unable to measure it, although it may guide her/his financial behaviour. An interesting question is the connection between objective and subjective financial capability: a household can be highly capable with its economy in objective terms but fails to recognise this – or vice versa.

Two studies conducted in Britain in 2005 suggest that in practice, consumers understand financial capability as behaviour rather than as knowledge (Atkinson, 2005, 18-19; FSA, 2005b). This is an interesting finding: even though knowledge and understanding are certainly needed for financial capability, consumers pay more attention to actual behaviour, something that is concrete for them.

In the U.S., a survey of consumers (Hilgert and Hogarth 2003, 310-315) investigated the financial practices and knowledge of American consumers. The survey revealed that 89 percent of households had a checking account, 88 percent paid their bills always on time and 79 percent had some financial record-keeping system. Less than half (46%) of households, however, had some kind of budget or plan for spending. The survey also tested the consumers' financial IQ, quizzing them about credit, saving, investment and mortgages. An average of 81 percent of households was knowledgeable about mortgages and 77 percent about saving. The study did not reveal the effect of scoring

well on financial issues: did it mean that knowledgeable consumers had heard something or used those services themselves or were they otherwise familiar with the details of the services? In their study of low-literate consumers, Adkins and Ozanne (2005) made a shocking finding: as a coping strategy in shopping in a store, illiterate consumers had chosen to act as if they were literate (Adkins and Ozanne, 2005, 104).

Interestingly enough, in her Finnish study Peura-Kapanen (2005) came to a similar conclusion as Hilgert and Hogarth (2003) in their American survey. Based on qualitative group discussions and personal interviews of financially better-off consumers and those in financial difficulties, Peura-Kapanen (2005) discovered that financial management was thought of as a short-term activity. As far as their personal economy was concerned, consumers felt it most important to pay their bills on time and maintain a balance between their expenditure and available income, checking the balance of their banking account on a monthly basis. Economic planning in the form of budgeting and monitoring of expenditures was not typical of their financial management. The study participants engaged in mental accounting, however. Financial planning was linked to major, expensive purchases or was done by consumers with low or irregular income.

An ANZ Bank Survey in 2002 revealed that Australians have a rather good level of financial literacy. Almost every Australian had a bank account and knew how to use cash, ATMs, cheques and credit cards. They also understood that income and expenditure have to be in balance and knew what to do if their income were to diminish. They felt they were well informed in making their financial decisions. (Roy Morgan Research, 2003, 3-4) The same survey suggested that a low level of financial literacy can be connected to being single and either young (18-24 years old) or elderly (over 70 years old); being unemployed; or having a low education, low income and low savings (Roy Morgan Research, 2003, 4). Thus, the survey revealed that limited financial resources were the most important reason for financial illiteracy. Certainly there are some characteristics, like education and age, underlying a low income, which may largely account for this result. Consumers are not equal in their financial capability:

wealthier consumers have more advantages in the financial market (see Hogarth and Hilgert, 2002) and are better capable of acting in the market.

Financial capability is an evolving characteristic which develops over time: it is obvious that working adults are better capable of managing financial issues than children. The supply of information affects the level of a person’s financial capability. Again, when approaching a certain phase of life like retirement, the financial capability of consumers begins to decline. This is partly due to changes in their personal characteristics, such as functional and cognitive competence (Wielingen et al., 2004) and changes in their personal life, and partly due to changes in the environment, such as an increasing supply of on-line services. Changes in the financial environment require a new type of capability as the old type of capability is no longer useful. Consumers today are expected, for instance, to manage their banking over the Internet, which demands new kinds of capabilities.

Baek and DeVaney (2004, 345) found that a higher educational level of consumers leads to increased saving and investing. Education, employment status, homeownership, attitude towards credit and risk, and shopping for credit were significantly related to financial wellness among baby-boomers (Baek and DeVaney, 2004, 343). Furthermore, the ratio of debts and assets in the household was essential for its financial latitude. Does this mean that people who are more educated and wealthier are also more capable in their financial management? We suspect the relationship is not so straightforward. Instead, we suggest that skills alone are not enough, but that appreciation is relevant: appreciation of knowledge and information together with responsibility for the consequences of one’s actions.

According to the above-mentioned Australian survey, the main constraints to financial literacy are related to problems in understanding financial records, knowledge of fees and charges, use of new payment methods, investment fundamentals and retirement plans. (Roy Morgan Research, 2003, 6-8) Rapid growth in the financial market – meaning more new forms of services and more service providers – and the greater

complexity of financial services poses increasing challenges to consumer financial capability (Hogarth and Hilgert, 2002, 1).

As mentioned earlier (p. 3), Finnish banks expect their customers to go to the Internet to find out about interest rates and how to affect the costs of the loan. (Lehtinen and Leskinen, 2003, 11) How well can a customer understand all the costs of a housing loan when it is not possible for her/him to pose questions to any real person? Is the information on the Internet trustworthy – trustworthy enough to allow the consumer to make long-term financial decisions safely based on that information? By shifting more responsibility to consumers concerning their finances, banks are able to cut down on their own costs.

The Finnish National Consumer Research Centre conducted a survey in late 2003 focusing on the general characteristics of consumer credit markets, legitimacy of their marketing and formation of costs to consumers from using these credits (Peura-Kapanen, 2004). Altogether sixty consumer credit products were analysed based on the marketing information provided by the credit company, including both online and printed material (brochures). According to the Finnish interpretation, consumer credit includes any credit for consumption, but not housing loans (mortgage credit).

The survey indicated that the brochures provided for marketing highlight the positive aspects of credit products. Part of the information was outdated and so complicated it is difficult to understand, but information concerning the real annual rate was generally appropriate. Online information provided by credit companies offered a variety of tools for comparing different credit products and calculating costs. The home pages of credit companies varied in scope and in content, and it was not always easy to access the information. The study proposed several recommendations for consumer authorities, such as empowerment of consumers in their ‘credit literacy’, improvement of online credit marketing including up-dating of information, concretisation of credit costs, and improvement of the sellers’ professional expertise. (Peura-Kapanen, 2004)

The influence of financial information is a very complex issue. In their working paper on behavioural economics, Mullainathan and Thaler (2000) suggested that a consumer may have too much trust in certain institutions and may therefore neglect to gather any information on her/his own. On the other hand, another consumer may be too sensitive to new information and may overreact in a situation to which this information applies. A third consumer may want to donate to charity without realising that s/he is unable to afford it. A fourth type of consumer might be indifferent to financial issues and ignore them as far as possible.

Consumers receive and also actively collect information from various sources in their micro and macro environments. Well-informed and financially educated consumers are able to make good decisions for their families and thereby increase their economic security and well-being. Consumers also learn from their own experiences, listening to their friends and other household members, and receive information from external sources such as the media (television, radio, newspapers, magazines, and internet) and through education. The already mentioned U.S. survey of consumers reported that American households preferred to learn about money management through the media. (Hilgert and Hogarth, 2003, 309-319.) Media sources are easily accessible and information is usually in an appropriate form and easy to understand. But what is the importance and effectiveness of these various media sources of information? Today's consumers are more educated than before and there is more information, including the Internet, available in the marketplace. This means a huge amount of information to be searched for and processed. Braunstein and Welch (2002, 453) reported that it was unclear how much impact information actually has on consumer behaviour in financial matters. There are a wide diversity of consumers whose aims and needs vary during their lifetime. Exactly the same information may, therefore, have different effects on their behaviour.

A consumer survey issued by Statistics Finland on a monthly basis examines the opinions of Finnish consumers about their own economy and the national economy (see Statistics Finland, 2005). In addition, respondents are also asked to evaluate changes in

their personal economy over the past year. The idea is the same as in Porter's and Garman's study (1993). Consumers evaluate their financial situation both in the macro environment (economic climate in the community) and in the micro environment (similar households in the community, friends, acquaintances or relatives). Public discussion seems to have a great influence on consumer reactions: news about rising unemployment, for instance, may make consumers start to feel uncertain about making investments or taking loan. The more likely the risk to meet unemployment, the more guarded consumers will be with respect to their own economy.

6 Discussion and conclusions

Our focus in this paper is on the characteristics, prerequisites and outcomes of consumer financial capability. Financial capability is particularly important because of its various consequences both to the individual and the household but also to society. Well-being in families contributes to the whole community's economic development. The effectiveness of consumers' transactions in the market is based on their capability to use money: make purchases, save or invest, and has direct influences on the community economy. The financial capability of the community members affects the economic and social well-being of the community and, ultimately, the strength of the national economy. This is a complex phenomenon and dynamic in time. Further empirical study is needed in order to understand the many dimensions of the phenomenon.

In order to attain financial well-being, the financial capability of the household has to be operationalised into financial management. Even if a consumer has the knowledge and skill needed to manage her/his finances, dissatisfaction with her/his income, savings and investments may make financial management difficult for her/him. The consumer may therefore feel that the financial well-being of the household is not rewarding enough.

Today, consumers are expected to organise their financial affairs largely on their own. They are also expected to have initiative in the financial market regarding their personal

economy. Is the exercise of financial capability a right or a responsibility? Consumers are required to take more responsibility for their financial management. But to do that, how much do they have to know about financial issues? An interesting question worth examining is how consumers understand their personal financial capability and its role in their life.

It may be impossible to define what kind of financial capability is sufficient and what is not. Atkinson (2005, 10) points out that financial capability is a highly relative concept which varies from culture to culture and from period to period. The concept of financial capability is always an agreement at a certain point in time and in a certain culture. The financial system in society forms the basis for consumer financial capability: what abilities are of relevance at this particular moment in time? Financial capability which was effective twenty years ago in the regulated financial market of 1980s might not work in today's complex financial environment anymore. Further, what about financial capability in the context of housing loans spanning 20-60 years? One important prerequisite for financial capability is the ability to learn new issues in a changing financial environment: consumers have to update their knowledge and skills continuously.

The concept's relativity underlines the perspective of the individual. Financial capability is dependent both on the living circumstances and also the personal needs, values and attitudes of the consumer: on what is actually important in her/his life. Financial capability also includes an understanding one's own financial situation and adapting one's behaviour to that situation. Low-income families, for example, have to accept that they cannot afford certain expensive durables. And does a consumer who does not own any shares have to know their market price?

We are entitled to ask whether it would be possible to define an *adequate* or *necessary* level of financial capability? We can argue over 'good', 'better' and 'best' financial capability – or should we, based on Simon (1978), make an effort to reach an adequate level of financial capability? What kind of conception of man lies behind those different

financial capabilities? Fundamentally we are dealing with philosophical questions that deserve a study of their own.

In spite of several open questions, some conclusions for consumer policy can be drawn to empower consumers in their financial capability:

- The information delivered to consumers should be concrete and easy to understand, and directly connected to their own lives. The style of the language and choice of terms should fit their own ways of thinking and talking.
- Tailored, targeted information on financial management is needed for increasingly diverse and individualised consumers in different phases of the life cycle (see also Sandlin, 2000). Educational aims will probably not be achieved if the information is based on models of middle-class life and traditional nuclear family forms.
- Efforts are needed to break the attitudinal barriers of consumers: regardless of the amount and quality of education and counselling it is the consumers themselves who decide whether or not they need help. If a consumer sees no problems in her/his economy, what good can education or counselling do?
- Active discussion on the ’sickness’ itself and a search for a ‘medicine to cure that sickness’ is needed alongside the discussion on the ‘symptoms’ and ‘preventive medication’. This is not a simple problem, however. The reasons that have led households into financial difficulties are diverse and their own activities are not always the primary reason for their problems. (see p. 10)
- Due to the highly relative and evolving nature of consumer financial capability and the rapidly changing environment, more studies are needed to complement benchmarking and learning from those consumers and households who seem to have financial capability (comparative studies).
- Finally, the actors and institutions which are responsible for consumer financial capability, have to communicate with each other. They have to have a clear distribution of work in this field. In today’s world consumer financial capability

cannot be taken for granted, and the responsibility for an individual must not be too heavy to bear.

References

Adkins, N.R. and J.L.Ozanne, (2005), "The Low Literate Consumer", *Journal of Consumer Research,* Vol. 32, 93-105.

Ahlqvist, K. and M-A. Berg (2003), *Kotitalouksien kulutusmenojen muutossuunnat [*The changes in the household consumption expenditues*],* Tilastokeskus*,* Tulot ja kulutus 2003:21. Helsinki: Yliopistopaino.

Allardt, E. (1976), *Hyvinvoinnin ulottuvuuksia [The dimensions of the well-being],* Helsinki:WSOY.

Arnett, Jeffrey J. (2000), "Emerging Adulthood: A theory of Development From the Late Teens Through the Twenties", *American Psychologist,* Vol. 55, No. 5, pp. 469-480.

ASIC (Australian Securities & Investments Commission) (2003), *Financial literacy in schools*. ASIC Discussion paper, June 2003.

Atkinson, Adele (2005), *Introducing financial capability skills: A pilot study with Fairbridge West, Bristol*. An evaluation report from the Personal Finance Research Centre, University of Bristol.

Baek, E. and S.DeVaney (2004), "Assessing the Baby Boomers' Financial Wellness Using Financial Ratios and a Subjective Measure", *Family and Consumer Sciences Research Journal,* Vol. 32, No. 4, pp. 321-348.

Braunstein, S. and C. Welch (2002), *Financial Literacy. An Overview of Practice, Research and Policy.* Federal Reserve Bulletin, November 2002, pp. 445-457.

Cramer, K., H.A. Tuokko, C.A. Mateer and D.F. Hultsch (2004), "Measuring awareness of financial skills: reliability and validity of a new measure", *Aging & Mental Health,* Vol. 8, No. 2, March 2004, pp. 161-171.

Davis, E.P. and S.A. Helmick (1985), "Family financial satisfaction: The impact of reference points", *Home Economics Research Journal,* Vol. 14, pp. 123-131.

Deacon, R.E. and F.M. Firebaugh (1988), *Family Resource Management. Principles and Applications,* USA: Allyn and Bacon, Inc.

Envall, M. (2005), *Perheen aika*, Helsinki: Kirjapaja.

European Comission (2002), Directive 2002/65/EC of 23 September concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC.

Financial Capability through Personal Financial Education (2000), *Guidance for Schools at Key Stages 1 & 2.* July 2000.

The Finnish Bankers' Association (2005), Survey on saving and use of credit (retrived from http://www.pankkiyhdistys.fi/English(index.html).

FSA (Financial Services Authority) (2005a), *Financial Capability: developing the role of generic financial advice.* London.

FSA (Financial Services Authority) (2005b), *Measuring financial capability: An exploratory study,* Report for the Financial Services Authority by Personal Finance Research Centre, University of Bristol, Consumer Research 37.

FSA and BSA (Financial Services Authority and Basic Skills Agency) (2002), *Adult Financial Capability Framework,* London: Government of the United Kingdom.

Gross, I.H., E.W. Grandall and M.M. Knoll (1973), *Management for Modern Families,* New York: Meredith Corporation.

Hallman, H. (1991), *Kodin talouden avaintieto,* Helsinki: Yliopistopaino.

Heinonen, V. and A. Raijas (2005), *Kuluttajaekonomia: Kotitalous ja kulutus* [Consumer Economics: Household and Consumer], in V. Heinonen et al. (2005), *Kuluttajaekonomia, kotitalous ja kulutus.* Helsinki: WSOY, pp.7-23.

Hilgert, M.A. and J.M. Hogarth (2003), *Household Financial Management: The Connection between Knowledge and Behavior,* Federal Reserve Bulletin, July 2003, pp. 301-322.

Hogarth, J.M. and M.A. Hilgert (2002), "Financial Knowledge, Experience and Learning Preferences: Preliminary Results from a New Survey on Financial Literacy", *Consumer Interest Annual*, Issue 48, pp. 1-7.

Kajanoja, J. (2005), "Mitä on hyvinvointi?", *Kuntapuntari* 3, 2005.

Laki kuluttajansuojalain muuttamisesta [Law concerning the changing of the consumer legislation](2005), (retrived from http://www.finlex.fi/laki/alkup/2005/20050029).

Lea, S.E.G., R.M. Tarpy and P. Webley (1981), *The Individual in the Economy. A Textbook of Economic Psychology,* London: Cambridge University Press.

Lehtinen, A-R. and J. Leskinen (2003), *Monitoring the uptake and the effectiveness of the Voluntary Code of Conduct on Pre-contractual Information for Home Loans. Country Report. Finland.* National Consumer Research Centre Working Papers 78/2003 (retrived from http://www.ncrc.fi).

Martin, A. and J.C. Oliva (2001), "Teaching children about money: Applications of social learning and cognitive learning development theories", *Journal of Family and Consumer Sciences,* Vol. 93, No. 2, pp. 26-29.

Mullainathan, S. and R. Thaler (2000), *Behavioral Economics,* NBER (National Bureau of Economic Research) Working Paper 7948, October 2000 (retrived from http://www.nber.org/papers/w7948).

Oxford English Dictionary (2005), *OED Online*. Oxford University Press, (retrived from http://dictionary.oed.com/).

Pantzar, M. (2005), *Kotitalouksien varallisuus ja tarpeet tulevaisuudessa* [The wealth and needs of the households in the future], unpublished lecture in the Future Forum of the Uusimaa Region 5.9.2005.

Peura-Kapanen, L. (2004), *Markkinoiden kulutusluotot* [Monitoring the consumer credit supply of market], Kuluttajatutkimuskeskuksen työpapereita 82/2004.

Peura-Kapanen, L. (2005), *Kuluttajien rahatalouden hallinta* [Consumers and the management of personal finances], KTM Rahoitetut tutkimukset, Markkinaosasto, 1/2005, Helsinki.

Porter, N.M. and E.T. Garman (1992), "Money as a measure of financial well-being", *American Behavioral Scientist*, 35, July/August, pp. 820-826.

Porter, N.M. and E.T. Garman (1993), "Testing a Conceptual Model of Financial Well-Being", *Financial Counselling and Planning*, Volume 4, pp. 135-164.

Prochaska-Cue, K. (1993), "An Exploratory Study for a Model of Personal Financial Management Style", *Financial Counselling and Planning,* Vol. 4, pp. 111-134.

Raijas, A. (2005), *Kotitalouden voimavarat ja niiden hallinta* [Household resource management], in V. Heinonen et al. (2005), *Kuluttajaekonomia, kotitalous ja kulutus,* Helsinki: WSOY, pp. 69-100.

Roy Morgan Research (2003), *ANZ Survey of adult financial literacy in Australia,* Final report. May 2003, ANZ Banking Group, Melbourne.

Sandlin, J.A. (2000), "The politics of consumer education materials used in adult literacy classrooms", *Adult Education Quarterly*, Vol. 50, No. 4, pp. 289-307.

SEDI (Social and Enterprise Development Innovations) (2004), *Financial Capability and Poverty,* Discussion paper July 2004, PRI (Policy Research Initiative) Project 'New Approaches for Addressing Poverty and Exclusion', Canada.

Sen, A. (1993), *Capability and Well-Being,* in M.C. Nussbaum and A. Sen (eds.) *The Quality of Life,* Oxford: Clarendon Press, pp. 30–53.

Simon, H. (1978), "Rationality as process and as product of thought", *American Economic Review,* Vol. 68, No. 2, pp. 1-16.

Simon, H. (1990), "Invariants of human behavior", *Annual Review of Psychology,* Vol. 41, No. 1, pp. 1-19.

Statistics Finland (2005), *Consumer survey. Description,* [retrived from http://www.tilastokeskus.fi/meta/til/kbar_en.html]

Timonen, P. (2002), *Pyykillä – arkinen järkeily ja ympäristövastuullisuus valinnoissa* [Doing the laundry – mundane reasoning and environmentally responsible choices], Kuluttajatutkimuskeskus. Kerava: Savion kirjapaino.

Timonen, P. (2005), *Arkinen järkeily* [Ordinary reasoning], in V. Heinonen et al.

(2005), *Kuluttajaekonomia, kotitalous ja kulutus,* Helsinki: WSOY, pp. 101-116.

Valkama, Elisa (2004), *Velkaneuvonta 2000-luvun alussa. Talous- ja velkaneuvontalain vaikutukset asiakaskyselyn ja tilastotietojen valossa* [Debt Adjustment brings relief. A fresh start for overindebted Finnish households], OPTL:n julkaisuja 208, 2004, Helsinki: Hakapaino.

Varjonen, J., K. Aalto and J. Leskinen (2005), *Kotityön markkinat* [The market of house work], Helsinki: Edita.